Critical Information Required to Effectively Mediate Uninsured or Under-Insured Business Disputes

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I. INTRODUCTION.

This Article presumes that both the plaintiff and the defendant’s counsel are fully cognizant of all issues relevant to the prosecution and the defense of the claims being mediated. So, assuming unencumbered assets exist to pay those claims, either from property owned by the defendant or by the defendant’s insurer, all that the counsel involved in the mediation need concern themselves with is the merits of the claims themselves. However, where there is no insurance or inadequate insurance to pay these claims (which is usually the case in business disputes), other issues may well dwarf the actual merits of the claims in importance and failure to consider these issues may lead to a disastrous result for either the plaintiff or the defendant.

The reason for this is that where (a) a defendant pays claims with assets which are duly encumbered, i.e., subject to a duly perfected lien of another creditor; or (b) a defendant pays claims with assets which are unencumbered but nonetheless, in the process, commits what is known as an “avoidable preference” or a “transfer in fraud of creditors”, the asset used by the defendant to pay those claims may have to be disgorged by the plaintiff by reason of a subsequent proceeding (i) by the creditor whose collateral was used to pay the claims, or (ii) by a bankruptcy trustee or debtor in possession in the exercise of avoiding powers provided under the Bankruptcy Code should the defendant become embroiled in a bankruptcy proceeding (either voluntary or involuntary.

Should any of these things occur, the disastrous result from a plaintiff’s perspective would be that he would be unable to retain any of the
consideration received to settle the claim and at the same time may have also compromised his claim based on the actual merits of the claim with nothing to ultimately show for it. The disastrous result from a defendant’s perspective would be that assuming there were adequate protections for the plaintiff in the mediated settlement, a compromise which may have been critical to the defendant for a variety of reasons becomes nullity.

The only way that these disastrous results can reasonably be avoided is through the appropriate appreciation of information regarding the defendant’s financial/legal condition much of which is usually readily available online. While it is at least possible that a defendant will volunteer this type of information at the request of the plaintiff, in that this type of information is normally not discoverable prior to a judgment and a defendant at the middle stages of a lawsuit tends to not be particularly forthcoming with any information he is not absolutely required to provide, such cooperation is the exception rather than the rule.

II. INFORMATION A PLAINTIFF SHOULD ATTEMPT TO OBTAIN PRIOR TO A MEDIATION.

For a mediation to be truly meaningful in a dispute where the defendant will have to settle the plaintiff’s claim with the defendant’s own assets (again, this is the case with most business disputes which are largely uninsured although whether there is possible insurance coverage is a question that should always be asked during discovery), the plaintiff should attempt to ascertain answers to the following questions regarding the defendants financial/legal condition:

A. Is the defendant involved in other litigation?

This information is obviously important to the plaintiff because (a) the defendant is in all likelihood paying for the defense of the other litigation out of his own pocket which he may not be able to afford; and (b) the mere existence of other litigation means that the defendant has more claims against his assets than just the plaintiff’s. This concern would be ameliorated somewhat if the other claims were covered by insurance. Other litigation against a defendant is usually (but not always) brought in the defendant’s principal residence or place of formation if it is, for example, a corporation or partnership.

Copies of the relevant pleadings in the other litigation can normally be obtained online directly from the court or courts where the other litigation is pending. While it may not be the case that all litigation in which the defendant is involved is pending where the defendant resides or was formed, it always the place to start.

B. Are the defendant’s assets subject to liens or encumbrances?

This information is also obviously important to the plaintiff because (a) assuming that the defendant actually has assets which may be available to pay the plaintiff’s claim, they will be unavailable for that
purpose, at least legally, if they are encumbered by valid liens and/or encumbrances. Finding such liens and encumbrances is normally not difficult and can usually be obtained online. Specifically, the object of the search is to determine if there are liens and encumbrances against the defendant’s property which afford the holders of the liens and encumbrances legal priority over the defendant’s other creditors. This concept is known as “perfection”:

1. **Liens or encumbrance against real property.**

   If the defendant owns real property, any lien or encumbrance against that property in order to be perfected must be duly recorded in the county of the state where the real property is located. Any lien (such as an abstract of a judgement) or encumbrance (such as a mortgage) which is recorded in any other location is normally not perfected and therefore not a lien or encumbrance on the real property at all so the defendant would have the ability to transfer the real property to the plaintiff in settlement of the plaintiff’s claims. However, such a transfer by the defendant may nonetheless present avoidable preference or transfer in fraud of creditor issues discussed below.

2. **Liens or encumbrances against personal property.**

   If the defendant owns personal property (generally anything other than real property), notice of any lien or encumbrance against that property must be duly filed with the Secretary of State where the defendant maintains his principal place of residence or if the defendant is a corporation or partnership (or the defendant owns or has an interest in a corporation or partnership), with the Secretary of State under the laws of which the entity was formed. The notice is normally a Form UCC-1 financing statement which is a creature of the Uniform Commercial Code adopted with certain deviations not important here throughout the United States.

   Failure to file the notice with the correct Secretary of State will result in an unperfected lien or encumbrance. Should this occur, as is the case with unperfected liens and encumbrances against real property, the defendant would have the ability to transfer the real property to the plaintiff in settlement of the plaintiff’s claims. Once again, however, such a transfer by the defendant may nonetheless present avoidable preference or transfer in fraud of creditor issues discussed below.

   Selecting the correct Secretary of State to search for such liens and encumbrances is often tricky in that in the case of a corporation or partnership, the only relation the entity may have with a particular state is that it was formed there – a fact which
may be nearly impossible to determine from the manner in which the corporation or partnership does business. Likewise, an individual’s residence in a state may be only temporary so that the state of the defendant’s actual principal place of residence may well be elsewhere.

III. INFORMATION A DEFENDANT SHOULD ATTEMPT TO OBTAIN PROR TO A MEDIATION.

The plaintiff is not the only party who should be gathering information his opponent’s financial/legal situation. Rather, the defendant should be going through the same exercise in order to obtain the identical information regarding the plaintiff’s financial/legal situation as set forth in Section II., above.

IV. What the developed information may demonstrate and how it should be used in a mediation.

If the parties have done their pre-mediation homework correctly, what each will be armed with will be a picture of the financial/legal challenges the other party is facing which may and often does have a major impact on what the other party either will want to do or is able to do regarding resolution of the dispute actually being mediated. While it would be most helpful to know with certainty that what has been developed by one side is completely accurate, in most cases that is unlikely. Nonetheless, a party armed with this information is a lightyear ahead of a party who has not gone to the effort in that he will be able to play on weaknesses in the other party’s overall financial/legal situation that may have nothing to do with that party’s strengths or weaknesses in the matter actually being mediated.

A. Should the developed information be disclosed at the arbitration?

This decision obviously belongs to the party that developed the information but from a mediator’s perspective, if it is not disclosed at the mediation, it will serve no purpose in resolving the case. So, in most cases, the author believes the information should be disclosed.

B. What the developed information may demonstrate from a plaintiff’s perspective.

From the plaintiff’s perspective, the developed information may be used to demonstrate, among other things, that (a) the defendant’s “pleas of poverty” often made by a defendant in settlement discussions are unfounded and that the defendant has adequate assets to pay the plaintiff’s claim in full if he wanted to; (b) although the defendant has assets to pay the plaintiff’s claim, he lacks adequate liquidity to wage a long and expensive trial so settlement with the plaintiff in some reasonable amount remains the defendant’s only realistic option; and/or (c) the defendant has committed material transfers in light of the plaintiff’s claim which would be avoidable as transfers in fraud of creditors or as avoidable preferences by a trustee or debtor in possession should the defendant become embroiled in a bankruptcy proceeding. The net effect of this might
be that the defendant would rather settle than subject the defendant’s transferees (often family or friends) to avoidance litigation to recover those transfers.

C. What the developed information may demonstrate from a defendant’s perspective.

From the defendant’s perspective, the developed information may be used to demonstrate, among other things, that (a) notwithstanding the plaintiff’s “death before settlement” posture, in fact, the plaintiff is in a very fragile financial/legal situation and desperate for any funds to ameliorate his woes; and (b) the plaintiff lacks adequate liquidity to wage a long and expensive trial so settlement with the defendant in some reasonable amount is the plaintiff’s only realistic option.

V. Navigating the disastrous results which might arise from either receiving or making transfers of property in a mediated settlement which are avoidable.

Once the plaintiff and the defendant are able to agree upon an acceptable amount the defendant must pay to the plaintiff in order to resolve the dispute actually being mediated, analysis of whether the actual payment of that amount would be an avoidable transfer becomes critical.

A. Potential avoidability of transfers to the plaintiff by the defendant or liens obtained by the plaintiff against the defendant’s property made pursuant to a settlement agreement – an overview.

Generally, if the defendant commences a bankruptcy proceeding of any type within 90 days of the receipt of (a) a transfer of property by the defendant to the plaintiff; (ii) to pay in whole or part an existing claim against the defendant; and (3) which would enable the plaintiff to receive a greater portion of his claim than other creditors of the defendant that did not receive such a transfer, the transfer may be subject avoidance in the bankruptcy proceeding and the plaintiff compelled to return what was transferred to the defendant’s bankruptcy estate. If the plaintiff is what is known as an “insider” of the defendant, then the look-back period is increased from 90 days to one year.

The same analysis would apply to the avoidability of any liens on the defendant’s property the plaintiff may have obtained within the same time periods. Further, any pre-petition settlement agreement entered into within that period may be “rejected” giving rise only to an unsecured claim against the bankruptcy estate.

Similarly, a transfer of property which is unsupported by adequate consideration or a transfer of property made with the actual intent to put the property transferred beyond the reach of the transferor’s other creditors may be avoided under the Uniform Fraudulent Conveyance
Act adopted with minor variations throughout the United States as well as being incorporated into the Bankruptcy Code

B. The disastrous result which the plaintiff should seek to avoid.

If the plaintiff has any realistic reason to believe the defendant is insolvent (including the defendant himself so informing the plaintiff that he is insolvent such as by way of a “plea of poverty”, the plaintiff should attempt to negotiate provisions in the settlement would (a) allow the plaintiff to treat the settlement agreement as a nullity if a bankruptcy proceeding is commenced by or against the defendant within the preference period and (2) allow the underlying litigation to remain open until the settlement consideration has actually been paid and the relevant preference period has expired. That way, he plaintiff will not be bargaining away his claim in exchange for a mere promise to pay.

Rather, the plaintiff’s position should be that the settlement should be an “accord and satisfaction” so that the claim will not be satisfied until the preference period has expired after the transfer without a bankruptcy proceeding having been commenced. In so doing, the plaintiff would be able to avoid the result of having compromised his claim yet wind up receiving nothing of value in return – truly a disastrous result for the plaintiff.

C. The disastrous result the defendant should seek to avoid.

It may be the case that resolution of the claim being mediation is of critical importance to the defendant’s financial future such as, for example, a claim clearing title to a patent the defendant has been working on his entire career or to real property which the defendant has spent his entire career attempting to develop. In this regard, even a totally well intentioned plaintiff cannot necessarily head off an involuntary bankruptcy proceeding commenced by another of the defendant’s creditors.

Thus, if the defendant allows the protective provisions suggested above to be included in the settlement agreement, it may be the case that all of the defendant’s efforts in the litigation including the settlement achieved through the mediation will have become a nullity – truly a disastrous result for the defendant.

Therefore, the defendant should resist to the extent possible the inclusion of the protective provisions on the basis that assuming the matter actually went to trial in the underlying litigation, the plaintiff would not be entitled to receive any of the things he is insisting upon but rather only a judgment.
VI. Conclusion.

The suggestions contained in this Article are vital for the parties to a mediation to keep in mind in that failure to do so may render the mediated result a nullity for both sides. Because of the severity of the impact implementation of these suggestions may have on the rights of the parties, the better source of the suggestions is from the parties rather than the mediator. Stated another way, it is the mediator’s role to facilitate a resolution of the dispute being mediated. However, it is not the mediator’s role to protect the parties from themselves when both parties are represented by counsel.

To schedule a mediation, please contact case manager Kathy Purcell at:
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