

Six Arguments for Avoiding Arbitration in Bankruptcy

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Introduction²

It goes without saying that the best way to avoid arbitration in bankruptcy is to never agree in the first place to a contract that contains an arbitration clause. Unfortunately, few people (if any) ever consider the impact of arbitration during bankruptcy when they enter into any agreement. When faced with the difficult task of opposing a motion to compel arbitration in a bankruptcy proceeding, it is helpful to have a wide array of arguments to assert. To that end, this article will identify and briefly discuss six arguments that could be made to avoid arbitration in a bankruptcy proceeding.

The Arbitration Clause is Wholly or Partially Unenforceable and Thus Severable

When considering a motion to compel arbitration, courts simply consider whether (a) a valid arbitration agreement exists and (b) whether the dispute falls within the scope of the agreement.³ Critically, the Supreme Court recently affirmed, “a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.”⁴ In light of the strong opinion in *Buckeye*, it is imperative that a challenge to an arbitration provision be to just the provision itself and *not* to the underlying agreement as a whole. A pre-*Buckeye* decision accurately illustrated this principle when it stated that “[w]here there is a general claim that the underlying agreement was fraudulently induced, the court must refer it to arbitration. A claim of fraud in the inducement of the arbitration provision itself, however, should be decided by the federal court.”⁵

The Federal Arbitration Act provides that written arbitral agreements are “valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.”⁶ With respect to the arbitration clause itself, state contract law determines the validity of an arbitration agreement.⁷ Under state law, the regular rules of statutory construction apply to arbitration clauses.⁸ This includes issues of severability or non-severability of certain arbitration

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² The views expressed herein are solely those of the author and do not necessarily represent the opinions or belief of Blackwell Sanders Peper Martin LLP.

³ *Equal Employment Opportunity Commission v. Woodmen of the World Life Ins. Society*, 4798 F.3d 561, 565 (8th Cir. 2007).

⁴ *Buckeye Check Cashing Inc. v. Cardegna*, 546 U.S. 440, 126 S.Ct. 1204, 1210 (2006).

⁵ *In re Fleming Companies Inc.* 325 B.R. 687, 694 (Bankr. D. Del. 2005).

⁶ 9 U.S.C. §2; *see also Stutler v. T.K. Constructors Inc.*, 448 F.3d 343, 346 (6th Cir. 2006) (the FAA requires party to look to state law contract defenses rather than federal common law defenses.)

⁷ *Equal Employment Opportunity Commission v. Woodmen of the World Life Ins. Society*, 4798 F.3d 561, 565 (8th Cir. 2007).

⁸ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 859 (Mo. 2006).

provisions.⁹ Indeed, courts often will sever an unenforceable provision of an arbitration agreement.¹⁰ Severability is proper because “as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract.”¹¹

Courts have identified a host of unenforceable arbitration provisions. For instance, an arbitration provision will not be enforced where it deprives a party of statutory rights.¹² Likewise, “[i]t is unconscionable to have a provision in an arbitration clause that puts all fees for arbitration on the consumer. This is particularly true when the cost-shifting terms could work to grant one party immunity from legitimate claims on the contract.”¹³ The unconscionability of an arbitration clause is determined at the time it is made.¹⁴

As a rule of thumb, an “unenforceable contract or clause of a contract will not be enforced.”¹⁵ Under Missouri’s version of the Uniform Arbitration Act, arbitration clauses in adhesion contracts are unenforceable.¹⁶ If one hopes to avoid an arbitration agreement on the grounds that it is an unenforceable adhesion contract, then they should demonstrate elements such as (a) no contract negotiation, (b) that there was no other opportunity to obtain better contracts for the similar goods or services and (c) that there was an unexpected surprise.¹⁷ In contrast, a party cannot simply argue that a pre-printed form (without any other proof) is a contract of adhesion.¹⁸

The Matter Involves A Core Proceeding and the Court Has Discretion Whether to Enforce the Arbitration Clause

Various courts have noted that where a claim is non-core in nature, a bankruptcy court generally has no discretion and must compel arbitration.¹⁹ With respect to core claims, numerous courts have rejected the argument that a proceeding that is core in nature, standing alone, is a sufficient basis to allow the court, in its discretion, to refuse to enforce an arbitration provision.²⁰ Rather, a court has discretion whether to compel arbitration on a matter involving a core proceeding if the arbitration would jeopardize and/or conflict with the purposes of the Bankruptcy Code.²¹

⁹ *Jackson v. Cintas Corp.*, 425 F.3d 1313, 1317 (11th Cir. 2005).

¹⁰ See e.g., *Scovill v. WSYX/ABC*, 425 F.3d 1012 (6th Cir. 2005); *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853 (Mo. 2006).

¹¹ *Buckeye Check Cashing Inc. v. Cardegna*, 546 U.S. 440, 126 S.Ct. 1204, 1209 (2006).

¹² See e.g., *Jackson v. Cintas Corp.*, 425 F.3d 1313, 1317 (11th Cir. 2005) (arbitration provision that shortened the time to bring a statutory claim held invalid and severable); *Whitney v. Alltel Communications Inc.*, 173 S.W.3d 300 (Mo App. W.D. 2005) (statutory right of the prevailing party to recover attorney’s fees).

¹³ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 860 (Mo. 2006).

¹⁴ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 861 (Mo. 2006).

¹⁵ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 858 (Mo. 2006).

¹⁶ V.A.M.S. §435.350; *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 857 (Mo. 2006).

¹⁷ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 857-58 (Mo. 2006).

¹⁸ *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853, 858 (Mo. 2006).

¹⁹ See e.g., *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 796 (11th Cir. 2007); *MBNA America Bank v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006); *In re Gandy*, 299 F.3d 489, 495 (5th Cir. 2002); *In re Anthony*, 334 B.R. 780, 787 (Bankr. N.D. Miss. 2005).

²⁰ See e.g., *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 796 (11th Cir. 2007); *In re Cooley*, 2007 WL 512758 (Bankr. N.D. Ala. 2007); see also *In re Mintze*, 434 F.3d 222, 231 (3d Cir. 2006).

²¹ See e.g., *MBNA America Bank v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006); *In re Gandy*, 299 F.3d 489, 495 (5th Cir. 2002); *In re Brown*, 354 B.R. 591 (D.R.I. 2006); *Lewallen v. Green Tree Servicing, LLC*, 343 B.R. 225 (W.D.Mo.

With respect to statutory claims, it is well settled that “federal statutory claims can be appropriately resolved through arbitration, and [the Supreme Court has] enforced agreements to arbitrate that involve such claims.”²² To determine whether a statutory claim may be arbitrated, the Court first considers whether (a) the parties agreed to arbitrate their claims and then (b) whether Congress has manifested intent to prevent waiver of the judicial remedies for the particular statutory rights at issue.²³ “If a party opposing arbitration can demonstrate that ‘Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue,’ the FAA will not compel courts to enforce an otherwise applicable arbitration agreement.”²⁴

“To overcome enforcement of arbitration, a party must establish congressional intent to create an exception to the FAA's mandate with respect to the party's statutory claims. 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 purposes.’”²⁵ “In applying the *McMahon* factors, ‘questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration.’”²⁶ Indeed, “[a]pplying the *McMahon* factors to the Bankruptcy Code, [courts have found] no evidence within the text or in the legislative history that Congress intended to create an exception to the FAA in the Bankruptcy Code.”²⁷

The Arbitration Would Be Cost Prohibitive and Thus It is Unenforceable

In some instances, courts have held cost-shifting provisions in arbitration agreements to be cost prohibitive and/or unconscionable and thus unenforceable.²⁸ “Whether the cost is prohibitive must be considered from the vantage point of the potential litigant including the fact that the litigant must continue to pay for housing, utilities, transportation, food and other necessities of life in contemporary society.”²⁹ Unfortunately, increased costs associated with arbitrating a dispute in a far away forum, standing alone, are an insufficient basis for a chapter 11 trustee to avoid arbitration.³⁰

2006); *In re Mirant Corp.*, 316 B.R. 234, 238 (Bankr. N.D. Tex. 2004). For a succinct discussion regarding the subtle differences between circuit court rulings on a court’s ability to enforce arbitration of core matters in bankruptcy see Jason W. Harbour, “The Enforceability of Arbitration Clauses in Core Bankruptcy Matters,” *American Bankruptcy Institute Bankruptcy Litigation Committee Newsletter*, Vol. 3, No. 2 (July 2006).

²² *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79, 89, 121 S.Ct. 513, 521 (2000); see also *In re Mintze*, 434 F.3d 222, 229 (3d Cir. 2006) (“[T]he FAA mandates enforcement of applicable arbitration agreements even for federal statutory claims.”)

²³ *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79, 90, 121 S.Ct. 513, 521 (2000).

²⁴ *In re Mintze*, 434 F.3d 222, 229 (3d Cir. 2006) (citing *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987)); see also *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 795 (11th Cir. 2007).

²⁵ *In re Mintze*, 434 F.3d 222, 229 (3d Cir. 2006) (citing *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 227 (1987)); see also *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 795-96 (11th Cir. 2007).

²⁶ *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 796 (11th Cir. 2007) (citing *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26, 111 S.Ct. 1647, 1652 (1991)).

²⁷ *In re Electric Machinery Enterprises Inc.*, 479 F.3d 791, 796 (11th Cir. 2007); see also *In re Mintze*, 434 F.3d 222, 231 (3d Cir. 2006).

²⁸ See e.g., *Scovill v. WSYX/ABC*, 425 F.3d 1012, 1020-21 (6th Cir. 2005).

²⁹ *Scovill v. WSYX/ABC*, 425 F.3d 1012, 1021 (6th Cir. 2005) (citations omitted). The *Scovill* decision was a non-bankruptcy, arbitration related decision where there were state law tort claims and an alleged violation of the Age Discrimination in Employment Act.

³⁰ *In re Mercurio*, 402 F.3d 62, 66 (1st Cir. 2005).

The Supreme Court has stated (in the context of a TILA claim) that where “a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, that party bears the burden of showing the likelihood of incurring such costs.”³¹ Indeed, various courts have permitted enforcement of arbitration clauses involving TILA claims on the basis that the party opposing arbitration failed to demonstrate that the costs of arbitration were prohibitive.³²

While the *Green Tree* rationale would allow invalidation of an arbitration provision that was prohibitively expensive, the Seventh Circuit has noted that “[i]t remains unclear whether the rationale of *Green Tree* applies to situations that do not involve the assertion of federal statutory rights.”³³ Indeed, the Sixth Circuit has held that a party with only state law claims cannot avoid arbitration on the grounds that the arbitration would be prohibitively costly under federal law.³⁴

The Trustee (or Liquidating Agent) Was Not a Party to the Underlying Arbitration Agreement and Thus It Cannot Be Compelled to Arbitrate Any Causes of Action That It is Authorized to Bring and for Which There is No Agreement to Arbitrate

It is generally accepted that the trustee or a liquidating trust “stands in the shoes of the debtor for the purposes of [an] arbitration clause and that the trustee-plaintiff is bound by the clause to the same extent as would the debtor.”³⁵ Indeed, a “trustee is bound to arbitrate all of its claims that are derived from the rights of the debtor under §541.”³⁶ With that rationale in mind, a court may refuse to allow a Rule 2004 exam where an applicable arbitration agreement limits discovery and the 2004 exam could be used as a vehicle to circumvent the discovery limitations.³⁷

In contrast, however, it has been held that a trustee’s claims under §544(b) are not arbitrable because they do not derive from the debtor.³⁸ The rationale for this is that “there is no justification for binding creditors to an arbitration clause with respect to claims that are not derivative from one who was a party to it.”³⁹ For these reasons, courts have refused to enforce arbitration provisions where the trustee brought fraudulent transfer claims.⁴⁰ Likewise, it has been held that the court has discretion to stay arbitration in the context of §547 preference claim.⁴¹

³¹ *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79, 92, 121 S.Ct. 513, 522 (2000).

³² See e.g., *Green Tree Financial Corp.-Alabama v. Randolph*, 531 U.S. 79, 121 S.Ct. 513 (2000); *Livingston v. Associates Finance Inc.*, 339 F.3d 553 (7th Cir. 2003).

³³ *James V. McDonald’s Corp.*, 417 F.3d 672, 679 (7th Cir. 2005).

³⁴ *Stutler v. T.K. Constructors Inc.*, 448 F.3d 343, 346-47 (6th Cir. 2006).

³⁵ See *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 885 F.2d 1149, 1153 (3d Cir. 1989); see also *In re Mercurio*, 402 F.3d 62 (1st Cir. 2005); *Trefny v. Bear Stearns Securities Corp.*, 243 B.R. 300 (S.D. Tex. 1999); *In re Olympus Health Care Group Inc.*, 352 B.R. 603 (Bankr. D. Del. 2006) (claims brought by liquidating agent); *In re Anthony*, 334 B.R. 780, 786-87 (Bankr. N.D. Miss. 2005).

³⁶ *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 885 F.2d 1149, 1154 (3d Cir. 1989).

³⁷ *In re Daisytek Inc.*, 323 B.R. 180 (N.D. Tex. 2005).

³⁸ *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 885 F.2d 1149, 1153 (3d Cir. 1989).

³⁹ *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith*, 885 F.2d 1149, 1155 (3d Cir. 1989).

⁴⁰ See e.g., *In re EXDS Inc.*, 316 B.R. 817 (Bankr. D. Del. 2004); *In re Hagerstown Fiber Ltd. Partnership*, 277 B.R. 181 (Bankr. S.D.N.Y. 2002).

⁴¹ *In re Oakwood Homes Corp.*, 2005 WL 670310 (Bankr. D.Del. 2005).

The Arbitration Clause Constitutes an Executory Contract that Has Been Rejected

In the April 2007 issue of the American Bankruptcy Institute Journal, Jason Brookner and Monica Blacker argued that arbitration clauses could be selectively rejected as executory contracts.⁴² This novel idea is a good faith argument that could be made when seeking to avoid an arbitration clause. Nonetheless, one should also be aware of the counterarguments that would exist. For instance, various courts have held that, despite the rejection of an executory contract, a party may still be compelled to arbitrate.⁴³ Indeed, the District of Delaware has held that an arbitration clause survives the rejection of a contract that was rejected under 11 U.S.C. §365(g).⁴⁴ Moreover, clear Supreme Court pronouncements regarding the strong federal policy in favor of arbitration suggests that courts will ultimately be hesitant to allow a selective rejection of an arbitration clause.⁴⁵

The Right to Arbitrate Has Been Waived

“A contractual right to arbitrate may be waived expressly or implicitly.”⁴⁶ “Courts must examine the totality of the circumstances and determine whether based on all the circumstances, the party against whom the waiver is to be enforced has acted inconsistently with the right to arbitrate. Although several factors may be considered in determining waiver, diligence or the lack thereof should weigh heavily in the decision—*did that party do all it could reasonably have been expected to do to make the earliest feasible determination of whether to proceed judicially or by arbitration?*”⁴⁷

In the Third Circuit, a party seeking to demonstrate the right to arbitrate has been waived must show prejudice.⁴⁸ In contrast, the Seventh Circuit does not require a showing of prejudice in order to find a waiver of the right to arbitrate.⁴⁹

“Prejudice can be substantive, such as when a party loses a motion on the merits and then attempts, in effect, to relitigate the issue by invoking arbitration, or it can be found when a party

⁴² Jason S. Brookner and Monica S. Blacker, “The Rejectability of Arbitration Clauses,” *ABI Journal*, Vol. XXVI, No.3 (April 2007).

⁴³ *In re Fleming Companies Inc.* 325 B.R. 687, 693-94 (Bankr. D. Del. 2005) (citing cases in support of the proposition that a party can be compelled to arbitrate despite a rejection or breach of the underlying contract and holding that rejection of a contract did not void the arbitration clause).

⁴⁴ *In re Fleming Co.*, 2007 WL 788921 (D. Del. 2007); *see also In re Mirant Corp.*, 316 B.R. 234, 238 n.5 (Bankr. N.D. Tex. 2004) (“rejection does not alone prevent applicability of the arbitration clause.”)

⁴⁵ *See Shearson/American Exp. Inc. v. McMahon*, 482 U.S. 220, 226, 107 S.Ct. 2332, 2337 (1987) (*citations omitted*) (“The Arbitration Act thus establishes a federal policy favoring arbitration requiring that [the court] rigorously enforce agreements to arbitrate.”); *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 24-25, 103 S.Ct. 927, 941 (1983) (“The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.”)

⁴⁶ *Ernst & Young LLP v. Baker O’Neal Holdings Inc.*, 304 F.3d 753, 756 (7th Cir. 2002).

⁴⁷ *Ernst & Young LLP v. Baker O’Neal Holdings Inc.*, 304 F.3d 753, 756 (7th Cir. 2002) (*citations omitted*).

⁴⁸ *Wood v. Prudential Ins. Co. of America*, 207 F.3d 674, 680 (3d Cir. 2000).

⁴⁹ *Grumhaus v. Comerica Securities Inc.* 223 F.3d 648, 650 (7th Cir. 2000) (“The central question is whether the party against whom the waiver is to be found intended its selection and not whether either party would be prejudiced by the forum change.”)

too long postpones his invocation of his contractual right to arbitration, and thereby causes his adversary to incur unnecessary delay or expense.”⁵⁰ “In order to determine whether prejudice exists for a finding of waiver a court should consider the following factors: the timeliness of the motion to arbitrate, the degree to which the moving party has contested the merits of the opponent's claims, whether the moving party has informed its adversary of the intention to seek arbitration, the extent of the moving party's prior non-merits motion practice, the moving party's assent to pretrial orders and the extent to which both parties have engaged in pre-trial discovery.”⁵¹ Failure to establish prejudice will mean that a waiver will not be found.⁵²

While waiver of an arbitration clause will ultimately depend on the particular facts of each case, it is helpful to consider cases where waivers have or have not occurred. For example, arbitration clauses have been deemed waived in the following situations: (a) participation in chapter 11 plan confirmation and failure to object to plan language that provides for bankruptcy court adjudication of disputes⁵³ and (b) extensive participation in litigation.⁵⁴ In contrast, an arbitration clause was deemed *not* to be waived in the following situations: (a) failure to include an arbitration defense in amended answers filed with the bankruptcy court which had previously denied an initial motion to stay pending arbitration,⁵⁵ (b) relatively minor participation in litigation where there was no prejudice to the opposing party,⁵⁶ (c) three-year delay, standing alone, in seeking arbitration held not to constitute a waiver,⁵⁷ (d) filing a proof of claim⁵⁸ and (e) litigating with debtors in foreign courts.⁵⁹

Conclusion

The thought of facing arbitration in a bankruptcy proceeding can be daunting—particularly where the debtor is a consumer. But when armed with a solid understanding of the law a practitioner can more effectively seek to avoid the arbitration for his or her client.

⁵⁰ *In re Fleming Companies Inc.* 325 B.R. 687, 691 (Bankr. D. Del. 2005) (citing *Kramer v. Hammond*, 943 F.2d 176, 179 (2d Cir.1991)).

⁵¹ *In re Charter Behavioral Health Systems, LLC*, 277 B.R. 54, 58 (Bankr. D. Del. 2002).

⁵² *In re Fleming Companies Inc.* 325 B.R. 687, 692 (Bankr. D. Del. 2005).

⁵³ *Ernst & Young LLP v. Baker O’Neal Holdings Inc.*, 304 F.3d 753 (7th Cir. 2002).

⁵⁴ See e.g., *Morewitz v. West of England Ship Owners Mutual Protection and Indemnity Ass’n*, 62 F.3d 1356, 1366 (11th Cir. 1995) (“Waiver occurs when a party seeking arbitration substantially participates in litigation to a point inconsistent with an intent to arbitrate and this participation results in prejudice to the opposing party.”); *LeWallen v. Green Tree Servicing, LLC*, 343 B.R. 225 (W.D. Mo. 2006); *In re Power*, 282 B.R. 31 (Bankr. S.D. Ala. 2001)

⁵⁵ *In re Crysen/Montenay Energy Co.*, 226 F.3d 160, 162 (2d Cir. 2000).

⁵⁶ *Stifel, Nicolaus & Co. v. Freeman*, 924 F.2d 157 (8th Cir. 1991); *In re Charter Behavioral Health Systems, LLC*, 277 B.R. 54 (Bankr. D.Del. 2002).

⁵⁷ *Shearson Lehman Hutton Inc. v. Wagoner*, 944 F.2d 114, 122 (2d Cir. 1991); see also *Stifel, Nicolaus & Co. v. Freeman*, 924 F.2d 157 (8th Cir. 1991).

⁵⁸ *In re Kaiser Group Int’l Inc.*, 307 B.R. 449, 455 (D. Del. 2004).

⁵⁹ *In re Kaiser Group Int’l Inc.*, 307 B.R. 449, 455 (D. Del. 2004).