



**Are Settlement Agreements Executory Contracts? Courts That Say “No” Give More
Power to Creditors in Bankruptcy Actions**

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Introduction

In order to provide for quick and efficient resolutions in bankruptcy cases, courts will often encourage settlement agreements.¹ Settlement agreements are so common that it is unusual for there not to be a settlement between adversaries.² Additionally, settlement agreements are favored by law to allow the parties to avoid the expense and burdens that are associated with litigating claims.³

Courts have taken two approaches when analyzing disputes that involve settlement agreements. Some courts have held that a settlement agreement is a court approved contract between two adversarial parties and its interpretation is governed by the general provisions of contract law.⁴ Other courts have held that settlement agreements are executory contracts under

¹ See *In re TSIC, Inc.*, 393 B.R. 71, 78 (Bankr. D. Del. 2008).

² See *Myers v. Martin (In re Martin)*, 91 F.3d 189, 193 (3d Cir. 1996).

³ See *In re SCBA Liquidation, Inc.*, 451 B.R. 747, 768 (Bankr. W.D. Mich. 2011).

⁴ See *Mesabi Metallics Co. LLC v. Cleveland-Cliffs Inc. (In re Essar Steel Minnesota LLC)*, 590 B.R. 109, 113 (Bankr. D. Del. 2018).

section 365 of title 11 of the United States Code (the “Bankruptcy Code”) allowing a trustee to assume or reject any executory contract or unexpired lease of a debtor.⁵

This memorandum explores the consideration of courts when deciding which approach to take when determining the validity of settlement agreements. Part I examines the use of common law contract doctrine to be applied to settlement agreements. Part II analyzes court decisions that have held settlement agreements to be executory contracts under both the “Countryman” definition of executory contracts and the “functions test.” This memorandum concludes with a discussion of the effects that this choice has on bankruptcy litigation.

I. Construction and Enforcement of Settlement Agreements is Generally Governed by State Law Principles of Contracts

As a threshold issue, courts ask whether the settlement agreement would be a contract had there been no bankruptcy action.⁶ If a settlement agreement would be considered a valid contract outside of bankruptcy, it will be a contract in bankruptcy “[u]nless some federal interest requires a different result.”⁷ If a settlement agreement is deemed to be a contract, its interpretation presents a question of contract law in which the primary objective is to give the effect of the intention of the parties.⁸

In *Columbia Gas*, the court held that the settlement agreement was a contract, and therefore not executory for the purposes of rejection under section 365.⁹ There, producers of natural gas sued for breach of the gas purchase contract by Columbia Gas Transmission Company (“TCO”) for paying less than the maximum price.¹⁰ The two parties reached a

⁵ 11 U.S.C. § 365(a); *see also In re W.B. Care Center, LLC*, 419 B.R. 62 (Bankr. S.D. Fla. 2009).

⁶ *See Enterprise Energy Corp. v. United States (In re Columbia Gas System, Inc.)*, 50 F.3d 233, 237 (3d Cir. 1995).

⁷ *See Butner v. U.S.*, 440 U.S. 48, 55 (1979).

⁸ *See Lumpkin v. Envirodyne Industries, Inc.*, 933 F.2d 449, 455 (7th Cir. 1991), *cert. denied*, 502 U.S. 939 (1991).

⁹ *See In re Columbia Gas*, 50 F.3d at 239.

¹⁰ *Id.* at 236.

settlement that released TCO from all claims in exchange for \$30 million.¹¹ TCO made the first \$15 million payment but subsequently filed for bankruptcy.¹² The court held that in a non-bankruptcy context this agreement would be a contract and there was no reason to take a different approach.¹³ The court found that sophisticated parties drafted the settlement agreement and that the bankruptcy court approved it.¹⁴

When the bankruptcy court looked at this issue through the lens of section 365, this was the only result that made sense under the Bankruptcy Code.¹⁵ If the contract was held to be executory and subject to assumption or rejection, the only difference would be that the producers would have had higher priority to the unpaid \$15 million.¹⁶ If the contract was to be assumed, there would be no assets added to the bankruptcy estate and would fail to meet the purpose of the section 365 to add value to the debtor's estate.¹⁷ Given this result, it only made sense for the bankruptcy court to look to the intentions of the parties in making the settlement agreement.¹⁸

This same rationale was stated by the bankruptcy court in *Mesabi Metallics*, where a settlement agreement was held to be interpreted using contract law principles.¹⁹ There, the debtor was the lessee to mineral leases and entered into a settlement agreement that was dependent on the debtor's Chapter 11 plan becoming effective by October 31, 2017.²⁰ The Chapter 11 plan did not become effective by the required date, so the leases were rejected and reverted back to the lessor.²¹ The Delaware bankruptcy court held that the effective date requirement for the Chapter

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* at 238.

¹⁴ *Id.*

¹⁵ *See id.* at 244.

¹⁶ *See id.*

¹⁷ *See id.*

¹⁸ *See id.* at 241.

¹⁹ *See In re Essar Steel Minnesota*, 590 B.R. at 118.

²⁰ *Id.* at 112–13.

²¹ *Id.* at 113.

11 plan was a material condition precedent that was not met rendering the rest of the settlement agreement unenforceable.²²

The bankruptcy court found that the settlement agreement was negotiated by sophisticated parties and included unambiguous explicit language to reach the decision that the settlement agreement was to be interpreted as a contract.²³ The bankruptcy court detailed how this decision put the destiny of the debtor into its own hands.²⁴ All the onus was on the debtor to ensure that it stuck to the terms of the agreement in order to resume the leases; by failing to adhere to the settlement plan the debtor had no additional recourse under the Bankruptcy Code to assume the leases.²⁵

These decisions demonstrate how courts interpreting settlement agreements strictly by contract law gives more power to creditors that have been frustrated by a debtor and are skeptical of a debtor's ability to perform in the future. As expressed by the *Mesabi Metallics* court, a settlement agreement is a chance for the debtor to take control of its own destiny and restructure the relationship with the creditor. If the debtor meets the terms of the agreement, the relationship could continue to be fruitful for both the debtor and creditor going forward. If the settlement agreement was found to be executory then section 365 of the Bankruptcy Code would allow the contract to still be assumed.

However, since these courts interpreted the agreements under contract law principles, the debtors had no further recourse under the Bankruptcy Code. This will lead to creditors having greater ability to regain control of the debtor's assets if a debtor is unable to meet the conditions of the agreement.

²² See *In re Essar Steel Minnesota*, 590 B.R. at 117.

²³ See *id.* at 118.

²⁴ See *id.* at 119.

²⁵ See *id.*

II. Rejection of Settlement Agreements on the Basis that they are Executory Contracts.

In contrast with interpreting settlement agreements strictly under common law contract principles, some courts looked to whether the agreements are executory contracts. Courts use two tests to determine if a contract is executory under section 365 of the Bankruptcy Code: 1) the Countryman test; and 2) the functional analysis test. Under this approach, courts are giving more power to the debtor in bankruptcy actions by allowing them to utilize section 365 to accept or reject the settlement agreements.

A. Countryman Definition of Executory Contract

The Countryman test states that a contract is executory “if the obligations of both the bankrupt and the other party to the contract are so far underperformed that the failure of either to complete the performance would constitute a material breach excusing performance of the other.”²⁶ This test lines up with the legislative history of section 365 which provides that executory contracts include contracts on which performance remains due to some extent on both sides.²⁷

The Countryman definition is “based on a functional approach to the trustee’s powers.”²⁸ Under the Countryman test, the option to accept or reject the contract is only allowed when that choice benefits the estate.²⁹ Since the purpose of this section of the Bankruptcy Code is to benefit the estate, it would not make sense to allow debtors to reject contracts that were fully performed on one side.³⁰ This is reinforced by the fact that if a debtor rejects a contract, a creditor can file a

²⁶ Vern Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439, 446 (1973).

²⁷ See *In re Spoverlook, LLC*, 551 B.R. 481, 484 (Bankr. D.N.M. 2016).

²⁸ Benjamin Weintraub & Alan N. Resnick, *From the Bankruptcy Courts: What is an Executory Contract? A Challenge to the Countryman Test*, 15 UCC L.J. 273, 273 (1983).

²⁹ See *id.*

³⁰ See *id.*

claim against the estate for damages, just as if the debtor had breached the contract.³¹ The assumption or rejection option only benefits the estate if the contract remains substantially underperformed on both sides which leads to the logical Countryman definition of an executory contract.³²

In *Spovertlook*, the court adopted the Countryman definition and held that “neither party to the Agreement had received the benefit of their bargain” resulting in the settlement agreement being executory under section 365.³³ The debtor and the San Pedro Overlook Community Association (the “HOA”) entered into a settlement agreement where the debtor agreed to pay \$13,178 in property taxes and convey the common areas to HOA in exchange for HOA paying \$4,952 in property taxes.³⁴ Both parties agreed to a release of claims provision and that when all the conditions were met, both would submit a stipulated order of dismissal.³⁵ Despite the settlement agreement there was still a dispute over the “Tract D” parcel of property, HOA contended that the settlement agreement obligates the debtor to convey “Tract D” as part of the common areas.³⁶

Because “neither party to the Agreement had received the benefit of their bargain,” under the purpose of the Countryman definition, the court correctly ruled that the contract was executory.³⁷ Moreover, the court held that the settlement agreement was both an asset and a liability to the estate meaning that performance was still owed by both the bankrupt and nonbankrupt party which renders this explicitly within the definition of an executory contract.³⁸

³¹ *See id.*

³² *See id.* at 274.

³³ 551 B.R. at 488.

³⁴ *Id.* at 483.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *See id.* at 488.

³⁸ *See id.*

Here, the result differs than if the court had just interpreted the agreement under contract law doctrine. In that scenario the court would look to the intention of the parties and determine if “Tract D” needed to be conveyed by the debtor to HOA.³⁹ Instead, the settlement agreement is rejected as an executory contract and gives more power back to the debtor in this bankruptcy action by allowing the trustee to assume or reject the contract for the benefit of the bankruptcy estate.

B. The Functional Analysis Test

The functional analysis test or “functional approach” has a court determine if a contract is executory by investigating whether rejection of the contract would benefit the debtor’s estate.⁴⁰ This test is the minority approach but often courts apply this test in conjunction with the Countryman approach.⁴¹ The functional approach is used in order to comply with the broad purposes of section 365 and its legislative history.⁴²

The functional approach essentially works backward from the purpose that rejection of a contract is expected to accomplish.⁴³ If the purposes of rejection have already been accomplished or if they cannot be accomplished through rejection, then the contract is not executory.⁴⁴ Courts that have adopted the functional approach have done so under the belief that a contract need not be executory as a prerequisite to assumption or rejection.⁴⁵

³⁹ *See Lumpkin*, 933 F.2d at 455.

⁴⁰ *Stevens v. CSA, Inc.*, 271 B.R. 410, 413 (Bankr. D. Mass. 2001).

⁴¹ *Id.*; *see, e.g., LA Electronica, Inc. v. Capo-Roman (In re LA Electronica, Inc.)*, 995 F.2d 320 (1st Cir. 1993); *Sipes v. Atlantic Gulf Communities Corp. (In re Gen. Dev. Corp.)*, 84 F.3d 1364 (11th Cir. 1996).

⁴² *Stevens*, 271 B.R. at 413.

⁴³ *See Chattanooga Memorial Park v. Still (In re Jolly)*, 574 F.2d 349, 351 (6th Cir. 1978).

⁴⁴ *See id.*

⁴⁵ *See Cohen v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 138 B.R. 687, 708 (Bankr. S.D.N.Y. 1992).

In *W.B. Care Center*, the court held that this easily passes the functional approach test as rejecting the contract would clearly benefit the debtor's estate.⁴⁶ The debtor had previously filed for bankruptcy and had signed a settlement agreement with Institutional Leasing.⁴⁷ Disputes continued as Institutional Leasing filed an eviction action and the debtor filed a second bankruptcy action.⁴⁸ The court stated that most of the settlement agreement's provisions pertained to the lease of the W.B. Care Center, and were purely reinforcements of the lease itself.⁴⁹ The court further held that it would be impossible for the debtor to breach the lease without breaching the settlement agreement.⁵⁰

Working backward under the functional approach, the court determined that the lease is "a weight upon the Debtor's shoulders" that would make reorganization impossible because of the settlement agreement's provisions dealing with the lease.⁵¹ The lease is "extremely favorable" to Institutional Leasing and rejecting the lease could only be seen as favorable to the debtor's estate resulting in the debtor's ability to reject the settlement contract as an executory contract under section 365.⁵²

Again, the debtor's ability to reject a lease that is favorable to a creditor is only possible because the settlement can be rejected as an executory contract under section 365. If the court had determined to analyze the settlement agreement under the principles that govern contract law, the result may have been different. Section 365 gives more flexibility to the trustee, and by extension to the debtor, to reject the settlement agreement if it would not benefit the bankruptcy estate. The power of section 365 is shown in *W.B. Care Center*, as the rejection allowed the

⁴⁶ 419 B.R. at 71.

⁴⁷ *Id.* at 64.

⁴⁸ *Id.*

⁴⁹ *Id.* at 70–71.

⁵⁰ *Id.* at 71.

⁵¹ *See id.*

⁵² *See id.*

weight of the lease to be lifted off of the debtor's shoulders. Without the provision, the results of the debtor's bankruptcy would have been far less favorable to the debtor.

Conclusion

The two approaches to dealing with settlement agreements can have very different outcomes for debtors. Creditors who want more control over the assets of debtors in bankruptcy would prefer courts to look at settlement agreements strictly as contracts. Under this approach, creditors have more power by being able to negotiate the terms of the agreement. If the agreement favors the creditor, the debtor will have no further recourse under the Bankruptcy Code as the agreement will only be interpreted under general contract principles.

In comparison, debtors may have more options available to them if courts apply either the Countryman definition or the functional analysis test to determine if the settlement agreement is an executory contract that can be rejected under section 365 of the Bankruptcy Code. Even though these tests are different, they both look to the effects of the contract on the estate. Through this approach the power shifts back to the trustee and the powers given to the trustee under the Bankruptcy Code. How much protection bankruptcy courts want to give debtors in bankruptcy may be looked at through the lens of how bankruptcy courts treat settlement agreements.