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Alternative Dispute Resolution in Bankruptcy

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ALTERNATIVE DISPUTE RESOLUTION IN BANKRUPTCY

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> Discourage litigation. Persuade your neighbors to compromise whenever you can. As a peacemaker the lawyer has superior opportunity of being a good man. There will still be business enough.
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> —Abraham Lincoln

Alternative dispute resolution ("ADR") is becoming increasingly popular and is now widely used by litigants to resolve their disputes, even in bankruptcy.[1] This article will identify the authority of the bankruptcy courts to implement ADR and will explore why ADR is especially effective in bankruptcy practice.

AUTHORITY FOR BANKRUPTCY COURTS TO USE ADR TO RESOLVE DISPUTES

In 1998, Congress enacted the Alternative Dispute Resolution Act of 1998[2] ("ADR Act"). The ADR Act defines alternative dispute resolution as "any process or procedure, other than an adjudication by a presiding judge, in which a neutral third party participates to assist in the resolution of issues in controversy, through processes such as early neutral evaluation, mediation, minitrial, and arbitration."[3] In apparent recognition of the usefulness of ADR in bankruptcy, the ADR Act requires that each United States district court "authorize, by local rule adopted under section 2071(a), the use of alternative dispute resolution processes in all civil actions, including adversary proceedings in bankruptcy" and further requires that each district court "devise and implement its own alternative dispute resolution program, by local rule adopted under section 2071(a), to encourage and promote the use of

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1. As of September 1999, about 30 of the 90 bankruptcy courts have local rules that govern the referral of disputes to mediation. *See* Robert J. Niemic, *Mediation in Bankruptcy—Results of FJC Survey*, 18-Sep. AM. BANKR. INST. J., Sept. 1999, at 1.

2. Alternative Dispute Resolution Act, Pub. L. No. 105-315, 112 Stat. 2993 (1998) (codified as amended at 28 U.S.C. §§ 651-658 (Supp. 2000).

3. 28 U.S.C. § 651(a) (Supp. 2000).

alternative dispute resolution in its district."[4] The statute expressly applies to bankruptcy. Yet, even without the express reference to "adversary proceedings in bankruptcy," the ADR Act arguably applies to bankruptcy courts, just as it does to district courts, because bankruptcy courts are units of the district courts.[5]

Disputes in bankruptcy practice are classified two ways: as contested matters,[6] governed by Fed. R. Bankr. P. 9019, or as adversary proceedings,[7] governed, with some modifications, by the Federal Rules of Civil Procedure, found in Part VII of the Bankruptcy Rules, 7001 through 7087. Included among the Part VII series Bankruptcy Rules is Rule 7016, which makes Fed. R. Civ. P. 16 governing pretrial conferences applicable in adversary proceedings in bankruptcy court just as it applies to civil actions in district court. This is important because Rule 16(c) authorizes a court to "take appropriate action, with respect to ... settlement and the use of special procedures to assist in resolving the dispute when authorized by statute or local rule." Because contested matters proceed more expeditiously than adversary proceedings, Fed. R. Bankr. P. 9014 does not expressly make the pretrial process of Rule 16 applicable in contested matters; however, the Rule allows the court to "direct that one or more of the other rules in Part VII shall apply." Thus, Fed. R. Civ. P. 16 provides authority for bankruptcy courts to require the parties to mediate a dispute, in both adversary proceedings and contested matters.

Section 105(d) of the Bankruptcy Code,[8] part of the Bankruptcy Reform Act of 1994, provides yet more authority for a bankruptcy court to establish an ADR system to resolve disputes. The legislative history explains that the 1994 amendment to Section 105 "authorize[s] bankruptcy court judges to hold status conferences in bankruptcy cases and thereby manage their dockets in a more efficient and expeditious manner."[9] One way to manage the docket is by referring the parties to mediation.

The ADR Act requires that the ADR process be established by the district courts by local rule pursuant to the district court's rulemaking authority.[10] Bankruptcy courts likewise are afforded the power to adopt local rules.[11] Parties may be compelled to participate in mediation or early neutral evaluation, but arbitration can be required only with the parties' consent.[12] Consistent with this authorization, the Bankruptcy Court for the Northern District of Oklahoma has adopted local rules,

4. *Id.* § 651(b).

5. *See* 28 U.S.C. § 151 (1993).

6. Contested matters are disputes within the bankruptcy case not required to be resolved as an adversary proceeding. Nevertheless, under FED. R. BANKR. P. 9014, certain rules of the Part VII series apply; those rules track the Federal Rules of Civil Procedure.

7. Adversary Proceedings are lawsuits in a bankruptcy case. Bankruptcy Rule 7001 identifies those types of disputes that must be resolved by the more formal adversary proceeding process. FED. R. BANKR. P. 7001.

8. 11 U.S.C. § 105(d) (Supp. 2000) ("The court, on its own motion or on the request of a party in interest, may... issue an order... prescribing such limitations and conditions as the court deems appropriate to ensure that the case is handled expeditiously and economically...").

9. 140 Cong. Rec. H10, 710-64 (Oct. 4, 1991).

10. *See* 28 U.S.C. § 2071 (1994).

11. FED. R. BANKR. P. 9029 allows district courts to authorize bankruptcy courts to adopt local rules.

12. *See* 28 U.S.C. § 652(a) (1993).

including Local Rule 9070: Alternative Dispute Resolution. This rule (1) authorizes the bankruptcy court to order a settlement conference on its own initiative or upon the request of any of the parties, (2) designates a district judge, bankruptcy judge, magistrate judge, or adjunct settlement judge eligible to preside over the settlement conference, as long as the person is disinterested, (3) requires someone with settlement authority to attend for each party along with an attorney familiar with the case, and (4) establishes the confidentiality of the settlement discussions.[13]

In 1988, the United States District Court for the Northern District of Oklahoma established an Adjunct Settlement Judge ("ASJ") program in civil cases to conduct settlement conferences. These ASJs are licensed attorneys, trained by the court in ADR methods, who follow guidelines established by the court and who generally perform the service without pay. Following the district court's lead, between 1988 and 2000, the bankruptcy court used the ASJs on an ad hoc basis, but in 2000 the bankruptcy court formally adopted the ASJ program established by the district court through the assistance of the Center on Dispute Resolution at the University of Tulsa College of Law, chaired by Professor Martin A. Frey.

WHY ADR IS EFFECTIVE IN BANKRUPTCY PRACTICE

According to the ASJ manual used in the Northern District of Oklahoma, the advantages of settlement conferences over trial include:

- It is a relatively inexpensive, non-binding process that often results in the immediate resolution of the dispute.
- If a settlement can be reached, the parties will save discovery, litigation, and appeal costs.
- It is private and non-coercive, and proceeds under the protection of a strict confidentiality order imposed by the Court.
- It is informal and unstructured with each litigant having an opportunity to discuss his or her case in private with the settlement judge, an independent third party.
- It allows the litigants to control the outcome of their dispute, and encourages creative resolutions which would not be available through trial.
- It is more cooperative and less confrontational than a trial.
- It eliminates the uncertainties that are inherent in a trial.
- If a settlement is not reached, the settlement judge will not participate in the trial of the case.[14]

These advantages, particularly the cost savings, apply to bankruptcy as well. Bankruptcy is about money. Creditors want to be paid what they are owed, while the debtor insists that he or she cannot pay. These same creditors are competing for a limited pool of assets (called a bankruptcy estate), and the pool is almost never large enough to pay everyone. Bankruptcy is also about compromise. Consequently, it is

13. *See* Bankr. N.D. Okla. L.R. 9070.
14. U.S. Dist. Court for the N. Dist. of Oklahoma et al. *Adjunct Settlement Judge Manual* 2-3 (2000).

usually in everyone's best interest to consider ADR early in the case so as to minimize attorney fees and costs, particularly when the dispute involves representatives of the bankruptcy estate who are being paid from the bankruptcy estate, the very source of the money available for creditors.

At least one bankruptcy court has designated specific proceedings for mediation, including "(1) objections to claims; (2) valuations of collateral; (3) dischargeability of alimony, child support and property settlements; (4) preference actions; (5) fraudulent transfers; (6) turnover actions; and (7) applications for administrative expenses."[15] No specific disputes have been declared eligible for the ASJ program in the Northern District of Oklahoma. With the plethora of issues presented in bankruptcy cases, however, it seems short-sighted to limit the scope of ADR, particularly if the parties request it.

The Bankruptcy Court in the Northern District of Oklahoma has had particular success utilizing settlement conferences in dischargeability[16] actions under section 523 of the Bankruptcy Code. Dischargeability actions are especially well suited for settlement conference because:

- They generally do not involve a large sum of money.
- Many dischargeability complaints are initially brought by a creditor on principle, but the creditor soon learns that such principles are expensive - adversary proceedings are costly and add measurably to the loss already sustained in the form of the claim that may never be paid.
- The debtor is bankrupt. Winning the adversary proceeding does not guarantee that anything will ever be paid on the claim.
- As long as the superdischarge[17] exists in chapter 13, the prevailing creditor is at risk of having his or her non-dischargeable claim discharged in a subsequent chapter 13 case.
- Settling the dispute on terms agreed upon by the debtor increases the likelihood that the debtor may be able to pay the claim and it may make the debtor feel more obligated to pay because he or she agreed to pay rather than being ordered by the court to do so.
- Most grounds for determining dischargeability under Section 523 require an all or nothing result, that is, the claim is rendered entirely dischargable or entirely non-dischargable. Mediation affords the parties the option of fashioning a settlement on terms which the court could not award in a judgment.

15. *See* Lisa A. Lomax, *Alternative Dispute Resolution in Bankruptcy: Rule 9019 and Bankruptcy Mediation Programs*, 68 AM. BANKR. L.J. 55, 74 (1994).

16. Dischargeability is the term commonly used to identify whether a particular debt may be discharged by a debtor. A determination of dischargeability may be sought by either the debtor or a creditor by filing a Complaint that initiates an adversary proceeding. FED. R. BANKR. P. 4007(a).

17. Certain debt that cannot be discharged in cases under chapter 7-such as debt incurred by fraud, embezzlement, larceny, conversion, and intentional torts-may be discharged under chapter 13. *See* 11 U.S.C. § 1328(a) (Supp. 2000).

CONCLUSION

With the enactment of the ADR Act, the uncertainty that existed regarding the bankruptcy court's power to implement alternative means of resolving disputes has been eliminated. As courts and litigants become more accustomed to ADR, both the frequency and the scope of its use will undoubtedly expand. Given the ever increasing costs of litigation, bankruptcy attorneys will serve their clients well by taking Abraham Lincoln's advice and encouraging settlement through the use of ADR.

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