RUTTER HOBBS & DAVIDOFF
INCORPORATED
LAWYERS

BANKRUPTCY BULLETIN

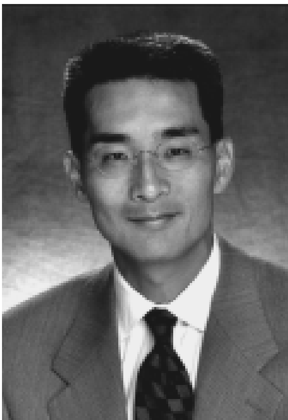
FOCUSED ON YOUR FUTURE

Volume I Issue 3

October 2003

Protecting Your Settlement Payment From Bankruptcy

By Duane Kumagai



Congratulations! You have finally settled a tough commercial collection case. The agreed payment is less than the amount owed, but you take the deal in order to end the litigation. Then, before you are paid in full, the defendant files bankruptcy. What happens now?

A settlement of litigation is supposed to give the parties repose. Most of the time it will. But, if one of the parties files bankruptcy, the settlement represents only a temporary break in the action, and the consequences to the non-filing party can be severe.

In our creditors' rights practice, Rutter, Hobbs & Davidoff Incorporated represents banks, manufacturers, distributors, landlords and other commercial creditors, in a wide variety of litigation matters, including those:

1. To collect commercial obligations;
2. To enforce contract rights;
3. To enforce intellectual property rights;
4. For fraud and unfair business practices; and
5. To enforce other business claims.

These clients routinely face the risk of bankruptcy filings by their opponents in litigation. Accordingly, we are sensitive to the bankruptcy-related pitfalls that may confront creditors following settlements. The risk of a post-settlement bankruptcy cannot be eliminated, but it can be managed.

How Does Bankruptcy Affect a Settlement?

Settlement agreements are contracts. In most instances, they obligate one party (the "Obligor") to pay money to the other party (the "Creditor"). If, after entering into a settlement agreement, the Obligor files bankruptcy, the impact upon the rights of the Creditor depends upon the timing of the bankruptcy filing. In a nutshell: If the bankruptcy is filed ***before*** the settlement is finally performed by both sides, the bankruptcy trustee may be able to reject the settlement agreement. The Obligor is then deemed to have breached the settlement agreement, and the Creditor's rights form the basis of a claim against the bankruptcy estate. Even if the trustee does not reject the settlement agreement, it will probably be necessary for the Creditor to take steps in the Bankruptcy Court to enforce its rights.

If the bankruptcy is filed ***after*** the settlement is fully paid, the bankruptcy trustee may seek disgorgement of the payment as a "preferential transfer." The law of preferential transfers or, simply, "preferences," is unique to bankruptcy. It empowers a bankruptcy trustee to recover certain transfers of money or property that were made by the debtor within the 90-days prior to the bankruptcy filing.[1] In some cases, the Creditor can even be forced to disgorge a settlement payment as a preference, ***but still be held to the terms of the settlement***.

[1] The preference period is increased to one year if the party who received the transfer is an "insider" of the debtor.

MATERIAL CONTAINED IN THIS NEWSLETTER IS FOR GENERAL INFORMATION ONLY AND SHOULD NOT BE INTERPRETED AS LEGAL ADVICE ON ANY PARTICULAR MATTER. TRANSMISSION OF THIS NEWSLETTER DOES NOT CREATE ANY ATTORNEY-CLIENT RELATIONSHIP. RH&D IS NOT RESPONSIBLE FOR ANY ERRORS OR OMISSIONS IN THE CONTENTS OF THIS NEWSLETTER.

Copyright 2003, Rutter Hobbs & Davidoff Incorporated.

1900 Avenue of the Stars ■ Suite 2700 ■ Los Angeles, California 90067-4301 ■ Office 310-286-1700 ■ Fax 310-286-1728 ■ www.rutterhobbs.com

How You Can Protect Yourself.

If you are the Creditor and are evaluating a settlement opportunity, you can take preventive measures. One thing that you ***cannot*** do is prevent your adversary from filing bankruptcy. Promises to not file bankruptcy are generally unenforceable as against public policy. Similarly, if you are settling a claim under an ordinary commercial contract, there are no magic words that you can insert into the settlement agreement that would give your claim special status within the bankruptcy.

The following strategies, however, can help:

1. **Perform a Credit Review.**

   It is common for an Obligor to offer future payments as the basis for a settlement. If such an offer is presented to you, you should treat it as a loan request. In effect, you are being asked to finance the settlement. While the offer may have enough value to be attractive, you should not hesitate to demand full financial disclosures, including financial statements (either audited or, at least, signed under penalty of perjury) from the Obligor. The disclosures will allow you to assess the level of risk involved.

2. **Put a Third Party on the Hook.**

   In certain cases, there may be a third party who is willing to guarantee the Obligor's settlement obligations. Look for this opportunity when the Obligor is a closely held corporation or a subsidiary. In such a case, do not hesitate to ask the Obligor's shareholder(s) to guarantee the obligations. A guaranty from a financially stable third party is the surest way to guard against preference liability. The guaranty could be in the form of a surety bond, a standby letter of credit, or an ordinary personal or corporate guaranty. The form of the third party obligation is not critical. What is critical is the creditworthiness of the third party guarantor; so, again, performing a credit review is important.

3. **Obtain Collateral.**

   The next best thing to a guaranty is collateral to secure the settlement obligation. Real property equity is excellent collateral, of course, but is not typically available. Look for opportunities to secure the settlement obligation against receivables, inventory, equipment and other business assets. If the settlement is with an individual, consider insurance policies and securities accounts. Remember to perfect your security interest by filing a UCC-1 Financing Statement with the Secretary of State.

   (If your Obligor files bankruptcy within the preference period, the bankruptcy trustee may take steps to void your security interest as a preferential transfer. Even in that circumstance, it is often possible to negotiate a compromise with the bankruptcy trustee. Thus, you are still better off having obtained the collateral than not. If the bankruptcy filing occurs after the preference period has passed, your security interest will give your claim priority in the bankruptcy case.)

4. **Obtain a Stipulation for Entry of Judgment.**

   This device is routinely employed when parties to a pending litigation settle, and the settlement calls for one or more future payments. The settlement terms are incorporated into a formal stipulation to the court. The stipulation authorizes the court to immediately enter judgment against the Obligor, should the Obligor default. If the Obligor defaults but promptly files bankruptcy, the stipulation for entry of judgment provides no real protection. However, in some cases, the Obligor will first default and suffer entry of a judgment before filing bankruptcy. If the bankruptcy filing is delayed long enough, it may be possible for the holder of the judgment to record judgment liens against the debtor's assets and thereby attain status as a secured creditor before the bankruptcy is filed.

5. **Have the Obligor Stipulate to Facts.**

If your underlying claim is for fraud or conversion,[2] stipulated facts can help you establish a claim for exception to discharge. Most settlement agreements contain a boilerplate disclaimer of admissions of liability or wrongdoing. If you have claimed fraud, you should attempt to replace this boilerplate, as it applies to your adversary, with detailed admissions of concrete facts that support the claim. The Obligor may object, but you can point out that the admissions will make no difference as long as the Obligor fulfills its obligations. The admissions are important to you, because in the event of a bankruptcy, you will want to obtain a bankruptcy court judgment declaring the debt to have been incurred by fraud and therefore nondischargeable. Bankruptcy courts will generally disregard a bare admission of fraud. Thus, it would be insufficient for the debtor to state simply that it committed fraud. However, detailed admissions by the debtor as to facts that would establish the elements of a fraud case are admissible to prove a nondischargeability case.

6. **Claim Preservation Clause.**

The most vexing of all results is one in which the Creditor is forced to disgorge a settlement payment as a preference, but is otherwise held to the terms of the settlement. For example, the Creditor sues to collect a $1 million debt, but accepts payment in the sum of $250,000 in settlement. The Obligor then files bankruptcy, and the Creditor is forced to disgorge the $250,000 payment as a preferential transfer. Under bankruptcy law, the Creditor would then be left with an **unsecured claim** against the bankruptcy estate ***in the discounted sum of $250,000.*** In other words, not only must the Creditor return the settlement proceeds, it is bound to the discounted claim amount as provided in the settlement. At RHD, we include in our creditor clients' settlement agreements a "claim preservation clause" that seeks to protect our clients from this inequitable result. Although the clause has yet to be tested in court, it can only enhance our clients' rights.[3]

We do not suggest that each of these tools can be utilized in every case. Our goal is simply to raise awareness of pitfalls that exist under bankruptcy law, and suggest some possible solutions for them. If you have any questions about the matters discussed, please do not hesitate to contact us.

Duane Kumagai practices in the area of commercial and bankruptcy litigation. For further information please contact him at Rutter Hobbs & Davidoff Incorporated, Tel: (310) 789-1850; email: dkumagai@rutterhobbs.com.

[2] Or is one of several other claims that, under Bankruptcy Code § 523, can form the basis for an exception to discharge.

[3] This strategy is analyzed in detail by Rutter Hobbs & Davidoff Incorporated attorneys Terence S. Nunan and Jeanne C. Wanlass in the article "Waiting for the Dust to Settle," published in the February 2003 edition of *Los Angeles Lawyer*. To view this article, go to http://www.rutterhobbs.com/community/media/cfm, or contact the firm to request a copy of the article.

Send the BANKRUPTCY BULLETIN to a colleague

Name: ____

Title: ____

Address: ____

Telephone: ____________________ Fax: ____________________

E-Mail: ____________________ Industry: ____________________

Submit your request by fax or mail to:
Rutter Hobbs & Davidoff Incorporated
Attn: Bankruptcy Bulletin Mailing List
1900 Avenue of the Stars, Suite 2700
Los Angeles, CA 90067-4301
Fax: (310)286-1728

RUTTER
HOBBS &
DAVIDOFF
INCORPORATED
LAWYERS

1900 Avenue of the Stars
Suite 2700
Los Angeles
California 90067-4301

Address Service Requested