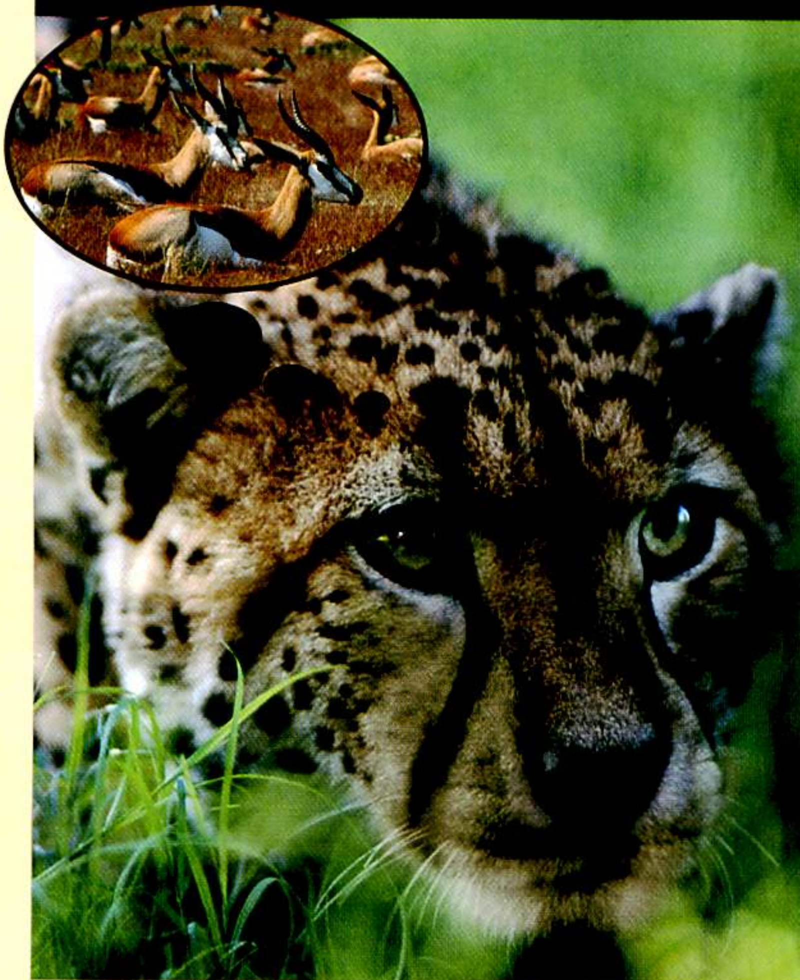
November/December 1998

Commercial Law Bulletin

FEATURE

Settlement Strategies: Preserving Your Place in the Food Chain



105th Annual National Convention Registration

Overcoming the Productivity Paradox

Success Rx: The Firm Physical

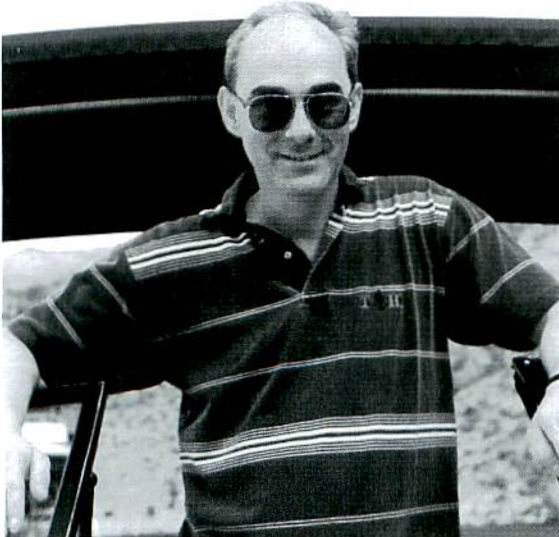
Eight Secrets of Successful News Releases

Healthy Eating: Avoiding the Restaurant Food Trap

CLLA®
COMMERCIAL LAW LEAGUE OF AMERICA®

Settlement Strategies: Preserving Your Place in the Food Chain

David Cook



Charles Darwin would love the Discovery Channel. Monday through Friday, this wonderful cable channel features animal documentaries such as "Craws and Paws," "Snacking at Midnight: Carnival of Carnivores," "Munching through the Foodchain," and "Roulette at Casino Darwino; or, The Loser Is Lunch." Sometimes set in the African savannah, these shows spotlight muscular cheetahs chasing down limber gazelles, culminating in the cheetah digging into the gazelle's hindquarters and converting its four hoofs into Four Seasons. Occasionally, the cheetah misses the meal because the gazelle's speed or agility saves it from the cheetah's manicure. Missing the gazelle's fanny, the cheetah's hurtling speeds cause it to careen head over heels. Infrequently, the gazelle's horns fend off the cheetah. The gazelle's light brown coloration also provides camouflage protection by blending in with the rolling plains, which burdens the cheetah in locating its brunch and creates sufficient delay to give the gazelle a head start. Yet the cheetahs usually win, and only the vast number of gazelles and low number of cheetahs (balance of nature of business) keeps everybody on the daily chalkboard menu.

Darwin wrote this script. The cheetah dines *au jus* because evolutionary changes and genetic chance gave cheetahs speed, agility, and decent eyesight. The gazelles avoid *Le charcuterie* because, likewise, evolution fostered natural coloration, greater numbers, agility, horns, and a decent sense of smell. Nonetheless, cheetahs usually enjoy "gazelle tartare, al naturale." For each Discovery Channel show, the credits list Darwin as director, who never varies from the script.

Like nature, Darwinian characters appear in the savannah of commercial settlements. The trick is choosing Darwinian sides: cheetah or gazelle? Maybe a lion? Max Moses reported to me that he had recently received an unusual number of "Letters to the Editor" that give a panoramic view of Darwin's savannah of settlements. He requested I provide the guided tour of this unique savannah through these letters. I hope you brought bush hats.

Enjoy the show.

Dear Editor:

After filing suit on a $5,000 commercial claim, I accepted a payment program of $500 per month and a stipulation for entry of judgment, subject to filing upon default. I promised notice of default, if nonpayment, and notice for the ex parte hearing to enter judgment. Sounds reasonable, if not civilized, to me. After the initial payment, the debtor defaulted, and after notice and judgment, I recorded the abstracts, but found the debtor sold his home and vacated the area. I learned that during the time between the suit and default, intervening liens consumed 50 percent of the debtor's equity, but the escrow could have paid off my judgment if timely recorded. After hearing this news, the client went ballistic because he thought that my settlement protected him against the debtor dissipating his assets and skipping town. Shall I notify my carrier? What is wrong with judgment upon default, rather than judgment upon settlement?

Signed, Concerned from Cucamonga

Dear Concerned:

I do not blame your client, although your client probably made the initial mess extending credit to a potentially known nincompoop. Furthermore, did your client tell you that the debtor was potential flight risk or crook? Did somebody run (within guidelines) a credit report? (Or would that help anyway?) Your settlement marginally enhanced your security because you lacked current liens to protect you against future liens and asset liquidations. Worse, your stipulation but not judgment gave you (and the client) a false sense of security, when in fact the debtor, along with other creditors, are free to encumber, dispose, or lien any assets. Remember, while you vaguely ruminate about this case, the debtor obsesses about his finances and studies the asset preservation "play book" to preserve his assets. The debtor's sworn goal is to shield assets from disfavored creditors (you and your dischargeable debt) or apply them to favored creditors, such as taxing authorities, home lenders, or family friends (nondischargeable debt or blood money).

Your settlement is "judgment upon default," rather judgment upon settlement, which creates unconscionable delays. If a default, you must convene a court hearing, ex parte, to obtain judgment. This court might give the debtor an additional opportunity to argue for reinstatement and avoid judgment and accompanying liens. When confronted with the repentant debtor, with omitted installments in hand, some judges will either place the matter on notice and hearing or decline entry of judgment altogether, further placing liens out of your reach. Compounding this travesty, taxing authorities, ambitious competing claimants, very aggrieved former spouses, hard-money lenders (willing to accept flawed collateral for a high interest loan), or favored relatives (converting their gifts into secured loans) might encumber the property ahead of your prospective liens.

Bankruptcy makes its appearance with the dreaded "P" word. (Let me guess: "persistence"? "perseverance"? "preferable"? Getting warmer?) Bankruptcy always drifts into a commercial setting. If your debtor owes your client, wager he owes everybody else in town. You must presume that your debtor will file bankruptcy to stop the crescendo of desultory debt collection actions. Bankruptcy stays this collection nightmare, in which the debtor (or the trustee) bumps off all liens, levies, transfer within ninety days as preferences. Given judgment (and ensuing liens) upon settlement, not default, your judgment lien might survive any preferential attack.

Given the debtor's proclivity to convey assets fraudulently, liens upon settlement, not judgment, will save your bacon, beef, or gazelle.

In short, bargain for final judgment. What if the debtor repulses this demand in settlement? Try a stipulated writ of attachment. Remember to execute under the attachment properly and encumber all real and personal property, such as a filing with the county recorder and secretary of state. Avoid self-executing attachment ("By virtue of this order, the Defendant's assets are attached"). Attachments are creatures of statute, and only the sheriff can execute an attachment. Avoid improperly executed attachments (for example, failing to open the sheriff's file, file the return with the sheriff, or even failing to use the sheriff altogether). Be careful of preprinted orders that omit or misstate the bond amount (for instance, using the debt as the bond amount), description of property, incorrect spelling of the Debtor, bonds that lacked the proper statutory reference, and levies failing to describe the property, debtor, third-party owner, or levies that lacked key documents, such as the orders and bond. Include in your settlement a provision for costs, fees, and interest, if judgment is entered.

The moral of this tale: In a settlement environment you are the cheetah and the debtor is the gazelle. You only have to grab the gazelle. We remind you that gazelles are smart, mean, and vengeful animals. If the gazelle bolts from your grasp, another cheetah might grab your prey, leaving you embarrassed and hungry, or you might become the gazelle to the new cheetah (your client), and the ugly lion (your client's new attorney). The settlement savannah is a casino, and you are always playing against cheetahs as equally talented or lucky. Darwinian democracy.

Dear Editor:

In collecting against a land-rich but cash-poor debtor, I settled the case for a land swap, which means I would dismiss the case in exchange for free and clear real property, deeded to the client. This proposition looked attractive to the client, who had dreams of developing the real property and converting debt (written off) into a valuable corporate asset. The deal provided that the debtor would deliver the deed upon execution of settlement documents, and I would provide the dismissal. I received the deed, caused it recordation, and obtained title report, showing the grant deed and something else. However, prior in time to the grant deed, the debtor encumbered the real property in favor of a hard-money lender (you see them on TV) and effectively scooped out all the equity. The property was junked; the debtor's new loan had awful terms. Loan sharking broke the dawn of the new millennium. The debtor subsequently filed a non-asset Chapter 7. What went wrong?

Signed, Tormented from Tarzana

Dear Tormented:

Your debtor recalled his classics better than you. I am not talking about *Romeo and Juliet*, but the *Iliad*: Beware of Greeks bearing gifts. This scenario is extremely common, and usually the losers are the creditor and counsel. Taking property for debt is a super- headache. Borrowing a page from Elizabeth Barrett Browning, let me tell you the reasons why:

1. If the debtor is offering you property, probably the debtor cannot sell the property, and therefore a *lis pendens*, toxic dump, bad location, rotten tenants, down market, terrible neighborhood, or something similar probably encumbers the property. Keep in mind that property may be polluted, subjecting your client to indescribable liability.
2. Most property swaps are done in a bargain basement atmosphere without a contemporaneous escrow *and* title report, title insurance, or other formalities. A clever debtor will exploit these infirmaries, scoop out the equity by a last-minute refinance from an asset-based lender (who cares about interest rates when the property is going to be dumped), and flee into the arms of bankruptcy court.
3. Commercial collection attorneys generally lack the time and energy to birddog a real estate transaction, which could consume twenty hours of billable time. This leaves the typical commercial collection attorney vulnerable to the debtor's machinations.
4. Forget bankruptcy discharge actions. Most bankruptcy judges are disinclined to reward a creditor for imprudence in dealing with an obvious scallywag, when a title report or escrow and title insurance could avoid this disaster. How can you claim fraud when dealing with a judgment debtor? Worse, if the debtor scooped out the equity on the eve of your deal closing (and assuming that you don't discover the fraud till afterwards), your claim for fraud probably fails for lack of an affirmative representation, and you will struggle mightily against the bankruptcy court's preconception that you swapped a debt collection action for land contract sale, which went sour.
5. Before you celebrate the proverbial good deal by trading debt for valuable real property, spend $300 for a preliminary title report and another $300 for an appraisal. Take a personal drive-by with a Polaroid and the debtor as your sidekick to inspect the property personally and have Mr. Debtor sign the back of the Polaroids as clear proof of your newfound prize. Treat the transaction as a land deal, not debt collection. Remember your client just bought the property, and as guardian of your client's well-being, you become the virtual guarantor of the business bona fides of the deal.
6. Don't release your judgment, attachment, or other liens, until you have in hand the final insured title report, appraisal, and title insurance, all of which evidence your position.
7. Let's think through this project one more time. The debtor conveyed real property in exchange for debt. All real property bears liability for taxes, insurance, toxic, and liability issues. If the property is subject to prior consensual liens, rest assured the debtor will default. The creditor, your client, must service the senior debt, or face foreclosure of the equity. Is the creditor willing to service taxes and insurance and pay for senior debt service, with the object of collecting a bad due receivable? If the creditor complained that your fees appeared excessive, the carrying costs of this newfound acquisition may dwarf the economic value of the bad debt.
8. As soon the deal is inked conveying the property in your favor, but before final conveyance, record a *lis pendens* spelling out your prospective interest. This filing will preclude your honest-Abe debtor (or his willing financiers) from exploiting the property and leaving you with a godawful shell.

The moral of this tale: In these swaps, the cheetahs feast on their young because the gazelles exited stage right. They know lousy odds. The lions left early. Remember Darwin does not guaranty any survivors. (No lifeboats, no movie, and no song.)

Dear Editor:

I deal mainly in deficiencies that are notoriously arduous to collect. These are loan and lease deficiencies, usually from equipment, auto, and real property deals gone sour. The debtor lacks liquid assets to satisfy the deficiency, and I settle almost every case through a payment program. This problem applies to my credit card cases because most consumers, again, lack adequate resources to pay these debts in full at once. Either I accept payment, or I will never collect, or, at best, I have to wait for the debtor to sell the house.

All my recoveries originate from payment plans. In fact, on the first of each month, I receive almost 100 checks ranging anywhere $10 to $2,000 per item. Besides recording the judgment, what can I can do to avoid a total bust at the end?

Signed, Waiting in Waco

Dear Waiting:

Most lenders, particularly equipment financiers, base their entire program on low payments, easily affordable by the commercial customers. Of course, upon default, the balloon is gigantic, inflated by a built-in residual, penalties, interest, and only marginally reduced by the Rule of 78s. Virtually no debtor could afford the balance due, and payment programs are the only avenues to whittle down this debt.

Keeping in mind federal and state restrictions, you have the following tools, subject to the corresponding risks:

1. **Spousal guaranties.** A spousal guaranty encourages the paying spouse to pay to avoid suit on the guaranty. Spousal liability might create a stream of payments in the event of single bankruptcy, divorce, death, or even separation. Spousal liability will avoid the temptation of the debtor-spouse transferring assets to the nondebtor-spouse and defending an expensive fraudulent conveyance action. There are risks: Carefully evaluate applicable law that may prohibit spousal liability. Second, most consumer bankruptcies involve both parties anyway, leaving in doubt the value of the spousal guaranty.

   From a drafting point of view, don't overdo these guaranties. "I guaranty payment and collection of my spouse's liabilities." This is the sorriest form of guaranty, but any signature near the word "guaranty" is better than no signature.
2. **Deeds of trust**, or other forms of consensual collateral. The advantage is that default will lead to a nonjudicial sale of the property. The downside of some security is that the creditor forfeits rights of common law levy and execution in exchange for the real property security. Don't forget title reports, title insurance for real property, the photos, and an appraisal.
3. **Attachment liens and levies.** Certain states, such as California, freely permit prejudgment attachment. As part of the package, the debtor can stipulate to an attachment lien on the house. Your attachment grants you priority against competing trade claims, but not against federal, and potentially state, tax liens, which take priority over the attachment lien. This quirk of priority tempts the debtor to exploit tax trust monies because the taxing authorities will most assuredly collect from the real property equity, ahead of attaching trade claims. In practice, this priority lets the debtor consume tax trust

A SIMPLE SIDE TOUR:

A debtor can prevail in debt collection litigation four ways (Remember, these combinations are not mutually exclusive):

- Winning the case.
- Negotiating a long-term payment program predicated upon minimal payments and the balloon payment at the end.
- Conveying away all valuable assets, paying off nondischargeable debts, cementing avoidable insider transactions, and laundering nonexempt assets into exempt assets.
- Stalling the litigation long enough to dispose of every asset, waiting ninety days (or one year) and filing a no-asset bankruptcy.

funds in exchange for repayment to the taxing authorities from real equities in which your attachment lien is junior, despite superior timing.

4. **Guaranties against preferences.** Wish to avoid a preference? If you are dealing with a corporation as the payer of the payment program, and lack the bargaining clout to extort a personal guaranty, the fall-back position of extracting a personal guaranty against any potential preference liability, if the debtor files any chapter. The advantage is the insider, your guarantor, will time the bankruptcy to avoid any potential preference liability. However, this personal guaranty is not the greater panacea: If the bankruptcy is delayed, and the preference is lost, the insider will face a great personal liability in light of the fact that the preference money, if collected, would pay priority creditors, such as tax authorities who can assert individual liability.
5. Beware of **mutual releases**, unless you are paid in full. Most smart lawyers demand and receive mutual releases resolving all obligations. This mutual release wipes out subterranean claims for: (1) violation of the local lending and anti-deficiency laws, if waivable; (2) claims for violation of the Fair Debt Collection Practices Act, both state and federal; (3) the Unfair Business Practices Act; and (4) any other vague claims that would impede your happiness. However, these releases may discharge other parties, such as guarantors, who might make the loss good if the debtor files bankruptcy, secondary claims for fraudulent conveyances, conspiracy, and tort claims, and potential claims against spouses. Avoid releasing the guarantor who might make your debt good if the debtor files bankruptcy, and you cough back the recovery as preferential. Beware of releasing "assignee and conveyees" absent full payment, because your true battleground lies in recovery of the fraudulent conveyance.
6. Don't forget a **consensual security interest** in the debtor's assets. These devices enhance your leverage because you can repossess without the necessity of judicial intervention. Insure that you perfect your security in the leasehold by recording the financing statement with the county recorder's office with a decent legal description and remember to perfect your security interest in the debtor's bank account by placing the financial institution on notice. Confirm notice with overnight service (such as Fed Ex or UPS overnight). The best value of a perfected security interest is a bankruptcy setting in which you may claim, in response to a preference claim, that your payment stream did not diminish the debtor's assets, given your concurrent interest in the estate. As a perfected secured creditor, you might gain priority of payment from the ultimate asset disposition (bulk sale or bankruptcy).

The moral of this tale: Don't think the gazelle will lie down dead for the cheetah. Worse, you are not the only cheetah on the savannah. Are you kidding? The cheetahs need lots of tricks to snare the gazelle, beat out other cheetahs, and avoid the lion. This is dining for one.

Dear Editor:

What is wrong with two for one? Typically, the debtor owes, say, $10,000, and this claim is disputed based on the debtor's allegations that the goods were defective and returned for credit. The debtor lacks any documentation supporting any claim of defect, product returns, or return material authorization. Nonetheless, the debtor intends to claim product returns — and worse, given that the invoices contained a security interest, complete discharge because, allegedly, the creditor did not dispose of the phantom goods in a commercially reasonable manner. Facing this dilemma, I offered the debtor to stipulate to judgment for $10,000 but with the option to pay $5,000 at $500 per month, until paid. If default, I enter judgment for the $10,000, less payments, and the costs, interest and boo-koo attorney fees. Sounded okay, I thought. The debtor accepted this "twofer." (You, two for one, twofer one, get it.)

As expected, the debtor defaulted, and I mean "as expected." The debtor was incompetent in purchasing products on credit, defaulted, failed to resolve the debt (the creditor would have been happy to accept $500 per month), failed to respond to my telephone calls to resolve the matter, and finally got sued. Of course, the debtor would default on this sweetheart deal. I entered judgment for a higher amount ($15,000) and commenced execution. Sound good? Sound familiar? I thought so.

In this line of work, every good story culminates in its own private disaster. The debtor retained counsel and filed a new (yeah, new) action to vacate the judgment. On what grounds, you ask. The debtor claimed that my judgment was a penalty because the arrangement provided for judgment of $15,000 in the event of nonpayment of $5,000, and the difference of $10,000 was a penalty, fine, or forfeiture. Worse, the complaint sought to vacate the judgment, along with costs, attorney fees, and injunction under the Unfair Business Practices Act and disgorgement of collections over $5,000.

Where did I go wrong?

Signed, Wronged from Wichita

Dear Wronged:

You might be a stuckee. That is right. Doubling the debt by way of judgment, entry of judgment as penalty, fine, or forfeiture violates the equitable rule abhorring forfeitures. Given the twofer strangulating the debtor, a court, sitting in equity, will readily oblige the debtor in vacating the judgment and reducing the principal to $5,000, and, potentially, imposing costs, interest, and attorney fees. As a possible solution, next time enter judgment for the total amount at the outset, and give the debtor the right to discharge the judgment for $5,000 at $500 per week, if paid timely, and absent sale of any assets outside the ordinary course of business.

The moral of the tale: Beware of settlements that penalize the debtor for a default. The judge is the cheetah and you are the gazelle. The savannah is chaotic, but the Darwinian rules remain universal.

Dear Editor:

This is a simple case with a bad ending. Reminds you of the due-on-sale dispute of the 1970s. I sued, served, and resolved the case for a stipulated judgment for $10,000 at the rate of $1,000 per month. The debtor defaulted, as expected, by nonpayment of the installment. About that time, the client informed me that the debtor was selling both his business and home. I entered judgment and record abstracts. The title company forwarded demand for full payment. Sounds good? Upon my demand, I received correspondence from the debtor's counsel demanding that I withdraw the record abstract upon payment of $1,000 (and any other missed installment). I declined, which caused the buyer to flee, pancaking the escrow. The debtor, buyer, along with the brokers (buyer and sellers) sued the creditor and yours truly. Why? I feel paranoid.

Signed, Paranoid from Pittsburgh

Dear Paranoid:

Well, every paranoid has enemies, as Henry Kissinger said. First, the payment program needs an acceleration clause, a frequent omission. No kidding. Absent an acceleration clause, a creditor can collect only the omitted installment. Entering judgment for the higher amount might precipitate either a motion to vacate the judgment or an independent action in equity. Compounding this travesty, the agreement did not provide for acceleration upon sale of real (or personal) property outside ordinary course of business. Assuming the cure of arrearage, the real property sale might not even generate full payment. To solve this problem, include the following:

"In the event of default by nonpayment of any installment when due, or sale of any real property or personal property outside the ordinary course of business, the creditor, without notice, may accelerate all remaining unpaid installments, declare the total due, without notice, and enforce all rights and remedies to collect the balance."

Furthermore, avoid providing notice of default to the debtor. Typically, most loan documents provide for seven days' grace and notice of default, in the event of nonpayment or other circumstances. I guess this works in the rarefied atmosphere of civilized adults paying obligation presumptively in a timely fashion. Yeah, yeah, right, right. This publication is not *Banking Today*. This is the *Commercial Law Bulletin*. Avoid, at all costs, notice of default, because the debtor will never pay unless you remind him. If pressed, at least limit notice of default to two notices, faxed to a designated fax number, which is complete upon faxing. Include in your payment program a waiver of right to vacate a default; add an independent attorney fee clause to the payment program to provide for fees upon entry of judgment and postjudgment execution, and add interest on the total at 10 percent until paid.

The moral of this tale: Chaos infuses the Darwinian savannah of settlement. You cannot predict tomorrow. Either adapt or eat tofu.

SIX PITFALLS IN DRAFTING SETTLEMENT AGREEMENTS AND SUGGESTIONS TO ADDRESS THEM:

- **What happens if a settling party does not fully perform its obligations under the settlement agreement?** Consider including "status quo ante" language giving the nondefaulting party the right, in effect, to elect whether to rescind the settlement or sue to enforce it. Or provide that the court condition dismissal upon performance of, and retain jurisdiction to enforce, the settlement agreement. If you want to attempt to leave the door open for a summary enforcement or revival of your claims if your settlement partner reneges, the settlement agreement should say so and, best case, also be formally approved by the court.
- **How can the court retain jurisdiction to enforce the settlement?** In federal court, you'll be back to square one unless your settlement is coupled with a court order that either expressly retains jurisdiction to enforce the agreement or specifically incorporates the terms of the agreement itself.
- **How can I get mediator to retain jurisdiction, post-settlement, to enforce the settlement?** Include appropriate language in the settlement to authorize the mediator to act as a post-settlement arbitrator. For example: "Any dispute relating to or arising out of any aspect of the interpretation or performance of this Agreement shall be resolved by final and binding arbitration, in [name of state], before [mediator], who shall have the power to authorize such discovery, and the means to obtain it, as [he or she] may deem appropriate. If [the mediator]

Dear Editor:

My client, a local collection agency, forwarded a commercial claim and instructed me to file suit but enter into a payment program of $1,000 until paid. Upon filing suit, I contacted the debtor, a limited liability company that willingly signed the stipulated judgment and made two payments. Right out of the collection playbook, the debtor defaulted, prompting execution on the judgment, and led to an oversized, and ugly, no-asset, Chapter 7 bankruptcy.

I was ready to close the case when the creditor, not agency, called me directly and inquired about the guarantor. I said, "What guaranty?" The guaranty whizzed through the fax, and I promptly filed suit and effected service. The guarantor, the principal of the limited liability company, retained counsel who filed an answer and promptly moved for summary judgment — successfully, I might add — on the grounds of exoneration and discharge. Why are all those cheetahs looking at me?

Signed, Deaf from Dallas

Dear Deaf:

Change the battery in your hearing aid. You changed yourself into a gazelle (and new guarantor) from a cheetah. Your deal exonerated the guarantor by altering the debt. Simply stated, you bought the case.

You did not have the complete file, or the agency gave you poor or inadequate information. In the future, in confirming the payment program, inform the agency, or client, that "absent his written consent, the guarantor is not released nor relinquished from liability on any guaranty. Please advise of any guaranties before consummating this payment program."

The moral of this tale: You have heard the expression "hostile environment." Darwin does not pick favorites in surviving incomplete files; and, absent care, you might consider relocating out of the Darwinian savannah of settlements. Quickly.

David J. Cook is an attorney with the San Francisco, California, law firm of Cook, Perkiss & Lew. He has written for the Commercial Law Bulletin each of the past three years.

is unavailable, the arbitration shall be conducted before another [for instance, JAMS arbitrator] agreed to by the parties, or if they cannot agree, before [another arbitrator selected by the mediator; or, if the mediator is unable to make such a selection, by an arbitrator selected by JAMS]. The cost of the arbitration shall initially be split equally with the prevailing party, as determined by the arbitrator, then to recover its costs and attorney fees incurred in the arbitration."

- **How can I make sure that I have an enforceable settlement agreement before all the formal paperwork is completed?** Have the clients — not just the lawyers — sign the preliminary terms sheet document.
- **What is being released?** If there is even a hint of other disputes on the periphery, careful attention should be given to broadening the scope of the release. Perhaps the best approach is to make the scope more restrictive. The key is to preserve your best options regarding other possible lurking disputes.
- **How can the "finality" of a settlement agreement be maximized?** You may wish to include "no reliance on representations not set forth herein" language. Other key candidates for your finality checklist might include approvals by counsel about form, notarization of the principals' signatures, merger or integration clauses, initials by particularly significant provisions, bold type, "entire agreement" and "no mistake" language, and, if appropriate and subject to the foregoing caveats, court approval.

Robert Stumpf is a partner in the San Francisco office of the law firm of Bronson, Bronson & McKinnon LLP.