

BANKRUPTCY FOR MEDIATORS: AN INTERACTIVE WORKSHOP

DISPUTE RESOLUTION CENTER CONFERENCE

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OBJECTIVES

- ▶ Understand basic bankruptcy concepts to avoid violating bankruptcy laws and rules and prevent bankruptcy litigation
- ▶ Recognize bankruptcy issues that can arise in mediation and how to address them
- ▶ Use bankruptcy knowledge to ask better questions to help parties analyze options when financial distress is an issue

ORGANIZATION OF THIS WORKSHOP

- ▶ Part I: Introduction to basic bankruptcy concepts and process
- ▶ Part II: Application to family law and commercial disputes
- ▶ Part III: Scenario for small groups to work through

A CAVEAT

- ▶ Bankruptcy is complex. Its scope is broad and it has powerful tools but it is honeycombed with exceptions and exceptions to the exceptions.
- ▶ This workshop is not intended to delve into subtleties of bankruptcy law and procedure but to acquaint mediators with basic terminology and a process overview to promote a general understanding of the issues bankruptcy may add to parties' disputes and avoid creating new ones.



PART I

BASIC BANKRUPTCY CONCEPTS

BANKRUPTCY AUTHORITY

- ▶ Article I, section 8 of the U.S. Constitution
- ▶ U.S. Bankruptcy Code (11 U.S.C. 101 et seq.)
- ▶ Federal appellate courts appoint bankruptcy judges for 14-year renewable terms
- ▶ 90 bankruptcy courts in federal districts
- ▶ Office of U.S. Trustee within the Department of Justice

BANKRUPTCY CODE GOALS

- ▶ Fresh start for honest but unfortunate debtor
- ▶ Equitable distribution to creditors to avoid race “going to the swift”

IMPORTANT BANKRUPTCY TERMS

- ▶ The Petition
- ▶ The Debtor
- ▶ The Estate
- ▶ Creditor/claim
- ▶ Automatic stay
- ▶ Discharge
- ▶ Exceptions to stay/discharge
- ▶ Bankruptcy chapters
- ▶ Trustee's avoiding powers

The Petition

- ▶ Filing petition with bankruptcy court initiates the case
- ▶ Petition divides debtors world into two temporal parts
 - ▶ Pre-petition
 - ▶ Post-petition

Bankruptcy claims generally arise from pre-petition activity.

THE DEBTOR AND THE ESTATE

- ▶ Debtor is the filer (in chapter 11 reorganization, term is debtor-in-possession)
- ▶ Filing the petition creates an estate
- ▶ Estate property defined differently under different chapters
- ▶ Debtor retains exempt property
- ▶ Property broadly defined to include interests such as unperfected claims

PROTECTION FOR THE FILER: IPSO FACTO CLAUSES

- ▶ Party to an unexpired contract or lease cannot terminate it **solely** because other party has filed for bankruptcy
- ▶ Bankruptcy Code has provision for debtor to assume or reject contracts not yet fully executed
- ▶ Exception: personal services contracts (i.e., services requiring special knowledge, judgment, taste or ability).

CREDITORS AND CLAIMS

- ▶ Creditor is anyone with a claim
- ▶ Claim broadly defined as either:
 - ▶ Right to payment whether liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured
 - ▶ Right to equitable remedy for breach of performance if such breach gives rise to right to payment, whether liquidated, etc.

TYPES OF CLAIMS

- ▶ Priority (pre-petition support obligations, case administrative expenses)
- ▶ Secured (mortgage holder, car loan holder, factor)
- ▶ Unsecured (everyone else except equity holders)
- ▶ Equity (shareholders are last in line)

AUTOMATIC STAY

- ▶ Arises by operation of law as soon as voluntary petition filed
- ▶ Stops pursuit of all judgments, collections, foreclosures, repossessions, by creditors on any debt or claim that arose before filing (whether or not reduced to a judgment)
- ▶ Very broad - includes all debt collection activity including telephone calls
- ▶ Willful violations of stay can lead to imposition of monetary damages including costs and attorney fees, and in extreme cases, punitive damages

EXCEPTIONS TO AUTOMATIC STAY

- ▶ Family law exceptions:
 - ▶ Civil action to establish paternity, domestic support, custody/visitation, marriage dissolution (but not to determine division of property that is property of the estate)
 - ▶ Actions with regard to domestic violence
 - ▶ Withholding income under domestic judicial or administrative order or statute, reporting overdue support to consumer reporting agency

OTHER IMPORTANT STAY EXCEPTIONS

- ▶ Exercise of governmental regulatory, tax, police power both criminal and civil (up to but not including actual collection of money)
- ▶ Eviction actions for commercial leases where lease term has expired
- ▶ Eviction actions where the landlord already has obtained judgment for possession
- ▶ Withholding for retirement accounts
- ▶ Offsetting and netting from swap agreements

RELIEF FROM STAY

- ▶ Motion to lift stay may be made for “cause”
 - ▶ Secured creditor seeking for foreclose on collateral can show cause where debtor has no equity in it.
 - ▶ Party suing debtor may seek to reduce claim to judgment in original court while agreeing to satisfy it solely in bankruptcy. Judges have discretion to grant and result may depend on timing.

THE DISCHARGE

- ▶ Permanent order issued at end of case prohibiting any form of action on certain types of specified debts, including legal action and communication with debtor
- ▶ Violation of discharge order punishable by contempt, fines
- ▶ Valid liens debtor has not been able to extinguish “ride through” the cases - once case is over secured creditor can enforce lien to recover property secured by lien

DISCHARGE EXCEPTIONS --AUTOMATIC

- ▶ Support or alimony
- ▶ Certain tax claims
- ▶ Fines and penalties imposed by governmental units
- ▶ Government funded or guaranteed education loans or benefit overpayments
- ▶ Personal injury from drunk driving
- ▶ Amounts owed to certain tax-advantaged retirement plans
- ▶ Certain condominium or coop fees

DISCHARGE EXCEPTIONS BY ADVERSARY PROCEEDING

Debts arising from

- ▶ Fraud
- ▶ Fiduciary defalcation
- ▶ Willful and malicious injury to another or to their property

DISCHARGE LIMITATIONS - CONCEALMENT AND FRAUD

- ▶ Debts not listed in required filings not discharged
- ▶ Bankruptcy court may deny discharge for
 - ▶ failure to provide tax documents,
 - ▶ failure to complete course in personal financial management,
 - ▶ transfer or concealment of property,
 - ▶ destruction or concealment of books and records
 - ▶ perjury
 - ▶ failure to account for loss of assets
 - ▶ violation of a court order.

Court may revoke discharge for fraud/concealment within statutory time frame

PRACTICE QUESTION

- ▶ Mediated settlement is filed in county court with the usual default clause that if performance is not made (i.e., payment made by the due date) judgment will be entered in the full amount of the claim. Defendant defaults and tells creditor they can't pay - creditor responds by filing affidavit to obtain judgment. Defendant files bankruptcy and suggestion of bankruptcy with the county court.
- ▶ What happens?
- ▶ What bankruptcy provisions are implicated?
- ▶ What options do the parties have?

TYPES OF BANKRUPTCY

- ▶ Chapter 7 Liquidation (69% of 2021 filings)
 - ▶ Chapter 9 Adjustment of debts of municipality*
 - ▶ Chapter 11 Reorganization (1% of 2021 filings)
 - ▶ Chapter 12 Adjustment of debts of family farmer or fisherman with regular income*
 - ▶ Chapter 13 Adjustment of debts of individual with regular income (29% of 2021 filings)
 - ▶ Chapter 15 Ancillary and other cross-border cases*
- ▶ * Chapter 9, 12 and 15 filings combined were less than 1% of 2021 filings.

CHAPTER 7 LIQUIDATION

- ▶ Who may file: individual, corporation, or other business entity. Individuals subject to means test to funnel debtors with disposable income into chapter 13.
- ▶ Process: trustee appointed to gather and sell non-exempt assets and distribute to creditors in accordance with bankruptcy priorities. Debtor must file list of all creditors and nature of claims, as well as list of all property, income and expenses.
- ▶ Property of the estate. Only assets (including inchoate assets like potential lawsuits) held as of petition date are property of estate. Debtor's post-petition income is not property of the estate and not available to creditors.

Nature of Chapter 7

- ▶ According to the U.S. Trustee's office, most chapter 7 cases are no asset cases, meaning there is no non-exempt property to distribute. If there are no claims for trustee to pursue to recover assets for benefit of creditors, case moves to conclusion swiftly.
- ▶ Chapter 7 discharge is subject to the exceptions described in the discharge exceptions slide.

CHAPTER 13 (WAGE EARNER'S PLAN)

- ▶ Who can file: any individual with secured and unsecured debts under maximum limits as adjusted with the CPI. (Above the limit goes to chapter 11) Corporations and partnerships are not eligible for chapter 13.
- ▶ Expanded stay: co-debtor on consumer debt also protected by stay
- ▶ Process: Debtor develops plan to make installment payments to creditors over 3 to 5 years. Unlike chapter 7, chapter 13 debtor can cure delinquent mortgage or car payments over time but must pay timely all payments that come due during the case. Trustee is appointed to administer case and disburse payments to creditors. Similar filing requirements to chapter 7.
- ▶ Property of the estate: Includes debtor's post-petition income. Plan payments come from disposable income, not liquidation of assets.
- ▶ "Super" discharge. Debts for willful/malicious injury, certain tax obligations, marital property settlements are discharged in chapter 13.

HARDSHIP DISCHARGE

If debtor fails to complete all plan payments, can get hardship discharge where:

- ▶ Failure results from circumstances beyond debtor's control
- ▶ Creditors received at least as much as would have in chapter 7 and
- ▶ Modification of plan is not possible.

No super discharge with hardship discharge; all exceptions apply.

CHAPTER 11 REORGANIZATION

- ▶ Who can file: individuals and business entities. With filing of petition, debtor becomes “debtor in possession” (DIP), keeping control of assets while undergoing reorganization without appointment of trustee. DIP may hire counsel and other professionals, with court approval, paid from the estate.
- ▶ Process: goal is creation of a reorganization plan voted on affirmatively by majority of creditors and confirmed by bankruptcy court. Largely a negotiated process. Mediators often brought in to help plan negotiations.
- ▶ Property of estate. For an individual debtor, includes post-petition earnings/assets but not for entity.
- ▶ Creditors committee. U.S. Trustee appoints an unsecured creditors committee (UCC) to negotiate with debtor over plan (not in small business cases). UCC may hire counsel and other professionals with court approval, paid from the estate.

THE REORGANIZATION PROCESS

- ▶ DIP has sole right to propose plan during first 120 days (subject to extensions granted by court up to 20 months) DIP must file disclosure statement explaining how creditor's claims will be treated and court must approve it.
- ▶ Statement is circulated and creditors vote on plan in classes (secured, unsecured priority, general unsecured). If any class not getting 100% it is impaired and at least 1 impaired class must vote to accept plan. Class accepts plan if affirmative votes are 2/3 of dollar amount and more than 1/2 in number of allowed claims in the class.
- ▶ If above criteria met, court holds hearing on plan. Court must find plan is feasible, proposed in good faith and in compliance with the bankruptcy code (e.g., can't ignore priorities of claims).
- ▶ This process applies to other parties that propose a plan once DIP's exclusive period ends.

PLAN IMPLEMENTATION

- ▶ Upon confirmation, DIP must make plan payments and is bound by plan provision. Confirmed plan creates new contractual rights that replace those that existed pre-petition.
- ▶ No discharge exceptions for corporate entities. Individuals are subject to the same discharge exceptions as Chapter 7.

PRACTICE QUESTION

You are mediating a case involving an unsecured loan. Defendant discloses the existence of multiple credit cards in default and that bankruptcy is an option.

- ▶ How is the evaluation of the alternatives for the parties affected by which bankruptcy chapter is available?
- ▶ What information do you need to determine under which bankruptcy chapter a filing could be made?

AVOIDANCE ACTIONS

Bankruptcy Code authorizes trustee or DIP to recover property transferred pre-petition, to ensure assets are distributed fairly among creditors. Two most common types of actions are:

- ▶ Preferences. Debtor prefers one creditor above others. Generally, payment to creditor within 90 days of petition for an antecedent debt may be avoided subject to exceptions such as ordinary course of business recurring payments or where new value was given in exchange. For insiders of debtor, time period extends to one year of petition.
- ▶ Fraudulent conveyances. Payment not in exchange for a reasonably equivalent value, or which causes insolvency, may be a fraudulent conveyance. State law generally governs these claims and how far back in time such transfers can be recovered.

AVOIDING AVOIDANCE ACTIONS

Sophisticated parties dealing with entities where there is some likelihood of bankruptcy (e.g., company has junk bond rating) try to build in protections against preferences.

- ▶ A settled claim might not be released until 91 days after payment
- ▶ Payment could be made by an advance fee retainer (where permitted by state law)
- ▶ Earmarking (payment by third party to a particular creditor).
- ▶ Advance payments could be held in an escrow account.

PRACTICE QUESTION

You are asked to mediate a case where one party is openly contemplating bankruptcy. You are concerned about losing your fee.

- ▶ What can you do?
- ▶ What can't you do?



Part 2

MEDIATION AND BANKRUPTCY IN ACTION

DIVORCE MEDIATION AND BANKRUPTCY

- ▶ Bankruptcy can be a tool for dealing with marital debt
- ▶ Stay and discharge exceptions designed to defer to family court on core family issues such as custody and support
- ▶ Bankruptcy court handles marshalling assets and dealing with creditors
- ▶ Complex because different issues going forward in two different courts

COORDINATING MEDIATION IN TWO FORA

Family court

- ▶ Child Support
- ▶ Alimony
- ▶ All issue related to children (e.g., custody)

Bankruptcy court

- ▶ Gathering of assets and debts
- ▶ Property settlement
- ▶ Avoidance actions
- ▶ Asset liquidation or plan

ADVANTAGE OF BANKRUPTCY COURT IN DIVIDING UP DEBT

- ▶ Divorce settlement assigning a joint debt to one ex-spouse does not bind absent creditor
- ▶ Creditors often pursue both spouses after divorce
- ▶ In bankruptcy, all creditors can participate and all will be bound by results and discharge

BANKRUPTCY QUESTIONS IN DIVORCE

- ▶ Timing -before or after divorce
- ▶ Who files - jointly or singly (joint available to married couple)
- ▶ Which chapter
- ▶ Division of assets and liabilities
- ▶ Dealing with exempt assets
- ▶ Is mediation needed in both courts



COMMERCIAL BANKRUPTCY

The Mediation Landscape in Chapter 11

MAJOR DETRIMENTS TO CHAPTER 11 FILING

- ▶ Broad disclosure obligations
- ▶ Fiduciary duty to creditors
- ▶ Potential loss of control
- ▶ Expensive

MAJOR BENEFITS OF CHAPTER 11

- ▶ All creditors are bound
- ▶ Reduces opportunities for spoilers and holdouts
- ▶ Requirement of judicial approval of settlements helps ensure fairness
- ▶ Strong culture of negotiation/mediation

MEDIATING IN BANKRUPTCY COURT -- DIFFERENCES

- ▶ New parties to the process
 - ▶ Trustee
 - ▶ Litigation trust
 - ▶ Unsecured creditors committee
- ▶ No history of case/dispute
- ▶ Different set of obligations and goals

MEDIATION AGREEMENT DIFFERENCES

- ▶ Payment distribution scheme impacts parties' recovery from a settlement
 - ▶ Can add complexity to agreements such as waterfall distribution
- ▶ Time frame can be constrained by Bankruptcy Code process
 - ▶ Notice to all creditors and motion to approve settlement
 - ▶ Coordination with plan proposal/confirmation process
 - ▶ Plan consummation to prevent drawn-out appeals
- ▶ Disputes over plan terms -many interested parties may want to participate other than the particular disputants

QUESTIONS TO CONSIDER

- ▶ Should case be in bankruptcy court or another court?
- ▶ What kind of mediator is needed?
- ▶ What procedures are needed to deal with multiple parties?



SCENARIO

You are mediating a case involving a large credit card debt. The defendant has been using a debt consolidation company to deal with several other credit cards but which did not get an agreement with this plaintiff. The parties are not anywhere near a settlement range. Defense counsel has raised the possibility of bankruptcy.

ASSIGNMENT

- ▶ What information is needed to assess the options available to defendant?
Make a list.
- ▶ Develop options based on assumed answers.
- ▶ What are the pros and cons for bankruptcy for this defendant? For the plaintiff?
- ▶ What are their BATNAs and WATNAs?

QUESTIONS?

Thank you for attending

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