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When is Mediation Appropriate, and Must a Mediator Be Retained Pursuant to Bankruptcy Code Section 327(a)?

By **Paul A. Rubin**

Mediation of a bankruptcy dispute takes place outside the presence of the judge before whom the case is pending. There is usually no direct communication between the mediator and the presiding judge before, during or after the mediation. Accordingly, with the utilization of mediation as a dispute resolution tool in bankruptcy cases becoming increasingly common, it is important that courts remain vigilant in protecting the integrity of the mediation process. As the U.S. Court of Appeals for the Second Circuit once famously stated in another context, "[t]he conduct of bankruptcy proceedings not only should be right but must seem right." *In re Haupt*, 361 F.2d 164, 168 (2d Cir. 1966).

The decision of the court in *In re Cody Smith*, 524 B.R. 689 (Bankr. S.D.Tex. 2015), highlights the importance of ensuring that bankruptcy mediations are conducted with sufficient judicial oversight, and it demonstrates the appropriateness of evaluating whether a particular case is suitable for mediation before mediation is ordered. *Smith* discusses the risk of at least an appearance of favoritism that is posed where the proposed mediator is a former bankruptcy judge. Unfortunately, that court's holding that a mediator is a professional person whose employment must be approved by a bankruptcy court pursuant to section 327(a) of the Bankruptcy Code leaves the misleading impression that a mediator is employed by just one side involved in the dispute, a trustee or debtor, and is not a neutral third party working to assist all parties in reaching a consensual resolution of their dispute

There is not a large body of case law addressing the issues discussed in *Smith*. A close look at this case and its reasoning is warranted, because this ruling, though helpful in many ways, could inadvertently undermine both the effectiveness of a mediator and confidence in mediation as a fair means of resolving contested matters, adversary

proceedings and other litigations that constitute obstacles to successful conclusion of Chapter 11 and Chapter 7 cases.

Background

In *Smith*, the Chapter 7 debtor was a limited partner in a partnership that owned a large ranch in Texas that generated significant cash flow. The Chapter 7 trustee sought a cash distribution from the partnership. The partnership, whose general partner was the debtor's mother, objected.

The Chapter 7 trustee filed a joint emergency motion to toll the time for the parties to file pleadings with respect to their pending litigation, stating that they had already scheduled a mediation of their dispute, and that they had selected a long-standing ex-bankruptcy judge from a neighboring district in the state to serve as their mediator. The bankruptcy court had not approved the mediation or the choice of mediator, and the parties had not advised the court that they were contemplating mediation before they filed this motion. During the hearing on the motion, the parties advised the court that they intended to use estate funds to pay a portion of the mediator's fee and to pay fees of the trustee's counsel for time incurred for participating in the mediation.

Rulings

The bankruptcy court denied the joint motion and held that the parties could not proceed with the scheduled mediation because they had failed to obtain the court's prior approval. It stated that a trustee may not unilaterally participate, or instruct his or her attorney to participate, in a mediation for which payment from estate funds will be requested without prior court approval of mediation of the dispute and of the proposed mediator. *See id*. at 693.

Retention of the Mediator By the Debtor or Trustee

Section 327(a) of the Bankruptcy Code provides that " … the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers or other professional persons … ." Similarly, Federal Rule of Bankruptcy Procedure 2014(a) also requires an order of the bankruptcy court "approving the employment of attorneys, accountants, … or other professional persons" after application by the trustee. The court held that a mediator is a "professional person" within the meaning of section 327(a). *See id*. at

695-96. It determined that because a mediator is a professional with a highly specialized skill set who has a substantial amount of discretion to help resolve a bankruptcy dispute that is significant to the overall administration of the estate, court approval of the mediators's appointment is required under section 327(a). The court noted that, although it could not locate any cases directly addressing the question of whether a mediator is a "professional person" under section 327(a), it did find multiple standing orders issued by bankruptcy courts throughout the United States "that require an estate representative to obtain approval before employing a mediator." *See id*. at 695.

Services of a Mediator Deemed Unnecessary

The *Smith* court acknowledged that the proposed mediator is a "consummate bankruptcy professional." But it also observed that the primary purpose of section 327(a) is "to contain the estate's expenses and avoid intervention by unnecessary participants." *Id*. at 696 (quoting *In re Garden Ridge Corp.*, 326 B.R. 278, 280 (Bankr. D.Del.2005)). In the court's opinion, each of the attorneys already involved in the case was a seasoned trial lawyer with substantial experience in bankruptcy matters. It viewed them as equally capable as a mediator of devising and recommending settlement offers and counter-offers to their clients, observed that they were on excellent speaking terms with one another as lawyers, and praised them as models of how to be warriors in the courtroom zealously representing their clients, while nevertheless being polite and professional. Under the circumstances, the court determined that there was no need to use estate funds to pay a mediator, and that it made more economic sense for the parties to continue communicating with each other without the involvement of a mediator. *See id.*

Considerations When the Proposed Mediator Is a Former Bankruptcy Judge

Going further, the court stated that even if there were no *per-se* rules governing retention of mediators under § 327(a), the protections of the statute should apply to the proposed appointment of an ex-judicial colleague of the sitting bankruptcy judge, to avoid the appearance of an abuse of the mediator selection process. *See id*. at 697. The court pointed out that the bankruptcy practice that emerged from the Bankruptcy Act of 1898 developed a reputation for incestuousness and cronyism. The specialized nature of the field and the relatively informal status of bankruptcy referees cultivated an insider-dominated atmosphere. The practice was essentially controlled by closely knit

groups that repeatedly appointed each other for roles in different cases, and this insularity bred a perception of bankruptcy practices as exploitative and unprincipled. *See id*. at 698.

The Bankruptcy Reform Act of 1978 was designed to end a "patronage" system in which bankruptcy judges often appointed friends and former colleagues and awarded them maximum allowable fees regardless of effort. In the court's view, allowing sitting judges to preside over cases while their former judicial colleagues will earn fees serving as mediators without the compliance with the procedural requirements of section 327(a) would eliminate protection against judicial overreaching and would invite the type of incestuous relationships that were rampant under the old Bankruptcy Act. *See id*. at 699.

In this case, the bankruptcy judge stated that he and the proposed mediator were longtime colleagues in the innermost circle of the bankruptcy profession, and he detailed examples in which they had worked together on bankruptcy-related professional activities. He went so far as to say that the proposed mediator was "the ultimate insider," who had a high-profile relationship with the bankruptcy system and himself as a sitting bankruptcy judge, and that, to unsecured creditors concerned about the use of estate funds, the proposed mediator was as much of an insider as anyone affiliated with the debtor. Accordingly, the court stated that it wanted the sun to shine brightly on the proposed appointment of a former bankruptcy judge having a relationship with a sitting judge, so that creditors would have an opportunity to object and to ensure that the process is as "clean as a hound's tooth." *See id*. at 699-700.

Factors to Be Considered When Mediation Is Proposed

Going even further, the *Smith* court set forth a variety of factors that it announced it would consider in determining whether to appoint a mediator in any case, including the subject matter of the dispute, the extent to which the parties had engaged in discovery and have had any substantive settlement discussions, whether the attorneys have explained the mediation process to their clients, the qualifications of the proposed mediator, and the anticipated cost of the mediation. *See id*. at 703-04. The court stated that parties should only pursue mediation after first attempting to reach a settlement without third-party intervention. The court identified situations in which a party may legitimately desire its day in court to vindicate its position, and the court decried the fact that our legal system is producing attorneys who

prefer mediation because they lack trial experience. The *Smith* court put parties on notice that, after receiving a motion describing application of the factors the court has identified as relevant to an application to retain a mediator, it may hold a hearing, require the parties to appear with counsel, and the court may require testimony from the parties that they understand the mediation process, agree to the associated costs, and confirm that they wish to proceed with mediation rather than trial or hearing of the contested matter. *See id*. at 704.

Analysis

Much can be favorably said about the *Smith* decision. Without commenting on the facts presented in that case, one can say generally that it would be presumptuous for attorneys to embark upon a mediation, including selection of the mediator, without obtaining prior court authorization to proceed down that path, and prior approval of the proposed mediator and of the arrangements for payment of the mediator's fees. In addition, while mediation may be appropriate in large cases in which dozens or even hundreds of avoidance actions have been filed, one cannot presume that mediation is appropriate in every case. It is certainly sensible that before rushing to mediation in a "one off," or stand-alone case, the parties should be required to confirm to the court that they have been advised regarding the financial and other costs of proceeding with mediation, and they must explain to the court why they believe mediation would be beneficial or appropriate.

The court's sensitivity to the risk of appearance of impropriety that is posed when the proposed mediator is a former sitting bankruptcy judge who is well-known to the appointing judge is well-taken. All insolvency practitioners should be aware of the reputation of favoritism for which our bankruptcy system was once notorious, and should strive to avoid creating the impression that today's cases are infected by an insider-dominated atmosphere. Concerns in this regard should be significantly reduced, however, where the parties voluntarily propose the former sitting judge to be a mediator, or where the former judge is just one of several potential mediators named on a panel from which the parties may voluntarily select their mediator.

One may question the *Smith* court's conclusion that a mediator was not needed in that case because the parties were represented by seasoned bankruptcy professionals. It is often useful for counsel and/or their clients to obtain a "reality check" by obtaining input and

reactions from an independent, experienced bankruptcy professional who is not beholden to any party. Moreover, a mediator may spot issues, arguments or authority that even a top-flight attorney might overlook. One cannot assume that a mediator is not needed whenever the parties are well represented by sophisticated counsel whose conduct is impeccable.

It is regrettable that the court concluded in *Smith* that a mediator must be retained pursuant to Code Section 327(a). While a mediator might be a "professional person," a mediator is not, or should not, be retained by an estate representative, because a mediator does not work for one party. The fundamental premise of mediation is that a mediator is a neutral party who does not work for either side, but who is attempting to help both sides reach a mutually-acceptable resolution.

Preserving the independence of the mediator is of critical importance. In order for a mediator to be able to function effectively, each side in a dispute must know that it is receiving unbiased statements and advice from someone who is not employed by, or a fiduciary to, only one side. The efficacy of a mediator would be compromised if a non-debtor learns, before beginning the mediation, that the debtor or trustee has hired the mediator. This is especially true in situations associated with larger bankruptcy cases, wherein many defendants in related avoidance actions find themselves forced to engage in a mediation mandated by a single, omnibus order of a bankruptcy judge.

Conclusion

It is essential that participants in bankruptcy mediations have full faith and confidence in the fairness of the process before it begins. The *Smith* court is correct that mediation is not a panacea to be prescribed for every adversary proceeding or contested matter that arises in a Chapter 7 or Chapter 11 case. Before authorizing mediation, a bankruptcy judge should require a meaningful explanation from the parties, and make an independent evaluation, of whether it would be appropriate to attempt to resolve the dispute in question through mediation. Non-debtor parties are entitled to assurance that the mediator assigned to their cases is not a bankruptcy insider chosen for having a close relationship with the presiding judge or estate representative. Requiring the estate representative to retain a mediator pursuant to section 327(a) however, would convey the harmful message that the mediator works for the estate, and is not a neutral party seeking to reach a just and practical resolution

acceptable to all.

Paul A. Rubin is the founder of Rubin LLC in New York, and a member of this newsletter's Board of Editors. His practice includes business bankruptcy, workouts and restructurings, and distressed acquisitions. He has served as a mediator in several well-known cases.