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When a Settlement No Longer Is Consensual

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You have just settled a complicated issue in a bankruptcy case. The other side was difficult, but reason prevailed, and you were able to finalize the terms of the settlement. Your client is happy that the matter is resolved, and you are satisfied with the way that you brought finality to the dispute. But before the bankruptcy court could consider the settlement, you receive a phone call and learn that the counter-party is backing out of the deal. What now?

This is a troubling question that many lawyers involved in bankruptcy matters will face at some point in their career. A quick review of Bankruptcy Rule 9019 makes clear that the settlement requires court approval. But does this mean that no settlement is binding until approved by the court, such that a party can unilaterally walk away before that point?

There is a split of authority on this issue. Some courts appear to say yes. Others take a seemingly opposite approach and bind the parties to their agreement unless and until the court rejects the settlement. We survey certain of this disparate case law and highlight facts relied on by courts that have reached these divergent conclusions.

Bankruptcy Rule 9019

We begin with the generally accepted principle that if a bankruptcy court actually denies a motion to approve a settlement, then the settlement is null and void as if it never existed. *See, e.g.*, *American Prairie Constr. Co v. Hoich*, 594 F.3d 1015, 1025 (8th Cir. 2010) ("no effective agreement was achieved because the bankruptcy court declined to approve the settlement proposed by the parties"); *Rafool v. Goldfarb Corp. (In re Fleming Pack'g Corp.)*, No. 04-8166, 2008 WL 682428, at *3 (Bankr. C.D. Ill. Mar. 7, 2008) ("a compromise or settlement that is disapproved by the court is null and void"). In short, if the bankruptcy court ultimately rejects the settlement, then one party cannot otherwise enforce the settlement terms against the other.

But what about the gap period after the settlement is agreed or signed, but before the bankruptcy court has considered it? As noted above, it is commonly stated (and understood) that a settlement agreement is not enforceable in the absence of court approval. *See also Billingham v. Wynn & Wynn, P.C. (In re Rothwell)*, 159 B.R. 374, 379 (Bankr. D. Mass. 1993). However, this principle does not necessarily speak to whether the parties have bound themselves so that neither can walk away before court approval. After all, under general principles of contract law, a contract can be binding between the parties even if performance is contingent on the occurrence of a future event. *See Musselman v. Stanonik (In re Seminole Walls & Ceilings, Corp.)*, 388 B.R. 386, 393 n.5 (M.D. Fla. 2008) (citing 13 Richard A. Lord, Williston on Contracts § 38.7 (4th ed. 2007)).

But does this principle hold true in bankruptcy in the context of settlements that are subject to the approval of the Bankruptcy Court? The case law reflects varying approaches on the issue. In one case, an Illinois bankruptcy court allowed the debtor to walk away from a settlement agreement because the settlement had not yet been approved by the court. *See In re Sparks*, 190 B.R. 842, 844–45 (Bankr. D. Ill. 1996). The court also rejected the counterparty's request to compel the debtor to seek approval of the settlement, on the grounds that to require the debtor to champion an agreement that it no longer supported would put the debtor in the untenable position of having to choose between its duties to the estate and its duties under the settlement agreement. *Id.* at 845.

A Georgia bankruptcy court decided differently. There, the court compelled the debtor to file the motion and further held that the debtor was bound by its settlement pending the court's determination of whether to approve the settlement. *See Providers Benefit Life Ins. Co. v. Tidewater Group, Inc. (In re Tidewater Group, Inc.)*, 8 B.R. 930, 933 (Bankr. N.D. Ga. 1981) ("an agreement by a debtor in possession to compromise litigation should also be binding upon all parties to the agreement pending a Court determination as to whether or not to approve the agreement…. Of course, the issue of whether the agreement should be approved as being in the best interest of the creditors remains to be decided."). Moreover, at least five other courts have refused to allow a party to withdraw from a settlement while the motion to approve was pending before the court, on the grounds that settlement agreements are valid and binding agreements—even if performance cannot yet be enforced—until considered by the court and rejected. *See Seminole Walls*, 388 B.R. at 392 (litigation counter-party tried to withdraw from settlement with trustee); *In re Frye*, 216 B.R. 166, 173–74 (Bankr. E.D. Va. 1997) (litigation counter-party tried to withdraw from settlement with the trustee); *Rinehart v. Stroud Ford, Inc. (In re Stroud Ford, Inc.)*, 205 B.R. 722, 725–26 (Bankr. M.D. Pa. 1996) (debtor tried to withdraw from settlement); *In re United Shipping Co.*, No. 4-88-533, 1989 WL 12723, at *5 (Bankr. D. Minn. Feb. 17, 1989) (litigation counter-party tried to withdraw from settlement with trustee); *White v. C.B. Hannay Co. (In re Lyons Trans. Lines, Inc.)*, 163 B.R. 474, 476 (Bankr. W.D. Pa. 1994) (litigation counter-party tried to withdraw from settlement with trustee).

What explains these differences in result? We identify below two key themes that shed light on why certain courts on both sides of the split ruled the way they did: (1) whether the debtor complied with Rule 9019's notice requirements and (2) the reason *why* one party wants to repudiate.

Did the Parties Follow the Notice Requirements of Bankruptcy Rule 9019?

Bankruptcy Rule 9019 requires the parties to obtain court approval of a settlement after providing notice to all parties in interest and an opportunity for a hearing. *See* Fed. R. Bankr. P. 9019(a); 11 U.S.C. § 102(a) (defining "notice and a hearing"); Fed. R. Bankr. P. 2002(a)(3) (requiring 21 days' notice for hearing to approve settlement). Rule 9019's purpose "is to protect other creditors against bad deals made between one creditor and the debtor." *United Shipping Co.*, 1989 WL 12723 at *5.

In some cases, the parties proceeded with a settlement despite not providing notice to parties in interest as Rule 9019 requires. *See, e.g.*, *Billingham v. Wynn & Wynn, P.C.C. (In re Rothwell)*, 159 B.R. 374, 379 (Bankr. Mass. 1993). When a debtor fails to comply with Rule 9019, courts have been unwilling to enforce the settlement, meaning that one party cannot hold the other to the settlement. *United Shipping Co.*, 1989 WL 12723 at *5.

Exceptions to these notice requirements exist.For example, if the assets underlying the settlement are assets that the debtor could dispose in the ordinary course of its business, then courts have bound the parties to their settlement even when the settlement was consummated without notice. *In re Stroud Ford, Inc.*, 205 B.R. at 726 ("If the substance of the agreement is in the ordinary course of business, then the debtor-in-possession is bound by its terms."). The reason lies in Bankruptcy Rule 9019's relationship to Bankruptcy Code § 363. Bankruptcy Rule 9019 is a procedural rule; Bankruptcy Code § 363 is the substantive basis for the debtor's disposition of property in bankruptcy. *See Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 351 (3d Cir. 1999). Under § 363, if a debtor disposes of estate assets outside the "ordinary course of business," then it must do so only after notice and a hearing. 11 U.S.C. § 363(b)(1). But if the asset is a type that the debtor disposes in the "ordinary course" of its business, no notice is required. *Id.* § 363(c). A debtor's legal claims are "property" of its estate, and generally the settlement of those claims is a "sale" of estate property outside of the ordinary course of business requiring notice and a hearing. *Northview*, 186 F.3d at 351. But situations may arise where the claim being settled is another party's claim against the debtor and where the subject matter of the claim is something that the debtor sells in the ordinary course of its business. *See, e.g.*, *In re Stroud Ford, Inc.*, 205 B.R. at 725–26. In such a case, a settlement agreement likely is enforceable even if entered into without notice. *Id.*

Another exception may arise if the debtor had pre-authorization to settle under Bankruptcy Rule 9019(b). Bankruptcy Rule 9019(b) authorizes the Bankruptcy Court (after notice and a hearing) to pre-authorize the debtor to settle certain types of controversies that fall within a defined range. For example, a debtor might seek pre-authorization to settle preference claims in a certain class, such as claims under $500,000 where the settlement at issue recovers 25 percent or more of the stated value of the claim. If a debtor settles with a defendant and the settlement comes within the scope of the Bankruptcy Court's prior approved settlement authority, then (subject to the terms of the court's settlement approval order) the fact that the debtor does not thereafter provide individualized notice of the settlement will not prevent the settlement from binding the parties immediately and without further action by the Bankruptcy Court. *See Boyd v. Eugene Haikkila Inc. (In re Check Reporting Servs., Inc.)*, 137 B.R. 653, 656 (Bankr. W.D. Mich. 1992).

Why Was One Party Trying to Withdraw from the Settlement?

Separate from whether the parties complied with required notice procedures, courts also consider *why* a party wants to withdraw from the settlement before court approval. In the case of non-debtors, some courts have not looked kindly on attempts to withdraw from a settlement simply to avoid a bad deal. For example, a non-debtor could not withdraw from a settlement that was pending court approval where an intervening change in the law granted that party an immunity

that would have allowed it to prevail in its lawsuit. *See Lyons Trans. Lines*, 163 B.R. at 476. Nor could a non-debtor walk away from its settlement of an appeal even when, while the motion to approve the settlement was pending, the appellate court reversed in the party's favor. *Frye*, 216 B.R. at 173-74.

By contrast, some courts have declined to enforce a settlement agreement in light of changed circumstances, particularly where the party seeking to withdraw was the debtor. *See, e.g.*, *In re Filene's Basement, LLC*, No. 11-13511 (KJC), 2014 WL 1713416, at *5–7 (Bankr. D. Del. Apr. 29, 2014); *Tidewater Group*, 8 B.R. at 933; *Sparks*, 190 B.R. at 844–45. This difference in treatment lies in the debtor's fiduciary duties to the estate, which can conflict with its duties under the settlement agreement when changed circumstances render the settlement less favorable to the estate. *See Myers v. Martin (In re Martin)*, 91 F.3d 389, 394 (3d Cir. 1996). Based on this reasoning, one court allowed a debtor to walk away from a settlement simply because a better deal was offered by another party. *In re Sparks*, 190 B.R. at 844–45.

But this rule highlights a double standard: A debtor potentially can avoid having to present or prosecute a motion to approve the settlement when a better offer emerges or in light of other changed circumstances, but a creditor cannot. In this scenario, the debtor argues that its fiduciary duties to the estate trump its prior agreement because the best interest of the estate is the primary protectable interest. The Third Circuit confronted this scenario in *Myers*, 91 F.3d 389. There, the court held that a trustee who no longer believes that a settlement is in the estate's best interest does not need to pick between his duties under the settlement agreement and the estate. Instead of forcing the trustee to "choose between these conflicting legal obligations," Bankruptcy Rule 9019 "demonstrates the legislature's intent to place this responsibility with the bankruptcy court." *Id.* at 394. According to the Third Circuit, the trustee should present the motion to the court, explain why he believes the settlement no longer is in the estate's interest, and let the court decide. *Id.*

The Third Circuit did not actually decide whether the trustee was contractually bound by his agreement prior to Bankruptcy Court approval. *See Id.* at 396 n. 3. However, the Third Circuit's reasoning supports the conclusion that debtors—like creditors—may not be entitled to unilaterally withdraw from a settlement agreement even when withdrawal is the better option for the estate. Recently, a Delaware bankruptcy court suggested in dicta that a debtor should not withdraw its motion to approve a settlement if a better deal emerges; instead, the debtor should bring the motion to the court and let it decide whether to approve it or not. *See Filene's*, 2014 WL 1713416 at *7 n.8. It then becomes the court's job to determine whether the settlement is appropriate in light of the changed circumstances. *Id.* at *7–8. Other courts that have considered the issue likewise have concluded that contract principles control, and while court approval may be a condition precedent to the enforcement of the terms of the settlement, it may not be a condition precedent to the formation of the contract itself. *See, e.g.*, *Seminole Walls*, 388 B.R. at 393 & n.5; *Pineo v. Turner (In re Turner)*, 274 B.R. 675, 680 (W.D. Pa. 2002); *Stroud*, 205 B.R. at 725–26. One court also noted that in non-bankruptcy analogues where settlements require court approval, parties could not repudiate prior to the court's consideration of the settlement.

Seminole Walls, 388 B.R. at 393.

Conclusion

So, what have we learned? Although there is support for the position that a party to a settlement agreement is not contractually bound and has no duties until after the bankruptcy court approves the settlement, there is substantial support for the opposite proposition, that a party—whether a creditor, debtor or trustee—cannot unilaterally walk away from a settlement after its formation but before the court's consideration of the settlement.

In short, the common understanding that a settlement is not binding in bankruptcy until approved by the court does not appear to be correct. Instead, depending on the specific facts at issue (including the precise language of the settlement agreement), it may be more accurate to say that a settlement may be binding prior to court approval and an obligation to present the settlement to the court may still be enforceable even if a party no longer supports the settlement itself. In this latter case, the burden will be on the party seeking to enforce the settlement to persuade the bankruptcy court that the settlement should be approved notwithstanding the changed circumstances giving rise to the other party's disavowment of the agreement.

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