A Publication of the Committee on Alternative Dispute Resolution

CONFLICT MANAGEMENT

American Bar Association ◆ Section of Litigation Winter/Spring 2010 Vol. 14 Issue 2

What to Do When Insolvency Becomes an Issue in Mediation

By Rebecca Callahan

For the past few years, we have lived through economically trying times. Virtually every sector has been hit: our national economy, state economies, Wall Street, financial giants, small businesses, banks, the public sector, the private sector, blue-collar workers, and white-collar workers. Even if we have not experienced a financial setback personally, we probably know someone who has, and the communities in which we live have most certainly been affected at many levels. As a result, some level of financial distress is evident in just about every aspect of our daily lives. It is not surprising to find that in many civil litigation disputes, the threat of a bankruptcy filing or a bankruptcy filing by one or more parties to the dispute is being encountered. This is the first of a two-part article, the purpose of which is to discuss how insolvency issues might be addressed during the mediation of such disputes. The focus of this article is on redefining the problem and possible solutions so as to help the parties achieve the most that is available under the circumstances and, at the same time, minimize loss and control unnecessary expenditures of resources (namely, time and money).

Insolvency is a financial condition where there is not enough money for what one wants, needs, or is otherwise obligated to pay. It can be inflicted on anyone, including

- the rich (Henry Ford, H. J. Heinz, Charles Goodyear)
- the famous (Jerry Lewis, Burt Reynolds, Larry King)

continued on page 9

Should Your Firm's Engagement Letter Contain an Arbitration Clause?

By Mitchell L. Marinello

Even well-managed law firms occasionally run into a client that refuses to pay its legal bill. In those instances, the firm sometimes faces a dilemma. Does it sue its client to collect unpaid fees despite the fact that such efforts may result in unfavorable publicity, intrusive discovery requests during the litigation, and possibly the client filing a baseless counterclaim for legal malpractice? Or should the firm just walk away and plan to choose its clients more carefully the next time? The preferred course of action may differ from firm to firm and matter to matter, but having an arbitration clause in your engagement letter may provide you with substantial benefits.

What Can Arbitration Offer That Litigation Cannot?

Reasonable people may disagree about whether arbitration is better than the court system for resolving business disputes. The answer may depend on the kind of case involved, its legal complexity, what is at stake, the need for discovery (particularly from non-party witnesses), and a host of

continued on page 13

In This Issue

ABA Section of Litigation

Insolvency in Mediation

continued from page 1

- the criminal (Enron, Bernard Madoff, Charles Keating)
- retail giants (Circuit City, Mrs. Fields Famous Brands, Big 10 Tire Stores)
- corporate giants (Chrysler, General Motors, United Airlines)
- municipalities (Orange County, City of Villejo, CA, Washington Public Power System)
- financial institutions (Lehman Brothers, AIG)

From a cash flow point of view, insolvency occurs when there is not enough money to pay debts as they are due. From a balance sheet perspective, insolvency occurs when total liabilities exceed the fair market value of total assets. When talking about insolvency, it is important to examine both points of view. It is also important to examine the perceived cause; quantify its magnitude in terms of lost revenue or lost value; compare the current condition to historical performance and/or values; and evaluate whether the condition is the result of a short-term reversal, a cyclical downturn, or an irreversible downhill slide.

Insolvency and bankruptcy go hand in hand. As such, when insolvency becomes an issue, a bankruptcy filing frequently is not far behind. Part two of this article will provide a more detailed discussion of "bankruptcy relief," common negotiating points when bankruptcy is threatened or in play, and reality factors that may dictate or influence the negotiation outcome.

When Might Insolvency Become an Issue in Mediation?

There are a number of litigation scenarios that may raise the specter of insolvency. The following are a few of the more common scenarios.

Monetary Recovery Disputes

In a dispute where significant dollars are being sought as general, special, or punitive damages, the potential insolvency of one or both parties may be an issue (e.g., personal injury, damage to property, failed business deal, breach of a duty, fraud, conversion, business torts, and violation of statutory duties). For the plaintiff, a financial recovery through litigation might be that which he or she needs to avoid or repair an insolvent condition. For the defendant, the creation of a judgment liability may create balance sheet insolvency, and the enforcement of such judgment could result in cash flow insolvency.

Ownership/Entitlement Disputes

Insolvency may be an issue where ownership or entitlement to property is disputed (e.g., quiet title disputes, marital dissolutions, and business dissolutions). Here, the outcome of the litigation might move an asset from one balance sheet to another and, in the process, might affect cash flow by removing the income generated by that asset.

Alternatively, such disputes might result in the property being forced to sale, which could impair the market value of the asset (thereby reducing or eliminating the return paid to the owner) and, at the same time, trigger a taxable event (thereby creating a new, current liability). Both scenarios could invite crippling tax ramifications to the parties.

Responsibility/Secondary Liability Disputes

In a dispute that seeks to shift the risk of loss or responsibility, insolvency may become an issue, e.g., guarantees, respondeat superior, indemnification, and scope of work and agent/principal. This situation invites a dilemma that is almost opposite to that encountered in ownership disputes, namely, the outcome of the litigation might add an unanticipated and unplanned liability onto the balance sheet as a liquidated debt and thereby instantly move the company or individual from being in the black to being in the red. In this area, it is not uncommon for parties to understand that certain transactions or activities include an element of risk (a contingent liability) that may not be quantified or fully understood at the time of undertaking.

Costs of Litigation

In all of the above situations, the costs associated with accessing the court system can impair both cash flow and the balance sheet if assets are being liquidated, savings are being depleted, or revenue is being diverted from operations to pay the attorney fees and other fees associated with preparing or presenting a case.

In any of these scenarios, the threat or existence of insolvency is important information in mediation. For one thing, it prompts a broader discussion that goes beyond assessing the collectability of any judgment. Once a party points to an existing or anticipated insolvent condition as a reason for its settlement position, this can serve as the beginning of a discussion aimed at examining the nature and extent of the insolvent condition, the prospects of reversing that condition, the interests or needs of the insolvent party to avoid or reverse the condition, and the realities of the situation to the other party in terms of receiving less than full satisfaction on any judgment victory achieved at trial.

Who Are the Potential Stakeholders?

Just as misery loves company, so does insolvency. When insolvency is an issue, a Party A versus Party B dispute can be transformed into something more complex in terms of the parties to be dealt with, interests to be accommodated, and issues to be resolved. The following are a few of the more common additional stakeholders that may need to weigh in and be included in the settlement negotiations when insolvency becomes an issue.

Other Creditors

As part of structuring a durable settlement, the rights and interests of other creditors may need to be accommodated or preferred. In some situations, other creditors may need to compromise their claims or subordinate their rights for an accord to be reached. In these cases, the creditors must at some point in time be brought to the negotiating table. Careful consideration needs to be given as to when this should happen—at the start of the mediation, at the start of the negotiations, or at the end of the negotiations when all other aspects of a settlement have been agreed to between the parties to the dispute at hand.

Employees, Customers, and Vendors

Where a settlement requires payments over time and is based on the assumption that a business will continue to operate, the company's relationships with its employees, customers, and vendors may need to be evaluated. For example, are there key employees, customers, or vendors who are critical to the company's continued

Rebecca Callahan is a mediator and arbitrator in private practice in Newport Beach, California.

Published in *Conflict Management*, Volume 14, Number 2, Winter/Spring 2010.

operations? If so, it may be necessary to obtain a commitment from those parties to reach an accord, in which case, such interested parties may need to be included in some way in the negotiation process. Careful consideration needs to be given as to how and when to obtain the commitments necessary for the settlement at hand.

Family and Friends

For individuals, it goes without saying that the needs and interests of their families may be threatened and their relationship with family and friends might be strained. For example, it may have been Dad who signed the guaranty of the company's bank loan, but his daughter's college plans and his wife's retirement plans could be derailed entirely if Dad has to use family savings, sell the house, or go without a draw to pay off company debt.

Ramifications When an Insolvent Condition Exists

Reality Factor

Insolvency and the threat of a bankruptcy filing are reality factors that can trump the merits of the parties' dispute. The first step is to deal with it and analyze it. That analysis takes a hard look at the situation and involves asking many questions, including

- How did this happen? Was the reversal inevitable? Was it anticipated? Who or what is responsible? Was it caused by wrongful conduct by another party?
- Is it a cash flow problem? If so, how bad is it? Is it temporary or permanent? Can it be fixed? If so, what will the "fix" cost in terms of time and money?
- Is it a balance sheet problem? If so, how bad is it? What assets have lost value and why? What liabilities have increased and why? Is there insurance to cover the loss? Can the problem be fixed? If so, what will the "fix" cost in terms of time and money?
- Are there any assets that can be sold or refinanced to bring money to the table today?
- Are there other parties who are liable for the debts that can be brought to the table?
- For the operating business, is all or some aspect of the business worth saving? If so, what will it cost in terms of time and money? Is there commitment from the company's owners who may be asked to continue working a business to pay non-guaranteed debt?
- For the individual, what are his or her future prospects in terms of earning capacity and inheritance?

Surprise

When insolvency is an issue, there are often several creditors engaged in litigation with the debtor who are seeking to liquidate the amounts of their respective claims. Each creditor is focused on the singular goal of obtaining a final judgment and executing upon the debtor's assets.

> Insolvency and the threat of bankruptcy offer an opportunity for the parties to participate in a constructive exchange of information.

They are engaged in a race to the courthouse and competing to be the first one to obtain judgment and attachment of the debtor's assets. In this race, the prospect of insolvency and possible bankruptcy resulting from a creditor's successful litigation outcome may be overlooked and, as a result, the potential creditor party (or parties) may be surprised when insolvency and/or bankruptcy are raised at mediation.

A typical reaction to surprise is to become guarded, resistant, and suspicious. The mediator faced with this situation likely has only two options to offer the parties:

- Proceed with mediation and predicate those discussions and any settlement proposal on certain assumptions, conditioned upon subsequent verification.
- Recess the mediation to allow the parties time to gather, exchange, and evaluate pertinent financial information and then reconvene at a later date.

Either scenario depends on the parties' willingness to include one (or possibly both) party's insolvency/bankruptcy on the agenda of matters to be discussed during the course of the mediation.

Expand the Pie

When the prospect of bankruptcy is an issue to be discussed during mediation, it creates an opportunity to "expand the pie" by examining the parties' options in (a) avoiding a bankruptcy and/or (b) planning for a bankruptcy. The following are some examples of possible discussion areas:

- What does the prospective debtor hope to accomplish through bankruptcy? Debt discharge? Orderly liquidation? Novation of prepetition liabilities and a structured payment plan?
- How does the prospective creditor expect to fare in a bankruptcy? Partial recovery? Full recovery? No recovery?
- Are there any hurdles the prospective debtor must surmount to obtain its bankruptcy relief objective? Can the debtor afford the cost of the bankruptcy proceedings? Can the debtor satisfy the Bankruptcy Code criteria for obtaining relief? Are there any timing issues?
- Are there any hurdles the prospective creditor must surmount to obtain payment on its claim? Can the creditor satisfy the Bankruptcy Code criteria for having its claim "allowed" for purposes of payment? Is the likely forum for the bankruptcy convenient or inconvenient to the creditor? Can the creditor afford the cost of participating in the bankruptcy case?

Difficult Conversation

Beyond making the statement "I have no money" or "A judgment along the lines you are asking for will force me into bankruptcy," talking about insolvency can be difficult, uncomfortable, frustrating, and threatening for all parties. For one thing, parties generally enter the mediation with an expectation that they are going to talk about the merits and demerits of the dispute. It can be disappointing and disorienting to have time and attention focused on an issue that was not anticipated and does not relate to the dispute at hand. For the party whose financial situation is put in the spotlight, that circumstance can invite a whole host of emotional reactions and issues, including

- pride/stubbornness—the need to save face within a certain community
- shame/avoidance—the loss of face within a certain community
- inertia—fear of failure, fear of the unknown, inability to adopt to change
- denial/ego—the need to put blame elsewhere and not be responsible for the problem or the solution
- depression/inertia—loss of control, trust, confidence, and hope
- insecurity—basic needs (e.g., loss of home, safety, comfort, and love) are threatened

For the party who is being asked to take the other party's financial condition into consideration, that circumstance can invite its own set of feelings and reactions.

- anger/aggression—directed at the situation or opposing party
- frustration/inertia—insolvency hurdle appears insurmountable; loss of control
- distrust—a perception that the other party is hiding something; insolvency is not real
- opportunism—a desire to take advantage of the other party
- vengeance—a desire to inflict pain on the other party
- compassion—understanding; willing to consider the other party's situation
- altruism—a desire to promote greater good
- pride/stubbornness—the need to save face within a certain community
- inertia—fear of failure, fear of the unknown, inability to adopt to change
- denial/ego—the need to put blame elsewhere and not be responsible for the problem or the solution

One thing is certain: A discussion about one party's existing or forecasted insolvent condition cannot be forced. Everyone needs to be ready and willing to have that discussion.

New Interests

When insolvency or bankruptcy are brought up during the course of a mediation, that is the beginning—not the end—of the discussion. That discussion invites a whole new set of issues and interests to talk about.

If, for example, the parties assume that defendant is liable and that plaintiff will recover damages in the amount requested, that moves the dialogue to collectability. If a "win" by the plaintiff will "kill the debtor" because it will force the closure of the business and/or the surrender of the debtor's assets to a bankruptcy trustee for liquidation in a "fire sale" environment, then this potential circumstance should motivate the parties to consider ways in which the dispute can be resolved so as to avoid this scenario. The treatment the plaintiff (creditor) would receive in a bankruptcy filed by the defendant (debtor) can provide an objective backdrop against which to evaluate settlement proposals that may be placed on the table. Is it better to take less now than to receive zero later? Likewise, the long-term benefit the defendant (debtor) hopes to derive by keeping its business open and running or holding on to assets expected to appreciate over time can provide a backdrop for assessing both the value of settlement and the financial viability of any settlement proposal that may be presented.

BATNA and WATNA

One way to evaluate a settlement proposal is to consider the best alternative to that proposal (BATNA). In the context of the litigated dispute, BATNA is proceeding with the judicial proceedings to judgment and evaluating the likelihood of prevailing/defending on some or all claims. Introducing one (or more) party's insolvency/potential bankruptcy forces all parties to consider their worst alternative to a pending settlement proposal (WATNA).

Theoretically, bankruptcy is intended to regulate and balance the interests of debtors versus their creditors. However, in practice, bankruptcy exacts a toll on all parties. The process itself is expensive because, where there are assets to be administered, the bankruptcy trustee's fees and the attorney fees and costs incurred in administering the bankruptcy estate are given preferred treatment under the Bankruptcy Code, allowing them to be paid in full before the allowed claims of unsecured creditors. This is a huge issue that needs to be considered if bankruptcy is truly on the horizon for any party to a civil dispute. Assuming that a bankruptcy trustee acts diligently and takes the most efficient and economical course of action in marshaling and liquidating the debtor's assets, the following questions must be addressed:

- What is the estimated cost of the bankruptcy trustee's activities?
- What is the estimated net recovery to the debtor's estate for distribution to unsecured creditors?
- What is the litigant creditor's estimated pro rata share of that "pot" taking into consideration other creditors' claims against the debtor?

Opportunity

Insolvency and the threat of bankruptcy offer an opportunity for the parties to participate in a constructive exchange of information. That circumstance creates an opportunity for candor and communication about a subject that is slightly off topic (i.e., not focused on the merits or demerits of the dispute) and relevant to both parties, especially if the objective of the litigation is to achieve a recovery of money or property from the other side. In those circumstances, the prospect of insolvency or threat of bankruptcy challenges the parties to think more broadly so as to come up with a solution that cuts their losses, maximizes value, avoids unnecessary expenditures, and does the most with a bad situation.

Conclusion

In many ways, insolvency is the ultimate "below the line" issue because it is an interest (or set of interests) that needs to be considered, discussed, and addressed irrespective of the merits of the dispute, the application of the law to the dispute, the perceived strength or weakness of either side's evidence, or the parties' feelings about the dispute. Insolvency operates as a big reality check for all involved and forces the parties to get creative and go beyond the distributive model of bargaining. When insolvency is an issue, the numbers that might otherwise be exchanged in a distributive negotiation are so out of reach that they are a non-starter simply because the party who is expected to pay does not have the financial wherewithal to do so, irrespective of the merits of the dispute at hand. Simply stated, insolvency is a "reality factor" that can trump the merits of the dispute. ■

Part two of "What to Do When Insolvency Becomes an Issue in Mediation" will appear in the Summer 2010 issue of Conflict Management.