

ANSWERS TO QUESTIONS ABOUT ARBITRATION IN BANKRUPTCY

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1. Does a Bankruptcy Court have discretion to deny enforcement of a contractual arbitration provision?

Answer: Yes, but the degree of discretion depends on the nature and origin of the dispute, and whether arbitration will adversely affect the bankruptcy case.

Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 107 S.Ct. 2332 (1987). In this case, the Supreme Court held that the Federal Arbitration Act requires courts to rigorously enforce arbitration agreements. This duty is not diminished when a party to the agreement raises a claim based upon a federal statute. However, this mandate may be overridden by a contrary congressional command. The party opposing arbitration has the burden to demonstrate that Congress intended for the statutory rights at issue to be determined only through judicial proceedings. The relevant question is, “Did Congress intend to prevent certain claims from being arbitrated.”

- The Supreme Court explained that Congressional intent can be discerned in one of three ways: (1) the statute’s text; (2) the statute’s legislative history; or (3) an inherent conflict between arbitration and the statute’s underlying

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purpose. Id. at 226-27, 107 S.Ct. 2332. This is now known as the *McMahon* test.

- Under *McMahon*, the party seeking to avoid arbitration of a bankruptcy dispute must demonstrate that there is an “irreconcilable conflict” between arbitration and the purposes of the Bankruptcy Code.

The Core vs. Non-Core Distinction

- **Non-Core Issues:** Courts agree that they have no discretion to decline to enforce an arbitration agreement relating to non-core matters. See Whiting-Turner Contracting Co. v. Elec. Mach. Enterprises, Inc. (In re Elec. Mach. Enterprises, Inc.), 479 F.3d 791 (11th Cir. 2007) (dispute between general contractor and debtor subcontractor did not involve rights created by bankruptcy law and, therefore, was subject to contractual arbitration provision); In re Mintze, 434 F.3d 222 (3d Cir. 2006) (court lacked discretion to deny enforcement of arbitration provision in debtor’s action seeking to enforce a pre-petition rescission of a loan agreement); In re Cooker Restaurant Corp., 292 B.R. 308 (S.D. Ohio 2003) (court had no discretion to deny motion to enforce arbitration of dispute stemming from pre-petition settlement agreement containing arbitration provision); MBNA America Bank, N.A., 436 F.3d 104 (2d Cir. 2005) (court recognized it had no discretion to deny motion to compel arbitration if issues were non-core); In re Winimo Realty Corp. et al., 270 B.R. 99 (S.D.N.Y. 2001) (same).
- **Core Issues:** Arbitration provisions **may** still be enforced in core proceedings, but it is likely the court will conclude that the matter does not fall within the scope of the arbitration provision, or that arbitration would conflict with the objectives of the bankruptcy code. See In re White Mountain Mining Co., L.L.C., 403 F.3d 164 (4th Cir. 2005) (affirming bankruptcy court’s refusal

to enforce arbitration provision as to core matter on basis that it would interfere with debtor's reorganization); In re Cavanaugh, 271 B.R. 414 (Bankr. D.Mass. 2001) (arbitration provision did not apply to allegations creditor violated automatic stay).

- Courts look to the origin and nature of the proceeding, as well as Congressional intent as instructed by *McMahon*.
- One of the first cases in which a federal circuit had to decide if a core bankruptcy matter could be submitted to arbitration is In re National Gypsum Co., 118 F.3d 1056 (5th Cir. 1997). In this case, the successors to the chapter 11 debtor filed a declaratory action against the debtor's liability insurance carrier claiming that the carrier's collection efforts were in violation of the discharge injunctions and confirmed plan. The carrier sought to compel arbitration and the debtor's successors objected on the basis that (i) the claims were core proceedings; and (ii) arbitration presented a conflict between the FEDERAL ARBITRATION ACT and the Bankruptcy Code.

The Fifth Circuit refused to find that the arbitration of core proceedings inherently conflicts with the Bankruptcy Code simply on the basis of the Bankruptcy Court's jurisdiction. The court explained that the decision of whether to enforce a valid arbitration provision would turn on the underlying nature of the proceeding. Not all core bankruptcy proceedings are necessarily based on provisions of the Bankruptcy Code that conflict with the FEDERAL ARBITRATION ACT, and arbitration of those proceedings may not jeopardize the bankruptcy proceedings or the objectives of the Bankruptcy Code.

More recently in In re Mintze, *supra*, the Third Circuit explained that the core/non-core distinction does not affect a bankruptcy court's discretion to

deny enforcement of an arbitration provision, but merely determines whether or not a bankruptcy court has jurisdiction to make a full adjudication.

- “Where 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 right at issue.” Id. at 213.
- See *also* **MBNA America Bank, N.A., 436 F.3d at 108** (recognizing that core proceedings will be found subject to arbitration provisions where they will not jeopardize or conflict with the purposes of the Bankruptcy Code).

2. Is a Trustee bound by pre-petition arbitration provisions?

Answer: The answer to this question turns on the nature of the proceeding. If the Trustee is bringing a claim that derives from the debtor’s pre-petition estate, then the Trustee is essentially stepping into the debtor’s shoes. In such a case, the Trustee is subject to all defenses that can be raised against the debtor, including a demand for arbitration. In contrast, if the Trustee is bringing an action that stems from the Bankruptcy Code, such as a proceeding seeking damages for violation of the automatic stay, arbitration agreements should not apply.

In **Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989)**, the Third Circuit analyzed whether the arbitration agreement was “otherwise applicable” to the dispute. The court explained that “the trustee-plaintiff stands in the shoes of the debtor for the purposes of the arbitration clause and that the trustee-plaintiff is bound by the clause to the same extent as would be the debtor.” Id. at 1153. The court emphasized that the intentions of the parties to the agreement must be carried out. Id. at 1155.

- However, to the extent the trustee was bringing claims authorized by the Bankruptcy Code, he was not standing in the shoes of the debtor. Those “creditor claims” are not arbitrable.

Whiting-Turner Contracting Co. v. Elec. Mach. Enterprises, Inc. (In re Elec. Mach. Enterprises, Inc., 479 F.3d 791 (11th Cir. 2007). Applying the *McMahon* factors to the Bankruptcy Code, the court found nothing in the text or legislative history that evidenced an intent by Congress to create an exception to the FEDERAL ARBITRATION ACT. As to whether a conflict exists between arbitration and the purposes of the Bankruptcy Code, the court explained that the existence of bankruptcy court jurisdiction was insufficient, on its own, to demonstrate a conflict. Even if a proceeding is “core”, it may still be subject to arbitration under the terms of an arbitration agreement.

- In this case, the debtor was seeking money from a third-party on a constructive trust theory. The Eleventh Circuit determined that the matter was a non-core issue because it did not involve a right created by the bankruptcy law, and it could have been brought whether or not the debtor was in bankruptcy. In other words, it was a debtor-derived claim.
- The Eleventh Circuit reversed and remanded the bankruptcy court’s determination that arbitration would be inappropriate. The bankruptcy court failed to assess whether enforcing the arbitration agreement, even if the matter was core, would inherently conflict with the purposes of the Bankruptcy Code.

In re Friedman's Inc., et al., 372 B.R. 530 (Bankr. S.D. Ga. 2007). Applying Hays, Mintze, and Whiting-Turner, the court held that some of the trustee's claims were subject to a pre-petition arbitration provision, while others were not.

In this case, the trustee of a creditors' trust brought an action against the companies ("Defendants") that provided pre-petition auditing and financial services to the debtor under various theories including, among other things, negligence, professional malpractice and breach of contract. Defendants' engagement letters contained provisions requiring arbitration of disputes.

- Defendants argued that the trustee stood in the shoes of the debtor and was bound by the pre-petition arbitration provisions. In contrast, the trustee claimed that he was asserting claims derived from the Bankruptcy Code that were not subject to arbitration. The trustee further argued that, to the extent the court concluded he was bound by the arbitration agreement, the court should nevertheless exercise its discretion to deny enforcement of the clause on the basis that there was an inherent conflict between arbitration and the purposes of the Code.
- The court determined that the causes of action that arose before the petition date were derived from the debtor and, as a result, were subject to the same defenses that could have been asserted against the debtor, including a demand for arbitration.
- The court then applied the *McMahon* test to the debtor-derived claims to determine if it should exercise its discretion and deny enforcement of the otherwise applicable arbitration clauses. The court found no conflict with the purposes of the Code and compelling arbitration for three primary reasons:

- Courts must not substitute their own views of economy and efficiency for those of Congress. Arbitrable claims should be sent to arbitration even if it might be inefficient and result in piecemeal litigation.
- There was no evidence that allowing the arbitration would jeopardize the central purpose of the Bankruptcy Code. The plan was confirmed and permitting arbitration of the claims would not impact the rights of creditors or unravel any fundamental purpose of the Code.
- The claims for negligence, professional malpractice, breach of contract and fraud were not unique or special. They did not require special insight or expertise, and arbitrators were capable of adjudicating the claims.
- The court held that the Trustee's Code-created claims (fraudulent transfers and violations of the automatic stay) were not arbitrable for several reasons. The Trustee was not subject to defenses that could have been raised against the debtor, nor was the Trustee a party to any arbitration agreement between the debtor and Defendants.

In re Cooley, 362 B.R. 514 (Bankr. N.D. Ala. 2007). The court articulates the following test: if the debtor brings the cause of action with him when he files bankruptcy, there is likely to be no inherent conflict with the enforcement of the arbitration provision. However, if the cause of action could exist only after the bankruptcy case was filed, such as an action for violation of the automatic stay, it should be adjudicated by the bankruptcy court.

- See *also* **In re Bethlehem Steel Corp.**, 390 B.R. 784 (Bankr. S.D.N.Y. 2008) (court determined that preference claims brought by trustee were not subject to arbitration and, alternatively, court exercised discretion to deny arbitration); **In re Martin**, 387 B.R. 307 (Bankr. S.D. Ga. 2007) (debtor-derived claims

were subject to arbitration provision in lease, while trustee's strong-arm avoidance claim was not).

3. Does the doctrine of issue preclusion apply to pre-petition arbitration?

Answer: The preclusive effects of an arbitration decision in bankruptcy court are determined by applicable state law.

In re Khaligh, 338 B.R. 817 (9th Cir. BAP 2006). A creditor sought to have its claim held nondischargeable under § 523(a)(6) based on willful and malicious injury. The creditor obtained a confirmed private arbitration award and then sought summary judgment in the bankruptcy adversary based thereon. The bankruptcy court applied California law on issue preclusion and determined that all pertinent issues regarding defamation were actually and necessarily litigated in the arbitration proceeding and were essential to the judgment. The court found that all elements of § 523(a)(6) were met and granted summary judgment in favor of the creditor.

- On appeal, the Ninth Circuit BAP affirmed, explaining that the confirmation of a private arbitration award by a state court has the status of a judgment and is entitled to the same full faith and credit in federal courts that it would enjoy in state court. Looking to California law, the BAP determined that the award satisfied the standard for applying issue preclusion.
 - In California, an arbitration decision will have preclusive effect if the arbitration was sufficiently adjudicatory in its procedural safeguards and the following threshold requirements are satisfied by a preponderance of the evidence;

- the issue sought to be precluded is identical to that decided in the former proceeding;
 - the issue was actually litigated in the former proceeding;
 - the issue was necessarily decided in the former proceeding;
 - the prior decision was final and on the merits; and
 - the party against whom preclusion is sought was the same as, or in privity with, the party to the former proceeding.
- See Lucido v. Superior Court, 51 Cal.3d 335, 341, 272 Cal.Rptr. 767, 795 P.2d 1223, 1225 (1990); In re Baldwin, 249 F.3d 912, 917 (9th Cir. 2001).
 - Although the Khaligh court distinguished between confirmed and unconfirmed arbitration awards, unconfirmed awards are given preclusive effect if the necessary elements are satisfied. As one court noted, “The fact that an arbitration award has been confirmed by a district court does not add significant weight to the validity of the award. Confirmation is necessary only when the losing party to the arbitration fails to abide by the judgment.” In re The Drexel Burnham Lambert Group, Inc., 161 B.R. 902 (S.D.N.Y. 1993).
 - So, both confirmed and unconfirmed arbitration awards may be given preclusive effect. See Glassey v. Amano Corp., 2008 WL 2704664 (9th Cir. 2008) (affirming district court’s grant of summary judgment based upon confirmed arbitration award); In re Sheinfeld, 2006 WL 2882681 (5th Cir. 2006) (holding that neither bankruptcy nor district court committed error by giving collateral estoppel affect to arbitral award); 114 Kimbell Square, Ltd. v. Ritter, 2007 WL 1660676 (ND Tex. June 8, 2007) (unconfirmed arbitration

award given preclusive effect in proceeding objecting to discharge); In re Rosendahl, 307 B.R. 199 (Bankr. D.Or. 2004) (California law determined preclusive effect of determinations by arbitrator); In re O'Neill, 260 B.R. 122 (Bankr. E.D. Tex. 2001) (unconfirmed arbitration award given preclusive effect in proceeding brought by creditor seeking determination debt was nondischargeable).

4. Can the bankruptcy rules of procedure be used to supplement or circumvent discovery limitations in arbitration?

Answer: It is possible a bankruptcy court will allow the use of 2004 examinations to investigate a dispute notwithstanding the fact that an applicable arbitration provision otherwise limits discovery.

In re Friedman's Inc. et al., 356 B.R. 779 (Bankr. S.D. Ga. 2005). In this case, the chapter 11 debtor sought discovery from Ernst & Young ("E&Y"), its pre-petition auditor, to determine if any potential causes of action existed. E&Y opposed the discovery on the basis that the arbitration provision contained in its engagement letter provided that all claims and controversies would be submitted to arbitration and, furthermore, no discovery would be permitted unless it was expressly authorized by the arbitration panel. The bankruptcy court ultimately allowed the debtor to proceed with the requested discovery because, at the time discovery was sought, no claim or controversy was actually pending in arbitration. Rather, the debtor was seeking to determine if any such claims existed.

- The court declined to follow In re Daisytek, Inc. et al., 323 B.R. 180 (N.D. Tex. 2005), a case in which the District Court concluded that a Rule 2004 examination could not be used to obtain discovery with respect to state law claims that were subject to a binding arbitration provision.

- The Friedman court distinguished Daisytek on that basis that the discovery being sought in Daisytek related to specific causes of action, whereas the debtor in Friedman had not yet identified whether or not it had any viable claims against E&Y.
- The Friedman court placed great emphasis on the plain language of the E&Y engagement letter that stated that arbitration would be used to resolve any “controversy or claim”. There was no known “claim or controversy” at the time of the discovery request and, therefore, the arbitration clause was not yet applicable. The court reasoned that, in fact, it was possible that the debtor’s examination would reveal that no claims or controversies against E&Y could be brought.

5. Does a claimant waive its right to arbitration by filing a proof of claim?

Answer: While some courts have held that a creditor does not waive its right to arbitration by filing a proof of claim, there are few decisions on this issue. Therefore, it is still possible some courts may determine that creditors submit themselves to the bankruptcy court’s jurisdiction, and waive any rights they have to arbitration, by filing a proof of claim.

- See Lewallen v. Green Tree Servicing, LLL, 487 F.3d 1085 (8th Cir. 2007) (creditor does not waive right to arbitrate dispute by filing proof of claim); In re Kaiser Group Intl., Inc., 307 B.R. 449 (D.Del. 2004) (creditor did not waive right to compel arbitration of claims asserted in debtor’s adversary proceeding by filing proof of claim in Chapter 11 case); In re Herrington, 374 B.R. 133 (Bankr. E.D. Pa. 2007) (court held that mortgage lender’s assignee did not waive contractual right to compel arbitration by filing proof of claim).