AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Mediation Matters

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Is Arbitration in Bankruptcy Cases a Viable ADR Option?

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Bankruptcy practitioners are generally familiar with the significant growth that has been happening in the use of mediation as a means of resolving disputes within bankruptcy cases. In contrast, another dispute-resolution tool frequently used outside of bankruptcy — arbitration — is not often utilized in bankruptcy cases. There might be a variety of reasons for this — from the (mistaken) belief that arbitration is not available to parties within the confines of a bankruptcy case, to concerns about the use of such a tool in a forum designed to promote a centralized resolution for many parties.

The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure (FRBP) do not prohibit the arbitration of disputes, but rather recognize arbitration as a viable option. Specifically, the FRBP contain a specific recognition of arbitration — Rule 9019(c) — that states that "[o]n stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration."[1] This provision dates back to the 1898 National Bankruptcy Act, as well as the 1983 modifications, which allowed a trustee, subject to the court's direction, to submit to arbitration any controversy arising in the settlement of the estate.[2] The legislative history for these statutes is equally supportive of the construct of arbitration.

This procedural grant has to be considered in light of the Federal Arbitration Act (FAA),[3] which governs areas where arbitration clauses should be honored in the face of other federal statutes. The FAA was enacted as a limited measure to counteract judicial hostility to arbitration and was intended mainly to apply to commercial agreements between equal parties. It has a strong policy in favor of honoring arbitration clauses.[4] Through the FAA, Congress has provided a guideline and instructions to federal courts in general requiring them to enforce arbitration agreements according to their terms. Thus, the FAA establishes a non-absolute federal strong policy favoring arbitration that can only be overridden by a contrary congressional command.[5]

Despite the policy of the FAA favoring arbitration, that policy can be overridden if the party opposing the arbitration can demonstrate that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue."[6] In order to determine whether congressional intent exists to preclude or waive the right of arbitration, the U.S. Supreme Court has established a three-part test to determine congressional intent: (1) the text of the underlying statute; (2) its legislative history; or (3) analyzing whether there is an inherent conflict between arbitration and the statute's underlying purposes.[7]

1 Fed. R. Bankr. P. 9019(c).
2 *See* Donald L. Swanson, "Bankruptcy's ADR Rules Have Changed a Little over the Past Century," *Mediatbankry: On Bankruptcy and Mediation* (Oct. 6, 2016), *available at* mediatbankry.com/2016/10/06/bankruptcys-adr-rules-have-changed-little-over-the-past-century (unless otherwise specified, all links in this article were last visited on Dec. 3, 2018).
3 9 U.S.C. § 1, *et seq.*
4 *See Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 217, 221 (1985); *Moses H. Cone Mem'l. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 (1983).
5 *See Mintze v. Am. Gen. Fin. Servs. Inc. (In re Mintze)*, 434 F.3d 222, 229, 231 (3d Cir. 2006).
6 *Id.* at 229 (quoting *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987)).
7 *Shearson/Am. Express Inc.*, 482 U.S. at 227 (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*, 473 U.S. 614, 628 (1985)). The Supreme Court recently spent a considerable amount of time addressing and expanding areas where arbitration clauses should be honored even in light of other federal statutes. *See generally Epic Systems v. Lewis*, 138 S. Ct. 1612 (2018) (upholding binding nature of arbitration agreements in context of labor dispute and rejected attempt to draw conflict between FAA and other federal labor statutes); *see also Oliveira v. New Prime Inc.*, 857 F.3d 7, 12, 16 (1st Cir. 2017), *cert. granted*, 86 U.S.L.W. 3428 (U.S. Feb. 26, 2018) (No. 17-340) (addressing (1) whether court or arbitrator must determine applicability of § 1 of FAA, which applies only to "contracts of employment"; and (2) whether this section would apply to independent contractor agreements); and *Valera v. Lamps Plus Inc.*, CY 16-577-DMG(KSx), 2016 U.S. Dist. LEXIS 189521, at *16 (C.D. Cal. July 7, 2016), *cert. granted*, 86 U.S.L.W. 3556 (U.S. Apr. 30, 2018) (No. 17-988) (addressing whether FAA precludes state law interpretation of arbitration agreement that would authorize class arbitration based solely on general language commonly used in arbitration agreements).

As previously noted, there is nothing in the Bankruptcy Code's text or legislative history that specifically precludes arbitration.[8] Thus, given the recognition of arbitration within the FRBP and support in the legislative history, the question then becomes whether arbitration of a specific dispute would run afoul of the objectives of the Bankruptcy Code. Of course, many types of contracts can become the subject of a dispute in bankruptcy. Given that so many contracts now include arbitration clauses, there is ample opportunity for a party to seek enforcement of an arbitration provision in a dispute arising out of a contract in bankruptcy. Examples can include general breach-of-contract claims, clawback claims where transfers were made pursuant to an underlying contract, or contract-rejection matters and the determination of associated damage claims.

So, when is use of arbitration appropriate or not at odds with the statutory framework of bankruptcy? Generally, bankruptcy courts will analyze the application of arbitration to a matter under the rulings in *Shearson/American Express v. McMahon*, performing a particularized inquiry in light of the specific facts and circumstances of the issues in dispute to determine whether an arbitration clause should be enforced. As noted by the Third Circuit, "[t]he starting point is *McMahon*."[9] Courts have held that "[w]here an otherwise applicable arbitration clause exists, a bankruptcy court lacks the authority and discretion to deny its enforcement *unless* the party opposing arbitration can establish congressional intent, under the *McMahon* standard, to preclude waiver of judicial remedies for the statutory rights at issue."[10]

At times, this determination has hinged on whether the matter in question concerns core vs. non-core matters. Historically, non-core matters — those merely related to a bankruptcy case wherein the underlying agreement contained arbitration provisions — were held to be appropriate for determination by arbitration. These courts have consistently been in wide agreement that both district and bankruptcy courts must enforce an otherwise-valid arbitration clause covering a non-core claim, as non-core claims do not rest on substantive rights created by bankruptcy law.[11] In fact, some courts have held that in non-core proceedings, a bankruptcy court does not have the discretion to decline to enforce an arbitration clause in an agreement.[12] More recently, courts have begun to find that even core matters could be found to be appropriate for arbitration. Some courts have noted that the decision on applicability of arbitration should not be impacted just because a dispute is core or non-core (although that might be an important factor).[13]

In *In re Hostess Brands Inc.*, the U.S. Bankruptcy Court for the Southern District of New York denied a request by ACE American Insurance Co. to arbitrate the issue of whether a collateral agreement was breached in the context of the debtor's request to use cash collateral under § 363 of the Bankruptcy Code. The bankruptcy court found that a determination as to whether to allow the use of cash collateral was a "substantially core" issue "central to the bankruptcy process that Congress contemplated as substantially altering otherwise existing and enforceable rights under applicable non-bankruptcy law."[14] Given that this was a bankruptcy-created issue, the dispute did not flow from the underlying agreement and should not be subject to arbitration.[15]

In addition, the Second Circuit recently affirmed the bankruptcy court's no-arbitration decision in the context of a discharge action.[16] Orrin Anderson was in default of obligations owed to Credit One on account of a credit card and listed the debt as part of his chapter 7 case. As part of that proceeding, the debt was discharged. Subsequently, the debtor sought to have Credit One take action to update the debtor's various credit reports to remove the defaulted debt. When the company refused, the debtor succeeded in having the bankruptcy case reopened in order to pursue alleged discharge violations. In response, based on the fact that the underlying credit agreement provided for disputes to be submitted to arbitration, Credit One moved to compel arbitration. The motion was denied and ultimately appealed to the Second Circuit. The court first determined that the dispute was a core proceeding, thus the court had discretion to determine whether to compel arbitration. Next, the court found that determinations concerning a bankrupt's discharge was part of "the foundation upon which all other portions of the Bankruptcy Code are built,"[17] and that violations of this construct would "seriously jeopardize a particular core bankruptcy proceeding."[18] As such, the court upheld the lower court's denial of a request to arbitrate.

Other cases have also recognized the use of arbitration. The U.S. District Court for the Eastern District of Arkansas recently reversed the bankruptcy court and found that state law causes of action arising out of an alleged breach of contract and other state law theories should be arbitrated consistent with the pre-petition contracts signed by the parties.[19]

Gavilon Grain LLC involved a failed chapter 11 restructuring for a grain broker that had been converted to chapter 7. The chapter 7 trustee had brought an adversary proceeding under state law breach-of-contract theories and turnover against the company, which had presumably received the benefit of the company's goods and services prior to the filing. In response to the suit, the defendant sought to implement the arbitration clause contained in the underlying agree-

8 *In re Mintze*, 434 F.3d at 231.

9 *Id.* at 229.

10 *Id.* at 231 (emphasis in original); *see also MBNA Am. Bank NA v. Hill*, 436 F.2d 104, 109 (2d Cir. 2006) (looking to see whether arbitrating the dispute jeopardizes objectives of Bankruptcy Code); *Phillips v. Congelton LLC (In re White Mountain Mining Co.)*, 403 F.3d 164, 170 (4th Cir. 2005) (finding that arbitration of dispute over whether contributions of money by creditor was loan or capital contribution could not be arbitrated, as it involved core issue that (if not resolved by bankruptcy court) would substantially interfere with debtor's ability to reorganize).

11 *In re Hostess Brands Inc.*, Ch. 11, 12-22052-rdd, 2013 Bankr. LEXIS 79, at *7-9 (Bankr. S.D.N.Y. Jan. 7, 2013) (holding that pre-petition claims flowing from pre-petition agreements, not derivative of bankruptcy laws, are potentially ripe for arbitration).

12 *Whiting-Turner Contracting Co. v. Elec. Mach. Enters. (In re Elec. Mach. Enters.)*, 479 F.3d 791, 796 (11th Cir. 2007).

13 *See In re Hostess Brands Inc.*, Ch. 11, 12-22052-rdd, 2013 Bankr. LEXIS 79, at *7; *In re Mintze*, 434 F.3d at 230-1 (quoting *Matter of Nat'l Gypsum*, 118 F.3d 1056, 1067 (5th Cir. 1997)) (noting that analysis applies equally to core versus non-core and rather turns on "underlying nature of the proceedings, *i.e.*, whether the proceeding derives exclusively from the provisions of the Bankruptcy Code and, if so, whether the arbitration proceeding would conflict with the purposes of the Code").

14 *In re Hostess Brands Inc.*, Ch. 11, 12-22052-rdd, 2013 Bankr. LEXIS 79, at *7.

15 *Id.* at *6-8 (citing *In re Bethlehem Steel Corp.*, 390 B.R. 784 (Bankr. S.D.N.Y. 2008)); *compare with Cardali v. Gentile (In re Cardali)*, Ch. 11, Case No. 10-11185 (SHL), Adv. Pro. No. 10-3531 (SHL), 2010 Bankr. LEXIS 4113 (Bankr. S.D.N.Y. Nov. 18, 2010) (finding fraudulent transfer proceeding could be arbitrated as underlying law was state law transfer law).

16 *Anderson v. Credit One Bank NA (In re Anderson)*, 884 F.3d 382, 389-90 (2d Cir. 2018).

17 *Id.* at 389.

18 *Id.* at 390 (quoting *In re United States v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n*, 197 F.3d 631, 641 (2d Cir. 1999)).

19 *Gavilon Grain LLC v. Rice*, No. 2:17-cv-40-DPM, 2017 U.S. Dist. LEXIS 130449, at *19 (E.D. Ark. Aug. 16, 2017); *see also In re Argon Credit LLC*, Case No. 16-39654, Ch. 7, 2018 Bankr. LEXIS 2883, at *8 (Bankr. N.D. Ill. Sept. 21, 2018) (allowing automatic stay to be modified to allow for arbitration clause in consumer loan contract to be employed, finding that claims were not core issues and case was in chapter 7 such that impact of arbitration was not "sufficiently entangled in the bankruptcy process").

ment requiring all disputes to be arbitrated by the National Grain and Feed Association (NGFA). The trustee argued that the turnover portion of its complaint rendered the action a core proceeding and subject to the bankruptcy court's exclusive jurisdiction.

While the bankruptcy court sided with the trustee, the district court reversed and remanded, requiring the state law causes of action to be submitted to the NGFA, and allowing the turnover claim to be held in abeyance until such time as the arbitration was completed in case it still needed to be adjudicated. The district court relied on the broad mandate of the FAA and noted the absence of any indication in § 542 of the Bankruptcy Code (or its legislative history) that Congress intended to eliminate arbitration (or otherwise supersede the FAA) where a trustee is seeking to recover alleged property of the estate. The court in this case recognized that the turnover dispute was not necessarily a *bona fide* turnover claim because it flowed from the state law claims and was in essence contingent and unliquidated.

According to the district court, federal policy generally favors arbitration, and the Supreme Court has generally upheld such language in other commercial disputes. In addition, there is no indication that Congress intended to eliminate arbitration as a possibility for companies under bankruptcy protection. Without such evidence, an ordinary commercial dispute like the one at issue in this case is better off left in arbitration, as the original agreement required.

So, there clearly are grounds in the right circumstances to refer matters to arbitration. However, assuming that the adverse party does not request arbitration, would bankruptcy lawyers ever advocate for its utilization? Possibly, but given some of the other aspects of arbitration, bankruptcy lawyers might not necessarily see it as advantageous. Mediation is often used as an economic and expeditious means to resolve a dispute during the course of a bankruptcy case. However, while arbitration might be more expeditious when compared to traditional federal or state court litigation, it might not compare so well to the speed of the bankruptcy court's ability to determine and decide a matter. Further, bankruptcy judges are well versed in hearing evidentiary disputes on a fast track in order to meet the often time-sensitive needs of the bankruptcy process.

Conclusion

Arbitration provides the means to serve discovery, engage in motion practice, and at times require the use of more than one panel arbitrator. For all these reasons, arbitration can certainly end up being more costly than mediation. Thus, it may be that the use of arbitration and any push toward it may come most often from the nondebtor party to the dispute. Whether the frequency of the use of arbitration changes moving forward will be interesting to observe. abi

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