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Second Circuit Rejects Arbitration of Debtor's Asserted Discharge Violation

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A bankruptcy court properly denied a bank's motion to compel arbitration of a debtor's asserted violation of the court's discharge injunction, the U.S. Court of Appeals for the Second Circuit held on March 7, 2018. *In re Anderson*, 2018 U.S. App. LEXIS 5703, 20 (2d Cir. Mar. 7, 2018). Finding a purported "inherent conflict between arbitration of [the debtor's] claim and the Bankruptcy Code," the Second Circuit reasoned that the bankruptcy court "properly considered the conflicting policies in accordance with law." *Id.*, quoting *In re United States Lines, Inc.*, 197 F.3d 631, 641 (2d Cir. 1999).

To reach its extraordinary result, the court strained to distinguish *Anderson* from its earlier decision in *MBNA America Bank v. Hill*, 436 F.3d 104, 111 (2d Cir. 2006) (*held*, arbitration of debtor's "automatic stay claim would not necessarily jeopardize or inherently conflict with the Bankruptcy Code."). The court also ignored Supreme Court precedent as well as the text of the Bankruptcy Code, the Judiciary Code and the legislative history. Most important, the *Anderson* decision may have significant consequences in business reorganization cases.

Relevance

Courts have disagreed on a clear test for determining whether a bankruptcy court must refer a dispute to binding arbitration. According to the Supreme Court, "the [Federal Arbitration] Act … mandates that district courts shall direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed." *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985). An agreement to arbitrate requires no relinquishment of substantive rights, but is, instead, a "trade [of] the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration." *Mitsubishi Motors Corp. v. Solar Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985); *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304, 2309-2310 (2013). (Arbitration is "a matter of contract" and courts must "rigorously enforce arbitration agreements according to their terms.")

The bankruptcy process centralizes the resolution of disputes in the bankruptcy court. That centralization is not absolute, though. *See*, 28 U.S.C. §1334(b) (district court has "original, but not exclusive jurisdiction" over proceedings "arising under" the Code, or "arising in or related to" bankruptcy cases). Thus, a judge has discretion to determine whether a "core" proceeding, such as an asserted discharge violation claim, should be referred to arbitration. "Bankruptcy courts are more likely to have discretion to refuse to compel arbitration of core bankruptcy matters." *Hill*, 436 F.3d at 108. That jurisdictional scheme, however, gives the bankruptcy judge less power with respect to related non-core proceedings when the parties do not consent to a bankruptcy court adjudication. *See*, *In re U.S. Lines, Inc.*, 197 F.3d 631, 637-37 (2d Cir. 1999).

The issues in *Anderson* turned on whether the debtor's discharge

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violation claim against the bank was subject to arbitration and whether that claim presented "the sort of inherent conflict with the Bankruptcy Code that would overcome the strong congressional preference for arbitration." *Anderson*, at 6. The Second Circuit had previously recognized that arbitration can conflict with the bankruptcy policy of centralized dispute resolution. "Disputes that involve both the Bankruptcy Code and the Arbitration Act often present conflicts of 'near polar extremes: bankruptcy policy exerts an inexorable pull towards centralization while arbitration policy advocates a decentralized approach toward dispute resolution.'" *Hill*, 436 F.3d at 108, quoting *U.S. Lines*, 197 F.3d at 640. But the purposes of the Code are "seriously jeopardized" only when arbitration would interfere with the bankruptcy court's ability "to centralize disputes concerning the estate." *Id*. at 109.

Facts

The debtor, Anderson, opened a credit card account in 2002 with the bank. The account agreement mandated arbitration of any controversy or dispute. Also, the arbitrator hearing the case had to be an experienced lawyer or a "former judge who must apply applicable substantive law," and could award damages or other relief.

Anderson failed to repay the bank on his account for more than 180 days. The bank was therefore required to "charge off" the account — *i.e.*, reclassify the account from a receivable to a loss. Consistent with federal regulatory guidelines, the bank noted the charge-off to the national credit reporting agencies and later sold the Anderson account to a third-party debt buyer. The bank also reported to the credit reporting agencies that it had sold Anderson's charged-off debt to another lender.

Anderson filed a Chapter 7 bankruptcy petition two years later in the Southern District of New York, and shortly after, obtained a standard form discharge order. He told the bank of his bankruptcy discharge, asking it to direct the credit reporting agencies to remove from his credit report any notation that it had charged off his loan. Because its charge-off was accurate, the bank declined. Federal regulators do not expect a bank to update an account after selling it to a third party, but instead, it need only state that it sold the account.

Anderson obtained the re-opening of his bankruptcy case several months later for the purpose of suing the bank on behalf of himself and a putative class. According to Anderson, by failing to furnish updates to the credit reporting agencies reflecting post-sale bankruptcy discharges, the bank intended to coerce payment on a discharged debt in violation of the bankruptcy court's discharge injunction.

The bank moved to compel arbitration of Anderson's claim. The bankruptcy court denied the motion, reasoning, among other things, that because the debtor's "fresh start" was implicated, Congress intended to preclude arbitration, and that the arbitrator would probably be unable to grant injunctive relief. The district court affirmed for the same reasons, but added that the debtor's claims arose from a discharge injunction, an affirmative order of the bankruptcy court, finding that arbitration would interfere with the bankruptcy court's authority to enforce its own orders.

The Second Circuit

The Second Circuit also affirmed, stressing that "the discharge is the foundation upon which all other portions of the … Code are built." *Id*. at 14. "The 'fresh start' is only possible if the discharge injunction … is fully heeded by creditors and prevents their further collection efforts. Violations of the injunction damage the foundation on which the debtor's fresh start is built." *Id*. Citing *United States Lines* and *Hill*, the court found "that arbitration of a claim based on an alleged violation of [Code] Section 524(a)(2) would seriously jeopardize a particular core bankruptcy proceeding.'" *Id*. at 14-15. A discharge violation claim thus requires continuing court "supervision … to enforce its own injunctions …." *Id*. at 15.

First, reasoned the court, the primary importance of a debtor's bankruptcy discharge makes "arbitration of Anderson's claim …. an inherent conflict with the … Code." *Id*. at 15. Second, "Anderson's [discharge violation] claims [were] still eligible for active enforcement." *Id*. at 16. To distinguish its earlier decision in *Hill*, the court said "the discharge injunction is likely to be central to bankruptcy long

after the close of proceedings," in contrast to the automatic stay violation in *Hill*. The automatic stay "exists only while bankruptcy proceedings continue to ensure the status quo ante," but "the integrity of the discharge must be protected indefinitely." *Id*. at 16. Finally, a discharge injunction requires the court's "unique expertise … in interpreting its own injunctions and determining when they have been violated." *Id*. at 17. Because the bankruptcy court, in the Second Circuit's view, considered "the conflicting policies," it had "properly" exercised its discretion. *Id*.

Comments

The Second Circuit in *Anderson* failed to cite a significant contrary district court decision. *Belton v. GE Capital Consumer Lending Bank*, 2015 WL 6163083, 6-8 (S.D.N.Y. Oct. 15, 2015) (Congress never "intended to preclude arbitration of [§]524 claims"; Congress gave federal district courts non-exclusive jurisdiction over §524 claims; no "inherent conflict" between arbitrating such claims and underlying purpose of Bankruptcy Code; debtor's rights could be vindicated in arbitration; discharge injunction a "national form"; nothing suggested that "bankruptcy court … more qualified than an arbitrator to adjudicate [§524] claim[s]."). *Belton* is currently on appeal to the Second Circuit.

The Second Circuit's reasoning in *Anderson* is superficial, at best. Nothing in the text or legislative history of the Code suggests that Congress intended bankruptcy courts to have exclusive jurisdiction over discharge violation claims. In fact, Congress enacted the Arbitration Act "to reverse centuries of judicial hostility to arbitration agreements." *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220, 225-226 (1987). The Second Circuit conceded in *Hill* that when "arbitration would not interfere with or affect the distribution of the estate" or "affect an ongoing reorganization," a bankruptcy court lacks discretion to deny arbitration. 463 F.3d at 109-110, citing *Bigelow v. Green Tree Financial Servicing Corp.*, 2000 WL 3359 6476, 6 (E.D. Cal. Nov. 3, 2000) (compelled arbitration of §524 claim). The *Anderson* case, of course, was closed and the debtor had his discharge — *i.e.*, no effect on reorganization or distributions to creditors.

Most important, Congress provided exclusive federal-court jurisdiction over specific bankruptcy-related claims (*e.g.*, §327), but *not* §524 claims. *See*, 28 U.S.C. §§1334 (a) and (e). Congress gave bankruptcy courts non-exclusive jurisdiction over §524 claims. *See*, 28 U.S.C. §1334(b) ("… original but not exclusive jurisdiction ….). Resolution of a discharge violation claim hardly requires unique bankruptcy expertise, for the issue is whether the alleged act merely sought "to collect" a discharged debt. In *Anderson*, the arbitrator would be a lawyer or former judge.

Courts should "rigorously enforce" arbitration agreements according to their terms, consistent with the intent of Congress when it enacted the Arbitration Act. *See*, *Italian Colors*, 133 S. Ct. at 2309-10. This duty to enforce arbitration agreements "holds true for claims that allege a violation of a federal statute." *Id*.; *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 at 24-25 (1991) ("[S]tatutory claims may be the subject of an arbitration agreement…."); *McMahon*, 482 U.S. at 226 (same). Thus, courts must enforce arbitration agreements "unless *Congress itself* has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue." *Mitsubishi Motors*, 473 U.S. at 628. (Emphasis added).

The Supreme Court has consistently rejected arguments that federal statutory claims are not arbitrable. *See*, *Mitsubishi Motors*, 473 U.S. at 634, 637 (1985); *Gilmer*, 500 U.S. at 24-25, 27-30; *Greentree Fin'l Corp – Alabama v. Randolph*, 531 U.S. 79, 90-91 (2000); *Compu Credit Corp. v. Greenwood*, 132 S. Ct. 665, 672 (2012).

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