COMPETING EFFICIENCIES: THE PROBLEM OF WHETHER AND WHEN TO REFER DISPUTES TO ARBITRATION IN BANKRUPTCY CASES

ALEXIS LEVENTHAL* AND RONI A. ELIAS**

CONTENTS

INTRODUCTION

Since the 1980s, the federal courts have struggled to resolve a conflict between the Bankruptcy Code's[1] policy favoring the centralized resolution of all disputes

* Shared Law Clerk, U.S. Bankruptcy Courts, Middle District of Florida; Adjunct Professor of Law, Florida A&M University College of Law; J.D. University of Florida Levin College of Law, 2013; M.U.R.P. University of New Orleans, 2010; B.A. Haverford College, 2007. I would like to thank my co-author for his research that inspired this Article and for his dedication and hard work throughout the writing process. My deepest gratitude to Judge Briskman for his support and comments on earlier drafts.

** J.D., Florida A&M University College of Law, 2015; B.A., Nova Southeastern University, 2005. I first thank and appreciate so much my co-author for countless revisions and in-depth analysis. I would like to

related to a bankruptcy estate and the policy favoring the enforcement of arbitration agreements embodied by the Federal Arbitration Act ("FAA").[2] When a party enters bankruptcy, and that party is involved in a dispute subject to arbitration under the FAA, the question arises whether to resolve the dispute in arbitration or within proceedings in bankruptcy court. Answering the question requires resolving a conflict between two powerful federal policies.

Courts have long recognized and deferred to the Bankruptcy Code's policy favoring the bankruptcy court as the sole forum for resolving all disputes concerning a debtor's assets.[3] Courts have similarly recognized the FAA's policy favoring the enforcement of contractual commitments to resolve disputes in arbitration.[4] Courts disagree about how to balance these conflicting policy objectives, however, and the law is unclear about when and under what circumstances arbitration agreements will be enforced in bankruptcy proceedings.

This disagreement is exacerbated by a long simmering conflict within the United States Supreme Court and among commentators about the purpose of the FAA. The predominant view is that the FAA creates a substantive right of contract law that must be enforced in federal and state courts in any dispute that would fall within federal jurisdiction.[5] According to the alternative view, the FAA creates procedural rights in federal courts designed to promote efficient dispute resolution.[6] Existing authority in the Supreme Court and the United States Courts of Appeals does not seem to provide a clear basis for resolving these varied perspectives. In *Shearson/American Express, Inc. v. McMahon*,[7] the Supreme Court established the standard for courts to evaluate whether Congress intended the FAA's policy favoring arbitration to yield to the jurisdictional policies behind a countervailing federal statute. *McMahon* has not been uniformly applied by the United States Circuit Courts of Appeals, however.[8]

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[1] All references to the "Bankruptcy Code" or "Code" are to 11 U.S.C. §§ 101, *et seq.* (2012).

[2] *See* 9 U.S.C. § 2 (2012).

[3] *See* Elscint, Inc. v. First Wis. Fin. Corp. (*In re* Xonics, Inc.), 813 F.2d 127, 131 (7th Cir. 1987) (reasoning "[t]he bankruptcy jurisdiction is designed to provide a single forum for dealing with all claims to the bankrupt's assets").

[4] *See* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983) (holding any ambiguities with regard to arbitration clause should be resolved in favor of arbitration).

[5] *See, e.g.*, *id.* at 25 n.32 (stating although enforcement of the Act is left largely to the states, it is federal policy and should be enforced by federal courts where appropriate).

[6] *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1, 25–27 (1984) (O'Connor, J., dissenting).

[7] 482 U.S. 220 (1987).

[8] *See* U.S. Lines, Inc. v. Am. Steamship Owners Mut. Prot. & Indem. Ass'n, Inc. (*In re* U.S. Lines, Inc.), 197 F.3d 631, 640–41 (2d Cir. 1999) (noting courts must carefully determine whether any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing arbitration clause); *see also* Cont'l Ins. Co. v. Thorpe Insulation Co. (*In re* Thorpe Insulation Co.), 671 F.3d 1011, 1021 (9th Cir. 2012); Mintze v. Am. Gen. Fin. Servs. (*In re* Mintze), 434 F.3d 222, 229 (3d Cir. 2006); White Mountain Mining Co. v. Congelton, L.L.C. (*In re* White Mountain), 403 F.3d 164, 168 (4th Cir. 2005); Ins. Co. of N. Am. v. NGC

Any contractual relationship can become subject of a dispute in bankruptcy, and because almost any contract can include an arbitration clause, the variety of situations in which arbitration and bankruptcy can collide is broad.[9] However, the enforceability of arbitration clauses arises in three contexts within a bankruptcy case.[10] In the first case, either a Trustee or a Debtor in Possession ("DIP") sues a counter-party to a contract of the Debtor's to recover money on a common-law or statutory claim, typically for breach of contract or fraud, and the counterparty moves to enforce an arbitration clause.[11] In the second case, the Trustee or DIP pursues a preference action against one of the debtor's counter-parties to avoid transfers made to the counter-party to the bankruptcy filing.[12] "Again, the counter-party usually moves to enforce the arbitration clause, while the Trustee or DIP prefers to have the matter decided by . . . the bankruptcy court."[13] In the third case, "the Trustee or DIP rejects an executory contract and the counter-party to the contract seeks to enforce an arbitration clause to determine the damages resulting from the rejection."[14]

This Article will examine whether and to what extent *McMahon*'s analysis can effectively solve the unique policy conflict presented by arbitration to resolve disputes involving a bankruptcy estate and to evaluate, in light of the most recent decisions and policy considerations, the proposals for addressing the disjointedness of opinions arising from the federal courts. To begin, this Article summarizes bankruptcy court jurisdiction and background of the FAA. Next, this Article discusses the United States Supreme Court's decision in *McMahon***,** which provides a methodology for courts to determine when other federal statutes should yield to the FAA, and the subsequent interpretation of this decision by several circuit courts. Finally, this Article will discuss three potential solutions, their strengths and limitations. First, it will consider whether the conflict can be resolved by applying existing bankruptcy law principles by treating agreements to arbitrate like other executory contracts affecting the bankruptcy estate. Second, it will explore whether the conflict can be resolved through legislation that would better distinguish between matters that are "core" to the bankruptcy proceeding and those that are "non-core" and that would make the enforcement of arbitration agreements easier in non-core matters and more difficult in core matters. Third, it will discuss whether a shift in the burden of proof about the enforceability of arbitration agreements would preserve bankruptcy law principles.

Settlement Trust & Asbestos Claims Mgmt. Corp. (*In re* Nat'l Gypsum Co.), 118 F.3d 1056, 1066 (5th Cir. 1997).

[9] *See* Paul F. Kirgis, *Arbitration, Bankruptcy, and Public Policy: A Contractarian Analysis*, 17 AM. BANKR. INST. L. REV. 503, 514 (2009).

[10] *See id*.

[11] *See id*. at 514–15.

[12] *See id*. at 515.

[13] *Id.*

[14] *Id.* at 516.

I. STATUTORY BACKGROUND

A. Bankruptcy Jurisdiction

The history and evolution of bankruptcy court jurisdiction demonstrates that the statutory definition of jurisdiction is not dispositive in determining whether a particular matter may be adjudicated within the context of a bankruptcy proceeding. It further demonstrates that the general bankruptcy policy in favor of centralized dispute resolution must give way to fundamental jurisdictional principles.

The Bankruptcy Reform Act of 1978 gave bankruptcy courts expansive authority to enter final judgments on all claims that could affect the bankruptcy estate.[15] This initial broad grant of authority from Congress was subsequently deemed unconstitutional under Article III by the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co*.[16]

Article III vests the judicial power of the United States in courts composed of judges with life tenure and undiminished compensation.[17] Bankruptcy courts lack these Article III attributes and, therefore, may finally adjudicate matters that fall within some exception to Article III.[18] The *Marathon* Court found the "public right" exception applies to bankruptcy court jurisdiction regarding disputes involving the restructuring of debtor-creditor relations.[19] However, state law breach of contract actions by the estate against non-creditors were matters of "private right" to which the parties were entitled to an Article III tribunal.[20] The Court concluded Congress' grant of jurisdiction to the bankruptcy courts as provided under the 1978 Act was unconstitutional.[21]

Congress addressed the unconstitutional aspects of bankruptcy jurisdiction by enacting the Bankruptcy Amendments and Federal Judgeship Act of 1984.[22] The 1984 Act divided all matters that could be referred to the bankruptcy courts into two categories: "core" and "noncore."[23] Under the 1984 Act, bankruptcy courts may hear matters that "arise under" the Bankruptcy Code; "arise in" a case under the

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[15] *See* Pub. L. No. 95-598, 95th Cong., 92 Stat. 2549, at 2668 (1978) (proposing both district courts and bankruptcy courts should have "original and exclusive jurisdiction of all cases under [the Bankruptcy Code]").

[16] 458 U.S. 50, 87 (1982) ("[T]he broad grant of jurisdiction to the bankruptcy courts contained in 28 U.S.C. § 147 . . . is unconstitutional.").

[17] *See* U.S. CONST. art. III, § 1 ("The Judges . . . shall hold their Offices during good Behaviour [sic], and shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office.").

[18] *See Marathon*, 458 U.S. at 61 ("In short, there is no doubt that the bankruptcy judges created by the Act are not Art. III judges.").

[19] *See id.* at 71.

[20] *See id.* at 69–72.

[21] *See id.* at 87.

[22] *See* 28 U.S.C. § 151 (2012).

[23] *See id.* § 157.

Bankruptcy Code; or are "related to" a bankruptcy case.[24] The district courts may refer any matter to a bankruptcy court, but the bankruptcy court may enter a final order or judgment for "core" matters only; those matters "arising under" the Bankruptcy Code or "arising in" a case under the Bankruptcy Code.[25] Matters "relating to" a bankruptcy case are defined as "non-core."[26] For non-core matters, the bankruptcy court may make only proposed findings of fact and conclusions of law, which must be submitted to the district court for approval and for the entry of final orders or judgments, unless all parties consent otherwise.[27]

Since the 1984 Act, the core and non-core distinction has become increasingly important and questions have arisen about whether an emphasis on this distinction will shrink bankruptcy court jurisdiction. In *Stern v. Marshall*,[28] the Supreme Court determined, even though bankruptcy courts may be statutorily authorized to enter final judgment on a particular class of bankruptcy-related claims, Article III may still prohibit bankruptcy courts from entering a final judgment on those claims.[29] The Court determined that a counter-claim brought in bankruptcy court and deemed "core" under the statutory scheme, but based solely on state law, could only be resolved in an Article III court and could not be finally adjudicated by a bankruptcy court.[30]

The Court reasoned there was no constitutional basis for giving a bankruptcy court the authority to exercise the judicial power described in Article III and that exercising the judicial power was involved in "the entry of a final, binding judgment by a court with broad substantive jurisdiction, on a common law cause of action, when the action neither derives from nor depends upon any agency regulatory regime."[31] The *Stern* Court concluded that even matters characterized as "core" by federal statute might not be properly within the bankruptcy court's jurisdictional province. It was not until the Court's holding in *Executive Benefits Insurance Agency v. Arkison*[32] that it was determined how bankruptcy and district courts should proceed with such "*Stern* claims."

The *Executive Benefits* Court held "that when . . . the Constitution does not permit a bankruptcy court to enter final judgment on a bankruptcy-related claim, the relevant statute nevertheless permits a bankruptcy court to issue proposed findings of fact and conclusions of law to be reviewed *de novo* by the district court."[33] This holding addresses one of the gaps left unaddressed by *Stern* by solving the constitutional conflict inherent in the statute. The Court will be asked to address

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[24] *See id*.
[25] *See id.* § 157(b)(1), (2).
[26] *See id.* § 157(c)(1).
[27] *See id.* § 157(c)(1), (2).
[28] 131 S. Ct. 2594 (2011).
[29] *See id.* at 2596–97.
[30] *See id.* at 2597.
[31] *Id*. at 2615 (emphasis omitted).
[32] 134 S. Ct. 2165 (2014).
[33] *Id*.

another unanswered question left by *Stern* and *Executive Benefits*: can the constitutional discrepancy created by the statute be resolved by the consent of the parties?[34] Argument is set for January 14, 2015.[35]

The changing, and diminishing, scope of bankruptcy jurisdiction impacts the matters bankruptcy courts may finally adjudicate including, potentially, those matters subject to competing arbitration clauses. This reality may affect the proposed solutions for resolving conflicts created by arbitration clauses in bankruptcy proceedings, particularly those proposals that rely on a "core" and "non-core" distinction.

B. The Federal Arbitration Act

The most relevant provisions of the FAA are those covering the enforceability of arbitration agreements and the mechanisms for obtaining enforcement in the federal courts. Section 2 of the FAA creates a right to the enforcement of arbitration agreements. It provides that, for maritime transactions or transactions in interstate commerce, any agreement to arbitrate, whether made pre- or post-dispute, "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[36]

Sections 3 and 4 of the FAA create a mechanism for enforcing that right in the federal courts. In any action already pending in the United States courts, section 3 provides that, if there is an issue or issues that can be referred to arbitration under an enforceable arbitration agreement, the court "shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration."[37] Section 4 of the FAA also provides a mechanism for enforcing an arbitration agreement in disputes where no federal action is pending. If a party to an enforceable arbitration agreement fails or refuses to arbitrate under the agreement, and if the arbitral dispute would fall within federal jurisdiction as defined under title 28 of the United States Code, the aggrieved party to the arbitration agreement may petition "any United States district court . . . for an order directing that such arbitration proceed in the manner provided for in such agreement."[38] Upon such a petition, the district court will determine what the

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[34] *See* Wellness Int'l Network v. Sharif, 727 F.3d 751, 756 (7th Cir. 2013), *cert. granted*, 134 S. Ct. 2901 (2014).

[35] *See Wellness International Network, Limited v. Sharif*, SCOTUSBLOG, http://www.scotusblog.com/case-files/cases/wellness-international-network-limited-v-sharif/ (last visited Dec. 8, 2014).

[36] *See* 9 U.S.C. § 2 (2012).

[37] *See id*. § 3.

[38] *See id.* § 4.

arbitration agreement requires and shall issue any orders under those requirements.[39]

There are two circumstances under which federal courts will not enforce arbitration agreements. First, the agreement will not be enforced if it is void or unenforceable for any of the reasons that any other contract would be void or unenforceable.[40] Second, even a valid and otherwise enforceable arbitration agreement can be set aside if, through its enactment of another statute, Congress has expressed its intention that the dispute should not be arbitrated, regardless of whether parties might have agreed between themselves to such arbitration.[41]

1. Early Understanding of the FAA's Purpose and Policies

Understanding the purpose of the FAA is crucial to determining whether and when the FAA's policy favoring arbitration has been superseded by the competing policy behind another federal statute, such as the Bankruptcy Code. Case law interpreting the FAA's purpose and underlying policies has evolved since its enactment in 1925. That evolution has important consequences for analyzing when disputes subject to arbitration involving a bankruptcy estate should be arbitrated and when they should be retained by the bankruptcy court.

The enactment of the FAA in 1925 was the product of a long effort by commercial groups, particularly trade associations, to streamline dispute resolution between commercial actors.[42] Before the FAA, many jurisdictions followed the rule that agreements to arbitrate were revocable at will.[43] This judicial hostility to arbitration was motivated by several factors, chief among them a distrust of the legal acumen of the persons typically selected as arbitrators and a desire to protect the province of the judiciary from incursion by other kinds of tribunals for resolving disputes.[44] Courts were concerned that parties would erode judicial authority by making contracts to opt out of the judicial system and resolve their disputes in other tribunals.[45] The effect of this rule diminished recourse to arbitration because parties

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[39] *See id*.

[40] *See id.* § 2 ("[An arbitration provision] . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.").

[41] *See* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987).

[42] *See* David S. Schwartz, *If You Love Arbitration, Set It Free: How "Mandatory" Undermines "Arbitration,"* 8 NEV. L.J. 400, 402–06 (2007).

[43] *See* Julius Henry Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 265 (1926); *see also* Alan Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 183, 185–87 (2007).

[44] *See* Resnick, *supra* note 43, at 185–87; *see also* Patrick M. Birney, *Reawakening Section 1334: Resolving the Conflict Between Bankruptcy and Arbitration Through an Abstention Analysis*, 16 AM. BANKR. INST. L. REV. 619, 627–28 (2008) (explaining arbitration before and after Federal Arbitration Act, conflicting federal schemes in arbitration and bankruptcy, and offering suggestions on how to create harmony between both).

[45] *See id*.

had relatively little incentive to ever enter into pre-dispute arbitration agreements.[46]

Many commercial and trade associations developed arbitration procedures to facilitate dispute resolution among their members. The FAA promoted recourse to those procedures by establishing a federal rule that arbitration agreements were to be enforced in disputes within federal jurisdiction.[47]

In light of these origins, the FAA was first understood to create a procedural rule for federal courts: if the parties have agreed to arbitration, that agreement must be enforced, and federal courts must refer the dispute to the arbitrator.[48] In this respect, the FAA functioned compelling federal courts to enforce a certain forum selection agreement between litigants. If the litigants agreed to resolve their dispute in arbitration, they could not later go to federal court to litigate that dispute. Their agreement to arbitrate would be a binding choice of forum.[49] The FAA was not, however, understood to create any rules that state courts had to follow. The FAA was treated as a creature of federal procedure, not of substantive law.[50]

2. The Evolving Understanding of the FAA's Objectives

Modern interpretations of the statue and its original purposes have departed from the initial view of the FAA which predominated during the first decades after its enactment. This departure began with a collection of cases involving the FAA, which were decided in the mid-1980s. In *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*,[51] the Court held that the FAA "creates a body of federal substantive law establishing and regulating the duty to honor an agreement to arbitrate."[52] In this respect, *Moses H. Cone* established a federal rule of contract law—that arbitration agreements were always enforceable by their terms. The opinion asserted that the stay provision of section 3 of the FAA would apply in state and in federal court.[53] It also pointed out that "Congress can hardly have meant that an agreement to arbitrate can be enforced against a party who attempts to litigate an arbitrable dispute in federal court, but not against one who sues on the same dispute

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[46] *See* Cohen & Dayton, *supra* note 43, at 265.

[47] *See id.* at 280; *see also* Schwartz, *supra* note 42, at 400.

[48] *See* Allied-Bruce Terminix Cos., Inc. v. Dobson, 513 U.S. 265, 289 (1995) (Thomas, J., dissenting); *see also* Southland Corp. v. Keating, 465 U.S. 1, 25–27 (1984) (O'Connor, J., dissenting); Schwartz, *supra* note 42, at 403; Christopher R. Drahozal, *In Defense of Southland: Reexamining the Legislative History of the Federal Arbitration Act*, 78 NOTRE DAME L. REV. 101, 126 (2002) (questioning legitimacy of Supreme Court decisions on arbitration and reexamining legislative history of the Federal Arbitration Act).

[49] *See Southland Corp.*, 465 U.S. at 27 (O'Connor, J., dissenting) ("The bill declares that [arbitration contracts] shall be recognized and enforced by the courts of the United States.").

[50] *See id.* at 28 ("Plainly, a power derived from Congress' Art. III control over federal-court jurisdiction would not by any flight of fancy permit Congress to control proceedings in state courts.").

[51] 460 U.S. 1 (1983).

[52] *See id.* at 25 n.32 ("[A]lthough enforcement of the Act is left in large part to the state courts, it nevertheless represents federal policy to be vindicated by the federal courts where otherwise appropriate.").

[53] *See id.* at 26 n.34 (citing Burke Cnty. Pub. Schs. Bd. of Educ. v. Shaver P'ship., 279 S.E.2d 816, 824 (N.C. 1981)).

in state court."[54]

In *Southland Corp. v. Keating*[55] the Court went further, concluding that the federal rule mandating the enforcement of arbitration agreements be applied in state courts. The *Southland* majority built upon the ruling in *Moses H. Cone* to hold that section 2 of the "the Arbitration Act 'creates a body of federal substantive law' and expressly stated what was implicit in *Prima Paint, i.e.*, the substantive law the Act created was applicable in state and federal courts."[56] The *Southland* majority explained that "'the purpose of the act was to assure those who desired arbitration and whose contracts related to interstate commerce that their expectations would not be undermined by federal judges, or . . . by state courts or legislatures.'"[57]

In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, *Inc.,*[58] the Court considered whether an international agreement to arbitrate could be enforced with respect to a statutory antitrust claim. The Court rejected the argument that arbitration agreements should not apply to claims arising from statutory rights. According to the *Mitsubishi* Court, the source of the rights to be arbitrated made no significant difference because "the Act itself provides no basis for disfavoring agreements to arbitrate statutory claims."[59]

A minority of the Supreme Court and many commentators think this understanding of the FAA improperly expands the statute's scope. In her dissenting opinion in *Southland*, Justice O'Connor emphasized the FAA was originally intended to create a procedural rule for the federal courts that would not be binding on state courts.[60] Justice O'Connor also pointed out that the statutory language of the FAA and the structure of the statutory scheme were both contrary to the *Southland* majority's reading of the statute.[61] Accordingly, the enforcement provisions of the FAA specifically and exclusively refer to procedures for enforcing arbitration agreements in the federal district courts.[62] Justice O'Connor further concluded that section 2 could not be read to provide a substantive contract right that was binding in state courts.[63]

This disagreement relates to understanding whether and when there is a conflict between the policies behind the FAA and the Code. If the FAA is understood to impose a purely procedural rule for federal courts, the FAA serves only the policy

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[54] *See id.* (citing Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 (1967)).

[55] 465 U.S. 1, 27 (1984) (reversing California Supreme Court's decision not to enforce arbitration agreement).

[56] *Id.* at 12.

[57] *Id.* at 13 (citing Metro Indus. Painting Corp. v. Terminal Constr. Co., 287 F.2d 382, 387 (2d Cir. 1961) (Lumbard, C. J., concurring)).

[58] 473 U.S. 614 (1985).

[59] *Id.* at 627.

[60] *See Southland Corp.*, 465 U.S. at 25–27 (O'Connor, J., dissenting).

[61] *See id.* at 29–30 (O'Connor, J., dissenting) (holding federal law enforcing arbitration agreements preempts contrary state law).

[62] *Id*.

[63] *Id.* at 31.

of promoting efficient dispute resolution. If bankruptcy disputes permit the centralized resolution of all disputes related to the debtor's estate, serving the interest of efficiency may require the rejection of arbitration agreements in bankruptcy. But if the FAA creates a substantive federal law of contract that applies with equal force to state and federal courts, then efficiency may not be the determinative consideration in deciding whether to enforce arbitration agreements for disputes arising within the context of a bankruptcy proceeding.

In the wake of *Southland, Moses H. Cone*, and *Mitsubishi,* the Supreme Court has concluded that the substantive contract right to arbitrate protected by the FAA must be protected over and against any consideration of efficiency.[64] In *Dean Witter Reynolds, Inc. v. Byrd*,[65] the Court held that, in a case within federal jurisdiction, pendant claims that can be arbitrated should be sent to arbitration. The *Byrd* Court explained that "the Arbitration Act requires district courts to compel arbitration of pendent arbitral claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums."[66] Given that efficiency and uniformity are among the principal objectives behind centralizing dispute resolution in the bankruptcy court, *Byrd* indicates those policies may not trump the policy considerations behind the FAA.

3. *McMahon* and the Method for Resolving Conflicts between the FAA and Other Statutes

In the wake of these decisions, the Supreme Court's opinion in *Shearson/American Express, Inc. v. McMahon* [67] articulated a standard for determining when the federal policy in favor of enforcing arbitration agreements must give way to countervailing policies behind a different federal statute.[68] *McMahon* specifically addressed whether arbitration clauses could be enforced when a plaintiff raised claims against a securities broker under the Racketeer Influenced and Corrupt Organizations Act ("RICO")[69] and section 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act").[70] *McMahon* held that arbitration agreements must be enforced unless a different federal statute articulated

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[64] *See id.* at 10–11, 13 (holding federal law enforcing arbitration agreements preempts contrary state law); *see also* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983) (affirming enforcement of arbitration); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 638–39 (1985) (reversing finding that antitrust claims not arbitrable).

[65] 470 U.S. 213 (1985).

[66] *Id.*

[67] 482 U.S. 220 (1987).

[68] *See id.* at 237–42 (enforcing arbitration agreement absent different federal statute's plain meaning or showing of congressional intent for exception to Arbitration Act).

[69] *See* 18 U.S.C. § 1961(1) (2012) (defining racketeering activity within act).

[70] *See* 15 U.S.C. § 78j(b) (2006) (describing unlawfulness of manipulative and deceptive practices when purchasing or selling securities).

a policy that would be undermined by the enforcement of the arbitration agreement.[71]

The plaintiffs in *McMahon* had signed brokerage agreements with the defendant, which included an arbitration clause.[72] When the plaintiffs filed complaints in federal court, alleging wrongdoing in the management of their brokerage accounts, the defendants moved to compel arbitration under section 3 of the FAA.[73] The plaintiffs argued that the arbitration agreements could not be enforced regarding claims under RICO and section 10(b) of the Exchange Act because the rights created and the remedies provided by those statutes could not be adequately protected in an arbitral forum.[74]

Regarding this argument about whether arbitration provided an adequate forum to protect the rights guaranteed by RICO and the Exchange Act, the *McMahon* Court drew on its recent decisions extending the FAA.[75] The *McMahon* Court established a default rule favoring arbitration regardless of the source of the rights at issue, and it concluded this default rule would be inapplicable only if the party opposing arbitration could establish that Congress sought to preclude arbitration for such disputes.[76] The Court explained:

> 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 intended to limit or prohibit waiver of a judicial forum for a particular claim, 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 purposes of the statute.[77]

Given the standard elaborated in *McMahon*, there are three principal ways to determine that Congress intended to create an exception to the federal policies favoring arbitration.[78] First, the text of the other statute can clarify that the disputes falling within its ambit are to be litigated in federal court, not arbitrated. Second, the legislative history of the other statute can indicate that Congress' purpose

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[71] *McMahon,* 482 U.S. at 242.
[72] *Id.* at 223.
[73] *Id.* at 224.
[74] *Id*. at 227.
[75] *Id.* at 228.
[76] *Id.* at 227.
[77] *Id.*
[78] *See id.*

contradicted the referral of the matter to arbitration. Third, there is an inherent conflict between the FAA's purpose and those of the other statute. Such an inherent conflict might appear from the text or the legislative history of the other statute, but it might also be evidence in the structure of the statutory scheme.

It has been difficult to apply the *McMahon* standard to bankruptcy cases because there is little guidance in either the text or the legislative history of the Bankruptcy Code to indicate Congress' intentions about the relative strength of the policies favoring arbitration and favoring the centralized resolution of bankruptcy disputes.[79]

II. THE CIRCUIT SPLIT REGARDING ARBITRATION IN BANKRUPTCY

The Second, Third, Fourth, Fifth, and Ninth Circuit Courts have all interpreted the *McMahon* standard in determining the enforceability of an arbitration clause in a bankruptcy proceeding.[80] Interpretation has not been uniform, however, and the circuit courts interpreting the Supreme Court holding have emphasized the importance of different considerations and have reached different outcomes. These decisions are discussed chronologically as the findings and holdings of each circuit influence many of the subsequent decisions.

A. The Fifth Circuit Court of Appeals

In 1997, the United States Fifth Circuit Court of Appeals was asked to settle a dispute arising from an agreement entered into in 1985 (the "Wellington Agreement")[81] between National Gypsum, a producer of asbestos-containing products, and one of its national insurers, INA.[82] The Fifth Circuit was asked to determine whether the Wellington Agreement, containing an arbitration clause, required enforcement of that arbitration clause where National Gypsum had filed

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[79] *See* Resnick, *supra* note 43, at 185–87 (citing Note, *Jurisdiction in Bankruptcy Proceedings: A Test Case for the Implied Repeal of the Federal Arbitration Act*, 117 HARV. L. REV. 2296, 2298 (2004)) (stating it is difficult to apply *McMahon* standard to bankruptcy cases).

[80] *See* U.S. Lines, Inc. v. Am. Steamship Owners Mut. Prot. & Indem. Ass'n, (*In re* U.S. Lines, Inc.), 197 F.3d 631, 639 (2d Cir. 1999); *see also* Cont'l Ins. Co. v. Thorpe Insulation Co. (*In re* Thorpe Insulation Co.), 671 F.3d 1011, 1020 (9th Cir. 2012) (each case analyzing *McMahon* standard); Mintze v. Am. Gen. Fin. Servs. (*In re* Mintze), 434 F.3d 222, 228 (3d Cir. 2006); White Mountain Mining Co. v. Congelton, L.L.C. (*In re* White Mountain), 403 F.3d 164, 168 (4th Cir. 2005); Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (*In re* Nat'l Gypsum Co.), 118 F.3d 1056, 1065 (5th Cir. 1997) (each case analyzing *McMahon* standard).

[81] The Wellington Agreement was a multi-party contract under which a group of companies that made asbestos-containing products and their insurers agreed to establish an "Asbestos Claims Facility" for expediting payment of settlements or judgments to personal injury claimants. According to the Wellington Agreement, the claims facility would make payments and then the companies and their insurers would apportion their respective shares of the payments. *See In re Nat'l Gypsum Co.*, 118 F.3d at 1058–59.

[82] *Id.* at 1058.

for bankruptcy and the bankruptcy court decided not to stay adversary proceedings pending arbitration between the parties.[83]

National Gypsum had obtained, without objection or appeal by INA, a confirmed reorganization plan.[84] However, two years after the plan was confirmed, INA sought payment of monies advanced and interest thereon under the Wellington Agreement by initiating arbitration proceedings against National Gypsum.[85] In response, National Gypsum filed an adversary proceeding-declaratory judgment complaint in bankruptcy court. The bankruptcy court found that, as the adversary proceeding sought to ascertain whether its reorganization plan precluded INA's claim, it had "core" jurisdiction under 28 U.S.C. section 157(b)(2)(B) and (C) and that the bankruptcy court was the most efficient forum to determine the issues raised.[86] The bankruptcy court refused to abstain or to stay the adversary proceeding pending arbitration.[87]

On appeal, the Fifth Circuit first found that actions to enforce the discharge injunction are core proceedings because they call on a bankruptcy court to construe and enforce its own order,[88] holding that a declaratory judgment action seeking merely a "declaration that collection of an asserted preconfirmation liability is barred by a bankruptcy court's confirmation of a debtor's reorganization plan is a core proceeding arising under title 11."[89] The court then considered whether a bankruptcy court may deny a motion to stay.

In its analysis, the court rejected the view that arbitration of core bankruptcy proceedings is inherently irreconcilable with the Bankruptcy Code, but rather that "nonenforcement of an otherwise applicable arbitration provision turns on the underlying nature of the proceeding, *i.e.*, whether the proceeding derives exclusively from the provisions of the Bankruptcy Code and, if so, whether arbitration of the proceeding would conflict with the purposes of the Code."[90] Applying this standard, the court found because the declaratory judgment complaint was central to National Gypsum's confirmed reorganization plan, which was derived from the Bankruptcy Code, the bankruptcy court was within its discretion to refuse to order arbitration of the adversary proceeding as to avoid conflict with the

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[83] *Id.* at 1061 ("INA argued that the Bankruptcy Court applied an incorrect standard for determining whether to grant a motion to stay under the Act, that the Bankruptcy Court had a duty to grant a stay pending arbitration, and that the Bankruptcy Court did not have core jurisdiction over the adversary proceeding.").

[84] *Id.* at 1059.

[85] *Id.* ("INA demanded payment of $3,866,055 . . . plus $1,027,118 accrued interest . . . INA's demand letter stated that, if payment were not received within thirty days, INA would 'institute formal proceedings to collect the amount due.'").

[86] *Id*. at 1060–61.

[87] *Id.* at 1061.

[88] *Id.* at 1063 (citing *In re* Polysat, 152 B.R. 866, 888 (Bankr. E.D. Pa. 1993)).

[89] *Id.* at 1064 (citing Wood v. Wood (*In re* Wood), 825 F.2d 90, 92 (5th Cir. 1987); *see also* 28 U.S.C. § 157(b)(2)(B), (C), (O) (2012).

[90] *In re Nat'l Gypsum Co.*, 118 F.3d at 1067.

Bankruptcy Code's purpose.[91] However, the court importantly made the distinction that "core" proceedings do not, categorically, give bankruptcy courts the discretion to not enforce arbitration agreements, but that the conflict between enforcement and the purpose of the Code must exist.[92] As the Fifth Circuit explained:

> The core/non-core distinction conflates the inquiry in *McMahon* and *Rodriguez* with the mere identification of the jurisdictional basis of a particular bankruptcy proceeding. Not all core bankruptcy proceedings are premised on provisions of the Code that 'inherently conflict' with the Federal Arbitration Act; nor would arbitration of such proceedings jeopardize the objectives of the Bankruptcy Code. Although, as appellees suggest, "the core/ non-core distinction is a practical and workable one," it is nonetheless too broad. The "discretion" that ACMC and the Trust urge should exist only where a particular bankruptcy proceeding meets the standard for nonenforcement of an arbitration clause in *McMahon* . . . .[93]

The Fifth Circuit established a two-part analysis for determining when a bankruptcy court should refer a matter to arbitration.[94] In the first stage of the analysis, the bankruptcy court would apply *McMahon* in determining the source of the rights that would be subject to arbitration if the arbitration clause were enforced.[95] The crucial determination was whether the arbitrable issues arose from the debtor's pre-petition rights or from the Bankruptcy Code.[96] In the second stage of the analysis, the bankruptcy court would consider issue-specific policy considerations to determine whether the arbitrable question would implicate the third dimension of the *McMahon* test: there is an inherent conflict between the FAA and the Code.[97] Other circuits have taken a different approach, disregarding the first step of the analysis in the *National Gypsum* opinion.[98]

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[91] *Id.*

[92] *See id.* ("[N]ot all core bankruptcy proceedings are premised on provisions of the Code that 'inherently conflict' with the Federal Arbitration Act; nor would arbitration of such proceedings necessarily jeopardize the objectives of the Bankruptcy Code.").

[93] *Id.*

[94] *Id*. (establishing that "non enforcement of an otherwise applicable arbitration turns on the underlying nature of the proceeding . . . and, if so, whether arbitration of the proceeding would conflict with the purposes of the Code").

[95] *See id*.

[96] *See id*. at 1068.

[97] *See id*. at 1067.

[98] *See In re* Payton Constr. Corp., 399 B.R. 352, 362–63 (Bankr. D. Mass. 2009) (holding "the core or non core status of a particular proceeding is not a dispositive indicator of whether arbitration of the matter would conflict with the purpose of the Bankruptcy Code").

B. The Second Circuit Court of Appeals

Two years later, like the Fifth Circuit's approach to determining the enforceability of arbitration clauses, the Second Circuit Court of Appeals considered, first, whether the proceedings are core and, second, whether the bankruptcy court may enjoin arbitration, however, noting that determining the proceeding as "core" will not automatically give the bankruptcy court discretion to stay arbitration in *In re U.S. Lines*.[99]

Here, an asbestos production company filed a voluntary chapter 11 petition and sought a declaratory judgment concerning the rights of creditors, specifically creditors holding claims for asbestos-related injuries for which the debtor had agreed to cover by entering into several Protection & Indemnity insurance policies containing arbitration clauses.[100] The bankruptcy court held that such action was within its core jurisdiction and denied the creditors' motion to compel arbitration of the proceedings.[101]

The Second Circuit first determined that a declaratory judgment action is core as necessary to effectuate an equitable distribution of the bankruptcy estate.[102] The declaratory proceedings directly affect the bankruptcy court's core administrative function of asset allocation among creditors, and they are core.[103] Distinction of core proceedings was important because, as the Second Circuit noted, a conflict between the bankruptcy code and the FAA is lessened in non-core proceedings which are unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration.[104]

The court reasoned "[i]n exercising its discretion over whether, in core proceedings arbitration provisions ought to be denied effect, the bankruptcy court must still carefully determine whether any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing an arbitration clause."[105] The court held that "it was within the bankruptcy court's discretion to refuse to refer the declaratory judgment proceedings, which it properly found to be core, to arbitration."[106]

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[99] *See* U.S. Lines, Inc. v. Am. Steamship Owners Mut. Prot. & Indem. Ass'n, (*In re* U.S. Lines, Inc.), 197 F.3d 631, 637, 640 (2d Cir. 1999) ("Whether a contract proceeding is 'core' depends on (1) whether the contract is antecedent to the reorganization petition, and (2) the degree to which the proceeding is independent of the reorganization, an inquiry that hinges on the nature of the proceeding.").

[100] *Id.* at 635.

[101] *Id.* at 634.

[102] *See id.* at 639.

[103] *See id*.

[104] *See id.* at 640.

[105] *Id.* (citing Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc., 885 F.2d 1149, 1161 (3d Cir. 1989)).

[106] *Id.* at 641.

C. The Fourth Circuit Court of Appeals

The Fourth Circuit Court of Appeals has largely followed suit with the Second and Fifth circuits. In *White Mountain*, in response to a motion to compel the creditor to submit claims to arbitration under a pre-petition agreement and to stay or dismiss the adversary proceedings, the bankruptcy court denied the motion reasoning that because the creditor's complaint sought a determination over whether he was owed money by the debtor, it entailed a core proceedings under 28 U.S.C. section 157(b)(2)(B).[107] The bankruptcy court found the core proceeding trumped the arbitration.[108]

On appeal, the Fourth Circuit noted the *McMahon* line of analysis: "[i]f Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, 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."[109] Under the third inherent conflict line of analysis, and in keeping with the reasoning of *U.S. Lines,* the Fourth Circuit found that, in the bankruptcy setting, congressional intent to permit a bankruptcy court to enjoin arbitration is sufficiently clear to override even international arbitration agreements.[110] The inherent conflict was clear because both the adversary proceeding and the arbitration involved a core issue: determining whether the creditor's advances to the debtor were debt or equity.[111]

D. The Third Circuit Court of Appeals

The Third Circuit most recently visited the enforceability of arbitration in bankruptcy proceedings in 2006.[112] The *Mintze* court, relying on the earlier Third Circuit decision in *Hayes,* stated that whether the *McMahon* standard is met determines whether the court has the discretion to deny enforcement of an otherwise applicable arbitration clause.[113] The circuit court clarified: whether core or not, the *McMahon* standard must first be satisfied before the bankruptcy court has the discretion to deny arbitration.[114]

The bankruptcy court had determined that the debtor's rescission claim, based on the Truth in Lending Act ("TILA") and several federal and state consumer protection laws, was sufficient to create an inherent conflict between the

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[107] *See* White Mountain Mining Co. v. Congelton, L.L.C. (*In re* White Mountain), 403 F.3d 164, 167 (4th Cir. 2005).
[108] *See id.*
[109] *Id.* at 168 (quoting Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 227 (1987)).
[110] *See id.* at 170.
[111] *See id.*
[112] *See* Mintze v. Am. Gen. Fin. Servs. (*In re* Mintze), 434 F.3d 222, 222 (3d Cir. 2006).
[113] *See id.* at 232.
[114] *See id.*

Bankruptcy Code's underlying purposes and those of arbitration, concluding the proceeding was best left in the bankruptcy court.[115] However, the Third Circuit stated "[the court] cannot agree with this conclusion" specifically noting the debtor's claims were not created by the Bankruptcy Code.[116] The Third Circuit further noted that without a bankruptcy issue to be decided by the bankruptcy court, "we cannot find an inherent conflict between arbitration of [the debtor's] federal and state consumer protection issues and the underlying purposes of the Bankruptcy Code."[117] The court further noted that the court could not perceive of a sufficiently adverse effect on the underlying purposes of the Bankruptcy Code should the arbitration clause be enforced. Ultimately, the Third Circuit concluded that the "[b]ankruptcy court erred when it determined it had the discretion to deny enforcement of the arbitration provision in the contract between [debtor and creditor]."[118]

E. The Ninth Circuit Court of Appeals

In 2012, the Ninth Circuit held that the arbitration of a claim presented by a creditor would conflict with the purposes of a provision of the Bankruptcy Code and the purposes and policies of the Bankruptcy Code as a whole.[119]

Here, the debtor, Thorpe Insulation Co. ("Thorpe"), distributed and installed asbestos-containing products from 1948-1972. About 12,000 claims for asbestos-related injuries or deaths had been brought against Thorpe[120] with Thorpe's insurers, including Continental Insurance Company ("Continental"), paying more than $180 million defending and indemnifying these claims.[121] In 1985, Continental and Thorpe entered into the Wellington Agreement calling for binding arbitration of coverage disputes.[122] In 1988, Thorpe had exhausted its coverage under Continentals' policies and Continental ceased indemnifying Thorpe.[123] Thorpe then sought "non products" coverage under Continental's policies, asserting that such "non products" coverage was not subject to the policies' liability limits.[124] Continental disputed this and initiated arbitration under the Wellington Agreement. The arbitrator sided with Continental, finding that Thorpe had no remaining

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[115] *See id.* at 231.
[116] *Id.* (holding statutory claims are based on TILA and several federal and state consumer protection laws).
[117] *Id.* at 231–32.
[118] *Id.* at 232.
[119] *See* Cont'l Ins. Co. v. Thorpe Insulation Co. (*In re* Thorpe Insulation Co.), 671 F.3d 1011, 1024 (9th Cir. 2012) (following lower courts in concluding creditors' claim would overlap with Bankruptcy Code provisions and interfere with section 524(g) process, and determining bankruptcy court had discretion to conclude arbitration clause unenforceable).
[120] *Id.* at 1014.
[121] *Id.*
[122] *Id.*
[123] *Id.*
[124] *Id.*

coverage rights under Continental's policies.[125] Thorpe appealed, and the parties agreed to settle. In April 2003, the parties executed an integrated Settlement Agreement and Release (the "Settlement").[126]

The Settlement only released Thorpe's claims against Continental, not the direct action rights of individual asbestos claimants or to the contribution, indemnity, or subrogation rights of other insurers.[127] Lawsuits continued against Thorpe and its insurance coverage with other insurers dwindled.[128] Thorpe considered bankruptcy, hoping to reorganize under section 524(g), a unique mechanism for consolidating asbestos-related assets and liabilities of a debtor into a single trust for the benefit of present and future asbestos claimants, in that it authorizes the bankruptcy court to enter a "channeling injunction" that channels claims to the trust in order to prevent claimants from suing the debtor.[129] The injunction may also bar actions against third party insurers based on asbestos-related claims against the debtor if the third parties contribute to the trust in amounts commensurate with their likely liability and requires that a class of claimants be established and at least 75% approve the plan.[130]

In preparation of filing for bankruptcy, Thorpe negotiated with insurers other than Continental to ensure their funding of the section 524(g) trust.[131] Thorpe also identified and negotiated with potential asbestos claimants to ensure their approval of the section 524(g) trust.[132] Continental contended these actions violated the Settlement Agreement and sought to arbitrate its claim.[133] Arbitration was scheduled for October 16, 2007.[134] Thorpe filed for chapter 11 bankruptcy on October 15, 2007.[135] Continental filed a proof of claim, which Thorpe objected to and, in response, Continental moved to compel arbitration alleging: (1) Thorpe's pre-petition acquisition of the other insurers' contribution; (2) Thorpe's post-petition assignment of such rights to the trust created under the 11 U.S.C. section 524(g) plan; (3) Thorpe's pre-petition encouragement of direct action claims against Continental; and (4) Thorpe's cooperation and participation as a plan proponent in drafting, proposing, and seeking confirmation of a Plan designed to assist asbestos claims and in bringing direct action claims against Continental.[136]

The bankruptcy court denied Continental's motion to compel arbitration and disallowed its claim holding that the allowance or disallowance of Continental's

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[125] *Id*.
[126] *Id.*
[127] *Id.* at 1015.
[128] *Id.*
[129] *Id.*; *see generally* 11 U.S.C. § 524 (2012).
[130] *In re Thorpe Insulation Co.*, 671 F.3d at 1015; *see generally* 11 U.S.C. § 524 (2012).
[131] *In re Thorpe Insulation Co.*, 671 F.3d at 1015.
[132] *Id.* at 1016.
[133] *Id.*
[134] *Id.*
[135] *Id.*
[136] *Id.*

claim was a core matter under 28 U.S.C. section 157(b)(2).[137] The bankruptcy court found that, "as a matter of fundamental bankruptcy policy, only a bankruptcy court should decide whether the manner in which someone has administered a bankruptcy estate gives rise to a claim for damages."[138] Ultimately, the matter in dispute, the bankruptcy court found, was a core matter and had discretion in a case not to send the issue to arbitration.[139] The bankruptcy court further disallowed Continental's claim as a matter of law—finding that Thorpe's actions did not violate the Settlement Agreement.[140] Continental appealed and the district court affirmed.[141] Continental appealed the district court contending that its claim should be arbitrated under the arbitration clause in the Settlement Agreement because the claim is non-core and, even if the claim is core, it should be arbitrated because arbitration would not inherently conflict with the Bankruptcy Code.[142]

Although the Ninth Circuit pointed out the liberal federal policy favoring arbitration agreements under the FAA, citing *McMahon*, the court also pointed out that the FAA's mandate may be overridden by a contrary congressional command.[143] The court had to determine whether Congress intended to make an exception to the FAA for claims arising in bankruptcy proceedings, an intention discernible from the text, history, or purpose of the Bankruptcy Code.[144] The court did not find such intent in the text or the legislative history of the Bankruptcy Code, but determined there is an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code.[145]

Ultimately, the Ninth Circuit found that regardless of whether the proceeding was core or not, the *McMahon* standard must still be met—that is, a bankruptcy court may decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code.[146] The court found that the core/non-core determination is not alone dispositive.[147] Continental's claim was found, however, to be a core proceeding because Continental filed a proof of claim, and Thorpe objected to the claim, so under 28 U.S.C. section 157(b)(2)(B), the allowance or disallowance of that claim was a core proceeding.[148] Continental's claim disputed or affected assets in the 11 U.S.C.

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[137] *Id.* at 1017.
[138] *Id.* (acknowledging policy arguments favoring arbitration, but ultimately deciding that in core matters such as this, bankruptcy court has discretion not to send dispute to arbitration).
[139] *See id.*
[140] *See id.*
[141] *See id.* at 1019.
[142] *See id.* at 1018–20.
[143] *See id.* at 1020 (quoting Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 227 (1987)).
[144] *See id.*
[145] *See id.*
[146] *See id.* at 1021.
[147] *See id.*
[148] *See id.* at 1017.

section 524(g) trust and the rights of other creditors.[149] Resolution of that claim directly affected the administration of the bankruptcy estate.

The court further reasoned that, "because Congress intended that the bankruptcy court oversee all aspects of a 524(g) reorganization, only the bankruptcy court should decide whether the debtor's conduct in the bankruptcy gives rise to a claim for breach of contract. Arbitration in this case would conflict with congressional intent."[150] The court further noted that "[a]rbitration of a creditor's claim against a debtor, even if conducted expeditiously, prevents the coordinated resolution of debtor-creditor rights and can delay the confirmation of a plan of reorganization."[151] These pragmatic concerns led the court to conclude that the "arbitration of the claim presented by Continental would conflict with the purposes and policies of 524(g) and the Bankruptcy Codes as a whole . . ." and that the bankruptcy court had discretion not to enforce the arbitration clause.[152]

F. Comparing and Evaluating the Decisions of the Circuit Courts of Appeals

The circuit courts seem nearly unanimous there is no discretion to deny arbitration of non-core claims if a valid arbitration clause applies. That does not mean, however, that courts have discretion to refuse to enforce valid arbitration clauses in core proceedings. Several different tests have emerged when a court may refuse to enforce an arbitration agreement in a core proceeding.

The Second and Fourth Circuits find the distinction between core and non-core more central to the *McMahon* analysis, whereas the Third, Fifth, and Ninth Circuits find such distinction, at minimum, dispositive, however, these latter courts circuits take the effort to define the issue as core or non-core. The circuits differ over the enforceability of arbitration clauses in core matters where the rights to be vindicated arise solely out of non-bankruptcy law. The Third, Fifth, and Ninth Circuits do not allow courts to refuse to enforce arbitration in such circumstances, while the Second and Fourth Circuits appear to allow it.[153]

The Third and Fifth Circuits have held that a bankruptcy court may refuse to enforce an arbitration clause if the proceedings are based on Bankruptcy Code provisions and arbitration would inherently conflict with the purposes of the Code.[154] The Second and Fourth Circuits have adopted a test providing an additional basis for refusing to enforce an arbitration clause. Besides holding that a court may refuse to enforce an arbitration agreement involving a core claim if the dispute is based on the Bankruptcy Code and arbitration would inherently conflict with the purposes of the Code, a court may also refuse to enforce an arbitration

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[149] *See id*. at 1021.
[150] *Id.* at 1022.
[151] *Id.* at 1023.
[152] *Id.* at 1024.
[153] *See* Kirgis, *supra* note 9, at 519–20.
[154] *See id*.

agreement if arbitration of the dispute would jeopardize the objectives of the Code.[155]

To clarify, the circuit courts are in agreement that both district and bankruptcy courts must enforce an otherwise valid arbitration clause covering a non-core claim. The courts recognize that non-core claims do not originate from substantive rights created by the Bankruptcy Code. Rather, they are based on state or federal laws outside the Bankruptcy Code. As such, bankruptcy courts can hear them only in their advisory role as adjuncts to the district courts and can provide findings of fact and recommendations. Bankruptcy courts have no discretion to refuse to compel arbitration if a district court judge could not refuse to compel arbitration when hearing the same claims in a non-bankruptcy context. However, a split has emerged among the circuits when a bankruptcy court may refuse to enforce an arbitration agreement covering a core claim.

III. PROPOSED SOLUTIONS FOR RESOLVING THE CIRCUIT SPLIT

The circuit split described in the preceding section mainly arises from a disagreement among the circuit courts about whether it makes a difference for applying *McMahon* that the arbitrable dispute arises from rights created by bankruptcy law or by some other form of law. One way to avoid this dispute is to determine arbitrability on another basis.

A. Characterizing Arbitration Agreements as Executory Contracts

Under the Bankruptcy Code, an executory contract is one that has yet to be fully performed.[156] The Trustee or DIP has a choice of how to proceed with executory contracts. The Trustee or DIP can reject those contracts or assume them.[157] If the contract is rejected, the contract is treated as breached and the estate is liable for a damage claim by the other party to the contract and the other party is excused from further performance of the rejected contract.[158] If the contract is assumed, the Trustee or DIP is bound to perform it as is the other party.

Given executory contracts, some commentators have posited that an agreement to arbitrate, by itself and those included as an arbitration clause in a broader agreement, could be an executory contract if the arbitration proceeding was not completed.[159] If the parties' dispute was not ripe when the bankruptcy proceedings began, or if the dispute was ripe but the arbitration was ongoing at the time of the bankruptcy filing, it would be possible to say that the agreement to arbitrate was not

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[155] *See id*. at 520.
[156] *See id*. at 508.
[157] *See id.* at 509.
[158] *See* Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 231 (1989).
[159] *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973).

fully performed and was therefore executory.[160] This definition requires the agreement to arbitrate be a separate and independent executory contract, as executory contracts must be rejected or assumed in whole.[161]

The problem with treating arbitration agreements as executory contracts is that they are often, if not usually, included as clauses in other agreements.[162] It can be difficult or impossible for a Trustee or DIP to make an independent judgment about an agreement to arbitrate.[163] Courts could, however, employ principles of severability to determine whether and when arbitration clauses in broader agreements could be enforced on their own.[164] Where a contract is "divisible" or "severable" under state law, however, courts allow the single contract to be separately assumed or rejected.[165]

If arbitration agreements are treated as a severable contract, then the Trustee or DIP may reject one, both, or neither of the contracts.[166] Determining whether to reject or assume the arbitration agreement could turn on whether assumption of the arbitration agreement creates value for the estate. Where the Trustee or DIP rejects the arbitration agreement, such rejection constitutes a breach of the agreement and entitles the other party to a pre-petition claim for the breach of contract.

B. Legislative Action to Clarify the Distinction between Core and Non-Core Matters

Another proposed solution is legislative: Congress could enact a rule providing that arbitration clauses are not enforceable in core proceedings regardless of whether the causes of action are derived from the debtor or are brought under provisions of the Bankruptcy Code designed to protect the interests of the creditors or the bankruptcy estate.[167] As an exception, bankruptcy courts could still exercise

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[160] *See* Polina Kushelev, *An International Approach to Breaking The Core of the Bankruptcy Code and FAA Conflict*, 28 EMORY BANKR. DEV. J. 355, 370 (2012).

[161] *See In re* Aneco Elec. Const., Inc., 326 B.R. 197, 200 (Bankr. M.D. Fla. 2005).

[162] *See* Kirgis*, supra* note 9, at 521.

[163] *See id.*

[164] *See id*. at 522.

[165] *See* Byrd v. Gardinier (*In re* Gardinier, Inc.), 831 F.2d 974, 976–78 (11th Cir. 1987), *cert. denied*, 488 U.S. 853 (1988); *In re* Adelphia Bus. Solutions, Inc., 322 B.R. 51, 54 n.10 (Bankr. S.D.N.Y. 2005) (citing Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co., 83 F.3d 735, 741 (5th Cir. 1996)); *In re* Wolflin Oil, L.L.C., 318 B.R. 392, 397 (Bankr. N.D. Tex. 2004); *In re* Cafeteria Operators, L.P., 299 B.R. 384, 389 (Bankr. N.D. Tex. 2003); *In re* Plitt Amusement Co. of Wash., Inc., 233 B.R. 837, 847–48 (Bankr. C.D. Cal. 1999); *In re* Steaks to Go, Inc., 226 B.R. 35, 38 (Bankr. E.D. Mo. 1998); *In re* Holly's, Inc., 140 B.R. 643, 681 (Bankr. W.D. Mich. 1992); *In re* Cutters, Inc., 104 B.R. 886, 889 (Bankr. M.D. Tenn. 1989); *In re* Brentano's, 29 B.R. 881 (Bankr. S.D.N.Y. 1983).

[166] Note, *Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act*, 117 HARV. L. REV. 2296, 2314 (2004) (arguing severability is fundamental to law of arbitration because without severability, "either an arbitration clause embedded in a contract would become invalid and therefore moot at the time the clause is most crucial, or parties would be required to enter into a formalist, concurrent signing of a separate arbitration contract").

[167] *See* Resnick, *supra* note 43, at 214.

their discretionary power to abstain under 18 U.S.C. section 1334(c)(1).[168] And bankruptcy courts should retain supervisory authority over arbitration matters referred out of a bankruptcy case.[169]

Advocates of this solution have argued such a rule would be justified by the principles and policy objectives underlying both bankruptcy law and the FAA.[170] The governing principle of federal arbitration law is borrowed from foundational principles of contract law—that parties should be required to arbitrate their disputes when they have agreed to do so.[171] Parties should not be compelled to arbitrate disputes they have not agreed to arbitrate. If a debtor is involved in a dispute subject to an arbitration agreement, the debtor and the other party to the arbitration agreement have agreed to arbitrate. But, once bankruptcy proceedings begin, if that dispute is a core matter of the bankruptcy proceedings, it no longer implicates only the interests of the debtor and the other party. That dispute has the potential to affect the interests of numerous third parties, who never agreed to arbitrate any dispute with the debtor. Permitting arbitration in all core matters would require parties to have their interests determined by an arbitrator when they had not agreed to do so.[172]

The same rationale explains why, regarding non-core matters, the default rule should be that arbitration agreements would be enforced.[173] Bankruptcy courts should retain discretion to preclude arbitration when parties who did not consent to the arbitration of the dispute have an interest in resolving that dispute.[174] New legislation could provide for interlocutory appellate review of all decisions regarding the enforceability of a pre-dispute arbitration agreement, in both core and non-core matters, and the enforceability of arbitration awards.[175] Providing for this appellate review would promote the speedy resolution of matters referred from bankruptcy to arbitration and would also assure more consistent results between arbitral decisions and those by the bankruptcy courts.

C. Shifting the Burden of Proof Regarding the Enforcement of Arbitration Agreements

Another approach to the conflict attempts to reconcile the *McMahon* test and the established rules for enforcing arbitration agreements while recognizing arbitration implicating bankruptcy estate assets often involves unfairness to other

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[168] *See id.*
[169] *See id*. (stating in instances where court abstains from hearing core proceeding, "a mandatory arbitration provision governing the dispute should be enforceable" to ensure such governing provision is consistent with rights of all affected parties).
[170] *See id.* at 216–17.
[171] *See id.* at 185–87.
[172] *See id*. at 218.
[173] *See id*.
[174] *See id*. at 219.
[175] *See id*.

creditors who have an interest in the estate but not in the particular dispute to be arbitrated. Under existing principles governing the application of the FAA, and particularly under the standard established in *McMahon*, the party seeking to avoid the enforcement of a facially valid arbitration agreement must show that the arbitration agreement should not be enforced. But in bankruptcy proceedings, a better course for advancing the policy objectives of both the Bankruptcy Code and the FAA might be to shift the burden to non-debtors who seek to arbitrate matters affecting assets in the bankruptcy estate.

One of the primary problems with the arbitration of disputes implicating a bankruptcy estate is that resolving a dispute through arbitration proceedings may cost more and take more time than resolving the dispute as part of the ordinary bankruptcy process. This added expense and delay can be prejudicial to creditors who are not parties to the arbitration but who have an interest in how all of the debtor's assets are disposed. An arbitration outside of bankruptcy court ties up an asset or assets that could be distributed among other creditors.

If a non-debtor who has an arbitration agreement with the debtor wishes to resolve a dispute with the debtor through arbitration, the need to be fair to other creditors and to preserve the fair and efficient disposition of the debtor's assets should require that the non-debtor demonstrate that arbitration is warranted. The burden regarding arbitrability should be shifted from the party seeking to avoid arbitration, as it is under *McMahon*,[176] to the party seeking to enforce an arbitration agreement—but only when that party is a non-debtor and when the enforcement of the arbitration agreement has the potential to delay the resolution of the bankruptcy process. Because of this burden-shifting, the party seeking arbitration must show that the reference of the dispute to arbitration would not substantially prejudice the creditors and other parties who have an interest in the bankruptcy estate but who would not be involved.[177]

In addition, both the bankruptcy court and the district court could exercise expedited judicial review over any arbitration award, both in the bankruptcy court's ordinary jurisdiction and of the district court's appellate jurisdiction over the decisions of the bankruptcy court. Such review would assure a reasonable level of consistency with the decisions in the other aspects of the bankruptcy. Such review would not require legislative changes because courts already may expedite both ordinary and appellate review of arbitration awards.

CONCLUSION

The *McMahon* Court established that, regardless of the kind of case, the question of when to enforce arbitration agreements depends upon determining the

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[176] *See* Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220, 227 (1987).
[177] *See* Kirgis, *supra* note 9, at 525.

predominant Congressional policy objective.[178] If the only policy consideration at stake in a case is the policy favoring arbitration, then arbitration must be ordered. If there are competing policy objectives at stake, the availability of arbitration depends upon which policy Congress intended to prevail. Because Congressional intent is the determinative factor here, the best way to determine Congressional intent is for Congress to enact legislation clarifying when arbitration should be ordered in a bankruptcy proceeding and when it should not. This need for Congressional action is necessary given that the Supreme Court has forgone an opportunity to further clarify determining the venue, arbitration or bankruptcy court, by declining to hear *Thorpe* on appeal.[179]

Should bankruptcy jurisdiction regarding core and non-core matters be clarified, a legislative solution would provide the greatest clarity and definitiveness on the matter of enforcing arbitration agreements in bankruptcy proceedings such that bankruptcy courts would have authority to enter final judgments and orders on core matters subject to arbitration agreements and should defer non-core matters subject to arbitration agreements to the appropriate arbitral tribunal. Distinguishing between core and non-core issues provides a bright-line rule on enforcement of arbitration agreements in bankruptcy. This solution would be most effective given the circuit court decisions all involve making a core or non-core distinction if the core and non-core distinction was clear and absolute.[180] As previously discussed, however, this distinction of core and non-core bankruptcy matters is far from well-defined and straightforward in light of the recent Supreme Court decisions on bankruptcy court jurisdiction and the increasing uncertainty of bankruptcy court authority to enter final orders and judgments on certain matters.[181]

Given, however, the apparent shrinking authority of bankruptcy courts to finally adjudicate what have been considered "core" matters and that action from Congress is not forthcoming, the most effective solution for determining when arbitration should occur in bankruptcy would be to permit bankruptcy trustees to treat arbitration agreements like executory contracts and to perform those contracts when it is in the best interests of the bankruptcy estate to do so. Treating arbitration agreements as severable executory contracts removes the need for any court to make the determination that the dispute is "core" or otherwise.

Although this approach provides a practical approach to addressing arbitration agreements in the bankruptcy context, it does little in the way of analyzing Congressional intent or recognizing the objectives of the FAA or giving any

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[178] *See McMahon*, 482 U.S. at 227.

[179] *See* Cont'l Ins. Co. v. Thorpe Insulation Co. (*In re* Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir. 2012), *cert. denied*, 133 S. Ct. 119 (2012).

[180] *See* Troy A. McKenzie, *Getting to the Core of Stern v. Marshall: History, Expertise & the Separation of Powers*, 86 AM. BANKR. L.J. 23, 24 (2012) (asserting core/non-core distinction became "commonplace").

[181] *See generally* Stern v. Marshall, 131 S. Ct. 2594, 2601–02 (2011) (stating distinction between core and non-core proceedings); *see also* Executive Benefits Ins. Agency v. Arkison, 134 S. Ct. 2165, 2174 (2014) (noting Bankruptcy Court's failure to state whether decision was pursuant to core or non-core authority).

deference to parties and their pre-bankruptcy agreement to arbitrate. This criticism is also fairly made of the recommendation to shift the burden of proof to the non-debtor party seeking enforcement of an arbitration agreement. Questions regarding the valuation of the claim giving rise from the rejection of an arbitration clause may provide difficulty, however, bankruptcy courts have a long history of providing valuation solutions where the value claim poses difficulty or uncertainty and, such issues are soundly within the bankruptcy courts' core jurisdiction.[182]

[182] *See, e.g.*, Durkin v. Benedor Corp. (*In re* G.I. Indus., Inc.), 204 F.3d 1276, 1280 (9th Cir. 2000); Continental Nat'l Bank of Miami v. Sanchez (*In re* Toledo), 170 F.3d 1340, 1349–50 (11th Cir. 1999); Wood v. Wood (*In re* Wood), 825 F.2d 90, 97 (5th Cir. 1987).

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