



AMERICAN
BANKRUPTCY
INSTITUTE

2018 New York City Bankruptcy Conference

Mediation

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INTRODUCTION



**THE LAW, THE BENEFITS, AND THE
DOWNSIDES OF MEDIATION**



The Law: 28 USC § 652(a)



- Local rules govern mediation:
 - 28 USC § 652(a) provides that “each district court shall ... require that litigants in all civil cases consider the use of an alternative dispute resolution process at an appropriate stage in the litigation. Each district court shall provide litigants in all civil cases with at least one alternative dispute resolution process, including, but not limited to, mediation, early neutral evaluation, minitrial, and arbitration”
 - 20 districts without local mediation rules.

The Law: Local Rules



- SDNY Mediation Procedures provide that “any adversary proceeding, contested matter or other dispute may be referred by the Court to mediation” and that “[t]he Court may order assignment of a matter to mediation upon its own motion, or upon a motion by any party in interest or the U.S. Trustee.”
- District of Del. Local Rule 9019-5 (a) provides that “[t]he Court may assign to mediation any dispute arising in an adversary proceeding, contested matter or otherwise in a bankruptcy case” and that “all adversary proceedings filed in a chapter 11 case and, in all other cases, all adversaries that include a claim for relief to avoid a preferential transfer ... shall be referred to mandatory mediation.”

Benefits of Mediation



- Flexibility and unique solutions?
- Fewer motions filed?
- Disposition of cases more quickly?
- Communicate directly with the opponent?
- Better understanding of the risks of opponent's case?

Downsides of Mediation



- Delay?
- Expenses resulting from dual-track process?

ISSUES RELATING TO MEDIATION



Issues Relating to Mediation

- When is it most effective for mediation to take place?
 - Immediately prior to confirmation?
 - Early in the case?
 - Adversary proceeding or contested matter?
- Mandatory court-ordered mediation vs. voluntary mediation?

Issues Relating to Mediation (cont.)



- **Selection of the mediator:**
 - Sitting judge? Retired judge? Attorney?
 - Does the bankruptcy judge select the mediator?
 - How to ensure disinterestedness of mediator given potential connections in large bankruptcy cases?

Issues Relating to Mediation (cont.)



- **Mediation confidentiality issues:**
 - Can/should the mediator speak to the bankruptcy judge?
 - Should the mediator file a report with the Court to ensure that parties participate in the mediation in good faith?
 - Should clients participate in substantive mediation sessions?
 - ✦ Does this create potential MNPI issues?
 - Potential for a party to inadvertently disclose discussions in mediation at a hearing or in a pleading?
- **Requirement to “mediate in good faith”**

Issues Relating to Mediation (cont.)

- Efficient and effective mediation structures:
 - How to prepare for mediation?
 - ✦ As a litigant
 - ✦ As the mediator
 - What materials to submit prior to the mediation?
 - ✦ Formal mediation statements? Formal settlement proposals? Other methods of getting the mediator prepared?
 - ✦ Should the parties share their statements with the other side or provide only to the mediator?

Issues Relating to Mediation (cont.)

- Efficient and effective mediation structures:
 - How to structure the mediation?
 - ✦ Joint sessions with all parties or separate sessions and “shuttle diplomacy?”
 - Strategies for getting to “yes” on a deal – especially with a lot of parties involved and a lot of important details to resolve?
 - ✦ Where there are many issues, and a party’s ultimate outcome depends on winning/losing each issue, and none of the issues are “gating issues,” how does a successful mediation work?
 - ✦ Are parties willing to mediate issue by issue, or does the mediation have to address all issues simultaneously?

MOCK MEDIATION



CONCLUSION



**FINAL THOUGHTS/TIPS FOR A SUCCESSFUL
MEDIATION PROCESS**

Fact Sheet and Role Play Instructions for Sunset Mining Operating Group

This mediation arises out of disputes associated with the recent financial difficulties of a coal mining business located in West Virginia known as Sunset Mining Operating Group. (“SMOG”). SMOG for many years profitably supplied coal from its mines to coal fired power plants and industrial facilities throughout the United States. SMOG has been under growing financial pressure lately due to changing environmental legislation and the low cost of oil and natural gas. There have been fewer orders, and sales and revenue for SMOG have declined sharply. Additionally, the value of the company’s coal reserves has also dropped substantially due to declines in commodity pricing. From a balance sheet perspective, SMOG’s assets were reduced during a recent audit by about 25%.

This write down, in turn, has resulted in the tripping of a tangible net worth covenant in SMOG’s senior credit facility with Big Bank (“BB”). BB has called a default, accelerated payment and has threatened legal actions against SMOG to obtain control of the company’s most productive mines. SMOG currently owes BB \$500 million (\$350 million term loan and \$150 million revolving credit) secured by all of the company’s assets. Depending on which appraiser is thought to be most credible, these properties are valued within a range of \$350 million to \$700 million. Certain mining experts believe that the mines should be operated, even at a loss, and others believe they should be shut down and mothballed pending a turnaround in the market for coal.

SMOG is a wholly owned subsidiary of Diversified Parent Company (“DPC”). DPC has helped to finance the operations of SMOG through cash advances. DPC is an enormously valuable company with a portfolio of assets ranging from intellectual property to prime commercial real estate. DPC is conservatively valued at \$12 billion. Some estimates would place its enterprise value as high as \$15 billion.

Unfortunately, DPC has not been careful in documenting advances made from time to time to SMOG and has funded its mining subsidiary inconsistently and with varying degrees of corporate formality, on occasion very strict and detailed and at other times extremely lax. In some instances, the contributions were carefully documented as unsecured loans with corporate resolutions and elaborate loan agreements and at other times funds were simply advanced as intercompany transfers without any detailed documentation at all.

The unpaid intercompany advances from DPC to SMOG total \$1 billion and have ballooned in recent months. Of this total, \$750 million has been documented with considerable care, while the remaining \$250 million has been advanced casually and may even be viewed by some observers as a capital contribution. Regardless of the formality of documentation, amounts have been repaid by SMOG to DPC at various times during the last year, without any predictable schedule of payments, on a discretionary basis depending on available cash flow and in response to periodic demands for payment by DPC. It is impossible to tell whether the amounts repaid have reduced the well documented or the poorly documented intercompany obligations, and the accounting records have not been well maintained.

As of January 31, 2018, \$500 million remains due and owing by SMOG to DPC, but the company also owes significant other obligations to unaffiliated third parties. SMOG owes \$1 billion to senior unsecured bondholders and \$500 million to a variety of other creditors for a total of \$2.5 billion, including the amounts owed to BB and DPC.

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There are conflicting estimates as to the value of SMOG as a going concern. The business has been valued by valuation experts for the creditors as falling within the range of \$1.25 billion to \$1.75 billion based upon assumptions regarding the value of SMOG's reserves and future pricing of metallurgical coal. DPC has retained valuation experts that value SMOG at between \$2.75 and \$3 billion. Most of the variance is attributable to assumptions in the business plan for SMOG.

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Restructuring discussions have started, and this group has been retained for the various parties to mediate the following disputes with the aim of helping the parties to agree on terms of a restructuring of SMOG that would include a significant new equity contribution by DMC. In order to achieve this restructuring, the parties must find a way to convince BB to forbear from exercising remedies, reconcile differences as to valuation of the mining assets and the going concern value of SMOG as an operating business and determine the probability weighted value of claims against DMC. It is difficult to align the competing goals of the parties:

BB wants to liquidate its collateral and has no faith in the future of the mining operations. It might agree to forbear in consideration of receiving a meaningful restructuring fee and equity in SMOG. It wants to motivate other parties to refinance its debt within the next six months and has no patience to wait for the turnaround predicted by SMOG. It believes that its collateral is worth at least \$500 million in a liquidation.

SMOG is optimistic about the future of its mines and wants to continue operating these assets, stabilize its business and avoid liquidation. SMOG believes that the market is going to turnaround by the end of 2018. It sees DPC as a deep pocket that can be encouraged to fund a restructuring. It is also interested in exploring an agreement with bondholders in which they would convert a portion of their debt for equity in SMOG.

DPC wants to exit the mining business altogether and focus on real estate investments. It has no interest in making additional investments in this legacy business, but it does hope to collect as much as it can from SMOG on its unsecured debt claims. DPC is also concerned about the risk that it may be exposed to potential liability for the obligations of SMOG due to sloppy record keeping and that some or all of its claims against SMOG may be characterized as equity.

The bondholders have sold their claims to a hedge fund known as Loan to Own ("LTO"). LTO purchased the bond debt for fifty cents on the dollar. It wants the balance sheet of SMOG to be restructured and new senior management to be brought into the company to improve operations and exploit new markets. It also wants to put pressure on DPC and has threatened to sue DPC to invalidate its debt claims.

The mediator's challenge is to convince parties with divergent objectives to work together and to promote a restructuring that benefits all stakeholders.

MOCK MEDIATION OUTLINE

Rachel: Narrator / Issue Presenter

Marc: Debtor / First Lien Plan Supporting Creditor Group

Kris: Second Lien Plan Objecting Creditor Group

Mike: FA for PBGC

Judge Chapman: Mediator

General outline

The Debtors are privately owned by Sponsor Fund.

Pre-bankruptcy capital structure

- First Lien Debt: \$700MM
- Second Lien Debt: \$200MM
- Underfunded Pension Liability: \$100MM
- Trade Claims: \$50MM
- All of the Debtors' domestic assets are encumbered by the prepetition liens of the secured creditors. One-third of the Debtors' equity in its foreign subsidiaries is not pledged.
- The intercreditor agreement between the first and second lien debt includes a pay-over provision from the proceeds of any collateral and requires that the second lien holders treat all liens as valid and enforceable but permits the second lien holders to make any argument an unsecured creditor could assert.

The Plan

The Debtors and the First Lien Plan Supporting Creditor Group have formulated a plan that provides as follows:

Classification and Treatment

- *Class A* is comprised of all First Lien Secured Debt Claims (\$350MM).
Treatment:
 - A) 99% of the equity of the reorganized Debtors (subject to dilution by MIP and Class D Warrants); and
 - B) \$300MM of take-back debt that will be junior to \$100MM of new first lien exit financing (rolled over from DIP financing).
- *Class B* is comprised of all general unsecured claims, including:

- a. First Lien Deficiency Claims (\$350MM);
- b. Second Lien Debt Claims (\$200MM); and
- c. all other general unsecured claims (\$50MM).

Treatment: 1% of the equity of the reorganized Debtors (subject to dilution by MIP and Class D Warrants).

- *Class C* is comprised of the PBGC's underfunded benefit liability claims resulting from termination of the Debtors' single-employer pension plans (\$100MM).

Treatment: \$25MM in cash (on account of the PBGC's agreement not to object to the termination of the pension plans).

- *Class D* includes the equity sponsors of the Debtors.

Treatment:

A) Warrants equal to 5% of the reorganized Debtors' equity at an out-of-the-money strike price; and

B) Releases of all claims by Debtors and third parties.

Plan values reorganized equity at \$50MM, and the Debtors' conservative projections show little to no growth in business over the next five years, despite being in a relatively high growth industry.

The Plan includes a MIP that reserves up to 10% of the reorganized Debtors' equity for distribution to certain members of the Debtors' management team. The reorganized Debtors' board will determine award schedule, vesting rights, etc.

Procedural Posture

- In connection with the Disclosure Statement Motion, the Second Lien Plan Objecting Creditor Group, which holds more than 2/3 of the Second Lien Debt, has objected to the plan on numerous grounds, including improper classification, disparate treatment, absolute priority rule violations, valuation issues, improper releases and bad faith.
- The Debtors and First Lien Plan Supporting Creditor Group assert that plan is fully consensual and that all impaired consenting classes will vote in favor of the plan, and, accordingly, the majority of the Second Lien Plan Objecting Creditor Group's arguments must be rejected.
- In response to these arguments, the SDNY Judge presiding over the case has sent the parties to mediate before Judge Chapman.