American Bankruptcy Institute

Top Five Tips in Preparing for Bankruptcy Mediation

Committee: Business Reorganization

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Most bankruptcy attorneys are born negotiators. It is part of our DNA to zealously advocate for our client's position and simultaneously explore options for consensual resolution. Unfortunately, many bankruptcy disputes cannot be resolved this way. Perhaps the client has unrealistic expectations, or perhaps there is a personality conflict between the lawyers and their clients. Or possibly the lawyer, the client or both view settlement dialog as a sign of weakness. Or the dispute is so complex that the parties are unable to figure out how to even begin discussing a compromise. The list of reasons for not resolving is infinite. As a result, it has become increasingly common for bankruptcy court judges to refer adversary proceedings and contested matters to mediation to facilitate a faster, more cost-effective and consensual resolution of disputes.

To facilitate this trend, bankruptcy courts in many jurisdictions have adopted local rules regarding mediation, while other courts are in the process of considering such rules. Moreover, the ABI Bankruptcy Mediation Committee has recently developed model rules that can be adopted in whole or part. Consequently, mediation, which has long been a routine part of state and federal court trial practice, will soon be equally ingrained in bankruptcy practice.

Few bankruptcy attorneys would go to court for a contested matter totally unprepared. What many attorneys do not realize is that it is equally important to prepare for mediation. This is particularly true for bankruptcy mediation, which is often more complex than mediation of a dispute pending in a state trial court. Ben Franklin had it right when he said that "[b]y failing to prepare, you are preparing to fail." With this in mind, below are practical tips to help you prepare to succeed at mediation.

Client Education

A successful mediation starts with client education. If the client has never attended mediation before, then they will need to be educated about the mediation process. Clients should understand that mediation is an informal process with a trained neutral party who will facilitate settlement discussions. The mediator is neither judge nor jury, but a facilitator. The client should be advised that while trials are about winning, mediation is about compromise. And they should understand an important corollary to this: At trial, clients do not decide the outcome, the court does, whereas in mediation, clients decide whether or not to settle, thus deciding the outcome.

Not only does mediation empower clients to resolve their disputes, instead of having a resolution imposed on them, but mediation is also an opportunity to be creative. This is an important aspect to settlement. Outside of consensual resolution (whether through negotiation or mediation), there is often little creativity involved in fashioning the remedy. The opportunity for creative solutions is particularly important in bankruptcy disputes because of the unique nature of bankruptcy litigation.

Client education should not be limited to discussing the mediation process (what it is and how it works), but should also include education about how bankruptcy mediation differs from mediation in other contexts. Many clients have participated in mediation before, but perhaps not in a

bankruptcy mediation. There are several important differences between mediation of a state or federal trial court dispute and mediation of a bankruptcy dispute. The most significant of these differences include:

1. *Confidentiality:* In contrast to civil litigation mediation, the confidentiality of mediation of a bankruptcy dispute may not be inviolate. If a debtor company with SEC reporting requirements is involved, then the debtor may have disclosure obligations.[1] Regardless of SEC disclosure requirements, settlements in a bankruptcy case are generally subject to court approval (thus disclosure) and/or may need to be addressed in a debtor's disclosure statement.
2. *Timing of Closing on Settlement:* A settlement in a bankruptcy case is typically contingent upon court approval and may also be contingent upon plan confirmation and consummation.
3. *Payment of a Settlement:* If the settlement will be paid by a debtor, then it may be paid in "bankruptcy dollars" (meaning the percentage of recovery under the confirmed plan) or a non-monetary form of plan consideration (such as stock, trust certificates and/or a note).
4. *Role of Third Parties:* In addition to possibly requiring court approval, even if the underlying dispute involves only two parties (*e.g.*, the debtor and a creditor), whether to settle and on what terms may require input from third parties such as the statutory unsecured creditor's committee, the post-petition lender, or the U.S. Trustee.

Moreover, it is quite common that a bankruptcy mediation is a multi-party dispute, which tends to add greater complexity to the process and the outcome.

Recognizing Cognitive Barriers

We are all human. Thus, our ability to objectively evaluate settlement offers may be clouded by cognitive barriers. Recognizing these cognitive barriers enables us to move past our blind spots to enhance settlement opportunities in mediation. Cognitive barriers may impact assessment of our own position or of the other side's position. They may impact assessment of risk — ours or the other side's. They may impact our understanding of the issues, which may be different for each side. Cognitive barriers can also impact our ability to evaluate the value of our case or the other side's case. Each of these barriers can impede the mediation and settlement process. Common cognitive barriers include:

a. *Advocacy Bias:* Both client and counsel may develop advocacy bias as the case progresses. Inherently, to build a case, we must focus on the facts and law that support our position. However, over time, we become so enmeshed in our "winning" position that we may be unable to comprehend adverse information. Instead, we are biased to either dismiss unfavorable information or re-interpret it to be favorable. But in mediation, parties must set aside their advocacy bias and truly examine the strengths and weaknesses of their case in order to accurately evaluate settlement offers.
b. *Cognitive Dissonance:* Cognitive dissonance presents a similar barrier. It is the psychological inability to consider data that contradicts our viewpoint. Instead of analyzing the information and re-evaluating the strengths and weaknesses of our case, we lash out at the other side, blaming them or devaluing their position or interests to strengthen ours. The result is that our emotions impede the settlement process.
c. *Loss Aversion:* Loss aversion is a psychological distortion causing us to negatively view any settlement proposals that we perceive to represent a loss. This results in the rejection of offers that, if re-framed to sound like either a win for us or a neutral outcome, would have been accepted.
d. *Competitive Arousal:* This barrier is exactly what it sounds like: A party in mediation becomes so fixated on winning the negotiation (aroused by the competition) that they reject compelling settlement offers because of their need to feel that they have defeated their opponent and obtained a better settlement than would otherwise have been achieved.

When preparing for mediation and during the mediation, parties (clients and counsel) should make every effort to overcome cognitive barriers when considering settlement parameters and settlement offers.

Analyze Your BATNA and WATNA

In order to meaningfully consider a settlement offer, parties must analyze their best alternative to a negotiated agreement (BATNA) and worst alternative to a negotiated agreement (WATNA). This analysis should begin prior to mediation and be re-assessed throughout the course of the mediation. Knowing your BATNA and WATNA will provide you with a basis to evaluate offers made during the mediation.

Determining your BATNA and WATNA requires a multi-faceted analysis. It is not simply what do I get if I win versus what do I get if I lose. Instead, it takes into consideration all of the costs associated with winning or losing. Factors to be considered include the quantifiable costs of going to trial (*i.e.*, attorney's fees, expert fees, court costs, etc.), intangible costs of going to trial (lost productivity, reputation concerns and publicity, witness availability, etc.), likelihood of success on the merits, collectability of any judgment, and, to the extent any judgment or settlement amount will be paid by a debtor, the anticipated rate of recovery and form(s) of plan currency available for payment. Other variables to

consider are the time value of money, the risk that there will be new developments in the bankruptcy case or case law that help or hurt your position, potential precedential value of any adverse ruling by the court, and, if relevant, the desire for ongoing business relationships.

For illustrative purposes, here is an overly simplistic example. Assume the dispute is a simple contract dispute over one provision where Party A asserts that Party B owes it $100,000 and that this particular claim will be paid in full. If Party A believes that it has a 70 percent likelihood of success at trial and that it will cost it $30,000 to try the case, then its BATNA is $49,0000 (70 percent of $70,000), while its WATNA is having to pay $30,000 in legal fees and receiving nothing from Party B. Thus, Party A's BATNA is to receive $49,000, while its BATNA is to pay $30,000. And this is before factoring in all of the other variables.

It is important to thoughtfully evaluate your BATNA and WATNA prior to starting the mediation. Depending on the complexity of the dispute, this analysis cannot be done "on the fly" at mediation. In addition, parties in mediation should constantly reexamine their BATNA/WATNA analysis during the course of the mediation. Information shared through the mediation process may impact the underlying assumptions, and thus change the assessment of your BATNA or WATNA or both.

Consider Settlement Options

Particularly in complex matters, parties should consider settlement options prior to starting the mediation. This includes exploring their interests, rather than positions, regarding the dispute. Interests represent the "why care" of the litigation. Why does either party care whether it wins or loses? While the dispute may nominally be about money, there are often other factors. For example, there could be underlying business concerns (*e.g.*, competition, reputation, publicity, safety or quality control) or financial concerns (*e.g.*, liquidity, solvency or covenant violations). Identifying and understanding each side's interests is often an important step toward developing a creative solution to the problem.

Equally important is exploring non-monetary consideration that a party could offer or request as part of any settlement. Non-monetary consideration includes an apology, discounts on future purchases, repair or modification of defective products, policy changes, letter of recommendation, outplacement services, or renegotiation and assumption of an existing contract. This is an area ripe for creativity. It is not uncommon that the non-monetary components are what ultimately bridge the parties to settlement.

Educate and Use Your Mediator

A mediator is a neutral third party responsible for the mediation process, while the parties are responsible for the outcome. Because the mediator is neither party nor judge, the mediator is coming "cold" to the dispute with no prior knowledge. It is important educate the mediator about prior settlement talks, actual or perceived barriers to resolution, and business concerns and considerations.

In mediation, information is currency. The mediator needs money in the bank (*i.e.*, to be fully informed) in order to effectively facilitate settlement of your dispute. With this information, the mediator can help parties gauge the timing and method of sharing information throughout the mediation process. The better informed the mediator is, the better job the mediator can do.

Mediators are there to serve. They want to help the parties reach the best possible settlement for their case, so use this to your advantage. A good mediator wants you to. Is there a concern for the safety of your client? Do you have a difficult client or one with unrealistic expectations? Do you have compelling facts, but bad law? Do you have compelling law, but bad facts? Do you have compelling facts and law, but there are other circumstances you perceive to be biased for the other side? Inform your mediator about all of these items. The mediator's job is to facilitate a settlement, and in order to do so, the mediator must understand not only your strengths, but also your weaknesses.

Conclusion

Following the suggestions outlined above may improve your chances of achieving a favorable settlement through mediation. However, it is important to recognize that while the goal of mediation is consensual resolution, even if the dispute is not resolved at mediation, parties tend to leave mediation with a better understanding of their dispute, strategic considerations and settlement options. Mediation is a valuable process for parties in a bankruptcy dispute, whether or not the matter settles.

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[1] To what extent, if any, an SEC reporting debtor company must make disclosure is an open and rapidly evolving issue. It can be — and has been — the subject of an article in its own right. As a result, beyond this mention, this article does not address this topic.