

# Top 10 Things Mediators Need to Know About Bankruptcy



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Bankruptcy lawyers speak  
their own language and it  
is full of numbers and  
acronyms.



- 341 Meeting
- 362 Stay
- 363 Sale
- 2004 Exam
- 9019 Motion
- SOFAs
- DIP


# Why is this important in mediation?

- Knowing the lingo increases understanding and communication between the parties.
- Knowing the concepts helps the parties understand the risks of not reaching a consensual settlement at mediation.




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Bankruptcy is a code-based  
practice.






- Bankruptcy is governed by title 11 of the United State Code, the Bankruptcy Code.
- While case law is important, bankruptcy practitioners start with the Bankruptcy Code.
- Then we have the Federal Rules of Bankruptcy Procedure, then the local rules, and the local, local rules.


# Why is this important in mediation?

- Once the bankruptcy is filed, settlements of the debtor's claims must be approved by the Bankruptcy Court and must comply with the provisions of the Bankruptcy Code, including the priority scheme of the Code.
- Removes some ability to be creative in settling disputes.

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The Bankruptcy Code provides  
for several chapters of  
bankruptcy.



# Bankruptcy Chapters

- **Chapter 7** – Liquidation – may be a business or an individual. A Chapter 7 trustee is appointed to gather and liquidate assets and pay the creditors.

# Bankruptcy Chapters

- **Chapter 9** – provides for the adjustment of debts of a municipality

# Bankruptcy Chapters

- **Chapter 12** – provides for the adjustment of debts of a family farmer or fisherman with regular annual income.

# Bankruptcy Chapters

- **Chapter 13** – provides for the adjustment of debts of an individual with regular income. It is available for individuals who have less than \$394,725 in unsecured debt and less than \$1,184,200 in secured debt.



# Bankruptcy Chapters

- **Chapter 11** – Reorganization – business or individuals

# Why is this important in mediation?

- Each chapter of bankruptcy has its own benefits and risks and may come into play when the parties are trying to reach a settlement.
- For example, in a chapter 7, an individual can be in and out of bankruptcy in a very short time, but they give up all non-exempt assets.


# Why is this important in mediation?

- By contrast, in a chapter 13, an individual retains all of his or her assets, but commits all of his or her discretionary income to the chapter 13 plan for up to 5 years.
- In chapter 7, if there are no unencumbered assets, an unsecured creditor gets nothing.


# Why is this important in mediation?

- If there are unencumbered assets, an unsecured creditor may get a lump sum after expenses and higher priority claims are paid.
- In a chapter 13, an unsecured creditor may get nothing or may receive small payments over the life of the plan.

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A bankruptcy case is generally  
not a two-party dispute.




# Main Players

- Debtor
- Creditors
- United States Trustee
- Chapter 7 Trustee
- Chapter 13 Trustee
- Contract Parties


# Why is this important in mediation?

- Once the bankruptcy case is filed, the plaintiff or the creditor loses its leverage as first to file.
- The Court must approve all settlements after notice and hearing, which means all other constituents in the bankruptcy case must have notice and an opportunity to object to any potential settlement.






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The Bankruptcy Code contains  
a priority scheme for payment of  
debts.



# Priority of Payment

- Secured claims – to the extent of the value of collateral
- Administrative Expense Claims of trustee appointed or elected under section 701, 702, 703, 1104, 1202, or 1302
- Certain Domestic Support Obligations

# Priority of Payment

- Administrative Expenses
- Priority wage claims up to \$12,850
- Claims for contributions to an employee benefit plan
- Claims by people engaged in grain production or fishing

# Priority of Payment

- Claims for deposits for consumer purchases, lease or rental of property or purchase of services.
- Certain taxes
- Claims for commitment to Federal deposit institution regulatory agency

# Priority of Payment

- Claims for death or personal injury from operation of a vehicle or vessel while debtor was intoxicated
- Other general unsecured claims
- Equity

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- Claims for death or personal injury from operation of a vehicle or vessel while debtor was intoxicated
- Other general unsecured claims
- Equity


# Why is this important in mediation?

- A creditor who was the first to file a lawsuit, may still be the last to be paid in a bankruptcy case.
- A creditor may be willing to take less on a settlement in mediation, rather than risk getting nothing by forcing a debtor into a bankruptcy.




# Why is this important in mediation?

- A debtor may want to pay something to a creditor to preserve an on-going relationship, rather than file for bankruptcy where the debtor has less control over the priority of payment of its creditors.
- As administrative costs increase in bankruptcy, less money is available for general unsecured creditors.



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Federal Rule of Bankruptcy Procedure 9019 governs court approval of settlements and provides:

“On a motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement. Notice shall be given to creditors, the United States trustee, the debtor, and indenture trustees as provided in Rule 2002 and to any other entity as the court may direct.”

Fed. R. Bank. P. 9019

# Why is this important in mediation?

- All compromises and settlements must be approved by the Bankruptcy Court.
- Court must review factual information to determine if the settlement is fair and equitable to creditors. *Protective Commonwealth for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424, 88 S.Ct. 1157, 20 L.Ed.2d 1 (1968)

# Why is this important in mediation?


- In making the determination, courts have considered the following *TMT Trailer* factors:
  - the probabilities of ultimate success should the claim be litigated
  - an educated estimate of the complexity, expense, and likely duration of such litigation,
  - the possible difficulties of collecting on any judgment which might be obtained,
  - all other factors relevant to a full and fair compromise.

# Why is this important in mediation?


- In determining whether to approve a proposed settlement, a bankruptcy court need not decide the numerous issues of law and fact raised by the settlement, but rather should “canvas the issues and see whether the settlement ‘fall[s] below the lowest point in the range of reasonableness.’”  
Cosoff v. Rodman (In re W.T. Grant Co.), 699 F.2d 599, 608 (2d Cir. 1983) (quoting Newman v. Stein, 464 F.2d 689, 693 (2d Cir. 1972)).

# Why is this important in mediation? In bankruptcy, everyone is invited to the party.

- It is appropriate for the court to consider the opinions of the trustee or debtor in possession that a settlement is fair and equitable. *Nellis v. Shugrue*, 165 B.R. 115, 122 (S.D.N.Y. 1994).
- Court should consider the amount of creditor support for compromise as a factor bearing on the wisdom of the compromise. *Connecticut Gen. Life Ins. Co. v. United Cos. Fin. Corp. (In re Foster Mortgage Co.)*, 68 F.3d 914 (5<sup>th</sup> Cir. 1995)



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Filing a bankruptcy case creates a stay. The stay is automatic, and the penalties for violating it are strong.

# What is stayed?

- Commencement or continuation of all actions or proceedings against the debtor that could have been commenced before the bankruptcy case
- Enforcements of judgment against the debtor or property of the estate
- An act to obtain possession of or control over property of the estate

# What is stayed?


- Any act to create, perfect, or enforce any lien against property of the estate or the debtor
- Any act to collect, assess, or recover a claim against the debtor that arose before the bankruptcy
- Tax proceedings

# Penalties for violating the Automatic Stay


- An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages. 11 U.S.C. 362(k)(1)
- Corporations may receive damages pursuant to contempt powers of Bankruptcy Court

# Why is this important in mediation?

- Everything is stayed.
- Any momentum that may have been generated by settlement discussions is lost.
- To proceed with litigation, the non-debtor party has to seek and obtain relief from stay from the bankruptcy court.
- Debtor party loses ability to settle without approval of bankruptcy court.



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# Bankruptcy calls for full disclosure

- Debtor must file complete schedules and SOFAs under penalty of perjury
- Debtor must attend a 341 meeting and answer questions of the trustee and creditors

Debtor, or any entity, could be subject to a 2004 examination related to the acts, conduct, property, or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or the debtor's right to a discharge.



# Why is this important in mediation?

- Potential Debtor may be motivated to settle rather than bear the scrutiny of a bankruptcy filing.
- Threat of bankruptcy can come from either side.
- Debtor can be put into a bankruptcy filing involuntarily.



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The Bankruptcy Code governs the  
allowance and disallowance of  
claims.

11 U.S.C. § 502

# Bankruptcy Code caps certain damages:

A landlord's claim for damages for future rent and other lease obligations resulting from a debtor's rejection of a lease of real property with more than one year remaining is limited to the rent reserved by the lease, without acceleration, for the greater of

- (a) one year or
- (b) 15 percent, not to exceed three years of the remaining lease term following the earlier of (x) the petition date and (y) the date on which the landlord repossessed or the debtor surrendered the property.

# Bankruptcy Code caps certain damages:

- Plus:
- The landlord's separate claim for any unpaid rent and other charges due under the lease, without acceleration, as of either the date of the filing of the bankruptcy petition or the date on which the landlord obtains possession, whichever is earlier.

**The claim of an employee for damages resulting from the termination of an employment contract, is disallowed to the extent such claim exceeds**

- (A) the compensation provided by such contract, without acceleration, for one year following the earlier of—
  - (i) the date of the filing of the petition; or
  - (ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract;plus

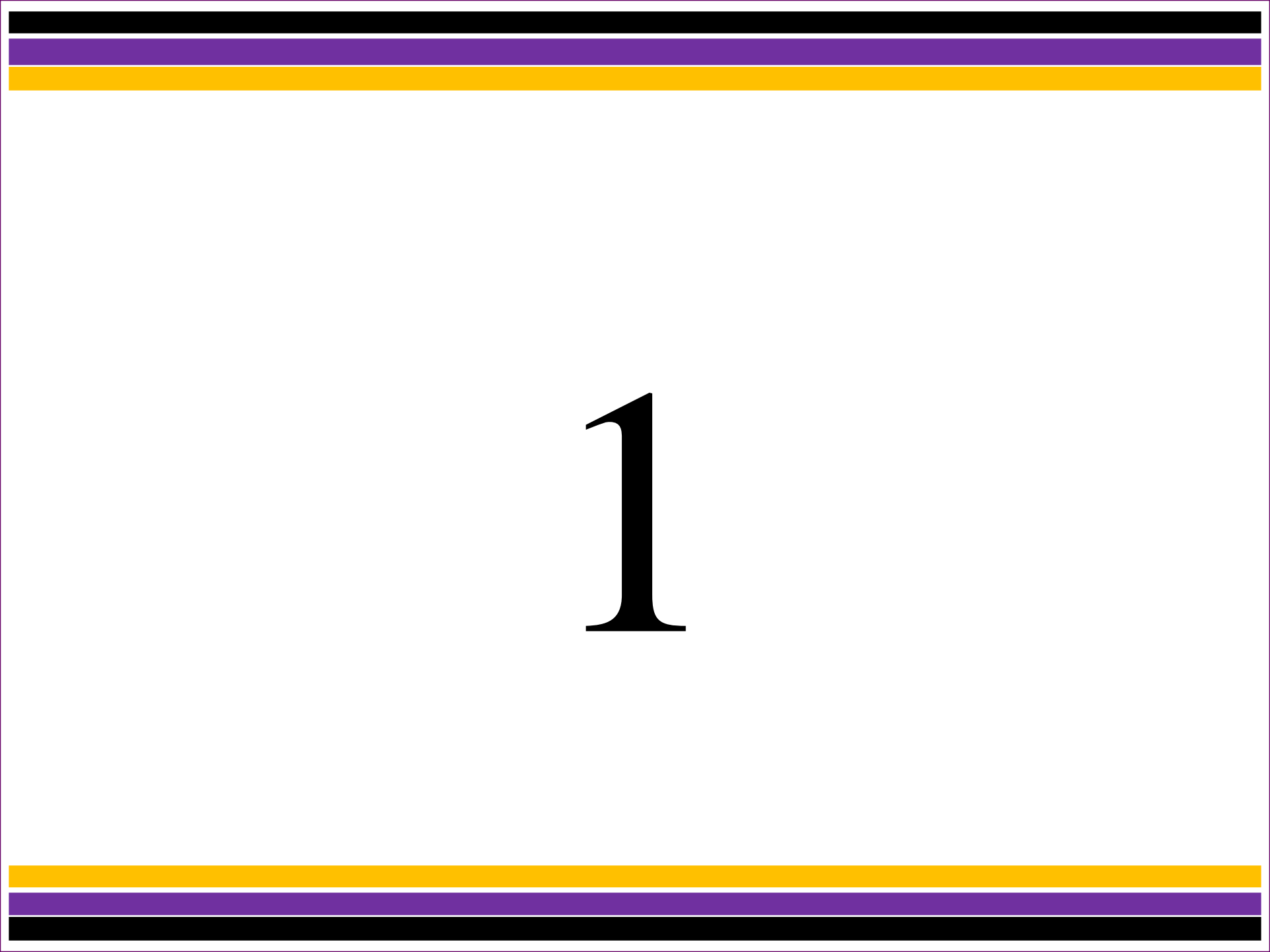
**The claim of an employee for damages resulting from the termination of an employment contract, is disallowed to the extent such claim exceeds**

- (B) any unpaid compensation due under such contract, without acceleration, on the earlier of such dates;

# **Why is this important in mediation? Pigs get fat and hogs get slaughtered.**

- Pushing too hard on potential debtors, may force them into bankruptcy where the Code will limit recovery.
- Settlement will not be approved over the limits provided in the Code.
- Even if the settlement is approved, there may not be sufficient funds to pay it.





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The goal of the individual debtor  
is the discharge of his or her debt.



**Bankruptcy Code provides for many exceptions to discharge. 11 U.S.C. § 523(a) exceptions include:**

- (1) Certain taxes
- (2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by
  - (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

# **Bankruptcy Code provides for many exceptions to discharge. Exceptions include:**

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive;

# More exceptions to discharge:

- (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;
- (5) for a domestic support obligation;
- (6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

# More exceptions to discharge:

- (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
  - (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
  - (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition;

# **More, but still not all, exceptions to discharge:**

- (15) to a spouse, former spouse, or child of the debtor and not of the kind described in paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other order of a court of record, or a determination made in accordance with State or territorial law by a governmental unit;

# Why is this important in mediation?

- If the potential debtor cannot get a discharge of his or her debts, then there is less incentive to file for bankruptcy.
- If the terms of the settlement require a finding of fraud, or one of the other elements that would render a claim non-dischargeable, that may be a deal breaker.





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