# What to Do When Insolvency Becomes an Issue in Mediation

By Rebecca Callahan

**Part one** of this article focused on defining insolvency, identifying scenarios in which insolvency might become a factor when mediating the litigated dispute, redefining the issues for discussion once insolvency is raised, and discussing what additional information and/or stakeholders might be needed at the table to achieve a negotiated resolution.

In **part two** of this article, the underlying assumption is that the defendant to a litigated dispute has threatened to file for bankruptcy, that the threat is not a bluff, and that the treatment afforded the parties in bankruptcy may represent the most likely alternative to a negotiated agreement. This part focuses on identifying the unique dynamics that come into play when bankruptcy becomes an issue and discussing the more common issues that may be encountered during the negotiation phase of a mediation.

Bankruptcy is a legally declared inability or impairment of ability by an individual or entity to pay its creditors. Just about anyone and anything can be a debtor in bankruptcy.[1] The key to eligibility is that the proposed debtor must reside or have a domicile, place of business, or property in the United States.[2] For example, a Chinese company that owns golf courses in the United States can file or be put into bankruptcy involuntarily in the United States. Likewise, a person who lives in California but whose primary assets are real estate holdings in Wyoming can file or be put into bankruptcy involuntarily in Wyoming or California. What this means in the context of mediation is that virtually anyone involved in an effort to mediate a dispute may be a prospective debtor in bankruptcy and that the party on the other side of the dispute may be a prospective creditor in bankruptcy. Thus, some knowledge and understanding of bankruptcy law will be key to assisting the parties in evaluating the settlement value of the case and developing settlement options and proposals once the threat of bankruptcy becomes a factor in the negotiations.

A key concept in bankruptcy is "property of the estate," because it delimits the pool of assets that will be available to satisfy creditors' claims in bankruptcy. The commencement of a bankruptcy case operates to create an "estate."[3] In general, all of the debtor's property as of the commencement of the bankruptcy case becomes property of the estate, except for certain assets expressly excluded by the Bankruptcy Code[4] and certain assets that individual debtors are allowed to claim as exempt.[5] The statutory definition of "property of the estate" is quite broad and includes all of the debtor's legal or equitable interests in property—wherever located—including all real and personal property as of the date the bankruptcy petition is filed. A potential estate asset is not outside the scope of that definition merely because it is novel or contingent or because enjoyment must be postponed.[6]

In the context of mediation, the threat or prospect of bankruptcy has the effect of putting the debtor's balance sheet on the table to look at both the asset-plus side of the ledger as well as the liability-minus side. The key question raised is whether or not the prospective debtor has "working assets" that either generate income or have equity that can be realized through sale or refinancing. If so, there is a dialogue to be had with respect to what will happen to those assets and the revenue they will generate in a bankruptcy, and what the debtor presently is doing with the income/potential value of those assets. If the debtor defendant has no "working assets" or assets with equity, then the key question raised is whether or not there is any value to the plaintiff creditor's claim beyond obtaining a judgment.

## Liquidation Through Bankruptcy

While the news media publishes stories about "reorganizations" and "restructurings" achieved through Chapter 11 of the Bankruptcy Code, the reality is that most bankruptcies—even ones filed under Chapter 11—are liquidation proceedings where creditors receive pennies on the dollar (if they receive anything at all). According to the Administrative Office of the U.S. Courts, there were 6,185,775 bankruptcy filings during the five-year period ending March 31, 2009, of which 4,366,460 (over 70 percent) were liquidation proceedings under Chapter 7 of the Bankruptcy Code.[7] The vast majority of these bankruptcies were filed by individuals. For example, during the same five-year period, 6,016,739 of the total bankruptcy filings (approximately 97 percent) were filed by individuals. Business filings were not a large percentage of total filings, but there were about 170,000 that liquidated and wound up their affairs in bankruptcy.

An important aspect of liquidation through bankruptcy is that a trustee is appointed by the court to handle the marshaling and sale of assets and the payment of creditors. Immediately after the petition is filed, the defendant debtor has no control or decision-making authority over the assets of his or her estate or the liquidation of the plaintiff creditor's claim. The appointment process and the trustee's rights and duties after appointment are defined by statute[8] and involve a fairly rigid and routine set of procedures whereby the bankruptcy trustee assumes total responsibility for the estate,[9] including whether or not to object to the plaintiff creditor's claim or to pursue claims or offsets against said plaintiff creditor. What this means in the context of mediating a litigated dispute is that once a bankruptcy is filed, the dispute will no longer be an "A-B dispute." It may involve the bankruptcy trustee, a new set of procedures defined by the Bankruptcy Code, and a new forum (i.e., the bankruptcy court). These potential circumstances introduce a whole host of unknowns that make the "bankruptcy outcome" somewhat unpredictable.

In terms of the plaintiff creditor's claims against the debtor defendant, the bankruptcy proceeding provides a summary procedure for liquidating the amount

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of the plaintiff's monetary claim in the debtor's estate. All the plaintiff has to do is file a proof of claim with appropriate supporting documentation and the claim is presumed valid as stated.[10] The pre-bankruptcy litigation proceedings are automatically stayed,[11] and any dispute about the validity or amount of the plaintiff's claim is resolved in the bankruptcy court through a "claim objection" that operates much like a law and motion proceeding.[12] In terms of payment rights, like-situated creditors are paid on a pro rata basis in bankruptcy in order of their priority status under the Bankruptcy Code.[13]

In the context of a negotiation in mediation, once the threat of bankruptcy is raised, the existence of competing creditors becomes highly relevant because they are the plaintiff creditor's "constituency" with whom it will share pro rata in any distribution made to general unsecured creditors. For example, if the plaintiff creditor believes it has a $500,000 claim and there are 10 other creditors who are asserting claims of similar values, there are potentially $5.5 million of like-situated creditors to be paid in bankruptcy. If the highest and best estimated value of the defendant debtor's unencumbered assets is $1 million, then the pro rata sharing among the aforementioned creditor group will amount to about 18 cents on the dollar. This is a meaningful and necessary exercise when evaluating the defendant debtor's proposals against the backdrop of the alternative treatment the plaintiff creditor may receive in bankruptcy if a negotiated resolution is not achieved.

As a side note, when the plaintiff in the lawsuit is the prospective debtor in bankruptcy, control and settlement authority over the action will cede to the bankruptcy trustee.[14] This raises the prospect that the trustee may not continue with prosecution of the action, may sell it to the highest bidder (if the claims are assignable), or may accept a defendant's lowball offer to bring cash into the estate without a large outflow of money to pay litigation expenses.

### Automatic Stay

Another key concept of bankruptcy is the "automatic stay" that takes effect immediately upon the filing of a bankruptcy petition.[15] That stay is directed against the commencement or continuation of a variety of acts affecting the debtor, property of the debtor, and property of the estate, including but not limited to the commencement or continuation of a lawsuit to collect sums owed, enforce any judgment against the debtor, or repossess or foreclose on any property of the debtor.[16] Any action taken in violation of the stay is *void ab initio*, or not merely voidable.[17]

Where bankruptcy is threatened, a common issue in mediation is what impact the automatic stay will have on the pending litigation. Generally speaking, the automatic stay protects only the debtor.

> An agreement in which the debtor purports to waive the benefits of a bankruptcy discharge is void against public policy.

As such, when the debtor is one of several defendants in a pending lawsuit, the automatic stay does not apply to the other parties, and the plaintiff can proceed as to the remaining defendants.[18] This circumstance may serve as leverage against the other non-debtor defendants, especially if the claims involve joint liability with the prospective debtor defendant.

Another point frequently overlooked or misunderstood by the parties when bankruptcy is threatened is that while the litigation against the debtor is stayed, the stay does not prohibit parties from taking discovery from the debtor on matters relating to the claims against the other defendants.[19] Additionally, while the automatic stay enjoins pre-petition litigation pending in the state or federal courts, it does not enjoin the commencement or prosecution of a lawsuit in the bankruptcy court where the debtor's case is pending.[20] Where the dispute concerns interests in property, equitable claims, and disputes that involve more than just a monetary claim against the debtor, the filing of the bankruptcy may not stop the litigation. It may simply move it to another forum (i.e., the bankruptcy court).

In the context of negotiation discussions, the automatic stay invites post-filing litigation over process, which in turn spells additional cost to the parties. It may also invite the filing of additional litigation proceedings in the bankruptcy court, which is a federal case and generally adds a layer of expense, complexity, and pretrial/trial procedures to that found in state court proceedings. In short, the automatic stay invites consideration of possible post-bankruptcy filing activities and expense.

### Debt Discharge

In the case of an individual, the filing of a bankruptcy signals the end of one financial life and the beginning of another.[21] As negative as bankruptcy may be in terms of stigma and loss of assets, it provides individual debtors "relief" in the form of a "discharge" from liability for pre-petition debts,[22] a "stay" of any collection activity while the bankruptcy case is open,[23] and a "permanent injunction" against creditors taking any action to resume collection activity against the debtor for pre-petition debts after the bankruptcy case is closed.[24] This means that individuals can exit bankruptcy leaving their debts behind, using their future earnings, income, and inheritance to pay future expenses and after-acquired debt.

Non-individuals, such as corporations and other business entities, are not eligible for debt discharge relief under Chapter 7,[25] but they do receive the benefit of the automatic stay during the pendency of the bankruptcy case. One reason businesses resort to bankruptcy for liquidation is because there is added risk to those who are owners or serve in the capacity as directors of a struggling company because, should their decisions and actions prove to be improvident, creditors may sue them for breach of fiduciary duty with regard to the decisions made and the transactions approved during the period that the company operated while insolvent.[26] A bankruptcy filing provides "relief" by transferring to a bankruptcy trustee the responsibility and expense associated with the windup of the company's affairs, and it assures that the liquidation of the company's assets and the payments to creditors will be completed in a controlled manner and with full/public accountability in the bankruptcy court record.

The bottom line is that the pros and cons of bankruptcy relief in the form of debt discharge (for the individual) or responsibility (for the business owner/manager) is a rich topic that offers the parties much to discuss, including whether or not resolution of the litigation dispute will avoid the bankruptcy filing or whether there are other issues that also need to be resolved if the bankruptcy outcome is to be avoided.

## Non-Dischargeable Claims

The primary reason individuals file bankruptcy is to obtain a discharge of their liability for payment of pre-petition debts. Once obtained, the bankruptcy discharge operates as an injunction that permanently restrains the collection of a debt or the enforcement of a judgment against the debtor.[27] That being said, not all debts are eligible for discharge. Certain types of claims are excepted from discharge by express statutory provision[28] so that the filing of a bankruptcy will not relieve the debtor from liability for these claims. For example, domestic support obligations;[29] student loan obligations;[30] obligations arising from the death or injury of another caused by operating a vehicle while intoxicated;[31] civil and criminal fines, penalties, and forfeitures payable to and for the benefit of a governmental unit;[32] and certain unsecured tax liabilities[33] survive the debtor's bankruptcy and are enforceable against the debtor's post-petition earnings and after-acquired assets as a matter of law (i.e., without any type of legal proceeding or order of the bankruptcy court). If the claims under negotiation qualify for automatic exception from discharge by statute, then that plaintiff creditor who holds such claim(s) has a powerful club in the negotiations that will need to be reckoned with.

For claims arising out of a transaction or dispute involving civil fraud, fiduciary defalcation, or intentional tort, those liabilities are not automatically excepted from discharge. Rather, the creditor who is owed such a debt must initiate proceedings in the bankruptcy court[34] and must do so within 60 days of the date first set for the first meeting of creditors in the bankruptcy case.[35] If the creditor does not file such a complaint on a timely basis, the debt will be discharged even though it may have been the product of fraud.

Having a debt judicially determined to be non-dischargeable is quite significant, because such debts "are forever barred from discharge in subsequent cases."[36] Even though the Bankruptcy Code allows individuals to file for bankruptcy more than once and to receive a discharge every eight years,[37] a determination in one bankruptcy case that a debt is non-dischargeable will allow that obligation to survive all subsequent filings by the defendant/obligor. In the situation where a debtor has the capacity or need to be a "high earner" or the prospect of inheriting wealth in the future, having a debt deemed non-dischargeable is a significant event and will most certainly invite discussion during the mediation of claims that may be eligible for exception from discharge.

> In most litigated disputes, there generally is not enough information to make an assessment of how likely it is that the defendant debtor will file for bankruptcy.

Talking about debt discharge in the context of a pre-bankruptcy settlement raises the issue of contracting around the debt discharge. As a general rule, an agreement in which the debtor purports to waive the benefits of a bankruptcy discharge is void as against public policy.[38] The same holds true with a state court stipulated judgment, because the res judicata doctrine will not be applied to foreclose litigation of a non-dischargability claim in bankruptcy court, which has exclusive jurisdiction to determine such claims.[39] While a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable as part of a pre-bankruptcy settlement,[40] in practice it is difficult (if not impossible) to obtain admissions to fraud or facts of fraud.

Talking about debt discharge in the context of a pre-bankruptcy settlement also raises the issue of novation. In 2003, the Supreme Court resolved a split among the circuits and rejected the novation theory,[41] meaning that creditor will not be barred from filing a non-dischargeability action simply because it entered into a pre-bankruptcy settlement in which it accepted the defendant debtor's promise to pay in exchange for settlement and dismissal of a fraud claim.[42] However, the amount of the settling creditor's non-dischargeable claim may be limited to that which was agreed to as part of the settlement.[43]

Issues abound in this area concerning the impact of a general release and dismissal with prejudice, which were not decided by the Supreme Court in the *Archer* case and are beyond the scope of this article. For purposes of this discussion, in the context of mediating a civil dispute pre-bankruptcy where those claims include fraud, fiduciary defalcation, and/or intentional tort, there is much to be discussed. In addition to negotiating the dischargeability and potential treatment of the particular plaintiff creditor's claim(s), consideration should also be given to what the defendant debtor's prospective balance sheet might look like if his or her contract debts are discharged. It may be that the filing of a bankruptcy becomes an integral part of the parties' settlement negotiations.

## Preferences

The final key concept in this discussion is the "strong arm" power of the bankruptcy trustee[44] to undo or avoid pre-petition payments to creditors so that the debtor's assets can be distributed ratably among the debtor's creditors and no creditor is preferred by a pre-filing transfer or distribution.[45] The most commonly encountered avoidance actions are those seeking recovery of "preferences."[46] Generally, a preference is a transfer/payment made within 90 days of the petition on account of an antecedent debt that enables the creditor to receive more than it would have received if, instead of receiving the transfer/payment, the creditor had received a distribution in the Chapter 7 bankruptcy case. A detailed discussion of this statutory cause of action and the defenses thereto[47] is beyond the scope of these materials, except to identify the concerns plaintiff creditors might have about giving a complete release and dismissal of claims in exchange for a payment (or set of payments) that it might have to return if the defendant debtor files a bankruptcy petition within 90 days of such payment(s).

In most litigated disputes, there generally is not enough trust or information available to make an assessment as to how likely it is that the defendant debtor will file for bankruptcy during the proposed payment period of any settlement. As such, the preference risk may result in the plaintiff creditor asking for a third-party guaranty, a front-loaded payment plan, or a condition to the settlement such that any release will not be effective and any dismissal will not be filed unless and until the settlement survives for a minimum defined period of time in excess of the 90-day preference period.

## Conclusion

Theoretically, bankruptcy is intended to regulate, balance, and protect the interests of debtors and creditors. In concept, then, the "threat" of bankruptcy should foster constructive dialogue between a plaintiff creditor and defendant debtor. As the foregoing discussion suggests, while the prospect of a bankruptcy filing can have the effect of expanding the parties' discussion points, that discussion is complicated. Moreover, for litigants, the bankruptcy discussion points can be frustrating because the discussion does not always concern the merits of their respective cases/defenses and involves a much broader set of interests and objectives. Finally, in any meaningful discussion concerning the impact a bankruptcy filing will have on the parties to a dispute, it usually becomes apparent that a bankruptcy filing will exact a toll on all parties and introduce a whole new level of uncertainty regarding the ultimate outcome.

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## Endnotes

1. 11 U.S.C. § 101(13), (40) and (41).
2. 11 U.S.C. § 109(a).
3. 11 U.S.C. § 541(a).
4. 11 U.S.C. § 541(b).
5. 11 U.S.C. § 522.
6. *See* Segal v. Rochelle, 382 U.S. 375 (1966).
7. *See* News Release, "Bankruptcy Filings Continue to Rise," www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsMar2009.cfm.
8. 11 U.S.C. §§ 701–704.
9. 11 U.S.C. § 726.
10. Section 502(a) of the Bankruptcy Code provides that upon filing of a proof of claim or interest, that claim or interest "is deemed allowed, unless a party in interest . . . objects." Additionally, Rule 3001(f) of the Federal Rules of Bankruptcy Procedure provides that a proof of claim executed and filed in accordance with the rules "shall constitute prima facie evidence of the validity and amount of the claim."
11. 11 U.S.C. § 362(a).
12. Section 502(b) of the Bankruptcy Code provides that the bankruptcy court determines the amount of any claim as to which an objection is made with certain enumerated exceptions. Rule 3007(a) of the Federal Rules of Bankruptcy Procedure provides that any objection to the allowance of a claim must be in writing and filed with the bankruptcy court and must be served on the claimant at least 30 days prior to the date scheduled for the hearing on such objection. Rule 3007(b) of the Federal Rules of Bankruptcy Procedure provides that to the extent the objecting party is seeking affirmative relief against the claimant that relief must be asserted and prosecuted as an adversary proceeding.
13. 11 U.S.C. § 507.
14. 11 U.S.C. §§ 544 and 704; Fed. R. Bank. P. 9019.
15. *In re* Johns-Manville Corp., 57 B.R. 680 (Bankr. S.D.N.Y. 1986); *In re* Schleier, 290 B.R. 45 (Bankr. S.D.N.Y. 2003). The automatic stay remains in effect unless or until the stay is lifted by court order under 11 U.S.C. § 362(d) or the case is closed or dismissed under 11 U.S.C. § 362(c). As to an individual debtor, the stay remains in effect until his or her discharge is granted or denied. 11 U.S.C. § 362(c).
16. 11 U.S.C. § 362(a); Far Out Productions, Inc. v. Oskar, 247 F.3d 986 (9th Cir. 2001); Contractors' State License Bd. v. Dunbar (*In re* Dunbar), 245 F.3d 1058 (9th Cir. 2001).
17. *Id.* This is true whether or not the violation was willful. Schwartz v. United States (*In re* Schwartz), 954 F.2d 569 (9th Cir. 1992).
18. Wedgeworth v. Fibreboard Corp., 706 F.2d 541 (5th Cir. 1983).
19. Groner v. Miller (*In re* Miller), 262 B.R. 499 (9th Cir. BAP 2001).
20. Rein v. Providian Fin. Corp., 270 F.3d 895 (9th Cir. 2001); Civic Center Square, Inc. v. Ford (*In re* Roxford Foods), 12 F.3d 875 (9th Cir. 1993).
21. 11 U.S.C. § 524(a).
22. 11 U.S.C. § 727(a). This discharge relief is available only once every eight years. 11 U.S.C. § 727(a)(8).
23. 11 U.S.C. § 362(a).
24. 11 U.S.C. § 524(a).
25. 11 U.S.C. § 727(a)(1). Business debtors also are not entitled to debt discharge relief under Chapter 11 of the Bankruptcy Code unless they confirm a plan of reorganization that does not provide for liquidation of all or substantially all of their assets and if the company emerges from bankruptcy as an operating business. Under those limited circumstances, the business debtor will receive a discharge to the extent that the amount of claims to be paid under the plan differs from the amounts owed to creditors as of the petition date. 11 U.S.C. § 1141.
26. The modern common-law notion that the directors of a financially distressed corporation owe a duty of care to its creditors finds its genesis in Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp. 1991 WL 277613, 1991 Del. Ch. Lexis 215 (Del. Ch. Dec. 30, 1991). Similarly, Pepper v. Litton, 308 U.S. 295, 307 (1939) is the seminal case that established, among other things, that controlling shareholders, like directors, owe fiduciary duties that are "designed for the protection of the entire community of interests in the corporation-creditors as well as stockholders."
27. 11 U.S.C. § 524(a)(2); Ruvacalba v. Munoz (*In re* Munoz), 287 B.R. 546 (9th Cir. BAP 2002).
28. 11 U.S.C. § 523(a).
29. 11 U.S.C. § 523(a)(5).
30. 11 U.S.C. § 523(a)(8).
31. 11 U.S.C. § 523(a)(9).
32. 11 U.S.C. § 523(a)(7).
33. 11 U.S.C. § 523(a)(1).
34. 28 U.S.C. §§ 157 and 1334(b); *In re* Green, 198 B.R. 564, 566 (9th Cir. BAP 1996); Pelletier v. Donald (*In re* Donald), 240 B.R. 141, 146 (1st Cir. BAP 1999).
35. 11 U.S.C. §§ 523(a)(2), (4) and (6); 11 U.S.C. § 523(c); Fed. R. Bankr. P. 4007(c).
36. *See* 3 Norton Bankruptcy Law & Practice, § 47:57 (2d ed. 2002); *see also*, *In re* Tranter, 245 B.R. 419, 420 (Bankr.S.D.Fla. 2000), citing Royal American Oil and Gas Co. v. Szfranski, 147 B.R. 976, 988 (Bankr.N.D.Okla. 1992).
37. 11 U.S.C. § 727(a)(8).
38. The Bank of China v. Huang (*In re* Huang), 275 F.3d 1173, 1177 (9th Cir. 2002); Hayhoe v. Cole (*In re* Cole), 226 B.R. at 647, 652–652 n. 6 (9th Cir. BAP 1998); Johnson v. Kriger (*In re* Kriger), 2 B.R. 19, 23 (Bankr.D.Ore. 1979); Klingman v. Levinson, 831 F.2d 1292, 1296 n. 3 (7th Cir. 1987).
39. Hayhoe v. Cole (*In re* Cole), 226 B.R. at 653; Seven Elves, Inc. v. Eskenazi (*In re* Eskenazi), 6 B.R. 366, 368 (9th Cir. BAP 1980); Doug Howle's Paces Ferry Dodge, Inc. v. Ethridge (*In re* Ethridge), 80 B.R. 581, 586 (Bankr.M.D.Ga. 1987); First Georgia Bank v. Halpern (*In re* Halpern), 50 B.R. 260, 262 (Bankr.N.D.Ga. 1985), *aff'd*, 810 F.2d 1061 (11th Cir. 1987).
40. The Bank of China v. Huang (*In re* Huang); Hester v. Daniel (*In re* Daniel), 290 B.R. 914 (Bankr.M.D.Ga. 2003).
41. Archer v. Warner, 538 U.S. 314 (2003).
42. *Id.* at 315.
43. *See, e.g.*, Ulliman v. Marino (*In re* Marino), 2009 WL 361386 (Bankr.M.D.Fla. 2009).
44. Section 544 of the Bankruptcy Code endows the trustee with the status of "perfect creditor" and a bona fide purchaser for purposes of pursuing actions to avoid pre-petition transfers and bring money and property back into the estate. *See*, Elliott v. Frontier Props. (*In re* Lewis F. Shurtleff, Inc.), 778 F.2d 1416 (9th Cir. 1985).
45. 11 U.S.C. §§ 544–550.
46. 11 U.S.C. § 547(b).
47. 11 U.S.C. § 547(c).