Bankruptcy Courts and Enforcement of Arbitration Clauses: Recent Developments 2006-07

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I Introduction

Leading into the late 1980s, contract arbitration clauses were frequently overlooked or ignored in disputes between the parties despite the Federal Arbitration Act. In 1987, however, the Supreme Court issued *Shearson/Am. Exp. Inc. v. McMahon*, 482 U.S. 220 (1987), which made it clear that arbitration is a favored proceeding and courts are to enforce arbitration clauses. But arbitration, by its nature, is generally a one-time, individualized remedy, applicable only to the immediate parties. When one party to the arbitration clause is in bankruptcy, however, this individualized remedy can conflict with bankruptcy policy, which is based on centralization and equality of treatment. What is a bankruptcy court to do when faced with an arbitration clause in a debtor-creditor dispute?

A. How Do These Conflicts Arise?

Creditors are beginning to discover the arbitration clauses in their contracts. When the debtor accuses her credit card company of violating the stay or objects to its claim, and perhaps combines that with a truth-in-lending or other consumer rights issue, the creditor is now more likely to respond with a motion to compel arbitration. In recent cases, requests for arbitration are common in:

- Debtor-initiated consumer protection litigation, often combined with stay violation claims
- Debtor-rescission claims
- Insurance disputes

[1] The opinions expressed in the case summaries are my own, and not those of the other panel members or of ABI. In addition, the comments contained herein are intended to be of a general nature only, do not constitute legal advice, and are not intended to be confidential. No reader is entitled to rely on them for any legal purpose, including creating an attorney client relationship.

B. What is the Nature of the Arbitration Clause?

Motions to compel enforcement of an arbitration clause force the bankruptcy court to consider just what an arbitration clause is:

- Merely a contractual choice of forum?
- But binding on contract parties only, not other creditors
- Does the Federal Arbitration Act (9 U.S.C. §§1-16) raise arbitration clauses to a substantive right, or does it merely require courts to enforce the contract to arbitrate according to its terms?

C. Court Analysis of Motions to Compel Arbitration in Bankruptcy

Courts facing a motion to compel arbitration engage in a two-step process.

- **Did the parties agree to arbitrate?**

  Sometimes this is clear; sometimes it is not. In *Tittle v. Enron Corp.* (*In re Enron Corp.*), 463 F.3d 410 (5th Cir. Tex. 9/1/06), for example, the insured and the insurer so agreed, but the issues before the court would bind third parties, who had not agreed to arbitrate. Result: arbitration clause not enforced.

- **Does the bankruptcy court have discretion to deny arbitration?**

  And if so, when? This is the question addressed by the rest of these materials.

II Bankruptcy Court Discretion to Deny Enforcement of Contract Arbitration Clauses

A. General Principles

- Most courts begin by acknowledging that under FAA, arbitration is strongly favored.
- Most also recognize that a conflict exists between bankruptcy and arbitration. Bankruptcy is based on a policy of centralization, while arbitration is based on a policy of decentralization.

B. Developing Rule

The cases summarized below appear to be trending toward a rule:

- In non-core matters, a bankruptcy court has no discretion to deny arbitration.

- In core matters, the scope of the court's discretion depends on congressional intent regarding the Bankruptcy Code in areas where it may conflict with the FAA.

- Congressional intent is to be determined from (a) the language of the Code, (b) its stated policy (usually legislative history) and (c) whether there is an "inherent conflict" between arbitration and the competing Code policy.

C. Determining "Inherent Conflict"

- **3rd Circuit test** (*see*, *Mintze v. American General Fin. Servcs. Inc.*, 434 F.3d 222 (3d Cir. (Pa.) 1/18/06). Is the claim derived from the debtor, including pre-bankruptcy rights or in ways not affecting the bankruptcy estate and other creditors (then arbitrate); or is the claim created by the Code or otherwise for the benefit of all creditors (court discretion to deny arbitration)?

- **2nd Circuit test** (*see*, *MBNA American Bank NA v. Hill*, 436 F.3d 104 (2nd Cir. (N.Y.) 1/25/06). Bankruptcy court may only deny arbitration where the proceeding is (a) based on a provision of the Code that inherently conflicts with the FAA, or (b) one in which arbitration would necessarily jeopardize the objectives of the Code. Even a substantive bankruptcy right will not automatically confer discretion to deny a motion to compel arbitration.

- **Alternative view** (*see*, *Brown v. Mortgage Electronic Registration Systems Inc.* (*In re Brown*), 354 B.R. 591 (D. R.I. 11/17/06): bankruptcy court discretion should be based on whether the matter is core or non-core. Arbitration clause is nothing more than a private contract for choice of forum and bankruptcy centralization policy should prevail.

III Standard of Review — How Much Deference Should Be Given to Bankruptcy Court Decisions?

A few of the cases noted below offer good examples of how important the chosen standard of review can be to the outcome (much like the importance of which dictionary a particular Supreme Court justice chooses to find his "plain meaning"):

- The review of a bankruptcy court decision regarding enforcement of an arbitration provision is a mixed question of fact and law. So where the reviewing court draws the line between fact and law is significant.

- Fact determinations are reviewed for clear error (and, correspondingly, the decisions that arise from them for abuse of discretion): If the bankruptcy court has properly considered legal standards and statutory policies, the reviewing court gives deference to its fact determination by applying a clear error standard, and to its conclusion by applying an abuse of discretion standard.

- Legal conclusions are reviewed *de novo*: The question of whether a bankruptcy court even has the authority to decline to compel arbitration is a matter of law and is subject to *de novo* review. Issues such as core vs. non-core and some elements of "inherent conflict" can be subject to such review, although reviewing courts (especially if they are going to affirm) treat the latter as fact-type issues.

IV RECENT CASES – 2006-2007 (chronological)

Mintze v. American General Fin. Servcs. Inc., 434 F.3d 222 (3d Cir. (Pa.) 1/18/06).

The debtor commenced an action against her mortgage company to enforce a pre-petition rescission. Court held that core/non-core distinction is not the determining factor in whether a bankruptcy court has discretion to deny enforcement of an arbitration agreement. To overcome enforcement of arbitration, the party must establish congressional intent to create an exception to the FAA mandate. Congressional intent can be discerned in one of three ways: (1) the statute's text, (2) the statute's legislative history or (3) the existence of an inherent conflict between arbitration and the statute's underlying purpose. Citing *Shearson/Am. Exp. Inc. v. McMahon*, 482 U.S. 220 (1987). The court found that there was not a bankruptcy issue to be decided by the bankruptcy court, so there was no inherent conflict, and the arbitration clause must be enforced.

ACandS Inc. v. Travelers Cas. & Sur. Co., 435 F.3d 252 (3d Cir. (Pa.) 1/19/06).

In an asbestos-coverage dispute, the parties agreed to arbitration and a panel was constituted. Before the award was issued, the company filed for chapter 11. Thereafter, the arbitration panel issued its award against the debtor. Then-Circuit Judge Alito held that the arbitration award was entered in violation of the automatic stay and that the automatic stay is vital provision of the Code, promoting an important public policy. The nondebtor party argued that the stay did not apply because the arbitration was an action initiated by the debtor, but the court dismissed that argument because "in the context of arbitration…it is impossible to definitively classify [who presented] the arguments presented."

MBNA American Bank, NA v. Hill, 436 F.3d 104 (2nd Cir. (N.Y.) 1/25/06).

The debtor commenced a class action against the creditor for willful, widespread and systematic violation of the automatic stay. The court ruled that the arbitration provision in the credit card agreement must be enforced. The court recognized the "polar extremes" of bankruptcy, which values centralization; and arbitration, which values decentralization. Even though the violation of stay was a core matter, it must be arbitrated absent an inherent conflict between bankruptcy

policies and the FAA. Although bankruptcy courts are more likely to have discretion to refuse to compel arbitration of core matters, which implicate the most pressing bankruptcy concerns, the court must inquire into the basic nature of the claim. Arbitration of this class action stay violation claim would not "seriously jeopardize the objectives of the Code," because the chapter 7 case had already been concluded and there would be no impact on creditors. A class action is, by its nature, not necessarily limited to hearing by a bankruptcy court and enforcement of the automatic stay is not the functional equivalent of a bankruptcy court enforcing its own order (in which case it would be allowed to do so).

Gertz v. Echo Rock Ventures LLC, (*In re Arter & Hadden LLP*) 339 B.R. 445 (Bankr. N.D. Ohio 1/31/06).

The chapter 7 trustee's collection action against the debtor-law firm's client must be arbitrated under the California legal fee arbitration statute. The action is a mere collection action, not a core proceeding, and the trustee is subject to the statute, as he stands in the shoes of the law firm debtor.

Buckeye Check Cashing Inc.. v. Cardegna, 456 U.S. 440 (2/21/06).

A challenge to the validity of a contract, as opposed to a challenge to the validity of just the arbitration provision, must be referred to the arbitrator. The Court held that the FAA *requires* that the validity of the contract as a whole be referred to an arbitrator, suggesting that the policy favoring arbitration might prevail over (some?) others. Unless the challenge is to the arbitration clause, it does not matter whether the claim is that the underlying contract is void or voidable. The validity determination must be made by the arbitrator in the first instance. Note that this was not a bankruptcy case, but a state class action alleging consumer law violations and usury in a loan agreement.

Lewallen v. Green Tree Servicing LLC, 343 B.R. 225 (Bankr. D.W.D. Mo. 3/22/06).

The chapter 13 debtor brought a consumer-protection claim against the mortgage lender as a counterclaim to the lender's proof of claim. The lender moved to compel arbitration per the mortgage contract. The bankruptcy court held that by filing a proof of claim and by participating in the preparation for litigation, the lender waived its right to arbitration. In addition, the bankruptcy policy of protecting debtors (it would be "inequitable to the debtor" to push it into arbitration—that's it) justified the decision not to compel arbitration. The district court affirmed, finding no abuse of discretion.

This is a good example of the importance of the standard of review applied by the appellate court. The district court noted that enforcement of an arbitration clause raised mixed questions of law and fact, with factual findings reviewed for clear error and legal conclusions reviewed *de novo*. It then concluded that the bankruptcy court properly considered the conflicting policies of the FAA and the Code so that district court review was for clear error and abuse of discretion. Despite the somewhat non-compelling reason for preferring bankruptcy court as a forum, the district court affirmed.

Merrill v. MBNA America Bank NA (*In re Merrill*), 343 B.R. 1 (Bankr. D. Maine 6/16/06).

The chapter 7 debtor sued MBNA and its attorney for violations of the automatic stay and state and federal consumer protection violations. Judge Haines found that the parties did agree to submit their claims to arbitration, then split the causes of action. The stay violation would be heard in the bankruptcy court, and the state and federal consumer protection claims would be arbitrated. The court did not buy the debtor's argument that all of the claims derived from the creditor's violation of the automatic stay and would not allow the debtor to piggyback the consumer protection claims on the bankruptcy claim.

Turner v. Frascella Ent. Inc. (*In re Frascella Ent. Inc.*) 349 B.R. 421 (Bankr. E.D. Pa. 7/17/06).

Debtor was a lender, and consumer borrowers brought a state court action against it and its principals, which was removed to federal court. The debtor and other defendants moved to enforce arbitration. Taking their cue from *Buckeye*, the plaintiffs argued that the arbitration provision was invalid. Chief Judge Sigmund noted that contract defenses, such as fraud, duress or unconscionability may be applied to invalidate arbitration provisions, and a court cannot compel arbitration unless the arbitration clause is valid. The court held that the parties had raised a sufficient issue so that the court would not compel arbitration but would determine the validity of the arbitration clause and the rest of the contract. The court also found that it had related-to jurisdiction over the nondebtors, and refused to sever those claims from the claims against the debtor.

Tittle v. Enron Corp. (*In re Enron Corp.*), 463 F.3d 410 (5th Cir. Tex. 9/1/06).

Enron's insurers filed an interpleader action to determine the proper distribution of certain insurance proceeds. Enron and other defendants moved to compel arbitration under the insurance policy clause. The Fifth Circuit affirmed the lower court determination that the contract arbitration clause applies only to disputes regarding the policy and involving the insurer and the insured. Here the dispute was with respect to distribution of insurance proceeds to third parties. The first test for determining enforceability of the arbitration clause was not met. The relevant parties had not, in fact, agreed to arbitrate, and arbitration could not be used to bind third parties.

Jalbert v. Pacific Employers Ins. Co. (*In re Olympus Health Care Group Inc.*), 352 B.R. 603 (Bankr. D. Del. 10/6/06).

A post-confirmation liquidating agent brought an action against debtor's workers comp insurer to compel turnover of funds. The insurer moved to compel arbitration. Attempting to meet the *Buckeye* standard, the liquidating agent challenged the arbitration clause as unconscionable. The court addressed the merits of that contention and determined that the clause was not unconscionable and that the court therefore had no discretion to deny arbitration, per *Buckeye*. The test enunciated by this court: "the appropriate analysis turns upon whether the claims are derived from the debtor, or the claims are those that the Code created for the benefit of the creditors of the estate." The court noted that this test stems from the basic premise that it is only the parties to the arbitration agreement who will be bound. As successor to the debtor, the trustee

was subject to the agreement. The court also found that the current action was not a true "turnover" claim, since the amount at issue was disputed, and enforced the arbitration clause.

Brown v. Mortgage Electronic Registration Systems Inc. (*In re Brown*), 354 B.R. 591 (D. R.I. 11/17/06).

This is a must-read case if you want a court to refuse to compel arbitration. The chapter 13 debtor brought an adversary proceeding against its mortgage lender alleging consumer protection violations. The bankruptcy court declined to compel arbitration and the district court affirms. The parties disagreed over the proper standard of review, and in a good discussion of the proper standards the court determined that it would review whether the bankruptcy court possessed discretion *de novo* and then, assuming it had discretion, would review its exercise of that discretion for clear error. Getting to the merits, the court criticized *Mintze* and *Hill* as according too much deference to the FAA. An arbitration clause is nothing more than a private forum selection contract. The FAA was remedial legislation, which does nothing more than require courts to enforce arbitration clauses in accordance with their terms. The Code's policy of centralizing dispute determination for the benefit of all creditors should prevail over the policy favoring enforcement of forum selection clauses.

The court concludes that the distinction between core and non-core matters should guide bankruptcy courts in exercising their discretion to enforce or not enforce arbitration clauses. Where conflict exists between the Code and the FAA, a bankruptcy court retains discretion to decide whether to compel arbitration if the proceeding is core. "The core/non-core distinction represents the best approach for resolving conflicts between the FAA and the Code because it locates arbitration agreements precisely upon the same footing as other forms of contracts, …while at the same time heeding [the Supreme Court's dictate in *McMahon*] that a waiver of judicial forum may only be prohibited where, *inter alia*, an inherent conflict is present between arbitration and the conflicting statute's purpose." Even where there is an arbitration clause, resolution of a core proceeding in bankruptcy court complies with the intent of the FAA by situating arbitration in exactly the same place as other forum selection clauses.

Rozell v. Citifinancial Auto Corp. (*In re Rozell*), 357 B.R. 638 (Bankr. N.D. Ala. 12/7/06).

The chapter 13 debtor brought a consumer protection claim against her motor vehicle lender in the context of a claim objection. (Compare *In re Lewallen*.) Citing *Buckeye*, the court held that the claims were non-core, and were not really related to the proof of claim. Relying on *Mintze* and *Hill*, the court compelled arbitration finding that the debtor had not met the burden of proving that Congress has "evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue."

Cooley v. Wells Fargo Financial (*In re Cooley*), _ B.R. _, 2007 WL 512758 (Bankr. N.D. Ala. 2/14/07).

The chapter 13 debtor brought consumer protection claims against his motor vehicle lender, in the context of a claim objection. Unlike his colleague in *Rozell*, the judge ruled that the creditor's filing of a proof of claim rendered the dispute a core matter. Nonetheless, the court determined

that it lacked discretion regarding arbitration. The test was whether the proceeding at issue derived exclusively from the Code or had non-Code origins. “Stated another way, if the debtor brought the cause of action, contested matter or other dispute underlying the proceeding with him when he filed bankruptcy, no inherent conflict is likely to be found with the enforcement of contractual arbitration. However, if such cause of action, contested matter or dispute could only exist after the bankruptcy case was commenced, then an inherent conflict exception under the underlying *McMahon* standard is more likely to be found.” Concluding that the Eleventh Circuit would most likely agree with the tests annunciated by the Second, Third, Fourth and Fifth Circuits [set out in *Mintze*, *Hill* and other cases], the judge granted the motion to compel arbitration.

Selby's Market Inc. v. PCT (*In re Fleming Companies Inc.*), 2007 WL 788921 (D. Del. 3/16/07).

Although addressing a different question (whether an arbitration clause survives rejection of an executory contract – yes), the court notes the Third Circuit position that “in the context of arbitration, a litigant's procedural right to the agreed forum is raised to a substantive right by the FAA.” The court in *Brown* would disagree.