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# Mediating Disputes Arising Out of Troubled Companies - Do It Sooner Rather than Later

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# ARTICLE

# MEDIATING DISPUTES ARISING OUT OF TROUBLED COMPANIES—DO IT SOONER RATHER THAN LATER

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My first employer after law school, U.S. District Judge Carl B. Rubin,[1] was fond of saying that only crazy or desperate people take cases to trial—everyone else settles. He may have been exaggerating a little, but what was true in the 1970's is still true today: the overwhelming bulk of all lawsuits in all courts settle before trial. That is no less true in bankruptcy court. Particularly in large chapter 11 cases, compromise is king. The shortest way to chapter 7 liquidation is to try to litigate your way into a chapter 11 plan. Generally speaking, if you cannot cut a deal with your major creditors, you cannot get a chapter 11 plan confirmed, and the business cannot be reorganized.

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[*] The Honorable Randall J. Newsome (Ret.), a mediator with JAMS San Francisco, served as a federal bankruptcy judge in Ohio and California for twenty-eight years, including six years as chief bankruptcy judge for the Northern District of California. He received his B.A., *summa cum laude*, from Boston University, and his J.D. from University of Cincinnati College of Law.



[1] On April 29, 1971, Judge Carl B. Rubin was nominated by President Richard M. Nixon to the U.S. District Court for the Southern District of Ohio where he served until his death on August 2, 1995.

Over the last several years, there has been much academic debate on the subject of "vanishing trials"—whether the settlement rate in bankruptcy and other courts is accelerating, and whether that is a healthy trend for our justice system.[2] A more interesting question is why disputes in chapter 11 cases are not resolved sooner. Why does it take so much time and so much money for parties to settle their differences and arrive at a consensual chapter 11 plan?

There certainly are ample financial incentives for settling early in the case. The most obvious inducement is that a chapter 11 debtor is, by nature, a wasting resource. The longer it remains in bankruptcy, the less value is available to pay creditors. Although this has always been true, the fact is that the chapter 11 process has become far too expensive. The problem is not merely the hourly rates and the number of hours billed, but the number of entities employed by the estate and how each of those entities staffs the case. The fee allowance process was intended to be self-regulating under the Bankruptcy Code of 1978 through objections by parties in interest and decisions on those objections by the courts.[3] That self-regulation simply has not materialized. One of the stated missions of the United States trustees (the U.S. Justice Department officials charged with overseeing the administration of bankruptcy cases) is to monitor fee applications and object to them if appropriate. But the United States trustee program does not have the resources to perform this task effectively, and other methods of addressing this problem, such as appointment of fee examiners and fee committees, have been equally ineffective.

Although bankruptcy judges have an independent responsibility to review fee applications, the judges in New York and Delaware—the two principal venues for large chapter 11 filings—have little, if any, time to hear adversary proceedings and other contested matters, much less slog their way through mountains of time sheets. Indeed, given the size of their case loads, it is a wonder they can function at all. The bankruptcy court for the District of Delaware has six full-time judges and one part-time visiting judge. Between March 31, 2009 and March 31, 2010, 1355 business chapter 11 cases were filed in that district.[4] During that same

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[2] *See* Elizabeth Warren, *Vanishing Trials: The Bankruptcy Experience*, 1 J. EMPIRICAL LEGAL STUD. 913, 929 (2004); Marc Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. EMPIRICAL LEGAL STUD. 459, 498-99 (2004).

[3] *See* 11 U.S.C.A. § 330 (Westlaw 2012).

[4] U.S. COURTS, U.S. BANKRUPTCY COURTS—BUSINESS AND NONBUSINESS CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIOD ENDING MARCH 31, 2010 tbl.F-2 (Mar. 2010), *available at* www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2010/0310_f2.pdf.

period, a staggering 3,349 adversary proceedings were filed, an increase of almost fifty percent over the previous year.[5] The eleven judges of the bankruptcy court for the Southern District of New York, the venue for such cases as Lehman Brothers, General Motors and Chrysler, are equally overwhelmed. Between March 31, 2009 and March 31, 2010, 1513 business chapter 11 cases were filed in that district.[6] During that same period, 2945 adversary proceedings were filed, an increase of some 168 percent over the previous year.[7]

Assuming (but in no way conceding) that scorched-earth litigation is ever a cost-effective, productive strategy for obtaining a desired result, there is no room for such a strategy in these two districts. The judges have neither the time nor the patience to provide the close judicial oversight that heated litigation battles require. Moreover, the lack of judicial resources to hear the case when it is finally ready for trial plays into the hands of those benefiting from delay.

Early resolution of disputes is essential if a claimant seeks to recover the greatest value in the shortest possible time. Engaging a mediator at the front end of a dispute, rather than after hundreds of thousands or millions of dollars have been spent on discovery and motion practice, can further that goal. Three cases in which I personally was involved demonstrate this point.

In September of 1983, an involuntary chapter 11 petition was filed against Baldwin-United Corporation in the Southern District of Ohio.[8] With over 200 subsidiaries, $9 billion in assets and $10 billion in debt, it was the largest chapter 11 case ever filed at that time. Many of the major banks east of the Mississippi were claimants. Initially, a ten-percent recovery seemed optimistic, and the case was predicted to last a decade or more.

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[5] U.S. COURTS, U.S. BANKRUPTCY COURTS—ADVERSARY PROCEEDINGS COMMENCED, TERMINATED, AND PENDING UNDER THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIODS ENDING MARCH 31, 2009 AND 2010 tbl.F-8 (Mar. 2010), *available at* www.uscourts.gov/Viewer.aspx?doc=/uscourts/Statistics/FederalJudicialCaseloadStatistics/2010/tables/F08Mar10.pdf.

[6] U.S. COURTS, U.S. BANKRUPTCY COURTS—BUSINESS AND NONBUSINESS CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIOD ENDING MARCH 31, 2010 tbl.F-2 (Mar. 2010), *available at* www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2010/0310_f2.pdf.

[7] U.S. COURTS, U.S. BANKRUPTCY COURTS—ADVERSARY PROCEEDINGS COMMENCED, TERMINATED, AND PENDING UNDER THE BANKRUPTCY CODE, DURING THE 12-MONTH PERIODS ENDING MARCH 31, 2009 AND 2010 tbl.F-8 (Mar. 2010), *available at* www.uscourts.gov/Viewer.aspx?doc=/uscourts/Statistics/FederalJudicialCaseloadStatistics/2010/tables/F08Mar10.pdf.

[8] Erti v. Paine Webber Grp., Inc. (*In re* Baldwin-United Corp. Litig.), 765 F.2d 343, 345 (1985).

The principal difficulty was that the bulk of the companies' assets were trapped in six insurance companies undergoing state rehabilitation proceedings in Arkansas and Indiana, while the bulk of the debt was held by the chapter 11 debtors. In January of 1985, the debtors and rehabilitators reached an agreement on their respective claims. But the path to a reorganization plan and the payment of creditors was blocked by three major disputes: a $450 million IRS claim; a $560 million secured claim held by a consortium of New York banks; and billions of dollars in indemnification claims held by stockbrokers who were being sued for securities fraud in federal court by Baldwin-United's annuity holders. These disputes had the potential to take five or more years to litigate. The IRS audit process was estimated to last up to a decade. The solution: each of these three major disputes was sent to mediation; they were all resolved by the end of 1985. A plan was confirmed in March of 1986, and the case was largely wrapped up by the end of 1986, just over three years after it was filed. Recoveries by unsecured creditors ranged as high as seventy cents on the dollar, seven times what the creditors would have been happy to receive at the outset of the case.

A more recent example is Pacific Gas and Electric Co., which filed a chapter 11 petition in the Northern District of California on April 6, 2001.[9] Although the genesis of the filing was the California energy "crisis" of the previous year, the real fight was between the debtor's parent, Pacific Gas and Electric Corp., and the California Public Utilities Commission (CPUC). The issue was not money—both the debtor's plan and CPUC's competing plan would have paid all creditors in full. Rather, the parties were deadlocked on a number of non-monetary questions, the most divisive being the extent to which the CPUC would continue to be the regulatory authority for the utility, as opposed to the Federal Energy Regulatory Commission.

The parties spent approximately seven months and millions of dollars preparing for and then trying a contested confirmation hearing involving competing plans. After twenty-eight days of trial with seemingly no end in sight, the matter was submitted to judicially supervised mediation in March of 2003. Three months later, a deal was reached that allowed a plan of reorganization to be confirmed by the end of December of 2003.

There is no question that this settlement cut months off of the plan confirmation process and years off of the inevitable appeals from a plan confirmation order, not to mention multiple millions of dollars in fees. But would even more time and money have been saved had the

[9] *In re* P. Gas & Elec. Co., 263 B.R. 306, 309 (Bankr. N.D. Cal. 2001).

mediation process been started in a serious way almost from the outset of the chapter 11 filing? As the mediator in that case, I have no doubt that it would have.

A smaller but perhaps more representative example is presented by Crescent Jewelers. When it filed its chapter 11 petition in the Northern District of California in August of 2004, the company had approximately 103 stores and $140 million in annual revenues.[10] Harbinger Capital Partners Master Fund I bought Crescent's parent company, Friedman's, Inc., which had filed its own chapter 11 case. Crescent owed Friedman's some $42 million. Harbinger acquired $20 million of Crescent's trade debt after Crescent's chapter 11 case was filed. In doing so, it controlled the majority of Crescent's $96 million in total unsecured debt. Beginning in 2005, Crescent put itself up for sale. When the only bidder turned out to be Harbinger, Crescent resisted. Harbinger then pursued an aggressive litigation strategy, objecting to the debtor's motion to extend its exclusive right to file a plan and filing a motion to appoint a trustee or examiner. The relationship between the parties and the court quickly deteriorated to a point that the presiding judge took the extraordinary measure of revoking the telephonic appearance privileges of Harbinger's counsel, and threatening to revoke their right to appear in the case at all.

In an attempt to end the fighting, the judge directed the parties to mediation. After a one-day session, an agreement was reached whereby Harbinger ended up owning Crescent in exchange for dropping its claims and making a substantial cash infusion into the company. A plan implementing this agreement was confirmed less than two months later. Through the mediation process, the parties recognized their own self-interests and avoided the additional fees and inevitable loss of value that a protracted fight would have brought.

Early initiation of the mediation process can be particularly effective in dealing with multi-party disputes such as Ponzi schemes. In Ponzi scheme bankruptcy cases, the trustee typically will bring dozens, if not hundreds, of preference and fraudulent transfer suits. Particularly as to preferences, it is difficult if not impossible to explain to defendants (even in non-Ponzi cases) why they are being sued for receiving money they were lawfully owed.[11] In Ponzi schemes, it is even more difficult.

[10] *Crescent Jewelers Files for Bankruptcy*, S.F. BUS. TIMES (Aug. 12, 2004, 8:21 AM), *available at* www.bizjournals.com/sanfrancisco/stories/2004/08/09/daily36.html?page=all.

[11] *See* 11 U.S.C.A. §§ 547 (providing for the avoidance of preferential transfers), 548 (providing for the avoidance of fraudulent transfers) (Westlaw 2012). Grossly oversimplified, if an insolvent debtor paid or transferred property to a creditor shortly before a bankruptcy case was filed, section 547 allows the debtor in possession or trustee to "avoid" the transfer in order to foster equitable treatment of similarly situated creditors. Section 548, again quite simplified, allows the

Preference defendants, who may have received only a small portion of their initial investment back, often feel outraged that they are now being sued to surrender what little they have recovered, particularly if it is unlikely they will recover more than a fraction of what they are owed. Moreover, the people who invest in Ponzi schemes are often unsophisticated and sometimes just plain odd, which may increase the level of emotional reaction when they are sued. They also may be broke.

There is no one correct way for the court to handle a mass of lawsuits with angry defendants. One useful approach, however, is to set them down for status or scheduling conferences spaced in one-hour increments with fifty cases (or as many people as the courtroom will hold) every hour. At the status conference(s), the court should begin by explaining the basics of preferences and fraudulent transfers, which many of the defendants (often representing themselves) may not understand. The court might then propose the following procedure: (i) the trustee or plaintiff is directed to tender an initial disclosure of evidence he intends to rely upon in his case-in-chief within ten days (if he has not done so already); (ii) the trustee (plaintiff) is directed to make an offer of settlement to each defendant within twenty to thirty days after making his initial disclosure; (iii) within ten days thereafter, each defendant will respond with a good faith counteroffer; (iv) within another twenty days, the trustee (plaintiff) will send a letter to the court indicating that the parties have done as the court directed (without saying what the offers and counteroffers are). The defendants will not be required to make an initial disclosure or file an answer until the foregoing preliminary settlement process is completed.

If the parties have settled, the trustee shall take whatever action is necessary to formalize the settlement. If the parties have not settled, the court will direct the defendant to file an answer or other responsive pleading to the complaint, tender initial disclosures, and appear at a continued status conference to set discovery cut-off dates and address other pretrial matters. Many of these lawsuits will settle in the preliminary settlement phase. Those that do not can be sent to mediation after discovery is completed. The odds are excellent that none of them will ever be tried.

If the court is unable or unwilling to be involved in this pretrial process, then a mediator can be appointed to handle the preliminary settlement phase and, ultimately, to mediate any cases that have not

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debtor in possession or trustee to avoid a pre-bankruptcy transfer that the debtor made either for less than reasonably equivalent value while the debtor was financially impaired, or with actual intent to hinder delay or defraud creditors.

settled as of the close of discovery. Submitting a dispute to mediation will not work miracles. It will not bring about instant peace or an immediate resolution of all problems surrounding a troubled company. But a mediator can focus the parties' attention on reconciling their differences rather than pursuing litigation, thus potentially taking years off of the reorganization process and saving everyone a great deal of money. It is important to involve the mediator early on, and it is most efficient if she is assigned all of the cases. As is true in any other commercial bankruptcy, it is important that the court direct the parties to attempt to settle their differences before large sums of money are spent preparing for trial.