Mediating Disputes Arising Out of Troubled Companies—Do It Sooner Rather Than Later

The Honorable Randall Newsome (Ret.)

My first employer after law school, United States District Judge Carl B. Rubin, 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.

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. A more interesting question, however, 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 there 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. That self-regulation simply has not materialized. One of the stated missions of the United States Trustees, the United States 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 the 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 the Southern District of 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 caseloads, it is a wonder that these judges can function at all. The

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United States 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. During that same period, a staggering 3349 adversary proceedings were filed, an increase of almost 50 percent over the previous year. The 11 judges of the United States 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. During that same period, 2945 adversary proceedings were filed, an increase of some 168 percent over the previous year. Assuming (but in no way conceding) that scorched-earth litigation is ever a cost-effective, productive strategy for obtaining a desired result, there is just 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.

If a claimant seeks to realize the maximum amount of dollars on their claim in the shortest possible time, then early resolution of disputes is essential. 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 1983, an involuntary chapter 11 petition was filed against Baldwin-United Corporation ("Baldwin-United") in the United States Bankruptcy Court for the Southern District of Ohio. 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 10 percent recovery seemed optimistic, and the case was predicted to last a decade or more.

The principal difficulty was that the bulk of the 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 debtors. In January 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 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. Each was sent to mediation, and they were all resolved by the end of 1985. A plan was confirmed in March 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 70 cents on the dollar, seven times what the banks 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 United States Bankruptcy Court for the Northern District of California on April 6, 2001. While 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 the competing plan of the CPUC 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. In March 2003, after 28 days of trial and with seemingly no end in sight, the matter was submitted to judicially-supervised mediation. Three months later, a deal was reached that allowed a plan of reorganization to be confirmed by the end of December 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 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 ("Crescent"). When it filed its chapter 11 petition in the United States Bankruptcy Court for the Northern District of California in August 2004, the company had approximately 103 stores and $140 million in annual revenues. Harbinger Capital Partners Master Fund I ("Harbinger") bought Crescent's parent company, Friedman's, Inc. ("Friedman's"), 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 such 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.

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. Most significantly, mediation is a process that ought to begin at the outset of conflict rather than after thousands or millions of dollars have already been spent pursuing the conflict.

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