CHAPTER 6

ADR and Bankruptcy

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EDITOR’S NOTE: A Bankruptcy Court is peculiarly an arena of negotiation. Indeed, many if not most, U.S. Bankruptcy Courts have promulgated discretionary or presumptive mediation programs. In this chapter, bankruptcy experts offer their observations and suggestions for protecting clients’ interests through principled use of collaborative negotiation, employing the value-add of a mediator.

Bankruptcy is a unique area of the law. While most litigation involves A vs. B and results in a binary outcome—either A or B wins (in the absence of a settlement)—bankruptcy typically involves multiple stakeholders who may have different liquidation priorities under applicable state law, and the outcomes may not be binary but instead “how much” rather than “whether.” It is a frequent and mutually shared goal that the assets of the business or individual debtor will not just be liquidated, which might recover relatively little for the stakeholders, but rather will continue in use or operation, possibly with its obligations reset or restructured. Bankruptcy is a clear case of social engineering. Instead of encouraging a race to the courthouse by competitive creditors seeking to exercise their respective rights and remedies under applicable state law, bankruptcy imposes a temporary suspension of creditors’ rights (the “automatic stay”) and initiates an orderly, structured process whereby a debtor is afforded a period of time to reorganize, restructure, sell some or all of its assets, and raise debt or equity capital, or some combination of these. The implicit justification is
that society—property owners, creditors, employees, communities—will realize better economic outcomes than the free-for-all of uncontrolled litigation by creditors, each seeking maximum return to the detriment of other creditors and the debtor. Opinions may differ about whether experience bears out this justification, but for the foreseeable future, bankruptcy law is a fact of life, and the ultimate proof is whether parties avail themselves of its processes.

Perhaps appropriately, bankruptcy has its roots in courts of equity, where the tribunal may tend to apply principles of fairness as much as law, can fashion remedies that are more creative than just money damages, and presides over proceedings that are so fact-rich that successful appeals of judicial decisions are relatively rare.

Although the Bankruptcy Code does not include provisions directing parties to mediation, several jurisdictions have developed programs that strongly encourage the practice. Local rules have been adopted in some jurisdictions, and others have a program of presumptive mediation. Among the jurisdictions that have adopted such procedures, the use of mediation has become quite prevalent in jurisdictions such as Delaware and New York, which have attracted the filing of “mega-cases” and have some of the most well-developed mediation procedural schemes. Some jurisdictions, such as New Jersey, have even adopted local rules that include presumptive mediation as a staple of their processes and procedures.

The Bankruptcy Code is applicable to both individuals and businesses, and mediation is in widespread use with respect to both. The comments in this chapter refer mostly to business bankruptcy; however, where there are sufficient assets involved, mediation is used widely for consumer bankruptcy as well. And as described below, mediation regarding mortgage foreclosure is an especially favored dispute resolution method.

Given the characteristics of bankruptcy, it is no surprise that mediation has become widely used in its practice and procedure. Rather than a monochrome dispute between A and B, bankruptcy may involve layers of senior and junior creditors as well as internecine disputes among them, all seeking to draw water from the same (limited) well. Furthermore, since one of the principles of bankruptcy is to treat creditors of the same class in the same way and prevent creditors from

1. References herein to the Bankruptcy Code refer to 11 U.S.C. §§ 101 et seq.
gaining an edge during the 90-day period\(^2\) prior to the bankruptcy filing, bankruptcy law contemplates a claw-back of preferential payments from creditors that received them, which creates a multiplicity of minor controversies within the bankruptcy proceeding, all of which potentially have to be adjudicated, providing a fertile ground for consensual, rather than adjudicative, disposition of disputes.

Finally, time is usually not anyone’s friend in a bankruptcy case, and therefore any proliferation of controversies or protraction of the process must be avoided. (In fact, lenders and other creditors are already displaying some impatience with bankruptcy, notwithstanding its history of increased efficiency, and evidencing a preference for state law alternatives to bankruptcy such as consensual workout, assignment for benefit of creditors, and receivership.)

**Best Practices in Bankruptcy Mediation**

Bankruptcy mediation has become both an important practice area and a mainstay of procedure in many jurisdictions. While some jurisdictions lag behind in the use of mediation, others see it as the best, most effective way to resolve critical issues, ranging from union contracts to complicated plan confirmation issues. Other areas where mediation has grown prevalent are in the Chapter 9 arena (which covers municipal bankruptcy), as well as mass tort litigation such as in recent cases involving the bankruptcy of Catholic archdioceses whose liabilities to victims of sexual abuse exceeded their liquid assets. Bankruptcy cases, which by definition involve financial distress, typically include the reality or threat of further deterioration of assets in the absence of swift resolution, and the initial promise of a successful reorganization can quickly evaporate into a liquidating Chapter 11 or conversion to a Chapter 7 liquidation. For this reason, parties in a bankruptcy case almost universally favor a good-faith effort at mediation rather than relying on more costly, more time-consuming, and less certain litigation.

With the rise of court-annexed or mandatory bankruptcy mediation programs, many jurisdictions have created standards for

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2. One year for insiders. See Bankruptcy Code § 547.
court-approved mediators. These include sanctioned training programs, the requirement that mediators initially accept pro bono mediation cases, and some level of experience in the area. Although lists of approved mediators are maintained by the Bankruptcy Court Clerk in several jurisdictions, parties are not limited to selecting them and can agree to choose any mediator who may be qualified, rarely with interference from the court.

Another aspect of bankruptcy mediation is the widespread use of judge mediators—sitting or retired bankruptcy judges. This has become an important part of bankruptcy mediation, especially in large, complex cases, because of the level of expertise a judge mediator can bring to the process. Although mediators in general caution the parties that the mediator is not a judge and has no authority, a judge mediator can nonetheless be more credible in his or her evaluation of a situation, and such credibility may be necessary and effective in helping the parties reach a settlement.

Relatively early in the course of any bankruptcy case involving substantial assets, the Bankruptcy Court will expect the parties to submit certain issues to mediation, and the Court’s calendar will be adjusted accordingly. Bankruptcy judges are typically not shy about “recommending” mediation if the parties seem recalcitrant, and while the Court cannot compel mediation, parties are usually well advised to follow the Court’s suggestion. In the absence of a settlement, little about the mediation efforts will be reported to the Court beyond the fact that the parties tried in good faith, including possibly confirming that the respective principals of the parties (i.e., authorized decision makers) attended the mediation sessions.

Virtually any issue in a bankruptcy case—from the nature (e.g., secured or unsecured) and amount of a claim, to adequate protection payments to a secured creditor, to “dividing the pie” through plan confirmation—can lend itself to mediation. One of the most prevalent uses of mediation in bankruptcy is the resolution of preference and fraudulent conveyance claims, which often may follow the principal outcome of the case, e.g., plan confirmation, sale of the assets via Bankruptcy Code § 363, etc.

3. For example, in 2011 the American Bankruptcy Institute (ABI) created a 40-hour Bankruptcy Mediation training program, which is a collaboration among ABI, St. John’s University’s Center for Bankruptcy Studies and its Hugh L. Carey Center for Dispute Resolution. See http://www.abi.org/events/forty-hour-bankruptcy-mediation-training (last accessed February 25, 2016).
The Use of Joint Session and Caucus in Bankruptcy Mediation

Two of the principal features of nonbankruptcy business mediation are the joint session and the caucus—the former referring to the mediator’s meeting together with more than one party, and the latter to meeting with just one party. In bankruptcy cases, judicious use of the joint session and the caucus can help make mediation more effective.

In the purest of mediation environments, the joint session is commonly used at the very start of mediation. The parties are brought together (often for the first time) face-to-face and with the mediator. There is typically proper premediation planning and laying of groundwork for the mediation process, and so although a joint session in the initial stage of bankruptcy mediation might be perfunctory, it can nonetheless be critical to the ultimate success of the mediation process.

Beyond the mediator’s setting forth the ground rules and the expected flow of the mediation process, the joint session is often used in nonbankruptcy mediation to allow the parties to summarize their positions. There is also a cathartic venting element whereby parties can use this session to “have their say” and assure that the other party is hearing loud and clear what they have always wanted to say face-to-face but may have not had the opportunity.

In bankruptcy mediation, one party may be more familiar than others with the bankruptcy process (especially in mega-cases, where significant preference claims may be at issue), and so the joint session offers an important and valuable opportunity to engage all parties in the process equally. This can be critical to those parties who are less familiar with the bankruptcy process, and who may feel victimized, as in preference cases, where defendants may feel that “insult is being added to injury,” as they are not only suffering all or part of their claim being uncollectible, but also having to disgorge payments they may have received during the preference period. Parties who are new to how the Bankruptcy Code works may come to the process with frustrations that need to be vented for the mediation to have a chance at success.

The mediator often uses this first joint session to demonstrate that he or she is in control of the mediation process and to explain that it offers an alternative to potentially expensive, and time-consuming litigation, the outcome of which is likely uncertain, especially in a court of equity such as bankruptcy. Beyond laying out the ground rules for
the mediation process and the alternative of bankruptcy litigation, the mediator has an opportunity to hear the positions of the parties in their opening statements and might offer limited feedback to them in summary form. It also allows the parties to hear each other’s value propositions and critical points, as the mediator helps “set the table” for the mediation process.

The joint session gives the mediator and the parties an opportunity to “touch and feel” where everyone stands. An effective bankruptcy mediator will evaluate whether the joint session is advancing or hindering the progress of the mediation. The mediator can use this opportunity to focus the parties on what needs to be addressed going forward, and the parties can probe each other to get a feel of where things stand at that point in time, as well as what compromises might be possible. As the vast majority of bankruptcy mediations are focused on problem solving as opposed to evaluative decision making, issues can valuably get focused and narrowed during this part of the process.

In the most effective joint sessions, the mediator is more of an active listener, a technique that is particularly effective if the mediator sees the parties advancing discussion in a positive way. Still, the mediator’s careful observation is critical here. The joint session can quickly become counterproductive if venting and discussion turn to anger and animosity, defeating the self-determinative and facilitative nature of the process. Active listening will also aid the bankruptcy mediator’s efforts to identify each side’s most important issues and interests.

For example, in bankruptcy the debtor may seek to modify prepetition collective bargaining agreements. Aside from the economic issues, a great deal of emotion may be involved when hard-won wage and work rule issues are now in jeopardy, not to mention the desire of union representatives to appear to their constituencies as effective champions for their cause.

So in a joint session, it is important that each side have its turn to speak and be clearly heard by the opposing side. Just as important, the mediator must show empathy, understanding and validation through active listening. The mediator can build confidence with the parties if they can see how the mediator reacts to each side’s issues and interests with all parties present.

Caucus can be an effective tool for private discussion or to ameliorate heated emotions that may have been manifested during a joint session. The question arises, when is caucus most effective, and therefore, when is the right time to break into private sessions with each party?
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Some bankruptcy mediators go right into a caucus after a brief joint session without any delay. Experience has shown that the best time for use of caucus may be when the joint session has served its purpose of letting each side have its say, when things seem to be breaking down, and/or when issues arise that are clearly sensitive or confidential and should be addressed privately.

The passage of time is usually a real factor in bankruptcy, and so proceeding directly to caucus after an initial joint session may be advantageous. Bankruptcy mediation largely involves only monetary issues, and so the parties themselves may favor proceeding to caucus directly after a joint session. Caucus in bankruptcy mediation should be used both to narrow and to focus the issues, as well as to aid the parties in assessing their own position. These can be tough discussions, but the mediator is there to facilitate, and that may include helping the parties look at aspects of their case that they have not previously addressed or have mistakenly overvalued, either outside of the mediation or during the joint session.

Caucus is a confidential process, and parties should always be reminded of this. What is discussed in a party caucus can be disclosed to another party only with the consent of the caucus party. So why utilize a caucus? Because caucus may allow “cooler heads” to prevail, and there tends to be less posturing or taking of extreme positions when the opponent is not present. Also, parties may not want to disclose certain matters to another party, at least not yet. In any case, the mediator should be mindful of why a caucus is being used and assure that it achieves its purpose. An effective mediator may prompt parties in a caucus to give themselves a “reality check” on their position and how far they can realistically expect the other party to go in compromising. The value of cultivating trust between the mediator and the parties cannot be overestimated.

Among the characteristics that distinguish bankruptcy mediation is the uniqueness of the laws that are at issue. The caucus can be an effective tool to allow the mediator to maintain control over the process, especially where the issues are complex and/or emotions may be running high. Private caucus gives both the parties and the mediator the opportunity to explore what the critical issues are that may be obstacles to settlement and how those issues might be overcome.

Many mediators employ a hybrid style, combining elements of joint session and caucus. Once a caucus has taken place, some mediators do not favor returning to a joint session until there has been movement
by one or both sides in their respective positions or until a settlement may be close at hand. Those that use a hybrid style, however, often bring parties right back into joint session after a caucus as a way to highlight progress, focus upon outstanding issues, or just reaffirm that this is the parties’ process and not that of the mediator. The hybrid approach may keep the process from going stale and maintain momentum, allowing the parties and the mediator a continuity of interaction. This is particularly critical in bankruptcy mediation because the fluidity of the underlying situation of the business involved may change during the mediation process.

The Role of a Financial Advisor in Bankruptcy Mediation

In Chapter 11 bankruptcy, the debtor is often assisted by a Financial Advisor (FA) or Chief Restructuring Officer (CRO), who acts in an advisory or managerial role, respectively. These advisors often take the lead in handling the bankruptcy-specific tasks, such as arranging for debtor-in-possession (DIP) financing, providing periodic reports to the Bankruptcy Court, dealing with vendors and claims, and preparing the debtor’s Plan of Reorganization and Disclosure Statement.

Debtors may seek court approval of a Financial Advisor pursuant to § 327 of the Bankruptcy Code, which governs employment of professionals during a bankruptcy proceeding. Chief Restructuring Officer is an officer role addressing a host of intensive restructuring or bankruptcy-related tasks that the affected company’s management team must perform, even as their full-time day jobs continue and are likely to have ramped up in terms of urgency and difficulty. These special tasks typically involve parties with which the incumbent management team has had little experience—bankruptcy courts, creditor committees, the Office of the U.S. Trustee, etc.—as well as matters that are similarly unfamiliar, such as managing for cash instead of to achieve return on investment (ROI), market share, or share price, and the court-specific duties described above. The appointment of a CRO is created through action of the company’s board of directors or LLC members, consistent with its bylaws or operating agreement and applicable state corporation law, and may involve Bankruptcy Code provisions in addition to or instead of § 327.
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In few such situations is time on the side of the debtor seeking to reorganize, and therefore the expense, delay, and distraction occasioned by litigation of any kind is often simply not affordably. This is one of the reasons that bankruptcy mediation has become so widespread, and those acting in the FA/CRO role typically favor an early resort to mediation regarding any disputes in the case that would otherwise get litigated.

In fact, even prepetition (i.e., before the bankruptcy filing), an FA or CRO that has been engaged to assist the company, including with preparation for a possible bankruptcy filing, will typically seek to move any pending litigation into a mode of alternative dispute resolution for the same reasons as stated above: Even if the company has a “good case,” the expense, delay and distraction involved with litigation may pose too great a risk to the company’s survival through the reorganization process.

And after the bankruptcy proceeding—post-confirmation of a Plan of Reorganization or following a sale of the business via Bankruptcy Code § 363—there is typically a good deal of cleanup required due to “preferences and avoidances,” which are claims created by the bankruptcy proceeding that are designed to level the playing field among each class of creditors. Under the preference provisions of the Bankruptcy Code, the debtor may claw back payments made during the 90 days preceding the bankruptcy filing (or one year, in the case of an insider) that exceeded what a creditor would have otherwise received via a Chapter 7 liquidation on the filing date of the Chapter 11 proceeding. In addition, other transactions may be avoided, and the debtor may seek disgorgement of funds received by others. Needless to say, preferences and avoidances can involve a proliferation of claims and create a substantial litigation burden on the debtor and the defendants (typically creditors) as well as the bankruptcy court. The issues in such cases are nearly all fact-based: What payments did the creditor receive and when, did the creditor change its payment terms or otherwise apply pressure during the preference period, and do the allegedly preferential payments fall within any of a handful of statutory exceptions, such as the creditor’s having been paid according to the terms of its sale to the debtor and consistent with how the creditor had historically been paid, or how suppliers in that industry are typically paid. For these reasons, use of mediation in resolving preference and avoidance claims is nearly universal in bankruptcy, and there is an anecdotal but widely reported desire by bankruptcy judges that such claims be settled through mediation and not require hearings (except in unusual or very large claims).
Especially in large bankruptcy cases, these claw-back claims may constitute a significant portion of the potential litigation. In recent years, the vast majority of these claims have been sent to mediation, either on an individual case basis or through standing court orders that set up procedures for preference mediation specifying the timing and location of mediation as well as the mediator’s fees.

As mediation has come into more widespread use in bankruptcy, turnaround and restructuring professionals have become very familiar with the mediation process and often participate in such mediations as the debtor’s representative or as an expert in proving the historical payment practices between the debtor and a specific creditor/defendant.

**Mediation in Consumer Bankruptcy Cases and Mortgage Modification Mediation in Bankruptcy**

Mediation is used in a number of consumer bankruptcy contexts. It is not uncommon for a debtor and a trustee or a creditor to mediate issues central to the administration of a bankruptcy case. These may include discharge and dischargeability proceedings, actions regarding a debtor’s exemption issues and turnover, and various other issues related to claims resolution.

Mortgage modification mediation is a prominent development in bankruptcy mediation that was created to address mortgage foreclosure issues brought about by the recent mortgage foreclosure crisis. Florida, one of the hardest-hit states during the recent foreclosure crisis, developed what has become a model for mortgage modification through mediation. In states where consumer bankruptcies are particularly prominent, this program has helped stay a wave of foreclosures that may have otherwise resulted.

At the start of the crisis, funds from the Troubled Asset Relief Program (TARP”) were issued to some of the largest servicers of mortgages, and those services agreed to modify the home loans of borrowers. By using the mortgage modification mediation program, borrowers can stay in their homes and the mortgage continues to perform for the creditor. Florida’s Mortgage Modification Mediation program (“MMM”) began in the Middle District of Florida in 2010, and by 2013 the program had reached the Southern and Northern Districts.
Mortgage modifications can be accomplished on properties that are homestead properties under applicable state law, rental properties, property occupied by dependents of the borrower, inherited property, or property obtained through dissolution, even if the party seeking the modification is not a signatory on the note. MMM programs are generally eligible to individual debtors in Chapters 7, 11, 12, and 13 bankruptcy cases, who have paid their filing fees in full. Both represented and pro se debtors are eligible to participate. However, there is anecdotal evidence that the success rate is significantly greater when the debtor is represented by an attorney.

Generally, the MMM program in Florida works as follows: (1) The debtor makes “adequate protection” payments of 31% of his or her gross income, less any homeowners’ association fees, to the lender. (2) Next, the debtor files a motion for referral to mediation within 90 days of filing the case. (3) After the motion is filed, the Court enters an ex parte order referring the parties to mediation and requiring the debtor to provide the lender with a package of information to be uploaded onto the MMM portal. Once the required information has been uploaded to the portal, the parties schedule a telephonic mediation.

Other MMM programs throughout the United States follow a similar track and maintain similar requirements. For instance, the programs in New York, New Jersey, Rhode Island, Pennsylvania, and Wisconsin all require payments in some amount that may be related to the amount of the debtor’s income, set forth the time in which the request for mortgage modification should begin, and use a MMM portal to facilitate the exchange of documents and other information. During an interim trial payment period, the homeowner pays to the lender a monthly amount, calculated by the lender, which represents what the lender believes the modification payment will be.

The portal is a particularly important component to the MMM process. Prior to the establishment of the MMM portal, there were issues with communication and risk of lost documents. MMM packages were sent, lenders complained that the packages were not complete, and borrowers complained that they were sending the same documents multiple times. Moreover, without the portal, the borrowers had very little opportunity to communicate with the lender. This resulted in borrowers’ paying trial payments for more than twelve months. Now, with the MMM portal, there is no question as to which documents are required and which documents have been uploaded. In addition, the borrower or the borrower’s attorney can now communicate directly with
the lender, and all of the communications are logged electronically and available for the mediator to review if needed.

In Florida, the order directing the parties to MMM gives them fourteen days to jointly select a qualified mediator. If the parties cannot agree on a mediator, the debtor may select a mediator, and the lender may object within seven days. If an objection to the mediator is timely filed, the Chapter 13 trustee (or in a Chapter 7 case, the Court clerk) will appoint a mediator from the Court's list of approved mediators. If the debtor is pro se, the Court may appoint a mediator.

The mediator's obligations are similar to obligations that exist in other proceedings. By way of example, the obligations in Florida are outlined in the order referring the matter to MMM. These include that the mediator shall (1) be governed by the standards of professional conduct set forth in the Florida rules for certified and court-appointed mediators and shall have judicial immunity to the same extent as a judge; (2) receive mediator's fees of $500.00 for preparation and participation in the first two hours of mediation, to be split equally between the debtor and the lender; (3) receive hourly compensation at an agreed hourly rate for any MMM conferences that extend beyond two one-hour conferences; (4) use the MMM portal to facilitate the exchange of information between the parties; (5) report on all mediation sessions on the portal; and (6) file a final report with the court within seven days after the final mediation, indicating whether an agreement was reached.

As with non-MMM mediations, there is a strong presumption of confidentiality in the MMM mediation process. Accordingly, all oral and written statements made by the parties, attorneys, and other participants at the mediation are privileged and confidential. All confidential statements cannot be reported, recorded, placed into evidence, made known to the Court, or construed as an admission.

The MMM mediation program also has a good-faith component. If parties do not engage in the MMM process in good faith, they could face possible damages or sanctions.4

Conclusion

While bankruptcy mediation is akin to other types of mediation, it is also unique in many ways. In consumer bankruptcy, debtors with little to lose could still lose everything they have. At the opposite end of the spectrum, in large Chapter 11, cases issues are complex and broad-ranging, potentially involving pensions, collective bargaining agreements, payments to creditors and the loss of equity, among other issues. What the mediation process brings to these issues is not just the avoidance of costly litigation, but a central arena to bring a host of complex issues and possibly multiple parties to the forefront in the most effective way possible. Parties get to be heard, but at the same time, a forum based upon bankruptcy knowledge and experience is established in which to create a roadmap for potential settlement.

A skilled, effective bankruptcy mediator can help counteract the financial damage to all parties that may otherwise result from delay in a situation involving economic distress. And while many of the principles of nonbankruptcy mediation apply, bankruptcy involves some unique aspects, to the potential benefit of all parties involved.