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Is Arbitration in Bankruptcy Cases A Viable Option?

What Are the Limitations Currently in Place?

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Dispute resolution professionals who frequently seek arbitration of contract disputes based upon the inclusion of arbitration clauses may be surprised that the viability of that strategy dramatically changes if a party to, or the subject matter addressed by, the agreement is the subject of a bankruptcy case. Parties routinely seek enforcement of arbitration provisions within the bankruptcy context, given that many contracts tied to disputes in bankruptcy cases include arbitration clauses. Examples of claims include general breach of contract, clawback of transfers made pursuant to an underlying contract, or contract rejection and determination of associated damages. While the Federal Rules of Bankruptcy Procedure allow arbitration of disputes during a bankruptcy case, there are significant limitations as to when that option is available.

First, Bankruptcy Rule 9019(c) 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." This, however, only concerns consensual agreements to arbitrate, as opposed to one party seeking to compel arbitration. Second, the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et. seq.*, establishes a strong federal policy favoring arbitration. Bankruptcy courts can deny a request to compel arbitration of a matter, if the opposing party demonstrates a contrary congressional command overriding this policy. *See Mintze v. Am. Gen. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222, 229 (3rd Cir. 2006)(quoting *Shearson/Am. Express, Inc. v. McMahon (McMahon)*, 482 U.S. 220, 227 (1987)) (No arbitration where "'Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue.'")).

The Supreme Court examines the following to determine whether congressional intent exists to preclude or waive the right of arbitration: (1) the text of the underlying statute; (2) the statute's legislative history; or (3) inherent conflict between arbitration and the statute's underlying purposes. *McMahon,* 482 U.S. at 227 (*citing Mitsubishi Motors Corp. v. Soler Chrysler- Plymouth, Inc.*, 473 U.S. 614, 628 (1985) *and Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 217, 221 (1985)).[1] There is nothing in the Bankruptcy Code's text or legislative history that specifically precludes arbitration. *In re Mintze,* 434 F.3d at 231. Thus, the question becomes whether compelling arbitration of a specific dispute would conflict with the Bankruptcy Code's objectives. Generally, bankruptcy courts perform a particularized inquiry under *McMahon* and its progeny of the issues in dispute to determine whether or not an arbitration clause should be enforced.

At times, this determination hinges on whether the arbitration provision in question implicates a core or non-core matter. District and bankruptcy courts have consistently enforced otherwise valid arbitration clauses covering non-core claims, which do not rest on substantive rights created by bankruptcy law and exist outside of bankruptcy. *See 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 claims flowing from pre-petition agreements, not derivative of bankruptcy laws, are potentially ripe for arbitration). *See also Whiting-Turner Contracting Co. v. Elec. Mach. Enters. (In re Elec. Mach. Enters)*, 479 F.3d 791, 796 (11th Cir. 2007)(Arbitration of non-core contract dispute regarding the amount owed between two creditors in a Chapter 11 case does not inherently conflict with bankruptcy code).

Conversely, bankruptcy courts consistently refrain from compelling arbitration of core proceedings that directly implicate the central purposes and policies of the Bankruptcy Code. *See Phillips v. Congelton, LLC (In re White Mountain Mining Co.)*, 403 F.3d 164, 170 (4th Cir. 2005) (finding that arbitration of a dispute over whether contributions of money by a creditor was a loan or a capital contribution could not be arbitrated, as it involved a core issue that if not resolved by the bankruptcy court would substantially interfere with the debtor's ability to reorganize). *See also MBNA America Bank, N.A. v. Hill*, 436 F.3d 104, 110 (2d Cir. 2006)(collecting cases where courts refused to compel arbitration of core matters).

Some courts have noted, however, that this decision should not hinge on the core/non-core distinction alone and have begun to find that even core matters could be appropriate for arbitration. *See In re Hostess Brands, Inc.*, Ch. 11, 12-22052-rdd, 2013 Bankr. LEXIS 79, at *7; *In re Mintze*, 434 F.3d at 231 (quoting *Matter of Nat'l Gypsum*, 118 F.3d 1056, 1067 (5th Cir. 1997)) (finding that the analysis turns on the "'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'").

A review of case law addressing the compulsion of arbitration demonstrates how context-specific each analysis and decision regarding this issue is. In *In re Hostess Brands, Inc.*, the Bankruptcy Court for the Southern District of New York denied a request by an insurance company to arbitrate the issue of whether a collateral agreement was breached in the context of the debtor's request to use cash collateral under Section 363 of the Bankruptcy Code. The 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. . . " *In re Hostess Brands, Inc.*, Ch. 11, 12-22052-rdd, 2013 Bankr. LEXIS 79, at *7 (Bankr. S.D.N.Y. (Jan. 7, 2013)). Thus, the dispute did not flow from the underlying agreement and should not be subject to arbitration. *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 a fraudulent transfer proceeding could be arbitrated as the underlying law was state transfer law).

More recently, the Second Circuit affirmed the Bankruptcy Court's no-arbitration decision in the context of a discharge action. *Anderson v. Credit One Bank, N.A. (In re Anderson)*, 884 F.3d 382, 389-90 (2d Cir. 2018). The debtor's credit card debt to Credit One had been discharged in a chapter 7 case, and the debtor subsequently requested that Credit One expunge the discharged debt from his credit reports. When the company refused, the debtor successfully had the bankruptcy case reopened in order to pursue discharge violations. Credit One moved to compel arbitration pursuant to the underlying agreement. On appeal, the Second Circuit upheld the court's denial of the request to arbitrate, finding that determinations concerning a bankrupt's discharge was part of "the foundation upon which all other portions of the Bankruptcy Code are built," *Id.* at 389, and that violations of this construct would "seriously jeopardize a particular core bankruptcy proceeding." *Id.* at 390.

The U.S. District Court for the Eastern District of Arkansas recently reversed a bankruptcy court decision, finding that state law causes of action arising out of an alleged breach of contract should be arbitrated consistent with the pre-petition contracts signed by the parties. *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 the automatic stay to be modified to enable arbitration, finding the contract claims at issue were not core matters and the case was in a chapter 7 such that the

impact of the arbitration was not sufficiently entangled in the bankruptcy process). In *Gavilon Grain LLC*, the chapter 7 trustee brought an adversary proceeding under state law breach of contract theories, as well as turnover, against a company which had presumably received the benefit of the debtor's goods and services prior to the filing. In response the defendant sought to implement the arbitration clause contained in the underlying agreement and the trustee argued that the turnover portion of its complaint rendered the action a core proceeding 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 for arbitration while holding the turnover claim in abeyance until after completion of arbitration. The District Court relied on the broad mandate of the FAA and noted the absence of any indication in Section 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, therefore sending the commercial dispute to arbitration as the original agreement required.

Based upon the foregoing, there clearly are grounds to refer matters to arbitration in certain circumstances during a bankruptcy case. Parties should be aware of the potential limitations and pitfalls associated with such requests, as well as how the Courts in that circuit in question have decided similar matters (if available). Parties should not presume, absent agreements, that the bankruptcy court will blindly adhere to the underlying arbitration clause. Finally, parties should consider that bankruptcy is designed to be an expeditious and economic process and that arbitration, while more efficient than traditional federal or state court litigation, may not match the speed of the bankruptcy court's ability to decide a matter, which can happen within days. This final point alone may serve as a key factor supporting the retention of certain disputes within the bankruptcy court notwithstanding an arbitration clause.

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[1] The Supreme Court has recently spent a considerable amount of time exploring whether to enforce arbitration clauses despite applicable federal statutes. *See generally Epic Systems v. Lewis*, 138 S. Ct. 1612 (2018) (upholding the binding nature of arbitration agreements in the context of a labor dispute and rejecting the attempt to draw a conflict between the 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 a court or an arbitrator must determine the applicability of Section 1 of the 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 the FAA precludes a state-law interpretation of an arbitration agreement that would authorize class arbitration based solely on general language commonly used in arbitration agreements).