LIMITING LITIGATION OVER ARBITRATION IN BANKRUPTCY

MARIANNE B. CULHANE*

INTRODUCTION

The Supreme Court has shown marked enthusiasm for enforcing contractual arbitration agreements under the Federal Arbitration Act (FAA),[1] aggressively expanding the FAA's reach to rights arising under federal statutes and putting a heavy burden of proof on a party opposing arbitration. In 1987, in *Shearson/American Express Inc. v. McMahon*,[2] a case involving claims under RICO and the Securities Exchange Act, the Court said:

> The burden is on the party opposing arbitration . . . to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue . . . If Congress did [so] intend . . . , such an intent "will be deducible from the statute's text or legislative history," . . . or from an inherent conflict between arbitration and the statute's underlying purposes . . . . To defeat application of the Arbitration Act, . . . the party opposing arbitration must demonstrate that Congress intended to make an exception to the Arbitration Act for claims arising under [the statute], an intention discernible from the text, history or purpose of the statute.[3]

The Supreme Court has not yet applied the *McMahon* test to the Bankruptcy Code, but federal courts at the circuit and lower levels have struggled to do so for more than 20 years. That history has been well told elsewhere.[4] Basically, courts have

---

* Professor of Law, Creighton University School of Law.

[1] Federal Arbitration Act, 9 U.S.C. §§ 1–307 (2006).

[2] 482 U.S. 220 (1987).

[3] *Id.* at 227.

[4] *See, e.g.*, Patrick M. Birney, *Reawakening Section 1334: Resolving the Conflict Between Bankruptcy and Arbitration through an Abstention Analysis*, 16 AM. BANKR. INST. L. REV. 619, 651 (2008) (describing how *McMahon*, in part, caused Third Circuit to re-analyze authority of bankruptcy courts to deny enforcement of arbitration agreements in core proceedings); Marianne B. Culhane & Michaela M. White, *Enforcing (or not) Arbitration Clauses in Bankruptcy*, 1362 PRAC. L. INSTI. CORP. L. & PRAC. HANDBOOK SERIES 39, 48–49 (2003) (analyzing amount of discretion courts have to refuse to enforce arbitration agreements); Michael D. Fielding, *Elevating Business above the Constitution*, 16 AM. BANKR. INST. L. REV. 563, 598 (2008) ("Core claims, however, create a greater judicial challenge because there is a tension between the FAA's arbitration mandate and the overall purposes of the Bankruptcy Code."); Alan N. Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 183, 202 (2007) ("As one commentator has noted, in applying the *McMahon* standards, courts have found little guidance either in the text or the legislative history of the Judicial Code provisions relating to bankruptcy jurisdiction; 'the inquiry, therefore, has been framed as whether arbitrating the dispute in question would pose an irreconcilable conflict with the Code.'"); Michael D. Sousa, *A Morass of Federal Policy: Enforcing Arbitration Agreements in Bankruptcy Proceedings*, 15 NORTON J. BANKR L. & PRAC. 259, 263–64 (2006) (discussing how *McMahon* made it difficult for courts to avoid arbitration)*; see* Mette H. Kurth, Comment, *An Unstoppable Mandate and an*

focused on the third prong of the *McMahon* test, looking for inherent conflict between arbitration and the Bankruptcy Code's underlying purposes. The decisions trend toward ever broader enforcement of arbitration agreements, expanding from debtor-derived rights in non-core matters into core proceedings[5] in some circuits. However, that general direction is all that the courts agree on in this context. No clear directions or bright line rules have emerged. Instead, the courts parse the facts of each case to determine whether arbitration of a particular issue would sufficiently frustrate some underlying Bankruptcy Code policy to meet *McMahon*'s stiff test. The bankruptcy court's initial decision on whether to compel arbitration is frequently followed by not just one but two rounds of appellate review, first to the district court or bankruptcy appellate panel and second to the circuit court, "and sometimes, if *certiorari* is granted, by the Supreme Court as well."[6] The result has

---

Immovable Policy, The Arbitration Act and the Bankruptcy Code Collide, 43 UCLA L. REV. 999, 1023 (1996) (noting, in core matters, courts generally distinguish between who is bringing suit—debtor/trustee or some third party— rather than having a singular interpretation of *McMahon* test); *see also* Note, *Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act*, 117 HARV. L. REV. 2296, 2299–300 (2004) [hereinafter Note, *Jurisdiction in Bankruptcy Proceedings*] (stating Bankruptcy Code gives little guidance to standard promulgated by *McMahon*, but Third Circuit helped by concluding " first, the trustee is bound only by an arbitration agreement as to debtor-derived claims; second, noncore claims are arbitrable").

[5] 28 U.S.C. § 157(b)(1) (2006) ("Bankruptcy judges may hear and determine all cases arising under title 11 and all core proceedings arising under title 11, or arising in a case under title 11 . . . ."). The non-exclusive list of core proceedings in 28 U.S.C. § 157(b)(2) sets forth a list of core-matters including:

> (A) matters concerning the administration of the estate;
> (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interest for the purposes of confirming a plan under chapter 11, 12, or 13 or title 11 but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distributing in a case under title 11;
> (C) counterclaims by the estate against persons filing claims against the estate;
> (D) orders in respect to obtaining credit;
> (E) orders to turn over property of the estate;
> (F) proceedings to determine, avoid, or recover preferences;
> (G) motions to terminate, annul, or modify the automatic stay;
> (H) proceedings to determine, avoid, or recover fraudulent conveyances;
> (I) determinations as to the dischargeability of particular debts;
> (J) objections to discharges;
> (K) determinations of the validity, extent, or priority of liens;
> (L) confirmations of plans;
> (M) orders approving the use or lease of property, including the use of cash collateral;
> (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;
> (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims;
> (P) recognition of foreign proceedings and other matters under chapter 15 of title 11.

Id.

[6] Resnick, *supra* note 4, at 212–13 ("[T]hree tribunals are usually involved in a [bankruptcy] proceeding if all appeals as of right are exhausted. In contrast, other federal lawsuits involve two tribunals . . . ."). The Third Circuit noted a similar irony this year, when it said "[t]o the extent that the courts' reluctance to

been burdensome, lengthy, and expensive litigation – just to get to the point of either ordering the parties to arbitrate or allowing the bankruptcy court to rule on the merits of the matter. This potential for delay and expense gives those seeking to enforce arbitration considerable bargaining leverage.

As Professor Resnick has observed, "[i]ronically, litigating disputes over the enforceability of arbitration clauses deprives parties of the primary benefits of arbitration: efficiency, speed, and avoidance of costs associated with litigation in the court system."[7] In insolvency cases, those costs and delays impact not only the parties to the arbitration agreement but all the creditors and the estate by jeopardizing going concern values and reducing overall recoveries, thus depriving them of the primary benefits of bankruptcy as well.

This brief essay will first consider arbitration's very limited accommodation to the rights of third parties, those who did not sign an arbitration agreement, and the apparent conflict with section 1109 of the Bankruptcy Code, which offers third parties a right to be heard on most issues. Then it will discuss two suggested resolutions of the bankruptcy/arbitration dilemma. The first, from Professor Alan Resnick, would make pre-petition arbitration agreements unenforceable in core proceedings. In non-core matters, on the other hand, he would enforce arbitration agreements unless that would unduly delay case administration or limit the rights of non-consenting parties to be heard on the issues. In addition, Professor Resnick would limit judicial review of decisions to compel or deny arbitration to a single level, either by the district court or bankruptcy appellate panel.[8] The second proposal, from Professor Paul Kirgis, would generally compel arbitration in bankruptcy, but then allow expanded review of arbitration awards prior to enforcement. Courts would treat the award as if it had been a term of the parties' pre-petition contact, and enforce it only if such a contract term would have been enforceable in bankruptcy.[9]

I. CONSENT TO ARBITRATION AND THIRD PARTY RIGHTS UNDER CODE SECTION 1109.

One fundamental difference between litigation and arbitration is the basis for participation. In litigation, anyone with a sufficient interest to protect may bring suit, and there are many mechanisms for interested third parties, those who might be

---

enforce arbitration agreements was based on their parochial desire to safeguard their monopoly position with respect to the authority to resolve disputes, they may take solace from the circumstance that the adoption of the FAA and comparable state laws has given rise to its own body of litigation." Century Indemnity Co. v. Certain Underwriters of Lloyd's, No. 08-2924, 2009 WL 3297322, at *4 n.7 (3d Cir. Oct. 15, 2009).

[7] Resnick, *supra* note 4, at 212.

[8] *Id.* at 219–20 (indicating in contexts analogous to bankruptcy cases, where limitations on appeals are found, Congress decided need for efficiency and speed outweighs importance of appellate review beyond single level).

[9] Paul F. Kirgis, *Arbitration, Bankruptcy and Public Policy: A Contractarian Analysis*, 17 AM. BANKR. INST. L. REV. 503, 538–39 (2009) (arguing this approach would give greater effect to arbitration agreements and allow bankruptcy judges to monitor arbitration process).

adversely affected by the court's decision, to intervene or be joined. Thus, the interests of multiple parties can be accommodated. Arbitration, on the other hand, is a creature of contract, where party autonomy is king. Normally, only parties who have signed an arbitration agreement may participate in the proceedings, the hearings are private, there is little or no explanation of the award, there are far fewer mechanisms for intervention and the grounds for refusing enforcement of the award are extremely limited.[10] While these features of arbitration are seen as advantages by the parties to an arbitration agreement, the same features make it difficult for non-parties who did not consent to arbitrate to protect themselves from awards that may nevertheless adversely affect them.

In bankruptcy, this problem is especially evident. Bankruptcy is quintessentially a collective proceeding with centralized control of the property of the estate and creditors' claims. The automatic stay and the bankruptcy courts' broad jurisdiction funnel most of the action into one specialized court. Arbitration substitutes arbitrators, who are less skilled in the relevant law and possibly inclined to favor particular creditors, for experienced and expert bankruptcy judges.

> [T]here is no guarantee that the substantive and procedural rights granted by the Code will be accorded deference within the arbitral regime: the right of the parties to select the applicable law and procedure, free of the legal restraints of the adjudicatory process, is one of the benefits of arbitration.[11]

Further, the extremely narrow scope of review of arbitrators' awards and limited explanation of those awards reduces uniformity. The inescapable impact of arbitration on third parties who have not consented is a cause for concern, given the collective nature of bankruptcy process.

The FAA rests on party autonomy, consent enshrined in a written contract to waive a judicial forum in favor of an arbitral board. Parties who have not consented are not to be forced to arbitrate.[12] In the bankruptcy arena, the debtor's signature on a pre-petition arbitration agreement has been held to bind the trustee or debtor-in-possession (DIP) in debtor-derived claims. Consent by the debtor is imputed to the trustee for such claims, and the trustee may have only the rights the debtor would

---

[10] *See* STEPHEN J. WARE, PRINCIPLES OF ALTERNATIVE DISPUTE RESOLUTION 99–100 (2d. ed., 2007) (discussing further issue of how in many arbitrations there are no rules of evidence and arbitrators tend to admit all evidence); Stavros Brekoulakis, *The Relevance of the Interests of Third Parties in Arbitration: Taking a Closer Look at the Elephant in the Room*, 113 PENN ST. L. REV. 1165, 1166–67 (2009) (highlighting protections lost in arbitration by third parties who are considered aliens and whose interests are viewed as irrelevant to arbitration).

[11] Resnick, *supra* note 4, at 218 (quoting Jaime Byrnes).

[12] *See* Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 83–84 (2002) (stating issues for judicial determination include whether parties have submitted particular dispute to arbitration and whether arbitration clause in concededly binding contract applies to parties).

have had outside of bankruptcy.[13] On the other hand, most courts will not order arbitration of claims that are not debtor-derivative, on the ground that consent cannot fairly be imputed in such cases.[14] For example, in *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, the Third Circuit said:

> Claims asserted by the trustee under section 544(b) are not derivative of the bankrupt. They are creditor claims that the Code authorizes the trustee to assert on their behalf. The Supreme Court has made it clear that it is the *parties* to an arbitration agreement who are bound by it and whose intentions must be carried out . . . . Thus 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 . . . . It follows that the trustee cannot be required to arbitrate its section 544(b) claims and that the district court was not obliged to stay them pending arbitration.[15]

It has been suggested however, that due to the impact on other creditors, consent should not be imputed even in debtor-derived claims. After all, a creditor who never signed an arbitration agreement may still have his recovery determined by arbitration, if another creditor has signed such an agreement and is allowed to enforce arbitration of his claims. Because the insolvent estate is finite and distributed pro rata to creditors, the arbitrator's valuation of one creditor's claim affects the recovery of other creditors as well. This effect is magnified if the arbitrated claim is entitled to priority and full payment before any payments are made on general claims. Bankruptcy's collective proceeding turns the debtor-creditor contest into a "creditor-versus-creditor" competition.[16]

Another consideration is Bankruptcy Code section 1109 on the right to be heard in a reorganization case. Section 1109(b) provides, "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security committee, a creditor, an equity security holder, or any indenture trustee, many raise and may

---

[13] *See* Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1153 (3d Cir. 1989) (holding trustee stands in shoes of debtor in relation to arbitration clause in customer agreement and is bound by clause).

[14] *See, e.g.*, Javitch v. First Union Sec., Inc., 315 F.3d 619, 629 (6th Cir. 2003) (refusing to compel arbitration until more evidence was considered on whether non-signatory sought direct or indirect benefit from customer agreements); Gandy v. Gandy (*In re* Gandy), 299 F.3d 489, 495 (5th Cir. 2002) (noting discretion permits bankruptcy court to examine purposes of Bankruptcy Code, including goal of centralized resolution of purely bankruptcy issues, protection of creditors and reorganizing debtors, and power of bankruptcy court to enforce its decision); Stewart Foods, Inc. v. Broecker (*In re* Stewart Foods, Inc.), 64 F.3d 141, 145–46 (4th Cir. 1995) (holding bankruptcy court decides issue of whether debtor has obligation to pay money under contract).

[15] *Hays & Co.*, 885 F.2d at 1155 (internal citations omitted) (emphasis in original).

[16] Note, *Jurisdiction in Bankruptcy Proceedings*, *supra* note 4, at 2307 (looking at contractual relations through bankruptcy system's lens); *see also* Resnick, *supra* note 4, at 217–18 (observing that persons whose interests are involved in bankruptcy proceeding often are not parties to original arbitration agreement and recognizing Bankruptcy Code is designed to protect rights of creditors).

appear and be heard on any issue in a case under this chapter."[17] This section is Congressional recognition that each creditor can be adversely affected by adjudication of other creditors' claims as well as by the trustee's or DIP's management of the estate. Congress thus gives non-party creditors' committees the right to intervene in claims adjudication and many other matters.

Arbitration, on the other hand, does not permit non-party creditors to participate and be heard, and yet in bankruptcy, they will be bound by the award just the same. Arguably, this inescapable impact requires "that under the FAA these *de facto* parties must either . . . consent or cannot be bound by these *ex parte* proceedings."[18]

> The modification of creditor status inherent in the bankruptcy regime not only implicates the rights granted by the Code, but also raises serious questions under the FAA. As a practical matter, the creditors' committee—notwithstanding lack of formal party status—will receive the benefit or bear the burden of the award. Thus, the due process concerns that mandate consent by the parties have just as much force with respect to these non-parties. Therefore, although the FAA requires consent to be bound by an arbitration award, the Code has modified this background law by creating a system that will bind creditors through determinations of others' rights regardless of nonparty status; this modification suggests the need to depart from a formalistically narrow definition of whose consent is required for arbitration.[19]

II. SUGGESTIONS FOR REFORM

Two suggested approaches to resolving conflicts between arbitration and bankruptcy take very different paths to that end. Professor Alan Resnick's plan builds on the jurisdictional and abstention provisions of the Judicial Code to: 1) provide bright-line rules on arbitrability; and 2) limit judicial review of decisions on enforcing pre-petition arbitration agreements in bankruptcy. Basically, Professor Resnick says contractual arbitration clauses should be made unenforceable in all core proceedings, both those derived from the debtor and those that the Bankruptcy Code provides to aid creditors and the estate. Arbitration of core proceedings would be allowed only where: 1) the court abstains in the interest of justice, a relatively rare occurrence; or 2) the DIP or trustee makes a post-petition contract to arbitrate a core matter or assumes, pursuant to Code section 365, an executory

---

[17] 11 U.S.C. § 1109(b) (2006).

[18] Note, *Jurisdiction in Bankruptcy Proceedings*, *supra* note 4, at 2309 (stressing seriousness of concerns when creditors' status is modified in bankruptcy) (emphasis added).

[19] *Id.*

contract which requires arbitration.[20] In these unusual cases where arbitration of core proceedings is ordered, the court would have authority to monitor the arbitration, retaining jurisdiction to assure efficient resolution.

In non-core matters, on the other hand, Professor Resnick would generally enforce agreements to arbitrate. Non-core matters usually raise issues under non-bankruptcy law arising from the debtor's pre-bankruptcy rights,[21] so arbitration there may pose less of a threat to uniformity, and there may be less need for the bankruptcy expertise of the judge. Even without arbitration, in non-core matters, either party could prevent the bankruptcy judge from deciding the issues by refusing to consent, thus sending the matter to the district court. And, in some non-core cases, even the district court is subject to mandatory abstention. "The Judicial Code requires district courts and, therefore, bankruptcy courts, to abstain from hearing non-core proceedings pending in state court if they can be timely adjudicated in the state forum and there is no basis for federal jurisdiction."[22] Professor Resnick would give bankruptcy and district courts limited discretion to deny enforcement of arbitration agreements in non-core matters, if arbitration would unduly delay estate administration or "interfere with the rights that non-consenting parties in interest may have to raise and be heard on the issues involved."[23]

The third plank in the Resnick platform is limitation of appeals from bankruptcy court decisions to enforce, or not, arbitration agreements. He would allow only one appeal, on an abuse of discretion standard, to the district court or bankruptcy appellate panel.[24] No further appeals to the circuit level or the Supreme Court would lie.

The combination of bright-line rules, few exceptions, and limitations on appeals would work some major improvements. Core matters would be decided by the bankruptcy judge with ample opportunity for wide participation, almost certainly leading to more uniform treatment of similarly situated creditors. And even if, in non-core matters, the arbitrator was the chosen decision maker, this regime's limited appeals would speed up the process of getting to the merits. By so doing, it would lower costs for all and reduce the bargaining chip value of an arbitration agreement. For after all, in bankruptcy, "the right to arbitration, like the right to a jury trial, is for all practical purposes a strategic matter, involving questions of procedural hurdles, delay and costs of litigation, all for the purpose of enhancing bargaining positions."[25]

---

[20] *See* Resnick, *supra* note 4, at 213–15 (arguing legislative reform is most effective and proposing to amend bankruptcy-related provisions of Judicial Code to adopt general rule making contractual arbitration clauses unenforceable in core proceedings with two exceptions).

[21] *See id.* at 218–19 (discussing non-core matters and stating non-core matters consist of nonbankruptcy issues).

[22] *Id.* (indicating when court must abstain from hearing non-core proceedings) (emphasis omitted).

[23] *Id.* (noting differences in enforcing core and non-core arbitration agreements in context of bankruptcy).

[24] *Id.* at 219 (positing that appellate review of decision permitting or denying arbitration should be narrow).

[25] Fred Nuefield, *Enforcement of Contractual Arbitration Agreements under the Bankruptcy Code*, 65 AM. BANKR. L. J. 525, 545 (1991).

Professor Paul Kirgis recently suggested a much different approach to enforcing arbitration agreements in bankruptcy. He says arbitration should be viewed as a form of contract rather than as a quasi-adjudication. On this point, he quotes labor law scholar Ted St. Antoine:

> [T]he arbitrator is the parties' officially designated "reader" of the contract. He (or she) is their joint *alter ego* for the purpose of striking whatever supplementary bargain is necessary to handle the anticipated unanticipated omissions of the initial agreement . . . . In sum, the arbitrator's award should be treated as though it were a written stipulation by the parties setting forth their own definitive construction of the labor contract.[26]

Professor Kirgis sees the award not as "the equivalent of a judgment . . . [but rather] the equivalent of a contract term that must be enforced unless some legal rule renders it unenforceable."[27]

Basically, Professor Kirgis would compel arbitration in bankruptcy in both core and non-core matters "unless the costs would preclude parties from effectively vindicating their statutory bankruptcy rights."[28] He would include undue delay as a ground for refusing arbitration. But, assuming the arbitration process passes those preliminary tests and goes forward, resulting in an award, he would then have the bankruptcy court review the award for violation of public policy. "The question is this: if the parties, pre-bankruptcy, had agreed to a contract term obligating them to do exactly what the award requires, would that contract term be enforceable?"[29] If the answer to that question is affirmative, then in his view, the FAA requires enforcement.

CONCLUSION

Professor Kirgis' proposal for enhanced review of arbitral awards in bankruptcy might, as he suggests, discourage parties "from using arbitration as a 'hammer' to extract concessions" in the bankruptcy proceeding.[30] However, his proposal seems

---

[26] Kirgis, *supra* note 9, at 535 (quoting Theodore J. St. Antoine, *Judicial Review of Labor Arbitration Awards: A Second Look at Enterprise Wheel and its Progeny*, 75 MICH. L. REV. 1137, 1140 (1977)).

[27] *Id.* (maintaining that treating arbitration agreement as contract is public policy for allowing judicial review).

[28] *Id.* at 541 (suggesting cost of arbitration is reason not to enforce arbitration agreements in bankruptcy context). The "effectively vindicate" language refers to *Green Tree Financial Corp.-Alabama v. Randolph*, which suggested that courts should not enforce arbitration agreements if the arbitration fees would be so great as to prevent the claimant from "effectively vindicating his or her statutory cause of action." 531 U.S. 79, 90 (2000).

[29] Kirgis, *supra* note 9, at 539 (establishing test for reviewing arbitration awards in context of bankruptcy).

[30] *Id.* at 542 (suggesting parties to arbitration agreements who expect review of award by bankruptcy judge will have less leverage than when review of awards is very limited as is currently the case).

not to permit third parties, such as a creditors' committee, to participate in the process. Further, it would appear to invite challenges and judicial review not only pre-arbitration, but also post-award, in the form of appeals from the bankruptcy court's decision on the public policy review. These seem to be significant shortcomings compared to Professor Resnick's abstention-based bright-line rules and limits on judicial review. The Resnick plan seems more likely to reduce the delays as well as enhance participation and protection of the rights of all parties to the bankruptcy proceedings.