

Publicaties

Mediation of a bankruptcy case,

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Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses, and waste of time.

—Abraham Lincoln

One may win the lawsuit, but lose one's money.

—Chinese Proverb

Abe Lincoln and the wise Chinese philosopher are correct. Parties should be encouraged to resolve their disputes through compromise. This is particularly true in an insolvency context, where time and cost are so critical. Statistics show that well over 95 percent of all litigation settles. However, as experienced litigators know, settlement is too often reached at the "courthouse steps" after the parties have spent large amounts of money, emotion and time conducting discovery and preparing for trial. If the dispute is part of a bankruptcy or reorganization, the failure to settle early may eliminate the opportunity to settle the lawsuit at all, due to the resources spent and opportunities lost in the battles along the way. Over the last decade or so, alternative dispute resolution (ADR), especially mediation, has become an acceptable method of resolving disputes in bankruptcy cases, and civil litigation in general.³ For good reason, the trend is increasing. While a settlement of a case pending in bankruptcy court will, in almost all instances, require court approval after notice and hearing,⁴ this contingency is not necessarily an obstacle. It is rare that a bankruptcy court would refuse to approve a settlement agreed to by the parties.⁵ The purpose of this article is to review the mediation process, look at ways that mediation has been used in bankruptcy cases, and explain why mediation has become the preferred ADR process in resolving many contested matters and adversary proceedings in bankruptcy cases.

Anatomy of a Successful Mediation

In mediation, the parties try to resolve their dispute by entering into an agreement with the help of a neutral third-party facilitator, the mediator. However, unlike an arbitrator or a judge, the mediator does not render a decision in the dispute.⁶ On the other hand, arbitration, mini-trials, summary jury trials and judicial settlement conferences involve a determination of a prevailing party, or an evaluation of who will most likely win or lose. If the decision is binding, the case is concluded. If the decision is non-binding, or an evaluation is given, the result is expected to encourage the "losing" or "weaker" party to settle. Conversely, the goal in mediation is to negotiate and reach a settlement through the process itself. Although the process involves reality testing and risk assessment, the main emphasis is to encourage negotiation, exploration of creative solutions, and compromise.

The mediator's role is to assist the parties in (1) separating the personalities from the issues; (2) removing obstacles to communication; (3) suggesting and exploring various (and often creative) settlement options and alternatives; and (4) assisting the negotiators in concluding a final settlement agreement.⁷ Since the mediator does not make a decision and has no power to impose a settlement of any kind, the final settlement agreement is one that must be acceptable to all parties. The word "acceptable" is emphasized because in mediation an important reality is that generally neither party is particularly happy with the settlement. Rather, in most instances, the parties find the settlement "acceptable" due largely to the fact that (a) they had an active role in the determination of the final outcome and (b) the final outcome is known, certain and quantifiable.

In bringing the parties together, the mediator should establish a safe environment for negotiation, assuring the disputants and their counsel that if the case does not settle, the positions taken by them during the mediation session will not be used against them in trial. By being an active listener and using other negotiation skills, a skilled mediator acts as a guide, leading the parties to common ground and, ultimately, to an acceptable agreement. If an agreement is not reached, however, the parties are free to pursue litigation.

A successful mediation requires that the appropriate client representative be present.⁸ By hearing the factual and legal arguments directly, and watching opposing counsel and the other side, the client representative has the opportunity to get a first-hand sense of the likelihood of success or failure, and the costs and risks attendant to continued litigation. The client also needs to have the chance to express its own side of the issues, and to discuss the finer aspects of the case with both counsel and the mediator. Thus, for a successful mediation, all individual parties should be present for the entire process.⁹ Corporate clients should be represented by an executive officer (as opposed to only in-house counsel) who has authority and discretion to settle.

During mediation, the attorneys should be more diplomats than advocates. The attorney's job is to persuade the other side that (1) his client's position is well taken, (2) it will be adopted by the court and that his client will win, and (3) the other side should settle the case to avoid this result. During the caucuses, which are discussed below, the attorneys should analyze the legal issues for their respective clients, provide advice based on the realistic alternatives and, generally, help the clients define what is in their best interest. This last task should involve weighing the risks and costs involved in the continued litigation, in light of the proposed settlement offers and opportunity to settle.

Although the mediation session may take many different forms, generally there are three distinct stages.

A. First Stage—General Session. The first stage of mediation involves a general session attended by all parties and counsel. The mediator will commence the general session by making introductory remarks explaining the process, caucuses, confidentiality and agenda. The mediator's introductory remarks should set a cooperative and calm tone. The mediator will confirm that the parties have settlement authority and emphasize that the day will be devoted to focusing on what is in the best interest of each party and attempting to resolve the existing dispute on terms that are acceptable to all parties. Then, each attorney summarizes the issues and his or her client's position on each issue. Clients are invited, but are not required, to participate in the general session. The mediator may ask questions of the assembled group during or after the parties' summations. After determining previous settlement negotiations, the mediator will adjourn the general session and send the parties and their counsel into separate rooms.

B. Second Stage—Caucuses. The second stage of mediation involves private caucuses between the mediator and each side of the dispute. The mediator will not disclose any communications during the caucuses without express approval of the communicating party. Because of the forthrightness shown in these discussions, the caucuses carry a higher degree of confidentiality than the general session. Although communications in the general session are privileged, any information that is disclosed in the general session will be known by the adverse party and may be established by proof other than the privileged communication. The facts disclosed during the caucuses are confidential and not communicated to the other side.¹⁰ The caucuses thus allow the parties to frankly express their personal frustrations with the mediator, and to give the attorneys an opportunity to openly discuss all aspects of their client's case. Consequently, these discussions will often focus on issues the attorneys may not want to disclose to opposing counsel, but still want their clients to consider. During the caucuses, the mediator talks directly with the client and discusses the strengths and weaknesses of the case with counsel. The mediator may assume a devil's advocate role and question the positions taken by the party and counsel. In some respects, the session can be viewed as negotiating with the mediator. The caucus is intended to permit the party, his or her counsel and the mediator to review the risks involved in the dispute and the interest to be protected. The mediator meets with each party and their counsel privately and repeats the same process. By participating with the different sides, the mediator is able to determine the extent of flexibility and the common ground that exists between the parties. Moreover, through shuttle diplomacy, the mediator is in a position to give feedback and bring the parties closer together and, ideally, to agreement.

C. Third Stage—Closure. The third and final stage of mediation is the closure of the agreement. When a general agreement is reached, the mediator will assist the parties in drafting the essential terms of the settlement agreement and will continue to smooth out controversies as they arise. The settlement should be reduced to writing before the parties leave the mediation. Since a complete agreement is usually not practical, an executed memorandum of settlement that contains the essential terms should be written and signed. As mentioned above, the settlement of a controversy in a pending bankruptcy case will require a motion, notice to the interested parties, an opportunity to be heard and court approval.

The cost of mediation generally is relatively low when compared to the other costs of litigation.¹¹ Many disputes can be mediated in a single day. Some mediators charge a fee based on an hourly rate, and others charge a flat daily rate that varies depending on the number of parties and the amount in controversy. Even in a complex case involving multiple parties and multiple days of mediation, the cost of the mediation is inconsequential when compared with the litigation expenses that will be incurred if the dispute goes to trial.

Mediation in Bankruptcy Court

The passage of the Alternative Dispute Resolution Act in 1998¹² resolved any questions concerning the bankruptcy courts' authority to order parties to mediation. The Act requires all federal district courts to authorize, by local rule, an ADR procedure in all civil cases, including adversary proceedings in bankruptcy. This reference to district courts includes the bankruptcy court.¹³ Prior to the passage of the Act, bankruptcy courts used the general inherent powers granted to the courts under §105 of the Bankruptcy Code and the provisions relating to the appointment of examiners under §§1104 and 1106 of the Code to appoint individuals to mediate negotiations in reorganization plan cases, and in other cases to resolve litigation.¹⁴

The bankruptcy practitioner's first course of action to resolve most contested matters and adversary proceedings has always been direct negotiation. If this fails, mediation should be considered as the next step. Choosing the mediator now becomes important, as an effective mediator can reduce the emotional atmosphere and minimize the brinkmanship that is often prevalent in the negotiation of bankruptcy issues. The mediator will focus the parties' efforts on the real and practical problems that must be addressed, and the costs and risks associated with having to fight through long and complicated trials and appeals.

Mediation has been used in bankruptcy cases for a wide range of disputes, including complex multi-party chapter 11 reorganization plan negotiations, preference and avoidance actions, objections to discharge other adversary proceedings, claim objections and other contested matters.¹⁵ One of the first cases involving ADR procedures to resolve disputed claims in advance of confirmation of a plan was *NLRB vs. Greyhound Lines*.¹⁶ In this case, a voluntary ADR procedure was proposed where claimants had the option of mediating or liquidating their claims pursuant to the provisions of the Bankruptcy Code. A claimant selecting the ADR procedure was required to provide a standardized form confirming its loss. The debtor was then required, within 30 days, to request additional information, deny liability, allow the claim in full, make an offer to settle the claim or request mediation. If the debtor denied liability, the claim went to mediation. If the dispute was not resolved at mediation within 60 days, the claimant had the option of proceeding to binding arbitration or filing a motion seeking release from the automatic stay to liquidate a disputed claim in a non-bankruptcy forum. Greyhound resolved 95 percent of the more than 3,200 pre-petition tort claims through the ADR procedure.

In *In re Columbia Gas Transmission Corp.*,¹⁷ the court used an ADR procedure to resolve contract claims involving rejected gas purchase contracts. Prior to the bankruptcy, it was estimated that the rejection of the contract would result in damages of \$1.6 billion. However, after the bankruptcy was filed and the bankruptcy claims for rejection of gas contracts were totaled, the amount exceeded \$15 billion. Since fixing the amount of the claims threatened the viability of the reorganization, the debtor moved to establish a comprehensive, estimation procedure for determining the rejection damage claims. Although what was called a "claims mediator" was appointed, the "mediator" in fact functioned more as a master, since he was charged with the responsibility of preparing recommendations for the court on the legal and factual issues common to the claims. The claimants then applied these recommendations in order to recalculate their claims. If the debtor reached a settlement with the claimants, the mediator reviewed the settlement to assess fairness and made a report to the court. If the debtor objected to the recalculated claim, the parties and the mediator would determine what further proceedings were necessary. Notably, this particular ADR procedure was not a standard "mediation," as the mediator became actively involved and made evaluations and recommendations to the court. Nevertheless, the procedure is an example of ADR procedures being considered and adopted by bankruptcy courts as a means to resolve contested matters.

In 1992, the U.S. Bankruptcy Court for the Northern District of Texas in Dallas ordered a mediator to assist the creditors in their efforts to negotiate a consensual consolidated reorganization plan in *In re Zale Corp., et. al.*, debtors.¹⁸ A similar order was issued in the reorganization case involving *Colt Manufacturing Co. Inc.*¹⁹ In the Northern District of New York, Judge Lefland approved mediation in the 1994 *In re H.R. Macy* bankruptcy for the purpose of formulating a consensual reorganization plan.²⁰

In the bankruptcy cases of *In re Quality Beverage* (a liquidation of a wholesale liquor distributor) and *In re Sunrise Energy Co.* (a liquidating chapter 11 case involving a company involved in the oil and gas trading business), the respective courts appointed a mediator to assist in the settlement of preference actions, turnover actions and other adversary proceedings being pursued by the trustees in those cases. Out of approximately 75 cases in the *Quality Beverage* case and approximately 55 cases in the *Sunrise Energy Co.* case, all but two of the contested cases settled at mediation, and those two ultimately settled. (To illustrate the procedure used by the trustee in *Sunrise*, a copy of the motion to have a mediator appointed in the *Sunrise* case is shown below.)

Bankruptcy judges in the Southern District of Texas have also appointed mediators in a number of cases to attempt to resolve contested matters and adversary proceedings, and to assist in resolving contested reorganization plans.²¹ The adversary proceedings and contested matters have included claims of breach of contract, negligence, usury, priority of liens, real estate title contests, equitable subordinations, plan objections, payment of administrative expenses, preferences, turnover actions, fraudulent conveyances and objections to discharge. Experience has shown that the vast majority of these disputes have been settled at mediation. Even in cases where settlement was not achieved at the mediation, a dialogue and framework was reached for ultimate settlement of the outstanding issues.

In 1996, one of the largest chapter 11 cases (\$110 million in assets) was filed in the Southern District of New York.²² The debtor in the case was Best Products, a national retailer with 169 stores in 23 states, 9,600 employees and more than 7,000 creditors. This was the second chapter 11 case of Best Products, and the petition was filed before all payments were made under the previously confirmed reorganization plan. Shortly after the second bankruptcy filing, it was determined that the debtor should be liquidated. After the sale of assets and the determination of claims, all unsecured creditors received distributions of almost \$0.96 on the dollar. While many factors contributed to the unusually large distribution, one of the major factors contributing to the success of the liquidation was the court's approval of the debtor's proposal, which empowered the debtor to require the holder of a disputed claim to participate in mediation. More than 85 percent of the mediated cases reached settlement.²³ A survey involving approximately 2,000 mediations was taken in November 1997 to determine the extent and severity of any problems regarding mediation conducted after judicial referral.²⁴ Notably, the respondents reported that problems occurred in 2.5 percent or less of the matters mediated for the various problems asked about in the survey.²⁵ Although problems were rare, the highest number of problems involved breach of confidentiality, perceived comments between mediators and judges, and mediators who were not "disinterested" (as defined by the bankruptcy court).²⁶

Another interesting result of the survey was that among the matters referred to mediation: bankruptcy judges referred less than 24 percent sua sponte; less than 7 percent of the matters were referred over the objection of one or more parties; the bankruptcy estate paid the mediator's fee in less than 21 percent of the mediations; and the mediator played a role in formulating a reorganization plan in approximately 9 percent of the mediator-identified matters.²⁷

Mediation as the Preferred ADR Process in Bankruptcy Cases

In bankruptcy cases, the creditors generally are angry and, in most cases, distrusting of the debtor and its management. Likewise, the debtor usually has no love for its creditors and is

skeptical that the creditors are interested in reorganizing the debtor. Further, the parties and their counsel are or should be aware that the costs and delay associated with litigation on most cases reduce the chances of a successful reorganization and reduce the amount of distributions ultimately made to the creditors.

In a case involving conflicting claims and litigation, and/or objections to the reorganization plan, a mediator is helpful in pulling the parties together to air their differences and assist counsel and their clients in coming to a compromise on the various issues. Mediation affords the parties an opportunity and a forum to meet on an informal basis, without prejudice to their positions, and explore options to resolving the numerous issues and disputes necessary to conclude the case. An enormous amount of time, energy and expense can be saved by structuring a series of mediation sessions with all interested parties and counsel (and then only with counsel, and then with counsel and parties together again) reviewing the interests of the parties, giving each of the parties an opportunity to evaluate the costs and alternatives to settlement, and exploring options to remove the impediments to settlement. Even if the entire case is not resolved, experience has proven that many of the contested issues are resolved, and the remaining issues are narrowed for trial, or potentially settled in the future.

Mediation thus provides the parties with the opportunity to confront each other and explain and justify their respective positions, and to focus on what the real return may be after an assessment of professional fees, expenses and other costs associated with the typical delays involved in litigating the case. Additionally, mediation gives the parties the control of determining the outcome of the dispute and avoids the uncertainty inherent in all litigation. Even if there is no settlement, the expenses of preparing for and participating in mediation are well spent. Experience has shown, for example, that the process of preparing for mediation and marshalling the evidence and arguments in support of your position is a valuable exercise in formulating your presentation for trial. Furthermore, any information that you gain from your adversary's arguments and positions is also helpful in the presentation of your case. Of course, if the case is settled, the costs associated with continuing litigation are avoided. Finally, the most important reason for the popularity of mediation is that it works, and with only a small percentage of problems.

Conclusion

Over the last 10 years, bankruptcy filings have soared by more than 43 percent (in excess of 96 percent of the total filings involve individual petitions).²⁸ It is expected that the enactment of the pending revisions to the Bankruptcy Code will increase litigation.²⁹ This growth, both in filings and in subsequent litigation, has led bankruptcy courts to search for ADR procedures and other means of better managing the caseload.³⁰

Corporations in the United States pay billions of dollars a year in attorneys' fees for litigation. These fees are in addition to the direct cost of key personnel being diverted from their management and business duties.³¹ Considering what is at stake in these lawsuits, the benefits of reaching settlement through mediation, and not engaging in combat in bankruptcy and reorganization cases, are as great, if not greater, than in a general civil litigation setting.

Footnotes

1 Michael Wilk is a managing shareholder of Hirsch & Westheimer P.C. This article expresses the personal views of the authors and does not necessarily represent the views of Hirsch & Westheimer P.C. Return to article

2 Rik Zafar is an associate at Hirsch & Westheimer P.C. Return to article

3 See, generally, Wirth, Steven R. & Mitchell, Joseph P., "A Uniform Structural Basis for Nationwide Authorization of Bankruptcy Court Annexed Mediation," 6 Am. Bankr. Inst. L. Rev. 213, 214 (1998). Return to article

4 Fed. R. Bankr. P. 9019(a) ("On motion by the trustee and after a hearing and notice to creditors, the court may approve a compromise or a settlement. Notice shall be given to creditors, the U.S. Trustee, the debtor and indenture trustee as provided in Rule 2002 and to any other entities as the court may direct."). See *In re United States Brass Corp.*, 45 B.R. 189, 192 (Bankr. E.D. Tex. 2000). See, also, *supra* Note 3 at 216 (1998) ("Settlements are typically evaluated under a 'fair and equitable' standard, with the overriding concern of the bankruptcy court to protect the best interests of the estate."). Return to article

5 See, generally, *In re Bell & Beckwith*, 77 B.R. 606 (Bankr. N.D. Ohio 1987) (to be approved, a settlement must be reasonable). Compare Burr, Anne M., "Building Reform From the Bottom Up: Formulating Local Rules for Bankruptcy Court—Annexed Mediation," 12 Ohio St. J. on Dispute Resolution 311, 335 (1997) ("[A]lthough the parties involved may reach agreement, they must realize that the settlement may not be approved based on objections by creditors.") (citing Izard, Robert A. Jr., et al., "Alternative Dispute Resolution in Bankruptcy," 3 J. Bankr. L. Prac. 291, 297 (1991)) with Lomax, Lisa A., "Alternative Dispute Resolution in Bankruptcy: Rule 9019 and Bankruptcy Mediation Programs," 68 Am. Bankr. L. J. 55, 59-50 (1994) (citing Bell and Beckwith for the following propositions: (1) a party seeking approval must present enough facts to provide an adequate basis for the court to make an independent evaluation; (2) one need only show that the settlement falls within a range of reasonable outcomes, not that it is the best possible outcome; and (3) a settlement made on this basis should withstand a creditor's objection.). Return to article

6 See, generally, 6 Norton Bankr. L. & Prac. 2d §146:7. Return to article

7 See *Id.* Return to article

8 See Burr, Anne M., "Building Reform from the Bottom Up: Formulating Local Rules for Bankruptcy Court—A Next Mediation," 12 Ohio St. J. on Dispute Resolution 311, 347 (1997). Return to article

9 See *Id.* Return to article

10 See F.R.E. 408. See, generally, Burr, Anne M., "Building Reform from the Bottom Up: Formulating Local Rules for Bankruptcy Court—Annexed Mediation," 12 Ohio St. J. on Dispute Resolution 311, 322 (1997). Return to article

11 See Mabey, Ralph R., Tabb, Charles J. and Dizengoff, Ira S., "Expanding the Reach of Alternative Dispute Resolution in Bankruptcy: The Legal and Practical Bases for the Use of Mediation and the Other Forms of ADR," 46 S.C. L. Rev. 1259, 1261 (1995). Return to article

12 28 USC §651. Return to article

13 28 USC §151. Return to article

14 See *In re Public Services Co. of New Hampshire*, 99 B.R. 177 (Bankr. D. N.H. 1989). See, also, 7 Collier, Bankruptcy §§1104.03, 1006.05 (15th. Ed. Rev.). Return to article

15 See, generally, Wirth Steven R. and Mitchell, Joseph P., "Note: A Uniform Structural Basis for Nationwide Authorization of Bankruptcy Court-Annexed Mediation," 6 Am. Bankr. Inst. L. Rev. 213, 218 (1998). Return to article

16 See *In re Eagle Bus Mfg. Inc.*, 134 B.R. 584 (Bankr. S.D. Tex. 1991); 158 B.R. 421 (S.D. Tex. 1993). See "Building Reform from the Bottom Up: Formulating Local Rules for Bankruptcy Court—A Next Mediation," 12 Ohio St. J. on Dispute Resolution 311 (1997). Return to article

17 (Bankr. D. Del. 1992); See Burr, Anne M., "Building Reform from the Bottom Up: Formulating Local Rules for Bankruptcy Court—Annexed Mediation," 12 Ohio St. J. on Dispute Resolution 311, 340-42 (1997). Return to article

18 Order signed Nov. 4, 1992, Case No. 392-30001-SAF-11. Return to article

19 See Bankruptcy Court Decisions (March 11, 1993). Return to article

20 See Mott, Cassandra G., "Note and Comment: Macy's Miracle on 34th Street: Employing Mediation to Develop the Reorganization Plan in a Mega-chapter 11 Case," 14 Ohio St. J. on Disp. Resol. 193 (1998). Return to article

21 See, generally, 6 Norton Bankr. L. & Prac. 2d §146:16. Return to article

22 See Dabney, H. Slayton Jr. and Hayes, Dion W., "Bankruptcy Lawyers Better Tune Up Their ADR Skills—Best Products is One Case Wherein Mediation Really Worked," Am. Bankr. Inst. J. (June 1999) at 16. Return to article

23 See *Id.* Return to article

24 See Niemic, Robert J., "Mediation in Bankruptcy—Results of FJC Survey," Am. Bankr. Inst. J. (September 1999) at 30. Return to article

25 See *Id.* Return to article

26 See *Id.* Return to article

27 See *Id.* Return to article

28 See Hopkins, Theodore S. and Simmer, Jarred, "Local Bankruptcy Court to Launch Mediation Program," 14 Lawyers J. (July 2000) at 3. Return to article

29 See *Id.* Return to article

30 See *Id.* Return to article

31 See Allison, John R., "Five Ways to Keep Disputes Out of Court," Harv. Bus. Rev.