When the Glass is Half-Filled with Emptiness: When Insolvency and / or the Threat of Bankruptcy Raise Issues in Mediation [Part 1]

by Rebecca Callahan[1]

For the past ten years we have lived through economically trying times. Virtually every sector has been hit: our national economy, our state economies, Wall Street, financial giants, small businesses, banks, the public sector, the private sector, blue collar workers, and white collar workers. Even if we have not experienced a financial setback personally, we probably know someone who has and most certainly the communities in which we live have been affected at many levels. As a result, some level of financial distress is evident in just about every aspect of our daily lives. It is not surprising to find that in many civil litigation disputes insolvency, the threat of a bankruptcy filing or a bankruptcy filing by one or more parties to the dispute are being encountered. This is the first of a two-part article, the purpose of which is to discuss how insolvency issues might be addressed during the mediation of such disputes. The focus of this article is on redefining the problem and possible solutions so as to help the parties achieve the most that is available under the circumstances and, at the same time, minimize loss and control unnecessary expenditures of resources (namely time and money).

What is insolvency?

Simply stated, insolvency is a financial condition where there is not enough money for what one wants, needs or is otherwise obligated to pay, and it is a condition that can be inflicted on anyone:

- the rich (Donald Trump, Henry Ford, H. J. Heinz, Charles Goodyear)
- the famous (Anna Nicole Smith, Jerry Lewis, Burt Reynolds, Larry King)
- the criminal (Enron, Bernard Madoff, Charles Keating)
- retail giants (Circuit City, Mrs. Fields Famous Brands, Crabtree & Evelyn, Big 10 Tire Stores)
- corporate giants (Chrysler, General Motors, United Airlines)
- municipalities (Orange County, City of Villejo (CA), Washington Public Power System)
- financial institutions (Lehman Brothers, AIG)

There are basically two perspectives from which to evaluate insolvency. From a *cash flow* point of view, insolvency occurs when there is not enough money to pay debts as they come due. From a *balance sheet* perspective, insolvency occurs when total liabilities exceed the fair market value of total assets. When talking about insolvency, it is important to examine *both* points of view. It is also important to:

---

[1] Ms. Callahan is a mediator / arbitrator in private practice in Newport Beach, California. Ms. Callahan received her law degree from Boalt Hall at the University of California / Berkeley and her undergraduate degree from the University of Southern California. Ms. Callahan also has an LLM in Alternative Dispute Resolution from the Straus Institute at Pepperdine University School of Law.

- examine the perceived cause,
- quantify its magnitude in terms of lost revenue or lost value
- compare the current condition to historical performance and / or values, and
- evaluate whether the condition is the result of a short-term reversal, a long-term challenge, or an irreversible, downhill slide.

Insolvency and bankruptcy go hand in hand. As such, when insolvency becomes an issue, a bankruptcy filing frequently is not far behind. Part two of this article will provide a more detailed discussion of "bankruptcy relief", common negotiating points when bankruptcy is threatened or in play and reality factors that may dictate or influence the negotiation outcome.

When might insolvency become an issue in mediation?

There are a number of litigation scenarios that might raise the specter of insolvency. The following are a few of the more common:

Monetary Recovery Disputes. In a dispute where significant dollars are being sought as general, special or punitive damages, the potential insolvency of one of both parties may be an issue. E.g., personal injury, damage to property, failed business deal, breach of a duty, fraud, conversion, business torts, violation of statutory duties. For the plaintiff, a financial recovery through litigation might be that which he / she / it needs to avoid or repair an insolvent condition. For the defendant, the creation of a judgment liability may create balance sheet insolvency and the enforcement of such judgment could result in cash flow insolvency.

Ownership / Entitlement Disputes. Insolvency may be an issue where ownership or entitlement to property is disputed. E.g., quiet title disputes, marital dissolutions, business dissolutions. Here, the outcome of the litigation might move an asset from one balance sheet and onto another and, in the process, might affect cash flow by removing the income generated by that asset. Alternatively, such disputes might result in the property being forced to sale, which could impair the market value of the asset (thereby reducing or eliminating the return paid to the owner) and, at the same time, trigger a taxable event (thereby creating a new, current liability). Both scenarios could invite crippling tax ramifications to the parties.

Responsibility / Secondary Liability Disputes. In a dispute that seeks to shift the risk of loss or responsibility, insolvency may become an issue. E.g., guarantees, respondeat superior, indemnification, scope of work and agent / principal. This situation invites a dilemma that is almost opposite to that encountered in ownership disputes: namely, the outcome of the litigation might *add* an unanticipated / unplanned liability onto the balance sheet as a liquidated debt and thereby instantly move the company or individual from being in "the black" to being in "the red." In this area, it is not uncommon for parties to understand that certain transactions or activities include an element of risk (a contingent liability) which may not be quantified or fully understood at the time of undertaking.

Costs of Litigation. In all of the above situations, the costs associated with accessing the court system can impair both cash flow and the balance sheet if assets are being liquidated, savings are being depleted or revenue is being diverted from operations in order to pay the attorney's fees, costs and other fees associated with preparing or presenting a case.

In any of these scenarios, the threat or existence of insolvency is important information in a mediation. For one thing, it prompts a broader discussion that goes beyond assessing the collectability of any judgment. Once a party points to an existing or anticipated insolvent condition as a reason for its settlement position, that can serve as the *beginning* of a discussion aimed at examining the nature and extent of the insolvent condition, the prospects of reversing that condition, the interests or needs of the insolvent party to avoid or reverse the condition, and the realities of the situation to the other party in terms of receiving less than full satisfaction on any judgment victory achieved at trial.

Who are the potential stakeholders when insolvency becomes an issue in mediation?

Just as misery loves company, so does insolvency. When insolvency is an issue, a Party A versus Party B dispute can be transformed into something more complex in terms of the parties to be dealt with, interests to be accommodated and issues to be resolved. The following are a few of the more common additional stakeholders that may need to "weigh in" and possibly be included in the settlement negotiations when insolvency becomes an issue:

Other Creditors. As part of structuring a durable settlement, the rights and interests of *other* creditors may need to accommodated or preferred. In some situations, other creditors may need to compromise their claims or subordinate their rights in order for an accord to be reached. In those cases, such other creditors must at some point in time be brought to the negotiating table. Careful consideration needs to be given as to when: at the start of the mediation, at the start of the negotiations, at the end of the negotiations when all other aspects of a settlement have been agreed to between the parties to the dispute at hand.

Employees, Customers and Vendors. Where a settlement requires payments over time and is based on the assumption that a business will continue to operate, the company's relationships with its employees, customers and vendors may need to be evaluated. For example, are there *key* employees, customers or vendors who are critical to the company's continued operations? If so, it may be necessary to obtain a commitment from those parties in order to reach an accord, in which case, such interested parties may need to be included in some way in the negotiation process. Careful consideration needs to be given as to how and when to obtain the commitments necessary for the settlement at hand.

Family / Friends. For individuals, it goes without saying that the needs and interests of their families may be threatened and their relationship with family and friends might be strained. For example, it may have been dad who signed the guaranty of the company's bank loan, but his daughter's college plans and his wife's retirement plans could be derailed entirely if dad has to use family savings, sell the house or go without a draw in order to pay off company debt.

What are some ramifications when insolvency and / or the threat of bankruptcy are raised during a mediation?

Reality Factor. Insolvency and the threat of a bankruptcy filing are "reality factors" that can trump the merits of the parties' dispute. So the first step is to deal with it and analyze it. That analysis takes a hard look at the situation and involves asking many questions, including some or all of the following:

- How did this happen? Was the reversal inevitable? Was it anticipated? Who / what is responsible? Was it caused by wrongful conduct another?

- Is it a cash flow problem? If so, how bad is it? Is it temporary or permanent? Can it be fixed? If so, what will the "fix" cost in terms of time and money?

- Is it a balance sheet problem? If so, how bad is it? What assets have lost value and why? What liabilities have increased and why? Is there insurance to cover the loss? Can the problem be fixed? If so, what will the "fix" cost in terms of time and money?

- Are there any assets that can be sold or refinanced to bring money to the table today?

- Are there other parties who are liable for the debts that can be brought to the table?

- For the operating business: is all or some aspect of the business worth saving? If so, what will it cost in time? Money? Commitment from the company's owners who may be asked to continue working a business to pay non-guaranteed debt?

- For the individual: what are his / her future prospects in terms of earning capacity, inheritance, etc.?

Surprise. When insolvency is an issue, there frequently are several or numerous creditors engaged in litigation with the debtor, seeking to liquidate the amounts of their respective claims. Each creditor is focused on the *singular goal* of obtaining a final judgment and executing upon the debtor's assets. They are engaged in a *race to the courthouse*, competing to be the first one to judgment and attachment of the debtor's assets. In this race, the prospect of insolvency and possible bankruptcy resulting from a creditor's successful litigation outcome may be overlooked and, as a result, the potential creditor party (parties) may be *surprised* when insolvency and / or bankruptcy are raised at mediation.

A typical reaction to surprise is to become guarded, resistant and suspicious. The mediator faced with this situation really has only two options to offer the parties:

- Proceed with their mediation and predicate those discussions and any settlement proposal on certain assumptions, conditioned upon subsequent verification, or

- Recess the mediation to allow the parties time to gather, exchange and evaluate pertinent financial information, and then reconvene at a later date.

Either scenario depends on the parties' willingness to include one (or possibly both) party's insolvency / bankruptcy on the agenda of matters to be discussed during the course of the mediation.

Expand the Pie. When the prospect of bankruptcy is an issue to be discussed during a mediation, it creates an opportunity to "expand the pie" by examining the parties' options in (a) avoiding a bankruptcy and / or (b) planning for a bankruptcy. The following are some examples of possible discussion areas, which will be discussed in greater detail in the second installment of this article:

- What does the prospective debtor hope to accomplish through bankruptcy? Debt discharge? Orderly liquidation? Novation of pre-petition liabilities and a structured payment plan?

- How does the prospective creditor expect to fare in a bankruptcy? Partial recovery? Full recovery? No recovery?

- Are there any hurdles the prospective debtor must surmount in order to obtain its bankruptcy relief objective? Can the debtor afford the cost of the bankruptcy proceedings? Can the debtor satisfy the Bankruptcy Code criteria for obtaining relief? Are there any timing issues?

- Are there any hurdles the prospective creditor must surmount in order to obtain payment on its claim? Can the creditor satisfy the Bankruptcy Code criteria for having its claim "allowed" for purposes of payment? Is the likely forum for the bankruptcy convenient or inconvenient to the creditor? Can the creditor afford the cost of participating in the bankruptcy case?

Difficult Conversation. Beyond making the statement "I have no money" or "A judgment along the lines you are asking for will force me into bankruptcy," talking about insolvency can be difficult, uncomfortable, frustrating and threatening for everyone involved. For one thing, parties generally enter the mediation with an expectation that they are going to talk about the merits and demerits of the dispute. It can be disappointing and disorienting to have time and attention focused on an issue that was not anticipated and does not relate to the dispute at hand. For the party whose financial situation is put in the spotlight, that circumstance can invite a whole host of emotional reactions and issues:

- pride / stubbornness - the need to save face within a certain community
- shame / avoidance - the loss of face within a certain community
- inertia – fear of failure, fear of the unknown, inability to adopt to change
- denial / ego – need to put blame elsewhere; not responsible for the problem; not responsible for the solution
- depression / inertia -- loss of control, loss of trust, loss of confidence, no hope
- insecurity – basic needs threatened (loss of home, safety, comfort, love)

For the party who is being asked to take the other party's financial condition into consideration, that circumstance can invite its own set of feelings and reactions:

- anger / aggression – directed at situation; directed at opposing party
- frustration / inertia – insolvency hurdle appears insurmountable; loss of control
- distrust – perception that other party is hiding something; insolvency not real
- opportunism – desire to take advantage of the other
- vengeance– desire to inflict pain on the other
- compassion – understanding; willing to consider other's situation
- altruism – desire to promote general / greater good
- pride / stubbornness - the need to save face within a certain community
- inertia – fear of failure, fear of the unknown, inability to adopt to change
- denial / ego – need to put blame elsewhere; not responsible for the problem; not responsible for the solution

One thing is certain, a discussion about one party's existing or forecasted insolvent condition cannot be forced. Everyone needs to be ready and willing to have that discussion.

New Interests. When "insolvency" or "bankruptcy" are brought up during the course of a mediation, that is the beginning – not the end – of the discussion, and that discussion invites a whole new set of issues and interests to talk about. If, for example, the parties assume that defendant is liable and that plaintiff will recover damages in the amount requested, that moves the dialogue to *collectability*. If a "win" by the plaintiff will "kill the debtor" because it will force the closure of the business and / or the surrender of the debtor's assets to a bankruptcy trustee for liquidation in a "fire sale" environment, then this potential circumstance should motivate the parties to consider ways in which the dispute can be resolved so as to avoid this scenario. The treatment the plaintiff (creditor) would receive in a bankruptcy filed by the defendant (debtor) can provide an objective backdrop against which to evaluate settlement proposals that may be placed on the table. Is it better to take less now than to receive zero later? Likewise, the long-term benefit the defendant (debtor) hopes to derive by keeping its business open and running or holding on to assets expected to appreciate over time can provide a backdrop for assessing both the value of settlement and the financial viability of any settlement proposal that may be presented.

WATNA. One way to evaluate a settlement proposal is to consider the *best alternative* to that proposal (BATNA). In the context of the litigated dispute, BATNA is proceeding with the judicial proceedings to judgment and evaluating the likelihood of prevailing / defending on some or all claims. Introducing one (or more) party's insolvency / potential bankruptcy forces all parties to consider their *worst alternative* to a pending settlement proposal (WATNA). This will be discussed in greater detail in Part 2 of this article.

Opportunity. Insolvency and the threat of bankruptcy offers up an opportunity for the parties to participate in a constructive exchange of information. Most importantly, that circumstance creates an opportunity for candor and communication about a subject that is slightly off topic (i.e., not focused on the merits or demerits of the dispute) and is relevant to both parties, especially if the objective of the litigation is to achieve a recovery of money or property from the other side. In those circumstances, the prospect of insolvency or threat of bankruptcy challenges the parties to think more broadly so as to come up with a solution that cuts their losses and allows both sides to do the best they can with a bad situation.

Concluding Remarks

In many ways, insolvency is the ultimate "below the line" issue because it is an interest (or set of interests) that need to be considered, discussed and addressed irrespective of the merits of the dispute, the application of "the law" to the dispute, the perceived strength or weakness of either side's evidence, or the parties' feelings about the dispute. Insolvency operates as a big reality check for all involved and forces the parties to get creative and go beyond the distributive model of bargaining. This is because when insolvency is an issue, the numbers that might otherwise be exchanged in a distributive negotiation are so out of reach that they are a non-starter simply because the party who is expected to pay does not have the financial wherewithal to do so – irrespective of the merits of the dispute at hand. Simply stated, insolvency is a "reality factor" that can trump the merits of the dispute.