PART 1 OF 2

Southern District Establishes Standards for 'Good Faith' Participation in Court-Ordered Mediation

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The *A.T. Reynolds & Sons, Inc.* decision reverses the bankruptcy court's order holding the secured lender in the underlying bankruptcy proceeding, and its counsel, in contempt for failing to mediate in good faith and imposing sanctions upon them. The decision not only vindicates the lender and its counsel for its "no pay" position taken at the mediation, but also articulates a clear and objective standard for parties' future "good faith" participation in a court-ordered mediation.

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The U.S. District Court for the Southern District of New York issued a significant decision on March 18, 2011, that elucidates a standard for what constitutes good faith participation in a court-ordered mediation. The *A.T. Reynolds & Sons, Inc.*[1] decision reverses the bankruptcy court's order holding the secured lender in the underlying bankruptcy proceeding, and its counsel, in contempt for failing to mediate in good faith and imposing sanctions upon them. The district court's decision not only vindicates the lender and its counsel for its "no pay" position taken at the mediation, but also articulates a clear and objective standard for parties' future "good faith" participation in a court-ordered mediation.

Background

Alternative dispute resolution has long been available as a timely and cost effective alternative to litigation. Typically, contract parties would include arbitration provisions in their agreements if they wished to avoid having disputes determined by the courts. At times, even absent a valid arbitration clause, parties would consent to submitting a dispute to a neutral party either to assist the parties in reaching a compromise or to serve as an arbiter and render a determination.

On November 10, 1993, then-New York Southern District Chief Bankruptcy Judge, Burton R. Lifland, issued General Order M-117, which established procedures for court-ordered mediation. With this order, the Southern District Bankruptcy Court commenced a process whereby parties could voluntarily submit to mediation, any party could bring a motion requesting mediation, or the court, on its own motion, could direct parties to mediation.[2] This early procedure for court-ordered mediation has now become the standard in most bankruptcy courts as well as in courts of general subject matter jurisdiction.

Section 3.2 of General Order M-117 (and each of its subsequent iterations) provided, in part, "The mediator shall report any willful failure to attend or participate in good faith in the mediation process or conference. Such failure may result in the imposition of sanctions by the court." Standards for participating "in good faith" were not established. While General Order M-117 and its progeny do not provide a definition of "good faith," *Black's Law Dictionary* (at the time it was issued) defined "good faith" as:

> *An intangible and abstract quality with no technical meaning or statutory definition, and it encompasses, among other things, an honest belief, the absence of malice and the absence of design to defraud or to seek an unconscionable advantage, and an individual's personal good faith is a concept of his own mind and inner spirit and, therefore, may not conclusively be*

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determined by his protestations alone... In common usage this term is ordinarily used to describe that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation.[3]

A number of commentators have noted the particular difficulties in defining "good faith" in the context of mediation.[4] Although parties directed to participate in court-ordered mediation are obligated to participate in good faith, they are neither obligated to make any offer to pay money nor to accept any offer.[5] The presence of a corporate representative is the cornerstone of good faith participation in mediation.[6] For mediation to work, the corporate representative must have the authority and discretion to change his or her opinion in light of the statements and arguments made by the mediator or the opposing party.[7]

While parties to a mediation are required to have "settlement authority" and must participate in the mediation in good faith, failure to reach a settlement does not demonstrate bad faith or lack of settlement authority, for the ultimate authority in a case belongs to the parties.[8]

Courts have generally found a lack of good faith only where parties failed to attend or failed to provide pre-mediation statements, while rejecting allegations of bad faith in all other situations.[9]

Based on the mediator's report, the bankruptcy court *sua sponte* issued an order to show cause why the lender should not be sanctioned for failure to comply with the mediation and scheduled an evidentiary hearing to be held on December 31, 2009.

A court has authority to press for a settlement between litigating parties only to the extent that "a court can require parties to appear for a settlement conference, and impose sanctions pursuant to Rule 16(f) [of the F.R.C.P.] if a party fails to do so."[10]

The Second Circuit has held that a party is "free to adopt a 'no pay' position" at a mediation.[11] Allegations of a lack of good faith in reported cases have generally fallen into one of five categories: 1.) failure to attend; 2.) failure of an organizational party to send a representative with sufficient settlement authority; 3.) inadequate preparation for the mediation, including the failure to have submitted a pre-mediation statement; 4.) insufficient efforts to resolve the matter, including the failure to make a suitable offer or any offer at all, making inconsistent legal arguments, not providing requested documents or unilateral withdrawal from the mediation; and 5.) miscellaneous allegations, including failure to sign a mediated agreement or engaging in unspecified bad-faith behavior.[12]

Underlying Action

The underlying case[13] began on uncommon terms in December 2008 as the debtor filed its Chapter 11 petition without notice to its secured lender, and continued to operate for a brief period of time before the lender learned of the filing only because of a newspaper article that mentioned it. Despite the unconventional filing, the lender provided use of cash collateral to an "undeserving" debtor[14] and acquiesced to use of cash collateral at times often in excess of the formulas contained in the various orders — generally upon the *coaxing* of the bankruptcy court. The debtor's assets were sold in a bankruptcy sale conducted in March 2009.

After the sale was approved by the bankruptcy court, the lender accepted the net proceeds and the reality that it would not recover the full amount of its loan and considered itself out of the case. However, in August 2009 (six months after the lender's exit), a dispute for unpaid wages arose between the debtor and the purchaser. At a hearing on this dispute between the debtor and the purchaser, the attorney for the purchaser claimed he had a "theory" under which the lender might be liable to pay the wages and asked the bankruptcy court to direct the parties to mediation. Although no adversary proceeding had been commenced against the lender and no motion for relief was brought against the lender, the bankruptcy court nonetheless ordered the debtor, the purchaser, the financial advisor to the debtor, counsel to the Official Committee of Unsecured Creditors and the lender to attend the mediation.

As the lender had believed that its interest in the case terminated upon the sale and expiration of the cash collateral order and, as a result, had not monitored the proceedings that followed such events, it contacted the mediator in an attempt to determine the issues to be discussed at the mediation so that it could prepare for the mediation and draft its required pre-mediation statement. In response, counsel for the debtor responded with a list of enumerated items with the catch-all provision of "any other issues anyone wants to discuss." While expressing its concerns over mediation with no boundary lines, the lender nevertheless submitted its pre-mediation statement and attended the mediation.

After listening to the parties at the mediation and weighing their positions, the lender asserted its position that it was not liable for any of the amounts claimed by the purchaser or the debtor. This prompted the mediator to hold several side sessions with the lender, but was unable to persuade the lender that it was subject to any liability. Claiming that the lender did not go through a "risk analysis," the mediator reported to the bankruptcy court that the lender was not participating in good faith.

Based on the mediator's report, the bankruptcy court *sua sponte* issued an order to show cause why the lender should not be sanctioned for failure to comply with the mediation and scheduled an evidentiary hearing to be held on December 31, 2009 (yes,

New Year's Eve). After declining the requests of all of the parties to adjourn the hearing, the bankruptcy court conducted a contentious evidentiary hearing on New Year's Eve day, where it accepted affidavits and heard testimony from the mediation parties.

Following the hearing, the bankruptcy court issued a memorandum decision and order holding that the lender did not participate in "good faith" at the mediation because it 1.) did not engage in risk analysis "that is fundamental to mediation," 2.) failed to send a representative with settlement authority, to among other things "enter into creative solutions," and 3.) "sought to control the procedural aspects of the mediation."

The bankruptcy court concluded that mediation is a process controlled by the mediator, in which "risk-analysis" and "discussion" are essential elements, and held that, "where a party is ordered to participate in mediation, the party fails to comply with the order when it does not engage in the process of mediation, which entails consideration of the other parties' arguments."[15] In light of these findings, the bankruptcy court held the lender and its counsel in contempt and imposed sanctions upon them for their violation of the mediation order.

The lender immediately appealed the bankruptcy court's decision to the United States Southern District of New York. On March 18, 2011 the district court issued its decision.

Stay tuned for part two of this article, which will delve into the Southern District's decision and discuss its implications on court-ordered mediation. abfj

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EDITOR'S NOTE: This is the first part of a two-part article offering an insider's view of *In re A.T. Reynolds & Sons, Inc.* Part two will appear in *ABF Journal's* September 2011 edition, and will discuss the decision rendered in this case and its implications on court-ordered mediation.

ENDNOTES

1 *In re A.T. Reynolds & Sons, Inc., d/b/a Leisure Time Spring Water*, 2011 WL 1044566 (S.D.N.Y. Mar. 18, 2011).

2 In 1995, the initial M-117 was amended by General Order M-143, which added some additional provisions for dealing with "special issues," determination of compensation issues and to provide the mediator with immunity from claims incident to his or her mediation services. Following the enactment of the *Alternative Dispute Resolution Act of 1998* (28 U.S.C. §651-§658), then-Chief Bankruptcy Judge Tina Brozman amended General Order M-143 with M-211, which added additional provisions for the use of early neutral evaluation and voluntary arbitration. Finally, in 2009, then-Chief Bankruptcy Judge Stuart Bernstein issued General Order M-390, which amended and restated M-143 and M-211 to conform to the time periods set forth in amendments to the Federal Rules of Bankruptcy Procedure.

3 *Black's Law Dictionary* 693 (6th ed. 1990).

4 See, e.g., John Lande, *Using Dispute System Design Methods to Promote Good-Faith Participation in Court-Connected Mediation Programs*, 50 UCLA L. REV. 69, 86 (2002) ("The definition of good faith in mediation is one of the most controversial issues about good-faith requirements."); Holly A. Streeter-Schaefer, *A Look at Court Mandated Civil Mediation*, 49 DRAKE L. REV. 367, 372 (2001).

5 See *G. Heileman Brewing Co. Inc. v. Joseph Oat Corp.*, 871 F.2d 648, 653 (7th Cir. 1989) (*en banc*) (suggesting sanctions cannot be based on the refusal to make a monetary offer); *Hess v. New Jersey Transit Rail Operations, Inc.*, 846 F.2d 114 (2d Cir. 1988) (arguing sanctions would be inappropriate where the defendant failed to make what the court considered a "bonafide offer"); *Kothe v. Smith*, 771 F.2d 667 (2d Cir. 1985) (fine reversed where the defendant failed to offer the amount recommended by the court); *Gray v. Eggert*, 248 Wis. 2d 99 (Ct. App. 2001) (concluding that the trial court had no factual basis for reaching a conclusion that the defendant had not mediated in good faith from the fact that defendant's settlement offer was $100).

6 *Nick v. Morgan's Foods, Inc.*, 99 F. Supp.2d 1056, 1062 (E.D. Mo. 2000), *aff'd*, 270 F.3d 590 (8th Cir. 2001).

7 *Id.*

8 See e.g., *Negron v. Woodhull Hosp.*, 173 Fed. Appx. 77 (2d Cir. 2006) (recognizing a party's right to adopt a no-pay position); *Bulkmatic Transp. Co. v. Pappas*, 2002 WL 975625, at *2 (S.D.N.Y. May 9, 2002) (noting that a party is not required to change its settlement parameters by reason of a court order to attend a settlement conference); *Dawson v. United States*, 68 F.3d 886, 890–93 (5th Cir. 1995) (discussing how parties to a mediation must not be forced to settle or offer a settlement). See Robert A. Baruch Bush, *Staying in Orbit, or Breaking Free: The Relationship of Mediation to the Courts Over Four Decades*, 84 N.D. L. REV. 705, 718 (2008) (stating: "[t]he ultimate authority in mediation belongs to the parties..."); Douglas A. Henderson, *Mediation Success: An Empirical Analysis*, 11 OHIO ST. J. ON DISP. RESOL. 105, 127 (1996) (focusing on informal process where parties make ultimate decision, only to be assisted by third party); see also *Black's Law Dictionary* 996 (8th ed. 2004) (defining non-binding dispute resolution as parties reaching "a mutually agreeable solution").

9 See Lande, *supra* at 84-85.

10 *Bulkmatic*, 2002 WL 975625, at *2. See *Mordechai v. St. Luke's-Roosevelt Hospital Center*, 2001 WL 699062, at *2 (S.D.N.Y. June 20, 2001) ("Although a court may not require litigants to settle an action, it is well established that a court may require parties to appear for a settlement conference."); *Dan River, Inc. v. Crown Crafts, Inc.*, 1999 WL 287327, at *2 (S.D.N.Y. May 7, 1999).

11 *Negron*, 173 Fed. Appx. at 79.

12 See Lande, *supra* at 83.

13 *In re A.T. Reynolds & Sons, Inc., d/b/a Leisure Time Spring Water*, 424 B.R. 76 (Bankr. S.D.N.Y. 2010).

14 In typical practice, a debtor alerts its secured lender of its intention to file a bankruptcy petition prior to filing so that the parties can arrange for use of cash collateral on a go-forward basis.

15 *Id.* at 85–86.