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Seth Meyer

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## A Bankruptcy Court's "Preference" Towards Mandatory Mediation

Seth Meyer, J.D. Candidate 2010

### Introduction

Mediation has gained general acceptance in the legal community but has been slow to take root in bankruptcy. *See generally* Geetha Ravindra, *Reflections on Institutionalizing Mediation*, 14 DISP. RESOL. MAG. 28, (Spring/Summer 2008). Over the past 20 years, mandatory bankruptcy mediation has become a feasible alternative to traditional litigation of adversary proceedings. In the beginning, creditors and debtors would mediate only if they agreed to mediate. As statutory authority for court ordered mediation strengthened, bankruptcy courts ordered parties to mediate with more regularity. Presently, mandatory mediation is statutorily authorized and bankruptcy courts have institutionalized the use of mandatory bankruptcy mediation, especially in adversary proceedings. The recent order by the bankruptcy court for the Eastern District of Michigan for mandatory mediation in Collin & Aikman Corporation's chapter 11 reorganization exemplifies this growing trend of court-ordered mediation. 376 B.R. 815 (Bankr. E.D. Mich. 2007).

The following discussion presents an overview of the developments of mandatory mediation of preference actions, following by a discussion of the merits of mandatory mediation in preference actions in relation to creditors, debtors, and the bankruptcy courts.

## Development of Mandatory Mediation of Preference Actions

The following section will discuss how bankruptcy courts use statutory authority and local rules to craft mediation programs to combat the high numbers of preference actions.

### *An Increase in Preference Actions Leads to Mandatory Mediation*

Preference actions arise after a preferential transfer is made pursuant 11 U.S.C. § 547(b). A preferential transfer is a transfer of property (typically a payment) made by a debtor within the 90-day or one-year (for transfers to insiders) period prior to the date the debtor filed for bankruptcy protection. Kurt A. Winiecki, *Defending Preference Actions: Optimal Strategies for Comprehensive Mathematical Analysis*, 25 AM. BANKR. INST. J. 18 (October 2006); see 11 U.S.C. § 547(b). Section 547(b) prevents a creditor from receiving more than other similarly situated creditors to ensure that they all share equally in the debtors assets. See *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991). Since many transfers are made during this 90-day or one year period, the court and parties spend substantial time and resources adjudicating these matters. Randall J. Newsome, *Vanishing Trials- What's The Fuss About?* 79 AM. BANKR. L.J. 973, 977 (Fall 2005).

Compounding the stress on the bankruptcy court, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) eased the creditor’s burden in using the “ordinary course defense” pursuant to § 547 (c)(2). Pub. L. No. 109-8, § 323, 119 St. 23, 97 (to be codified at 11 U.S.C. § 541(b)(7)(A)). Under the BAPCPA, the creditor-defendant has the choice of proving the objective or subjective requirement, effectively eliminating the need for an expert witness. *Id.* This has resulted in more preference action litigation. *Id.* Prior to the adoption of BAPCPA, creditor-defendants using the “ordinary course defense” were required to show that a transfer was made “[i]n accordance with ordinary business terms of the defendant’s

industry.” Kevin C. Driscoll Jr. *Bankruptcy 2005: New Landscape for Preference Proceedings*. AM. BANKR. INST. L.J. 56, 56, June 2005. Proving the ordinary terms prong required the creditor-defendant exhibit objective proof, usually from an industry expert. *Id.* Meeting this requirement was difficult because the main source of experts in a particular field were competing businesses, and they would be the least likely to help. *Id.* As a result, many claims settled or were dismissed before they were adjudicated. *Id.* With the relaxing of this hurdle, many more preference actions can go forward.

*Unsteady Grounds: Early Authority for Mandatory Mediation of Preference Actions*

The initial trials of bankruptcy mediation were far from mandatory. In 1986, the Bankruptcy Court for the Southern District of California established the first court-annexed mediation program to resolve adversary proceedings. Steven Hartwell & Gordon Bermant, *Alternative Dispute Resolution in a Bankruptcy Court: The Mediation Program in the Southern District of California*, Federal Judicial Center (1988). The court did not have the power to order the parties to undergo mediation; however, they were successful in “inviting” participants into the program. *Id.* Nearly 80% of the mediated claims came under the dischargeability statute (11 U.S.C. § 523), but a portion of the remaining claims were preference actions, and many of those were resolved. *Id.* The voluntary nature of mediation is also illustrated by *In the Matter of Sargeant Farms*, where the bankruptcy court appointed a mediator only after the parties filed a joint motion allowing it. 224 B.R. 842 (Bankr. M.D. Fla, 1998). The court required the parties to agree to mediation because the court was unsure if it had the authority to require the parties to mediate their claims. *Id.* at 844.

Congress laid the foundation for bankruptcy courts to authorize mandatory mediation when it passed the Judicial Improvement Act of 1990 (“JIA”) and the Judicial Improvement and

Access to Justice Act (“JIAJ”) in 1990. The JIA was enacted to reduce the delays of civil litigation by “refer[ing] appropriate cases to alternative dispute resolution programs . . . including mediation . . . .” 28 U.S.C. § 473(b)(4); 28 U.S.C. § 473(a)(6)(B). The JIAJ authorized district courts to use arbitration but only mentioned bankruptcy courts in passing. *See* Steven R. Wirth & Joseph P. Mitchell, *A Uniform Structural Basis for Nationwide Authorization of Bankruptcy Court Annexed Mediation*, 6 AM. BANKR. INST. L. REV. 213, 220 (1998). While the statutes did not explicitly grant bankruptcy courts mandatory mediation powers, bankruptcy courts reasoned that they could order parties to mandatory mediation because they were part of the district court. Hon. Ralph R. Mabey, Charles J. Tabb & Ira S. Dizengoff, *Expanding the Reach of Alternative Dispute Resolution in Bankruptcy: The Legal and Practical Bases for the Use of Mediation and the Others Forms of ADR*, 46 S.C.L. REV. 1259 (1995).

Congress moved closer towards expressly authorizing mandatory mediation in 1994 when it added Section 105(d) to the Bankruptcy Code. Section 105(d) permitted “the court, on *its own motion* . . . [to] issue an order . . . to ensure that the case is handled *expeditiously and economically* . . . .” 11 U.S.C. § 105(d) (emphasis added). Section 105(d) did not refer to mediation or any other form of alternative dispute resolution, however, when coupled with Section 105(a)’s power to “issue any order, process, or judgment that is *necessary or appropriate* to carry out the provisions of this title,” it implicitly granted bankruptcy court judges greater discretion to manage their dockets. *See In re Tax Shops Inc.*, 173 B.R. 605 (Bankr. E.D. Mich. 1994). One way bankruptcy court judges could better manage their docket was by ordering parties to mediate.

Utilizing the powers granted in Section 105, two bankruptcy courts in Texas ordered the parties to mediate their adversary proceedings. First, in 1995, the Northern District of Texas

ordered Quality Beverage (a wholesale liquor distributor) and its creditors to mediate the 75 preference actions, turnover actions, and other adversary proceedings associated with their liquidation. Michael S. Wilk & Rik H. Zafar, *Mediation of a Bankruptcy Case*, AM. BANKR. INST. L.J. 12 (May 2003). Second, in 1997, the Southern District of Texas ordered the 55 adversary proceedings filed in conjunction with Sunrise Energy Corporation's (a company involved in the oil and gas trading business) liquidation reorganization. *Id.* Out of the 130 adversary proceedings filed with the two courts, all but two of the contested cases settled in mediation. *Id.* The other two cases ultimately settled before trial. *Id.*

*Firm Foundation: Present Authority for Mandatory Mediation of Preference Actions*

Congress, aware of the successes of mediation in bankruptcy, passed the Alternative Dispute Resolution Act of 1998, which expressly authorizes the bankruptcy court to use mediation to resolve adversary disputes. 28 U.S.C. §§ 651-58. The act provides "[e]ach United States district court shall authorize, by local rule . . . the use of alternative dispute resolution processes in all civil actions, *including adversary proceedings in bankruptcy . . .*" 28 U.S.C. § 651(b) (emphasis added). The Act's goal is "to encourage and promote the use of alternative dispute resolution in its district." *Id.* With the Act's passage, the bankruptcy courts can now expressly order parties to undergo mediation in order to resolve preference actions.

In the spring of 2004, the Bankruptcy Court of Delaware utilized the ADR Act to create a formal mandatory mediation process to resolve preference actions. Under the stress of 15,617 adversary proceedings (nearly 15% of the nations total), of which approximately 10,000 to 11,000 were preference actions, the court ordered mandatory mediation "for all preference cases not resolved within 90 days of the due date for a responsive pleading to the complaint." Randall J. Newsome, *Vanishing Trials-What's all the Fuss About?* 79 AM. BANKR. L.J. 973, 978 (2005).

By January 1, 2005, the mandatory mediation program helped reduce the number of adversary proceedings to 11,767, despite an increase in the filing rate. *Id.* Furthermore, by the end of 2007, the number of pending adversary proceedings in the court had dropped to 6,466, while the overall number of adversary proceedings filed nationally decreased to 63,066. *See* Administrative Office of the U.S. Courts 2007, Judicial Business of the United States Courts Table F-8, available at [http://jnet.ao.dcn/Statistics/Judicial Business of US Courts/Judicial Business 2007/US Bankruptcy Courts.html](http://jnet.ao.dcn/Statistics/Judicial%20Business%20of%20US%20Courts/Judicial%20Business%202007/US%20Bankruptcy%20Courts.html). Through this innovative program of mandatory mediation, the Delaware Court was able to ease the docket of the two full time bankruptcy judges. *Id.*

### **Local Rules: Taking the Cue from the ADR Act**

While the ADR Act expressly authorized individual bankruptcy courts to promulgate local rules authorizing mandatory mediation, many bankruptcy courts introduced local rules prior to the passage of the ADR Act. In 1992, Chief Judge Bostetter issued General Order 92-1-2, implementing mediation in the Eastern District of Virginia. General Order No. 92-1-2. Judge Bostetter's General Order provided him with the authority to refer adversary proceedings to mediation even if the parties did not ask to have the case referred. *Id.* The goal was to reduce the cost to litigants and expedite resolution of the disputed issues. *Id.* In 1993, the Southern District of New York entered General Order No. 117 authorizing the court, or the parties, to refer any adversary proceeding to mediation. General order No. 117. In 1995, The Central District of California enacted General Order 95-01 which established a no cost ADR program. Mediation and other forms of ADR could be referred to mediation by consent of the parties, request of the parties, or by the court acting alone. *Id.* Finally, the Eastern District of Michigan enacted Local

Bankruptcy Rule 7016-2, which “[u]pon its own initiative, or upon a filed stipulation of the parties, or upon a motion by any party in interest after notice and opportunity for hearing, the judge may order the parties to engage in mediation.” L.B.R. 7016-2.

### **Advantages of Mandatory Mediation in Preference Actions**

Since the passage of the ADR Act, most bankruptcy courts have adopted mandatory mediation programs. The next section will discuss the advantages of mandatory mediation and how they relate to the mandatory mediation order in *Collins & Aikman*.

*Save Money, Save Time, Mediate!*

Mandatory mediation preference saves both the creditor and debtor substantial financial resources when the claims are mediated before the start of discovery. The process is seen as less costly because parties spend considerably less preparing for mediation than they do preparing themselves for discovery and eventually trial. Anne M. Burr, *Building Reform from the Bottom Up: Formulating Local Rules for Bankruptcy Court-Annexed Mediation*, 12 OHIO ST. J. ON DISP. RESOL. 311, 343 (1997). As Chief Judge Rhodes said in the *Collins & Aikman* mediation order “the mediation procedures established in this order will promote the just, speedy and inexpensive resolution of these adversary proceedings.” 376 B.R. at 816. In one example, a creditor spent \$60,000 just on discovery for a litigated case, when a similarly situated mediated case, including mediator fees, cost under \$55,000. Benjamin S. Seigel, *Mediation of Bankruptcy Disputes: A Risk Assessment Lesson for Lenders*, ANDREWS BANKR. LITIG. REP., 13 (Feb. 2005). Once parties start spending money on discovery, they often believe that the only way to justify the expense (to themselves and/or their client) is to have their claim heard by the court. Lester J. Levy, *FAQ on Bankruptcy Mediation*, 22 AM. BANKR. INST. L.J. 1 (Apr. 2003). Furthermore, in



a mediated matter, the parties have direct control over the amount they will pay, where as in a litigated matter, a judge will determine who will get paid and how much. Siegel, at 13. The *Collins & Aikman* mediation order set out a tiered system of costs based in proportion to the value of the preference to make mediation a worthwhile alternative to litigation. 376 B.R. at 817-18.

Parties that undergo mandatory mediation soon after the complaint is filed have a high likelihood of resolving their claim before trial. A bankruptcy filing in Delaware was accompanied by 600 preference actions. Levy, at 13. Of those 600 preference actions, half of them settled quickly through direct negotiations. *Id.* The other half, approximately 250-300, were ordered to undergo mandatory mediation. *Id.* As a result of the mandatory mediation, nearly 95% of the preference actions settled before going to trial. *Id.* The parties saved the expenses of a trial, while resolving their claims sooner than if the case had gone to trial. The *Collins & Aikman* court adopted a provision staying the responsive pleadings during mediation to focus the parties on mediation prior to trial. 376 B.R. at 818.

Mandatory mediation is an effective way to saving the litigants a significant amount of time. In a court with a crowded docket, parties can be required to make multiple appearances even before the trial begins, without factoring in the time associated with prolonged motion practice. Factoring in the trial and the time required for post trial briefings, the parties can be engaged in a routine preference matter for much longer than in a mediated case. Siegel, at 13. In contrast, a mediated matter can be resolved on the day of the mediation. *Id.* Furthermore, the pre-mediation “motion practice” is limited to what the parties agree upon and can effect how quickly a matter is resolved. *Id.* The mediators in *Collins & Aikman* were provided with the broad authority to “determine the nature and order of the parties’ presentation . . . . [E]ach

mediator may implement additional procedures which are reasonable and practical under the circumstances.” 376 B.R. at 817. This allowed for the mediators to determine what the best course of conduct would be for resolving the preference action, while remaining true to the goal of resolving the preference actions quickly and efficiently. *Id.* at 816–17.

### *Response to the Perceived Disadvantages of Mandatory Mediation*

While the court has the authority to order parties to mediate their dispute, a problem arises when a party does not take mediation seriously, or worse, does not attend. The problem is neutralized by Rule 16 in the Federal Rules of Civil Procedure. Rule 16 allows the court to impose sanctions when a party “fails to appear at a scheduling or other pretrial conference.” FED. R. CIV. P. 16(f)(1)(A). Under the authority granted to the court in Rule 37(b)(2)(A)(vi), the bankruptcy judge can enter a default judgment against the party that fails to mediate. *Id.*; FED. R. CIV. P. 37(b)(2)(A)(vi). Therefore, a hesitant party will attend mediation under the threat of a default judgment being ordered against them. Furthermore, if a party comes to mediation but does not participate in good faith, the court has the power to impose sanctions against them. FED. R. CIV. P. 16(f)(1). While defining “good faith” can be elusive, the fact that a party can be sanctioned for not participating in good faith is a strong deterrence to acting improperly. James J. Alfini & Catherine G. McCabe, *Mediating in the Shadow of the Courts: A Survey of the Emerging Case Law*, 54 ARK. L. REV. 171, 178–79 (2001). In *Collins & Aikman*, Chief Judge Rhodes prepared for party non participation by ordering default judgments against parties that did not attend the mediation sessions. 367 B.R. at 818.

Parties are also reluctant to undergo mandatory mediation because they feel that they will lose their day in court if they are forced to mediate. While the court can order parties to mediate, it cannot force them to settle their case. William J. Woodward, Jr., *Evaluating Bankruptcy*

Mediation, J. DISP. RESOL. 1, 7 (1999). If a party is not satisfied with the terms of the proposed settlement, they are free to walk away from the mediation table and pursue their full legal rights in court. *Id.* Mandatory mediation is a way to air out grievances and potentially resolve a matter before it becomes time and financially consuming. *Id.* In *Collins & Aikman*, the court provided that if mediation should fail, the stay would be lifted, and the parties would be free to resolve the claim in a traditional fashion. 376 B.R. at 818.

## **Conclusion**

Mandatory mediation of preference actions is the result of congressional decision-making, creative programs by individual bankruptcy courts, forward thinking bankruptcy court judges, and willing parties. Litigants should look to mandatory mediation programs to quickly and efficiently resolve preference actions and the courts should look to use mandatory mediation to clear their dockets and move preference actions along. In both case by case determinations and large scale institutionalized programs, mandatory mediation should be readily used weapons in the bankruptcy court's arsenal.

