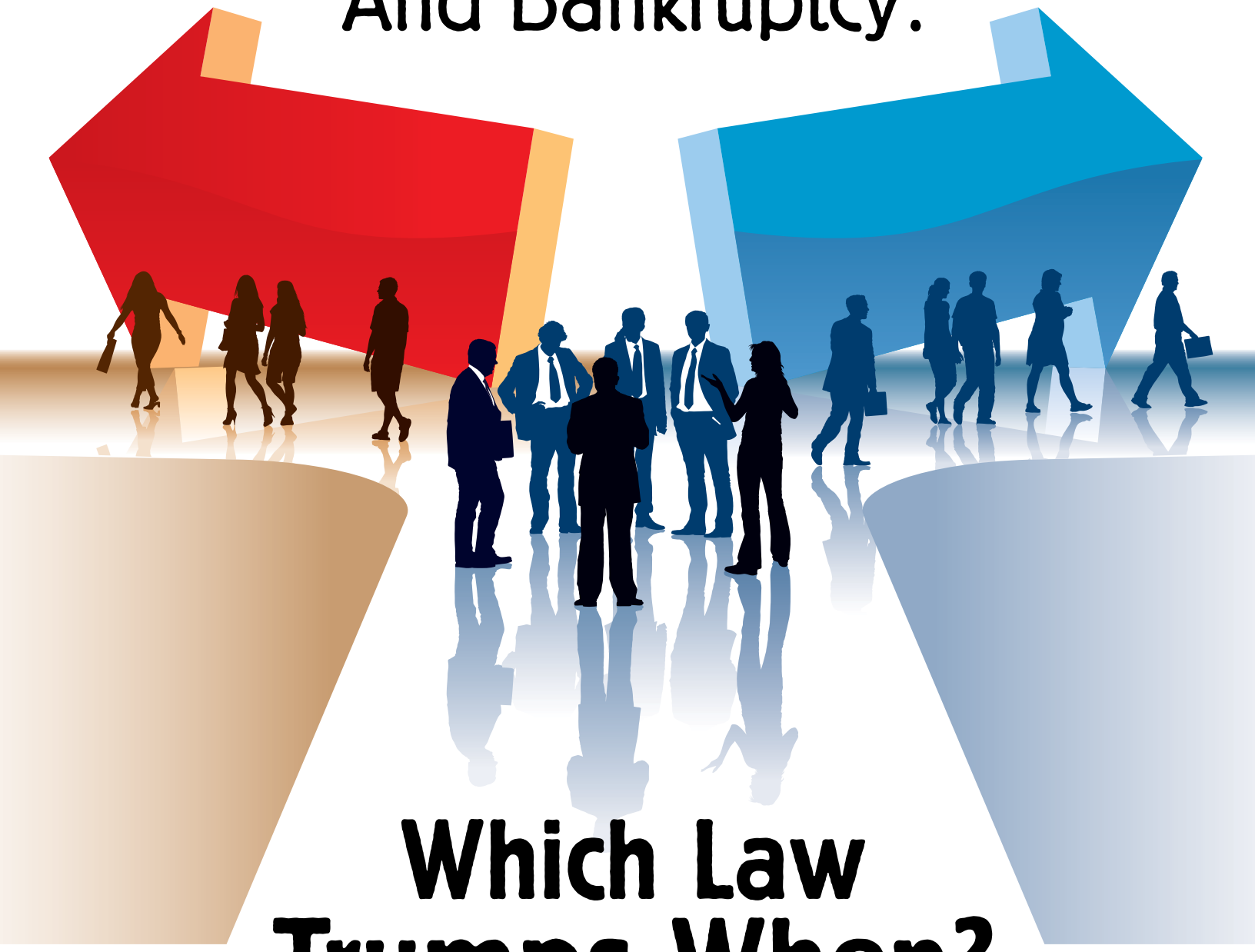
Arbitration Agreements And Bankruptcy:



Which Law Trumps When?

Edna Sussman with the assistance of Osata Tonia Tongo

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As reported by the Office of Administration of the U.S. Courts, in the 12-month period ending June 30, 2009, there was a 35% increase in bankruptcy filings compared to the 12-month period ending June 30, 2008. Business bankruptcy filings rose 63% while non-business filings rose 34%. Chapter 11 filings rose 91% during that period.[1] In light of these statistics and recent economic conditions, we review the principal cases that address what happens to arbitration agreements in the context of a bankruptcy proceeding. The short answer: there is no bright line.[2]

The Competing Policies

The Federal Arbitration Act (FAA) provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon grounds as exist at law or in equity for the revocation of any contract."[3] The Supreme Court has repeatedly stated that questions of arbitrability must be addressed with a "healthy regard for the federal policy favoring arbitration."[4] To accomplish the goals of the FAA, "the enforcement of private agreements to arbitrate and encouragement of efficient and speedy resolution," the courts must "rigorously enforce agreements to arbitrate even if the result is piecemeal litigation, at least absent a countervailing policy manifested in another federal statute."[5]

A principal purpose of the Bankruptcy Code[6] is to allow the bankruptcy court to centralize all disputes concerning all property of the debtor's estate so that the reorganization can proceed efficiently, protecting creditors and reorganizing debtors from piecemeal litigation and supporting the power of the bankruptcy court to enforce its own orders.[7]

The Second Circuit recognized the inherent tension between these statutes in commenting that there will be occasions where a dispute involving the Bankruptcy Code and the Arbitration Act "present a conflict of near polar extremes" as "bankruptcy policy exerts an inexorable pull towards centralization while arbitration policy advocates a decentralized approach towards dispute resolution."[8]

Case Law Developments

The first significant case to deal with the tension between the FAA and the Bankruptcy Code was the Third Circuit's decision in *Zimmerman v. Continental Airlines.*[9] The court recognized that both the FAA and the Bankruptcy Reform Act represented important Congressional concerns. Following a careful analysis, the court placed greater emphasis on the bankruptcy laws and stated that the intention of Congress would be better realized if the bankruptcy laws were read "to impliedly modify the Arbitration Act."[10] The court concluded that while the bankruptcy court could stay proceedings in favor of arbitration, the use of the power was to be left to the sound discretion of the bankruptcy court and established a series of considerations for the exercise of that discretion.

Subsequent to the *Zimmerman* decision, in *Shearson/American Express Inc. v. McMahon*[11] the Supreme Court addressed the question of whether a claim brought under § 10(b) of the securities laws and under RICO must be sent to arbitration in accordance with the terms of an arbitration agreement. In its review the court established the test to be used to review challenges to an arbitration clause based on another statutory imperative. The court held that to overcome the federal policy favoring arbitration, the burden is on the party opposing arbitration to show that Congress intended to limit or prohibit waiver of a judicial forum for a particular claim. The court said that this intent will be "deducible from the statute's text or legislative history…or from an inherent conflict between arbitration and the statute's underlying purpose."[12]

There is general agreement in the case law that there is no indication of a congressional intent to override the FAA in the text or legislative history of the bankruptcy laws, although as discussed below, this conclusion has been questioned by some courts. Accordingly, the third prong of the Supreme Court test, whether there is "an inherent conflict between arbitration and the statute's underlying purpose" has been the test applied by the courts.

In the wake of the *McMahon* decision, a series of other Supreme Court decisions strongly supporting arbitration, and the 1984 amendments to the Bankruptcy Code which scaled back the jurisdiction of the bankruptcy courts,[13] the Third Circuit revisited the issue in *Hays and Co. v. Merrill Lynch Pierce Fenner & Smith Inc.*[14] The court found an arbitration agreement to be a non-executory contract which like other contracts cannot be rejected by a trustee in bankruptcy. The court held that the trustee is "bound to arbitrate all of its claims that are derived from the rights of the debtor" as of the commencement of the case but not bound to arbitrate other claims that are not derivative of the bankruptcy but are rather statutory rights created by the bankruptcy code.[15]

The court then considered whether, having found that the trustee is bound, the court had discretion to refuse to enforce the arbitration clause. Guided by the developments in the Supreme Court and in Congress, the court held that an arbitration clause should be enforced for a non-core proceeding unless "it would seriously jeopardize the objectives of the [Bankruptcy] Code."[16] Where a trustee seeks to enforce a claim inherited from the debtor in court, the court "perceived no adverse effect on the underlying purposed of the Code from enforcing arbitration."[17] The *Hays* decision has been cited often for the proposition that where a party seeks to enforce a non-core pre-petition debtor derivative contract claim, a court does not have discretion to deny enforcement of an otherwise valid arbitration clause.[18]

As courts generally begin by determining whether the proceeding is core or not non-core in deciding whether to compel arbitration or stay the bankruptcy proceeding, a brief explanation of that dichotomy is necessary. The core/non-core distinction derives from the Supreme Court decision in *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*,[19] in which the court struck down the provision of the 1978 Bankruptcy Act which gave broad powers to the bankruptcy courts. The court found that the statute vested authority in Article I bankruptcy courts to decide cases that, without party consent, constitutionally could only be heard by Article III courts.

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To address this issue, Congress, in the amendments to the Bankruptcy Code in 1984 divided claims into core and non-core, 28 U.S.C. §157, giving bankruptcy judges authority to hear and determine "all core proceedings arising under title 11 or arising in a case under Title11" Non-core matters are only "related to" the bankruptcy proceeding. With respect to non-core matters the bankruptcy judges can only recommend findings of fact and conclusions of law to the district court. The Bankruptcy Code provides a non-exclusive list of core proceedings. [20] As the list is not exclusive, the courts have developed additional frameworks for the core/non-core analysis.

Extensive case law and confusion over the distinction between core and non-core has followed. Indeed, the difficulties in deciding whether a matter is core or non-core has been described by one commentator as a "'most difficult area of constitutional law,' in which 'the precedents are horribly murky, doctrinal confusion abounds, and the constitutional text is by no means clear."[21]

In *In Re U.S. Lines Inc.*[22] the Second Circuit stated that whether a proceeding is core depends on whether "(1) the contract is antecedent to the reorganization petition; and (2) the degree to which the proceeding is independent of the reorganization."[23] Proceedings can be core by "virtue of their nature if either (1) the type of proceeding is unique to or uniquely affected by the bankruptcy proceedings, or (2) the proceedings directly affect a core bankruptcy function…"[24] Other circuits have their own variations on the test to be applied to the core/non-core determination. A review of the cases demonstrates the difficulties the courts have with this as decisions by both the bankruptcy courts and the district courts are often reversed upon review.

The Fifth Circuit in *Matter of National Gypsum*[25] dealt with the question of how arbitration agreements in core proceedings should be handled. The court was urged to adopt a position that categorically found arbitration of core proceedings to be inherently irreconcilable with the Bankruptcy Code. The court refused, finding that doing so "conflates the inquiry" required by *McMahon* and is "too broad."[26] The court stated that not all core proceedings are premised on provisions of the code that inherently conflict with the FAA or jeopardize the objectives of the Bankruptcy Code. The court held that "non-enforcement of an otherwise applicable arbitration provision turns on the underlying nature of the proceeding, i.e. whether the proceeding derives exclusively from the provisions of the Bankruptcy Code and if so whether arbitration of the proceeding would conflict with the purposes of the Code."[27]

The Second Circuit's decision in *In Re United States Lines, Inc*[28] similarly concluded that arbitration of core proceedings does not necessarily conflict with the Bankruptcy Code. The case involved P&I insurance policies issued by several carriers that were the only source for payment of claims by thousands of employees for asbestos related injuries. The Trust, as successor in interest to the debtor, began an adversary proceeding in bankruptcy court for a declaratory judgment on the insurance coverage. The bankruptcy court held that the proceeding was core and denied the motion to compel arbitration. The district court reversed both determinations.

The Second Circuit looked first to whether the proceeding was core or non-core as a non-core proceeding is "unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration."[29] The court held that the matter was a core proceeding. The court further held that that the mere fact that a proceeding is core will not automatically give the bankruptcy court discretion to stay arbitration. On the facts before it concerning insurance coverage which the court found to be was integral to the bankruptcy court's ability to preserve and equitably distribute the assets, the Second Circuit found the bankruptcy court's refusal to refer the proceeding to arbitration to be proper.[30]

In *MBNA American Bank, N.A. v. Hill*[31] the Second Circuit reiterated its position that bankruptcy courts generally do not have discretion to refuse to compel arbitration of non-core bankruptcy matters or matters that are simply "related to" rather than "arising under" bankruptcy cases. Nor do bankruptcy courts have absolute discretion to refuse to compel arbitration of core proceedings. Rather that determination requires "a particularized inquiry into the nature of the claim and the facts of the specific bankruptcy."[32] Although finding the action before it to be a core proceeding, the court concluded that arbitration of the dispute would not jeopardize the objectives if the Bankruptcy Code and that the bankruptcy court did not have discretion to deny the motion to stay the proceeding in favor of arbitration.

Some years later, in *In Re Mintze,*[33] the Third Circuit clarified its holding in *Hays* stating that the decision applied equally to core and non-core proceedings and that the analysis requires a review under the *McMahon* standard for both. The analysis as to the arbitration clause thus raises both the complexity of deciding whether the proceeding is core or non-core and the complexity of deciding whether referring the proceeding to arbitration would jeopardize the objectives of the bankruptcy code.

Complicating the situation further, some courts have challenged the basic premise that the Bankruptcy Code does not itself evidence Congressional intent to override the FAA. For example, in *In Re White Mountain Mining Co.*[34] the Fourth Circuit followed the precedents discussed above in reaching its holding. However, the court suggested, without deciding the point, that, at least with respect to core proceedings, it could be argued from the statutory text that in granting bankruptcy courts jurisdiction over "core proceedings arising under title 11" Congress "reveal[ed] a Congressional intent to choose those courts in exclusive preference to all other adjudicative bodies, including boards of arbitration, to decide core claims."[35]

In a recent decision, *In Re Payton Construction Co.*,[36] the court's discussion also questioned the prevailing analysis of Congressional intent and urged a presumption that Congress "intended for the bankruptcy courts to be the principal and usual, if not exclusive, forum for most matters in bankruptcy."[37] The court cited the creation by Congress of bankruptcy's "centralized, collective proceeding to facilitate the expeditious and relatively inexpensive resolution of all matters relating to bankruptcy so as to make reorganization possible, enable the debtor's fresh start and maximize value and expedite recovery of creditors."[38]

Conclusion

The case by case approach in the case law, and the difficult analysis required where the matter is not clearly core and integral to the bankruptcy, has led to a lack of predictability and to costly and time consuming litigation. Indeed, the extensive litigation that can take place over the enforceability of arbitration clauses in bankruptcy can deprive the parties of the common goals of both legal regimes: efficiency, speed, and avoidance of costs.

The Supreme Court has dealt with the interplay of several statutory claims and the FAA but has not yet directly provided guidance to the courts by addressing the tension between the Bankruptcy Code and the FAA. Many commentators have urged that the Supreme Court or Congress should step in to clarify this area of the law.[39] Commentators have expressed various views as to how the question should be resolved.

One commentator suggests that arbitration of core claims should be precluded by the Bankruptcy Code, argues against a *per se* rule in favor of arbitration for non-core proceedings, and urges that debtors be permitted to reject the arbitration agreement[40] pursuant to §365 of the Bankruptcy Code.[41] Another commentator urges that the filing of a proof of claim in the bankruptcy should be deemed to be a waiver of the contractual right set forth in the arbitration clause.[42] Yet others favor a more nuanced approach that creates presumptions but allows exceptions for both core and non-core proceedings.[43]

The correct solution requires careful thought and analysis and must continue to give due deference not only to the needs of the debtor and the creditors but also to the contractual choice made by the parties to have any disputes resolved in the forum selected by the parties, a choice that can have significant impact on whether a deal is struck and on the economics of the transaction.[44]

The case by case analysis of the facts and of the impacts on the bankruptcy in each proceeding in which the enforceability of the arbitration clause can in good faith be debated has created a fertile field for arguments by both those who seek to enforce an arbitration agreement and those who seek to block it. Creative litigants will doubtless find many arguments to support their position.[45] Until such time as Congress or the Supreme Court steps in to simplify the task and create a more predictable litmus test, there will be little certainty in some cases as to whether an arbitration agreement will be enforced in a bankruptcy.

Footnotes:

1 Administrative Office of the U.S. Courts, News Release August 13, 2009, available at http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsJun2009.cfm.

2 For an overview on the subject, see 8 Norton Bankr. L. & Prac. 3d §169:4 (2009).

3 Federal Arbitration Act, which comprises Chapter 1 of Title 9, is codified at 9 U.S.C. §§ 1-16 (2000). *See* § 2.

4 *See* e.g., *Gilmer v. Interstate Johnson Lane Corp.,* 500 U.S. 20, 26 (1991).

5 *Dean Witter Reynolds Inc. v. Byrd,* 470 U.S. 213, 221 (1985).

6 11 U.S.C. §§101 *et. seq.*

7 See e.g., *In Re United States Lines,* 197 F. 3d 631, 640 (1999).

8 *Id.* at 640 (citations omitted).

9 *Zimmerman v. Continental Airlines* , 712 F.2d 55 (3d Cir. 1983).

10 *Id.* at 56.

11 *Shearson/ American Express Inc. v. McMahon*, 482 U.S. 220 (1987).

12 *Id*. at 227.

13 See discussion in *Hays and Co. v. Merrill Lynch Pierce Fenner & Smith Inc., 885 F.22d 1149, 1157 (1989)* of the scope of the bankruptcy courts jurisdiction.

14 *Id.*

15 *Id.* at 1154.

16 *Id.* at 1161.

17 *Id.*

18 For cases citing *Hays* for this proposition, *see e.g. In Re Crysen/Montenay Energy Co.* 226 F.3d 160, 166 (2d Cir. 2000) ("Bankruptcy courts generally do not have discretion to decline to stay non-core proceedings in favor of arbitration"); For cases following this proposition, *see e.g. In Re Electric Machinery Enterprises Inc.,* 479 F.3d 791 (11th Cir. 2007).

19 *Northern Pipeline Construction Co. v. Marathon Pipeline Co.*, 458 U.S. 50 (1982).

20 *See* 28 U.S.C. § 157 (b) (A)-(O).

21 Jason C. Matson, *Running Circles Around Marathon, The Effects of Accounts Receivable as Core or Non-core Proceedings in Article III Courts,* 20 Emory Bankr. Dev. J. 451, (2004).

22 *In Re U.S. Lines Inc., supra* n. 7.

23 *In Re U.S. Lines Inc. , supra* n. 7 at 637.

24 *Id.*

25 *In Re Matter of National Gypsum,* 118 F. 3d 1056 (5th Cir. 1997).

26 *Id.* at 1067.

27 *Id.*

28 *In Re United States Lines, Inc., supra*, n. 7.

29 *Id*. at 640.

30 However the Second Circuit did not look to whether the claim derived exclusively from the provisions of the Bankruptcy Code as seems to be required by the *In Re Matter of National Gypsum* decision. See discussion of this point in *Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act,* 117 Harv. L. Rev 2296 (2004).

31 *MBNA American Bank , N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006).

32 *Id.* at 108.

33 *In Re Mintze,* 434 F.3d 222 (3d Cir. 2006).

34 *In Re White Mountain Mining Company*, 403 F.3d 164 (4th Cir 2005).

35 *Id.* at 168.

36 *In Re Payton Construction Co*, Bankr. No. 07-11522-HB, Adv. No. 08-1173, 2009 WL 86968 (Bkrtcy. D. Mass., Jan 13, 2009); There is no First Circuit precedent on this issue.

37 *Id.* at *8.

38 *Id.*

39 *See e.g.*, Mette H. Kurth, *Comment: An Unstoppable Mandate and an Immovable Policy: The Arbitration Act and the Bankruptcy Code Collide*, 43 UCLA L. Rev. 999 (1999); Matthew Dameron, *Stop the Stay: Interrupting Bankruptcy to Conduct Arbitration,* 2001 J. Disp. Resol. 337 (2001).

40 The arbitration agreement is viewed in the case law as a separate agreement from the rest of the contract. See e.g., *Prima Paint v. Flood & Conklin,* 388 U.S. 395 (1967)

41 *Note: Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act,* 117 Harv. L. Rev 2296 (2004)

42 Michael Fielding, *Elevating Business Above the Constitution: Arbitration and Bankruptcy Proofs of Claim,* 16 Am. Bankr. Inst. L. Rev. 563 (2008)

43 Alan Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy,* 15 Am. Bankr. L. Rev. 183 (2007);

44 *14 Penn Plaza LLC v. Pyett,* 129 S. Ct. 1456, 1464 (2009); *Bremen* v. *Zapata Off-Shore Company,* 407 U.S. 1, 14 (1972); *Roby v. Corporation Lloyd's,* 996 F.2d 1353, 1363 (2d Cir. 1993).

45 For a discussion of some of the strategies for avoiding arbitration in bankruptcy, See, Michael Fielding, *How to Avoid Arbitration in Bankruptcy*, 26-6 American Bankruptcy Institute Journal 24 (July 2007)