

Enforcement of Pre-Bankruptcy Waivers is Not Guaranteed

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Settlement proposals with borrowers in default or litigants who may be candidates for a bankruptcy filing often include provisions delineating the parties' rights in the event that bankruptcy relief is subsequently sought. Though creditors bargain for bankruptcy-specific waivers and releases in pre-bankruptcy settlements to limit the desirability of bankruptcy relief in the name of finality and maximum recovery, enforcement of such provisions may be subject to scrutiny from a bankruptcy judge mindful of the Bankruptcy Code's policies of a fresh start for debtors and equality of distribution among creditors.

This article will provide an overview of the post-bankruptcy enforcement of pre-bankruptcy waivers and releases in three of the most common contexts: (1) waiver of the automatic stay provisions; (2) waiver of a debtor's discharge; and (3) release of a debtor's claims against a settling party.

Limited Enforcement of Stay Waivers

The breathing spell afforded to debtors by virtue of the automatic stay is without question one of the most vital benefits conferred upon the filing of a bankruptcy case. It should come as no surprise, then, that bankruptcy courts are particularly protective of the integrity of the automatic stay against inadvertent or unjustified waiver through agreements entered into before a bankruptcy petition is filed.

Pre-petition waivers of the automatic stay typically appear in forbearance agreements or other workout documents between secured lenders and distressed borrowers. A bank may, for example, allow a borrower in default to continue using the bank's cash collateral in exchange for the borrower's covenant not to object to the bank's motion for relief from the automatic stay in the event of a bankruptcy filing. Although there is at least some precedent for considering such waivers to be *per se* unenforceable, the modern trend is toward finding "cause" for stay relief exists when the parties bargained for a strict limitation on the debtor's protection afforded by the automatic stay before the bankruptcy came into being.

In considering whether to give effect to the debtor's waiver of its automatic stay protection, bankruptcy courts engage a multi-factor analysis. A leading case on this issue, *In re Bryan Road*, identified four factors weighing on the court's decision to enforce a stay waiver in a pre-bankruptcy agreement: (1) the sophistication of the borrower and its pre-bankruptcy counsel; (2) the consideration given by the lender in exchange for the stay waiver—i.e., the level of risk inherent in the forbearance agreement; (3) the effect that enforcement of the stay waiver would have on third parties; and (4) the feasibility of debtor's reorganization.

Enforcement of pre-petition stay waivers following analyses like that employed in *Bryan Road* is intended to strike a balance between promoting out-of-court workouts and preserving the debtor's going concern value for the benefit of creditor constituents not privy to the pre-bankruptcy agreement.

Waiver of Discharge

Protection of the right to seek discharge of indebtedness is steadfast within the Bankruptcy Code. For example, bankruptcy courts have consistently construed 11 U.S.C. 727(a)(10) to deny enforcement of a pre-petition waiver of the entire bankruptcy discharge by a debtor. Similarly, 11 U.S.C. 524, which establishes disclosure requirements for post-petition reaffirmation agreements, provides the statutory foundation for those decisions that have declined to enforce a pre-petition discharge waiver with regard to a specific debt.

Although pre-petition waivers of discharge are met with strong resistance in bankruptcy court, creditors can take solace in the fact that bankruptcy courts are nearly as vigilant in protecting creditors from unwittingly waiving non-dischargeable claims through pre-bankruptcy agreements.

In *In re Francis* (1998), a bankruptcy appellate panel in the 6th Circuit held that a general release obtained by a defendant in settlement of a tort claim prior to the defendant's bankruptcy did not serve as a novation that allowed the underlying debt incurred by fraud (the tort claim) to be discharged in bankruptcy. The *Francis* court reasoned that the bankruptcy discharge and the right to contest a discharge are bankruptcy rights that cannot be bargained away through a general release by either party before a bankruptcy filing. The debtor was unable to rely on the pre-petition release because Congress' mandate that debts incurred through fraud are not dischargeable in bankruptcy trumps any state law on releases or *res judicata*.

Nevertheless, there is authority for enforcement of pre-bankruptcy waivers of the discharge or a creditor's right to contest same. Creditors may avoid having to litigate issues of non-dischargeability if its pre-bankruptcy settlement includes a debtor's stipulation to the requisite elements of a non-dischargeable claim—i.e., an agreed judgment. Debtors may be able to avoid non-dischargeable debt determinations if their pre-bankruptcy settlements include specific releases of otherwise non-dischargeable claims.

Releases of Causes of Action Against a Creditor

While enforcement of pre-bankruptcy stay and discharge waivers encourages out-of-court workouts—and, presumably, reduces the number of bankruptcy filings—bankruptcy courts have expressed greater concern

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for the creditors at large when considering whether to treat a pre-bankruptcy release of a claim owned by the debtor as binding once a bankruptcy case is commenced. When a bankruptcy trustee pursues a creditor or other party without regard for a pre-petition release between the debtor and released party, the bankruptcy policy of maximum and equitable distribution to all creditors outweighs the interest of encouraging settlements within the legal system.

Upon commencement of a bankruptcy case, a trustee or debtor in possession steps into the shoes of the debtor with respect to the debtor's non-exempt property interests. In addition to the hypothetical transfer of the debtor's property interests, the trustee or debtor in possession is armed with statutory powers to avoid certain pre-petition transfers which reduced the overall value of the debtor's estate. The avoidance powers conferred upon a trustee under the Bankruptcy Code exist solely for the benefit of creditors and cannot be compromised by the debtor pre-petition. Therefore, claims owned by a debtor and thought to be resolved pre-petition may be revisited within the bankruptcy court.

A debtor's release of causes of action prior to a bankruptcy filing will be evaluated against whether the overall value of the debtor's estate upon filing was unfairly compromised due to the release. If the released party was absolved via the pre-bankruptcy agreement at the expense of the debtor's creditors, the release may be ignored and the cause of action may be revived. When a cause of action is released or waived pre-petition, a transfer of the debtor's interest has occurred and is subject to being avoided as preferential or fraudulent. A determination that the release obtained is avoidable in the bankruptcy case opens the door for the trustee or debtor in possession to pursue recovery from previously released parties.

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