

The Mediation Solution

Is there a better way to work out those problem deals?

by Paul Bent & Susan Rosenthal

As every lessor and lender knows, deals occasionally go bad. Lessees default, markets change, equipment loses value. Sometimes even the best planned and executed deal may turn out to be the biggest problem in a lessor's portfolio.

And historically, when a lease has turned out for the worst, the standard procedure for the lessor has been first to try working out some sort of resolution directly with the lessee and then, failing that, to call the lawyers—time to go to court. Conventional wisdom, in the most intractable situations, says litigation is the only way to force the lessee to meet at least most of its obligations under the lease and, it is hoped, to book a little something positive from the deal.

In a suit, after months of expensive discovery, management time, and the unpredictability of a trial, a judge and jury who don't know a leveraged lease from a checking account will decide the fate of the parties.

Too often, though, this “standard” procedure does not meet these objectives. After spending a great deal of money, executive time, and management resources, the result may be simply a substantial write-off and a ruined relationship with a lessee.

But there is an alternative to the conventional approach, one that has worked successfully in other business contexts and is becoming increasingly accepted in the legal community: mediation. This increasingly popular choice may be a much more effective and satisfactory way to deal with leases gone bad than winding up in the courtroom

The Transaction

To illustrate how mediation may play a vital role in working out problem deals, consider a large ticket leveraged lease in which the lessor has leased \$80 million of equipment to the lessee. At closing, the lessor advanced 30 percent of original equipment cost in cash and borrowed the balance non-recourse from the lender, to whom a first priority security interest in the leased equipment has been granted. The lessee is a substantial wholly

owned subsidiary of a large publicly-held conglomerate, but the lessee's parent is not a party to the deal.

The initial term of the lease was eight years, and the deal has just passed its sixth anniversary. So far, at two different times, the lessee has missed making its rental payments; but, after gentle reminders from lessor's counsel, these were cured and the rent is now current.

The deal was done in a lessee's market, at fixed pricing very attractive to the lessee. In the six years since lease inception the market has turned, and the lessor could do the same deal today at a significantly higher yield. What's more, the residual value of the equipment has deteriorated dramatically since the lease was closed; the lessor's advisors believe it is probably worth today only about 50 percent of booked residual.

The lessor recently learned that the lessee has transferred the equipment and the lease obligations to one of its corporate affiliates—a sister company. Although such transfers are allowed under the lease, the lessee is required to give notice, provide credit information on the assignee, obtain the lessor's consent, and satisfy other covenants con-

trolling transfers, none of which it has done. The lessee believes the assignment complies with the material terms of the lease and that only the notice and consent and other “technical” matters need to be cured. Under the lessor’s reading of the lease, however, the assignee does not meet the requirements to assume the lease obligations; and, since it finds the lessee in default (and given the lessee’s payment history), the lessor has threatened to give a notice of default and demand remedies under the lease.

Although they have made half-hearted attempts to discuss the problem, both lessor and lessee have decided they’re probably not going to work this out by themselves; the lawyers have been called. Meanwhile, although it holds a senior security interest in the leased equipment, the lender has not made its views on the matter known to either side.

The Traditional Approach

Something like this scenario is no doubt familiar to many lessors. The parties harden their positions; the lessor is motivated to get out of the deal, but still needs to think about a possible squeeze by the lender; the lessee believes it can easily cure the problem and that the lessor is being unreasonable.

Traditionally, either of two things may then occur. The lessor, confident that an event of default has actually occurred, that the lender can be brought on board, and that the lessee is in a weak position, digs in its heels, declares a default, and hopes to pay off the lender and recover most of its equity (and its attorneys’ fees) when the lessee loses in court. Alternatively, the lessee, thinking it can prove that no actual event of default has occurred, that the

default, if there is one, is not material, that the lessor is acting in bad faith, and that the lender may effectively stop the lessor, digs in its heels, forces the lessor to declare a default, and hopes to save the deal (and its attorneys’ fees) when the lessor loses in court.

In either case the deal is dead, and litigation is not far behind—litigation during which both the lessee and its assignee have most likely stopped making lease payments altogether. Then, after months or years of expensive discovery, management time, and the unpredictability of a trial, a judge and jury who don’t know a leveraged lease from a checking account will decide the fate of the parties. Although each party assumes it will prevail, the costs of getting to the end of this road (even for the winner) are substantial. And the risks of being wrong are enormous.

A Better Approach

There is a better alternative, one that is becoming more widespread throughout the business community—one that offers a way for all parties to salvage something from the deal, without the mounting costs and increasing risks of litigation. The parties can together bring in a professional mediator, a person knowledgeable in the details of leveraged leasing and trained as an expert in conflict resolution.

Mediation is a process in which a neutral, experienced leasing professional meets directly with the parties and their counsel and helps them find a way to resolve the issues that threaten to derail their deal or push them into litigation. Through creative and active listening, and based on frank and confidential communications with principals, attorneys, investment bankers, and others who play a key role in the deal, the mediator is able to get beyond the posturing and positioning, to understand and address the

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real issues and concerns of the parties, and to help them find workable solutions to the problems at hand.

Unlike an arbitrator, a judge, or a jury, the mediator does not make a ruling, does not solely determine the applicable law, does not solely assess the facts of the case, and does not impose a decision on the parties. Rather, the mediator meets with the parties and their counsel, both in “joint sessions” and separately, in confidential private caucuses, to dig into the issues and details underlying the dispute and to understand everyone’s real motivations

and interests in the deal. Using this information (but keeping it confidential), a skilled mediator can work with all sides to help fashion a resolution that all can live with—perhaps not a perfect resolution, but one that is acceptable to everyone and does not require years of expensive litigation and, ultimately, a roll of the dice in court.

And because all negotiations conducted during the mediation are kept completely confidential, even from the court, if the mediation is ultimately not successful and the case eventually goes to trial, the judge will never know what was said or why the matter didn’t settle. This complete blanket of confidentiality encourages open and honest negotiations during mediation and is often a key factor in reaching agreement.

The result of a successful mediation is a settlement agreement that is reached and documented by the parties themselves. The settlement agreement is final and enforceable as a judgment in court, while all the underlying details of the settlement and negotiations remain private and confidential.

Mediation in Leasing

In our hypothetical deal, what if, rather than “dropping the hammer” when the lessee defaulted, the parties had brought in a mediator who specializes in deals

and disputes of this kind. First in joint sessions, then through confidential private caucuses with all parties, the mediator would assess the underlying agendas of the parties.

The lessee has a really good deal and wants to keep it if at all possible. There are only two years to go, and they're confident they can make the rest of the rent payments. They really want to end up owning the equipment, especially at the lower residual in today's market. However, there is concern that the lessor may be right about the transfer being an event of default, and the lessee

would like somehow to make the lessor see that it's not a big enough problem to bring down the entire deal. They might even be willing to move the equipment back and try to undo whatever damage was done, and even to pay some additional rent in the nature of a penalty if that will keep the deal in place.

The lessor, of course, without saying so publicly, wants very much to get out of this deal. In today's market they are completely under water, and the transfer issue gives them an excellent excuse to bring down the transaction.

But they don't know where the lender is going to come out on the question of terminating the lease. If the lender triggers the default, given the current equipment residual, the

lessor is likely to get squeezed completely out of whatever payoff is made.

In confidential caucus with the lender, the mediator may find that they would like to declare a default under the loan sooner rather than later. They want to recover everything they can from the lessee, and they're not especially concerned about squeezing out the lessor. However, they're not sure the lessee's transfer of the equipment constitutes an event of default under the loan, as distinct from the lease; so they're not sure they have a basis for declaring the loan in default. Consequently, they're open to a mediated solution that will either keep the deal in place to term or will get them out now with their economics intact.

Having developed all of this background through confidential private meetings with the parties, the mediator now has the basis for helping craft a

It's Not Just "Show Me The Money"

Although most financial disputes result from a party's failure to meet its payment obligations under the contract, there may be more than meets the eye in resolving such disputes. In a recent mediation conducted by one of the authors, a large financial institution had brought suit against a packager who had sold it a large portfolio of secured transactions, claiming that the underlying appraisals on which the advances were based were fraudulent (as indeed they were). The matter looked straightforward: the packager was obligated under the indemnities in the assignment to make the purchaser whole for losses caused by fraud, even if not the fraud of the packager itself.

However, after several hours of discussion in confidential caucus, probing with the lawyers, and even calls to the bank's back office, the mediator learned that the purchaser had in turn securitized and sold the portfolio to another large institution and had been paid for essentially all the deals in the package. This revelation (which was probably not known even to the bank's lawyers at the beginning of the mediation) significantly changed the party's perception of its eventual chances of prevailing at trial; a serious "reality check" had occurred.

Without disclosing this confidential information to the packager, and through a further mediation session, the mediator was able to facilitate the parties' eventual resolution of the matter on terms acceptable to both sides.

Things are not always what they appear, even to the parties' experienced legal counsel.

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workable resolution of the issues. Key to this process is the mediator's ability to help the parties see what their best and worst case scenarios are most likely to be; to provide a "reality check" as to the expected outcome under various alternative courses of action. Because the mediator is neutral as to the outcome of the dispute, this process of reality testing often provides the parties with their most objective view of the matter, and helps them form their own insights as to the best course of action.

In the example situation, there may be a number of ways to structure

a resolution that the parties can all live with. Each alternative may have certain drawbacks for each party; but overall they will provide a workable global framework for putting this matter to rest, without the costs, tensions, and long-term risks of a protracted standoff or, worst case, of litigation.

Why it Works

Mediation works in complex corporate finance because:

- **It is entirely confidential.** Only the mediator knows what is said in

confidential caucuses, and nothing disclosed there can be used against a party in court. This allows for frank discussion of underlying issues, agendas, and interests and of the consequences of various alternative resolutions—a serious reality check.

- **It is completely neutral.** The mediator has no agenda except to help the parties find a way through the problem and get the issues resolved to the parties' mutual satisfaction. The mediator's compensation is shared equally among the parties, and there is no other objective than the development of a successful settlement.
- **It is fair.** When all is said and done there is not a "winner" or a "loser" in mediation. The mediator does not decide any issues or make any rulings; rather, the mediator's job is to ask questions, test each party's

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assumptions, and facilitate and guide the process. It's the parties themselves who craft the final, mutually acceptable settlement, ensuring its fairness and durability. Indeed, studies have indicated that mediated settlements are as much as three times more likely than arbitrated awards to survive over the long term.

■ **It is economical.** Compared with the substantial costs of litigation in time and money, mediation in big

ticket leasing is a bargain. The only out-of-pocket costs are the fees and expenses of the mediator, which are typically a fraction of the cost of going to court. If the mediation of a substantial dispute is successful, the relative costs in both time and money are *de minimis*. And even if the mediation is not successful, this relatively small cost is worthwhile in making a serious effort to craft a negotiated settlement before taking on the cost and risks of litigation.

Assessing a Mediator

Opinions within the mediation community differ as to the need for subject matter expertise in a mediator. One school of thought is that a professional mediator who is skilled and experienced in the technique and art of facilitating resolutions can be effective in most mediations, no matter how complex or arcane the subject matter. On the other side, in disputes involving highly specialized issues the subject matter, expertise of the mediator can be crucial in putting the parties at ease, in effectively understanding key issues and interests, and in helping to develop realistic solutions.

In disputes over complex leveraged leases, the following factors should be considered in assessing a prospective mediator:

■ Does the mediator have the basic

training and skills required to manage multiple parties and complex issues in mediation? Most professional mediators have completed at least 40 hours of formal mediation training plus supplemental training in specialized areas, and they are specialists in the skills and art of overcoming barriers to settlement.

- Does the mediator have experience in conducting mediations involving corporate finance? Although many mediation skills and techniques may be transferable from other subject matter areas, using a mediator who can speak the language and has “walked the walk” may make the difference between success and failure.
- Can the mediator provide references from prior mediations? Most professional mediators are

able to offer references from prior clients and attorneys with whom they have worked.

The First Step

Because the costs and risk of mediation are relatively quite low, the best approach in disputes (or potential disputes) over leasing deals may often be to try mediation first, using an experienced professional mediator who specializes in this area. In fact, the parties may even agree to include in their lease documentation a provision establishing a 30- to 60-day “cooling off” period in the event of a dispute or default. During this time no party may institute suit, and all agree to participate in a mediation conducted by an experienced impartial mediator, with the objective of trying in good faith to reach a mutually acceptable settlement

of the matter *before* going to litigation.

Perhaps the most important thing to remember is that, even if mediation is not successful, the downside risks in time and cost are minimal; all other options are still open. If mediation is successful, however, the savings in time and money may be substantial, important business relationships may be preserved, and everyone involved will be able, instead of fighting over a deal gone bad, to move ahead with the important work of getting new deals closed. **ELT**

Paul Bent, Esq. is a principal with The Alta Group. Susan Rosenthal, Esq. is a partner with Brown Raysman Millstein Felder & Steiner LLP.