

# Clash of the Statutory Titans: The Federal Arbitration Act v. The Bankruptcy Code

**W**hether a particular dispute arising in a bankruptcy case must be decided by arbitration or through litigation before the bankruptcy court is itself an issue that has been the subject of much litigation in the bankruptcy courts. The issue arises when a private agreement contains a provision requiring all or certain disputes between the parties to be resolved by arbitration, one of the parties to the agreement becomes a debtor under the U.S. Bankruptcy Code, and litigation is thereafter brought by the debtor or his trustee that arguably implicates the contract's arbitration provision.<sup>1</sup>

When litigation arises, “involving both the Bankruptcy Code ... and the Arbitration Act, 9 U.S.C. § 1 et seq.,<sup>2</sup> [it] presents a conflict of near polar extremes: bankruptcy policy exerts an inexorable pull towards centralization while arbitration policy advocates a decentralized approach towards dispute resolution.”<sup>3</sup> In short, “[w]hen arbitration law meets bankruptcy law head on, clashes inevitably develop.”<sup>4</sup> The source of arbitration law in this context is the Federal Arbitration Act (FAA), which “provides that a court must stay its proceedings if it is satisfied that an issue before it is arbitrable under the agreement” and authorizes a U.S. District Court to compel arbitration if there has been noncompliance with the arbitration agreement.<sup>5</sup>



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As observed by the U.S. Supreme Court in *Shearson*, “the Arbitration Act establishes a federal policy favoring arbitration,” requiring courts to “rigorously enforce agreements to arbitrate.”<sup>6</sup> This obligation applies with equal force when a party who is bound by an agreement to arbitrate raises a claim based on statutory rights,<sup>7</sup> such as rights or causes of action

arising under the Bankruptcy Code. In such a case, the right to arbitration should be enforced unless the party opposing it can show that Congress intended for the courts to adjudicate the statutory right at issue.<sup>8</sup> Such a showing can be made “from the statute’s text or legislative history ... or from an inherent conflict between arbitration and the statute’s underlying purpose.”<sup>9</sup>

For bankruptcy matters, courts have found no evidence of an intent to override the FAA in the Bankruptcy Code’s text or legislative history. Bankruptcy judges have thus focused on whether there is an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code in determining whether a particular bankruptcy dispute is arbitrable or should remain with the bankruptcy court for adjudication.<sup>10</sup>

## Arbitration of Disputes in Bankruptcy

The analytical approach courts have followed in deciding this question for bankruptcy matters has not been uniform,<sup>11</sup> but several recurring themes have emerged.

First, in non-core, “related to” matters,<sup>12</sup> a bankruptcy court generally lacks discretion to prevent an arbitration from going forward.<sup>13</sup> Second, even in core proceedings, the bankruptcy court lacks discretion to override an arbitration agreement unless it finds an inherent conflict between the nature of the claims or

rights asserted and the FAA, or that arbitration would necessarily jeopardize the objectives of the Bankruptcy Code.<sup>14</sup> Only if a “severe conflict is found” may a court conclude that “with respect to the particular Code section involved, Congress intended to override the Arbitration Act’s general policy favoring the enforcement of arbitration provisions.”<sup>15</sup>

Although courts have eschewed absolutes in this area, the question of whether bankruptcy litigation should yield to arbitration for core proceedings has often expressly or implicitly turned on “whether the underlying dispute concerns rights created under the Bankruptcy Code or non-bankruptcy issues derivative of the debtor’s pre-petition activities.”<sup>16</sup> “In the former situation, the bankruptcy court has discretion to refuse arbitration, but in the latter it does not.”<sup>17</sup>

**Code-Created Rights.** Examples of core proceedings that were not considered appropriate candidates for arbitration because they asserted Bankruptcy Code-created rights have included preference and fraudulent transfer claims,<sup>18</sup> improper set-off and avoidable post-petition transfer claims,<sup>19</sup> equitable subordination claims,<sup>20</sup> and claims for violation of the automatic stay.<sup>21</sup> Actions for non-dischargeability under Subsections 523(a)(2), (4), or (6) ordinarily should not be sent to arbitration,<sup>22</sup> but when the underlying debt that is claimed to be non-dischargeable has not yet been liquidated, arbitration has been ordered for that purpose.<sup>23</sup>

The reason for refusing to compel arbitration of disputes asserting code-created causes of action is that the trustee or debtor in possession is suing on behalf of the creditors, who did not agree to arbitration of such claims.<sup>24</sup>

**Other “Core” Claims.** The more difficult cases in this area have involved claims based on some pre-petition conduct, the resolution of which will significantly impact the administration of the estate, and what several courts from the Southern District of New York have characterized as “procedurally core” claims, which are defined as “garden variety pre-petition contract disputes dubbed core because of how the dispute arises or gets resolved.”

Although acknowledging that arbitration of these types of disputes will rarely conflict with bankruptcy policy, the 800-pound exception these courts have identified is when “resolution of the dispute fundamentally and directly affects a core bankruptcy function.”<sup>25</sup> The decisions on whether to compel arbitration in these more difficult cases defy precise categorization, but some general observations can be offered here.

In what are perhaps the most common type of proceedings in bankruptcy cases, most courts do agree that objections and counter-claims to proofs of claim that are covered by an arbitration clause should be resolved by arbitration.<sup>26</sup> But even in these situations, there are exceptions. For example, the bankruptcy court in *In Re Mirant* refused to allow a lease rejection claim to be decided by arbitration, principally because the debtor was a party to numerous other agreements with arbitration provisions and to allow one claim to be decided by arbitration could expose the debtor to piecemeal litigation.<sup>27</sup>

Non-bankruptcy causes of action affirmatively asserted by a debtor or trustee against a creditor or other party are frequently the subject of disputes over arbitrability. Common among such disputes are claims asserted by consumer debtors for violation of consumer protection or truth-in-lending laws. The tendency of the courts in these types of matters is to enforce the arbitration clause when properly raised by the defendant.<sup>28</sup>

**Arbitrable and Non-Arbitrable Claims in Same Proceeding.** As a practical matter, non-bankruptcy claims are often brought together with code-created causes of action. In such cases, courts must determine whether one set of claims should be stayed until the other is resolved, or whether all claims should be decided by the same tribunal. In resolving such questions, courts generally consider which of the two sets of claims predominates and whether they overlap. For example, in *Matter of Gandy*, it was held that since the debtor in possession’s claims for fraudulent transfer of her interests in a partnership predominated her state law claims, all of the claims should be tried in the bankruptcy court in the interest of judicial efficiency.<sup>29</sup>

The difference in results reached in *In re Hagerstown Fiber Limited Partnership* and *In re S.W. Bach & Company* illustrates that deciding whether arbitrable or non-arbitrable claims predominate a proceeding is decidedly in the eye of the beholder. Although the trustee’s complaint in *Hagerstown Fiber* was evenly divided between fraudulent transfer and turnover claims on the one hand and state law claims on the other,<sup>30</sup> all arising out of contractual disputes over the construction of a plant, the court concluded that the fraudulent transfer claims should be stayed pending conclusion of an arbitration since at their core, the trustee’s claims were contractual in nature.<sup>31</sup>

In contrast, in *In re S.W. Bach & Company*, where the trustee’s claims were for fraudulent

transfer under Bankruptcy Code Section 548, aiding and abetting breach of fiduciary duty, and restitution and unjust enrichment<sup>32</sup>—all arising out of a pre-petition transfer for no consideration of customer accounts serviced by the debtor<sup>33</sup>—the court concluded that the arbitrable state law claims should be stayed until the fraudulent transfer claim could be adjudicated in bankruptcy court.<sup>34</sup> The difference in result from *Hagerstown* was attributed to the lack of a direct connection between the arbitrable state law claims of unjust enrichment/restitution and aiding and abetting breach of fiduciary duty, and the non-arbitrable fraudulent transfer claim,<sup>35</sup> although an element of the unjust enrichment claim was lack of consideration.<sup>36</sup>

**Waiver of Arbitration.** A waiver of the right to arbitrate may occur by failing to timely raise the arbitration provision and/or by participating in litigation in bankruptcy court.<sup>37</sup> The factors considered in determining whether a waiver of the right to arbitration has occurred are “(1) the time elapsed from commencement of litigation to the request for arbitration, (2) the amount of litigation (including any substantive returns and discovery), and (3) proof of prejudice.”<sup>38</sup> The determination of waiver in this context is highly fact-specific.<sup>39</sup>

## Unique Considerations

The strong and liberal policy favoring arbitration is observed in bankruptcy cases, but not without limitation. As is typical of most disputes arising in bankruptcy court, the road to arbitration is paved with unique bankruptcy considerations. They should be carefully weighed before embarking on litigation over where to litigate. ■

<sup>1</sup> The procedural context in which this issue is raised is most commonly by a motion to compel arbitration and to stay the adversary proceeding or contested matter at issue until the arbitration is concluded.

<sup>2</sup> The Federal Arbitration Act strictly enforces arbitration provisions in any written contract “evidencing a transaction involving commerce....” 9 U.S.C. § 2.

<sup>3</sup> *United States Lines, Inc. and United States Lines (S.A.) Inc., Reorganization Trust v. American Steamship Owners Mutual Protection and Indemnity Association, Inc. (In re United States Lines, Inc.)*, 197 F.3d 631, 640 (2d Cir. 1999).

<sup>4</sup> *Kittay v. Landegger (In re Hagerstown Fiber Limited Partnership)*, 277 B.R. 181, 199 (Bankr. S.D.N.Y. 2002).

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- <sup>5</sup> *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226, 107 S. Ct. 2332, 2337, 96 L. Ed 285 (1987).
- <sup>6</sup> *Id.* See also *Cardali v. Gentile (In re Cardali)*, 2010 WL 4791801, at \*3 (Bankr. S.D.N.Y. Nov. 18, 2010) (citing numerous authorities for proposition that there is both a “liberal” and “strong” policy favoring arbitration).
- <sup>7</sup> *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226, 107 S. Ct. 2332, 2337, 96 L. Ed. 2d 185 (1987).
- <sup>8</sup> *Id.*
- <sup>9</sup> *Id.* at 227, 2337-38.
- <sup>10</sup> *The Whiting Turner Contracting Company v. Electric Machinery Enterprises (In re Electric Machinery Enterprises, Inc.)*, 479 F.3d 791, 795 (11th Cir. 2007); *Mintze v. Am. Gen. Fin. Services, Inc. (In re Mintze)*, 434 F.3d 222, 231 (3d Cir. 2006).
- <sup>11</sup> For example, there have been varying two-part tests applied, compare *Trefny v. Bear Stearns Securities Corp.*, 243 B.R. 300, 314 (S.D. Tex. 1999) with *Sternklar v. Heritage Auction Galleries, Inc. (In re Rarities Group, Inc.)*, 434 B.R. 1, 7-8 (D. Mass. 2010), as well as a more expansive four-part test applied by the bankruptcy courts in the Southern District of New York, which asks: “(1) did the parties agree to arbitrate; (2) does the dispute fall within their arbitration clause; (3) if federal statutory claims are raised, did Congress intend those claims to be arbitrable; and (4) if the court concludes that some but not all of the claims are arbitrable, should it stay the non-arbitrable claims pending the conclusion of the arbitration.” *Cardali v. Gentile (In re Cardali)*, 2010 WL 4791801, at \*5 (Bankr. S.D.N.Y. Nov. 18, 2010) (citing authorities).
- <sup>12</sup> The generally accepted definition of a “related to” matter is “whether the outcome of [the] proceeding could conceivably have any effect on the estate being administered in bankruptcy.” *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.6, 115 S. Ct. 1493, 1499 n.6, 131 L. Ed. 2d 403 (1995) (quoting *Pacor v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984)). Thus, an action will be considered related to a bankruptcy case “if the outcome could alter the debtor’s rights, liabilities, options, or freedom of action (either positively or negatively) and which in any way impacts on the handling and administration of the bankruptcy estate.” *Id.*
- <sup>13</sup> *The Whiting Turner Contracting Company v. Electric Machinery Enterprises (In re Electric Machinery Enterprises, Inc.)*, 479 F.3d 791, 796 (11th Cir. 2007); *Crysen/Montenay Energy Co. v. Shell Oil Co. (In re Crysen/Montenay)*, 226 F.3d 160, 166 (2d Cir. 2000); *Insurance Co. of North America v. NGC Settlement Trust & Asbestos Claims Management, (In the Matter of National Gypsum Co.)*, 18 F.3d 1056, 1066 (5th Cir. 1997); *Hays and Co. v. Merrill Lynch, Inc.*, 885 F.2d 1149 (3rd Cir. 1989); *In re Hermoyian*, 435 B.R. 456, 463 (Bankr. E.D. Mich. 2010).
- <sup>14</sup> *MBNA American Bank v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006); *Insurance Co. of North America v. NGC Settlement Trust & Asbestos Claims Management Corp. (In the Matter of National Gypsum Co.)*, 118 F.3d 1056, 1067 (5th Cir. 1997). The objectives of the Bankruptcy Code that have been identified as relevant to this analysis include “the goal of centralized resolution of purely bankruptcy issues, the need to protect creditors and reorganizing debtors from piecemeal litigation, and the undisputed power of a bankruptcy court to enforce its own orders.” *Hill*, 436 F.3d at 108.
- <sup>15</sup> *Hill*, 436 F.3d at 108.
- <sup>16</sup> *Kittay v. Landegger (In re Hagerstown Fiber Limited Partnership)*, 277 F.R. 181, 202 (Bankr. S.D.N.Y. 2002) (citing *Cibro Petroleum Prods., Inc. v. City of Albany (In re Winimo Realty Corp.)*, 270 B.R. 108, 123-24 (S.D.N.Y. 2001)).
- <sup>17</sup> *Id.*
- <sup>18</sup> *Bethlehem Steel Corp. v. Moran Towing Corp. (In re Bethlehem Steel Corp.)*, 390 B.R. 784, 790-793 (Bankr. S.D.N.Y. 2008) (following *Allegart* in denying arbitration of fraudulent transfer and preference claims); *OHC Liquidation Trust v. American Bankers Insurance Co. (In re Oakwood Homes Corp.)*, 2005 WL 670310, at \*4 (Bankr. D. Del. 2005) (refusing to relinquish fraudulent transfer and preference claims to arbitration); *Astropower Liquidating Trust v. Xantrex Technology, Inc. (In re Astropower Liquidating Trust)*, 335 B.R. 309, 326 (Bankr. D. Del. 2005) (declining to order arbitration of fraudulent transfer claims).
- <sup>19</sup> *Pardo v. Pacificare of Texas, Inc. (In re APF Co.)*, 264 B.R. 344, 363 (Bankr. D. Del. 2001).
- <sup>20</sup> *In re Transport Associates, Inc.*, 263 B.R. 531, 536 (Bankr. W.D. Ky. 2001).
- <sup>21</sup> *Merrill v. MBNA America Bank, N.A. (In re Merrill)*, 343 B.R. 1, 7-9 (Bankr. D. Me. 2006); *Grant v. Cole (In re Grant)*, 281 B.R. 721, 724 (Bankr. D. Ala. 2000). But see *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104, 109-10 (2d Cir. 2006) (claim for violation of automatic stay should have been referred to arbitration).
- <sup>22</sup> *Holland v. Zimmerman (In re Zimmerman)*, 341 B.R. 77, 80 (Bankr. N.D. Ga. 2006).
- <sup>23</sup> *In re Hermoyian*, 435 B.R. 456, 465-66 (Bankr. E.D. Mich. 2010). In such a case, collateral estoppel effect might be given to the findings made in the arbitration. See *Khaligh v. Hadaegh (In re Khaligh)*, 338 B.R. 817 (9th Cir. BAP 2006) (arbitration award was given preclusive effect on claim for willful and malicious injury under § 523(a)(6)), *aff’d* 506 F.3d 956 (9th Cir. 2007).
- <sup>24</sup> *Hays and Co. v. Merrill Lynch Pierce, Fenner & Smith, Inc.* 885 F.2d 1149, 1155 (3rd Cir. 1989); *Togut v. RBC Dain Correspondent Services, (In re S. W. Bach & Co.)*, 425 B.R. 78, 89 (Bankr. S.D.N.Y. 2010), *Kittay v. Landegger, (In re Hagerstown Fiber Limited Partnership)*, 277 B.R. 181, 207-08 (Bankr. S.D.N.Y. 2002); *Pardo v. Pacificare of Texas, (In re APF Co.)*, 264 B.R. 344, 363 (Bankr. D. Del. 2001).
- <sup>25</sup> *Hagerstown*, 277 B.R. at 203.
- <sup>26</sup> *Cardali*, 2010 WL 479180, at \*9; *In re Consolidated FGH Liquidating Trust*, 419 B.R. 636, 650-51 (Bankr. S.D. Miss. 2009); *In re Fries 2007 WL 1073868* (Bankr. D. Md. 2007); *In re Farmland Industries, Inc.*, 309 B.R. 14, 19-21 (Bankr. W.D. Mo. 2004); *Hagerstown*, 277 B.R. at 205. But see *Yarbrough v. Green Tree Servicing LLC, (In re Yarbrough)*, 2010 WL 3885046, at \*5 (Bankr. M.D. Ala. Sept 29, 2010).
- <sup>27</sup> *In re Mirant*, 319 B.R. 234, 241-42 (Bankr. N.D. Tex. 2004).
- <sup>28</sup> See e.g. *Mintze v. American General Financial Services, Inc., (In re Mintze)*, 434 F.3d 222, 231 (3d Cir. 2006); *Dixon v. Household Realty (In re Dixon)*, 428 B.R. 911, 915-16 (Bankr. N.D. Ga. 2010); *In re Cobey*, 362 B.R. 514, 518 (Bankr. N.D. Ala. 2007). But see *Brown v. Mortgage Electronic Registration Systems, Inc., (In re Brown)*, 354 B.R. 591 (D.R.I. 2006).
- <sup>29</sup> *Gandy v. Gandy (In the Matter of Gandy)*, 299 F.3d 489, 497-99 (5th Cir. 2002).
- <sup>30</sup> *Hagerstown*, 277 B.R. at 195.
- <sup>31</sup> *Id.* at 208.
- <sup>32</sup> *S.W. Bach & Company, Inc.*, 425 B.R. at 82.
- <sup>33</sup> *Id.* at 84.
- <sup>34</sup> *Id.* at 102-104.
- <sup>35</sup> *Id.* at 103.
- <sup>36</sup> *Id.*
- <sup>37</sup> See *Lewallen v. Green Tree Servicing, L.L.C.*, 487 F.3d 1085, 1091-93 (8th Cir. 2007) (creditor waived right to arbitrate debtor’s claims under Real Estate Settlement Procedures Act and other consumer protection laws by participating in bankruptcy litigation asserting such claims). See also *Ernst & Young LLP v. Baker O’Neal Holdings*, 304 F.3d 753, 757-58 (7th Cir. 2002).
- <sup>38</sup> *Crysen/Montenay Energy Co. v. Shell Oil Co. (In re Crysen/Montenay)*, 226 F.3d 160, 163 (2d Cir. 2000).
- <sup>39</sup> *Id.*

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