LJN LAW JOURNAL NEWSLETTERS

The Bankruptcy Strategist®

An ALM Publication

Volume 34, Number 3 • January 2017

Arbitration Denied In Bankruptcy Priority Fight

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"[T]he bankruptcy court did not abuse its discretion in denying [the debtor's former employees'] motion to compel arbitration" when the dispute turned on the relative priority of their claims, held the U.S. Court of Appeals for the Second Circuit on Oct. 6, 2016. *In re Lehman Bros. Holdings Inc.*, 2016 WL 5853265, *2 (2d Cir. Oct. 6, 2016). The Securities Investor Protection Act (SIPA) trustee in the Lehman Brothers, Inc. (LBI) liquidation had asked the bankruptcy court to subordinate the employees' claims under their compensation agreements, but the employees sought to enforce the arbitration clause in those agreements to avoid litigating in the bankruptcy court. According to the Second Circuit, because the priority dispute was a "core proceeding," arbitration "would have 'seriously jeopardize[d]' the objectives of the Bankruptcy Code." *Id.*, citing *MBNA Am. Bank v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006).

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). The Court reasoned that "passage of the [Arbitration] Act was motivated, first and foremost, by a congressional desire to enforce agreements into which parties had entered." *Id.* Moreover, an agreement to arbitrate requires no relinquishment of substantive rights, but is, instead, a "trad[e of] the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985). The Arbitration Act thus "establishes a 'federal policy favoring arbitration agreements,' and mandates the enforcement of contractual arbitration provisions." *Hill*, 436 F.3d at 107.

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" Code, or "arising in or related to" bankruptcy cases). The bankruptcy jurisdictional scheme ordinarily gives the bankruptcy judge discretion to determine whether a "core" proceeding should be referred to arbitration. That same scheme, however,

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gives the bankruptcy judge less power with respect to related non-core proceedings when the parties do not consent to a bankruptcy court adjudication. *In re U.S. Lines, Inc.*, 197 F. 3d 631, 636-37 (2d Cir. 1999).

The issue in *Lehman* turned on whether the bankruptcy court, in a core proceeding, had to defer to a contractually binding arbitration agreement. Because the Arbitration Act removes disputes from the judicial system, the Second Circuit had previously recognized that arbitration can conflict with the policy of centralized dispute resolution in bankruptcy cases. *In re U.S. Lines Inc.*, 197 F.3d at 641. "[W]hether or not a bankruptcy court should allow a dispute to be resolved by an arbitration forum to which the parties agreed implicates the clash of two federal statutes." *In re Spectrum Info. Tech., Inc.*, 183 B.R. 360, 362 (Bankr. E.D.N.Y. 1995) (quoting *In re Al-Cam Dev. Corp.*, 99 B.R. 573, 575-76 (Bankr. S.D.N.Y. 1989)).

Facts

LBI's former employees filed a claim for deferred compensation in the LBI SIPA case. After the trustee objected to the claims and sought to enforce the subordination clause in the relevant agreements, the former employees then moved to stay that proceeding in reliance on the arbitration clause in their agreements, and sought to compel arbitration. The district court affirmed the bankruptcy court's bench ruling denying arbitration.

The Second Circuit

The Second Circuit summarily affirmed, applying a "two-part test." 2016 WL 5853265, at *1. If "the proceeding is non-core, generally the bankruptcy court must stay the proceedings in favor of arbitration, as non-core proceedings usually do not warrant overriding the presumption in favor of arbitration." *Id*. But "if the proceedings are core, a court must consider whether enforcing the arbitration provisions would seriously jeopardize 'any underlying purpose of the Bankruptcy Code.'" *Id*., quoting *In re U.S. Lines*, 197 F.3d at 640. Moreover, when "arbitration [of a core proceeding] would seriously conflict with the text, history or purposes of the Bankruptcy Code, the bankruptcy court has discretion to compel or stay the arbitration." 2016 WL 5853265, *Id*., at *2.

The … case law is unpredictable, making litigation costly and time-consuming.

The central underlying substantive issue in *Lehman* was where the employees' "claims fall in the priority scheme of distribution … ." *Id*. Because a priority dispute is a "core" proceeding, the bankruptcy court, said the Second Circuit, "reasonably determined that 'Congress simply could not have intended to turn over the determination of the relative priority of claims against the estate and the equitable distribution of the estate's assets in the largest SIPA liquidation in U.S. history [to] the financial industry regulatory authority to be decided under the rules of the New York Stock Exchange." *Id*. According to the court, the bankruptcy judge had "considered the conflicting policies of the Federal Arbitration Act and the Bankruptcy Code, made a particularized inquiry into the nature of the claims and the facts, [finding] that an underlying purpose of the Bankruptcy Code would be jeopardized by enforcing an arbitration clause in this case." *Id*. Thus, reasoned the Second Circuit, "arbitration would have 'seriously jeopardize[d]' the objectives of the Bankruptcy Code." *Id*.

Comments

1. The Second Circuit's analysis in *Lehman* was deceptively simple. On the facts of the case, the court was correct. The priority status of a creditor's claim is ordinarily a core proceeding. *See*

28 U.S.C. § 157(b)(2)(B) (core proceedings include "allowance or disallowance of claims. … "). But appellate decisions from the Second and other Circuits tell a more complex story.

2. A threshold issue is whether the dispute is, in fact, a core proceeding. The Second Circuit's *U.S. Lines* decision shows how difficult that determination can be. The court there upheld a bankruptcy court's order denying arbitration of a post-bankruptcy declaratory judgment action against the debtors' indemnity insurance carriers. The insurance proceeds were the only potential source of recovery for employees who had filed asbestos-related personal injury claims against the debtors. 197 F.3d at 634, 640-41. Although the bankruptcy court had discretion to deny arbitration in a core proceeding when arbitration would "seriously jeopardize" the bankruptcy process, the district court in *U.S. Lines* had disagreed, holding that insurance contract disputes are not core proceedings under 28 U.S.C. § 157(b)(2).

The Court of Appeals reversed, holding that the dispute was a core proceeding because of "the impact these contracts have on other core bankruptcy functions. … " *Id*. at 638. A core proceeding determination turns on "(1) whether the conflict is antecedent to the reorganization petition; and (2) the degree to which the proceeding is independent of the reorganization." *Id*. at 636-37.

The other two members of the three-judge panel in *U.S. Lines* filed concurring opinions setting forth their separate views on how to define a core proceeding. "In my view, the efficient functioning of the bankruptcy system [requires] a bright-line rule that treats as core proceedings all suits alleging post-petition breaches of pre-petition contracts." *Id*. at 641 (Newman, J.). Another member of the panel, however, "would be inclined to favor a case-by-case approach … [and] would defer the matter to another day. …" *Id*. at 643 (Calabresi, J.). Nonetheless, all three judges agreed that the "particular post-petition breach of a pre-petition contract [in *U.S. Lines*] is core," and resolution of the suit was "integral to the bankruptcy court's ability" to administer the debtor's estate. *Id*. That court was "the preferable venue in which to handle mass tort actions involving claims against an insolvent debtor," underscoring the need "for a centralized proceeding. … " *Id*. at 641.

3. *Lehman* confirms that a bankruptcy court, in a core proceeding at least, must analyze each dispute on a case-by-case basis as to whether arbitration conflicts with the Code. The U.S. Court of Appeals for the Third Circuit, however, takes a more pragmatic approach. In *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149 (3d Cir. 1989), the Third Circuit limited the bankruptcy court's discretion in deciding whether to enforce an arbitration clause. Reversing the district court's denial of arbitration, the Court of Appeals held that "the trustee-plaintiff stands in the shoes of the debtor for purposes of the arbitration clause" when the trustee is enforcing the debtor's pre-bankruptcy claim — a non-core dispute. *Id*. at 1156-57, 1162.

As to a non-core matter, no bar to mandatory arbitration existed. *Id*. at 1157. Still, the trustee's non-derivative claims under Code § 544(b), created for the benefit of creditors, were held to be core matters *not* subject to mandatory arbitration, and creditors are not bound by the arbitration clause. *Accord*, *In re Nat'l Gypsum Co.*, 118 F.3d 1056, 1071 (5th Cir. 1997) (affirmed bankruptcy court's denial of arbitration in suit to enforce Code — created right to enforce debtor's discharge under its confirmed Chapter 11 plan; arbitration would undermine Code in this kind of dispute).

4. More significant is the Second Circuit's decision in *MBNA*

America Bank v. Hill, 436 F.3d 104, 109 (2d Cir. 2006), where the court held that the bankruptcy judge lacked discretion in a core proceeding and could not deny enforcement of an arbitration clause in a pre-bankruptcy loan agreement. After the Chapter 7 debtor had received a discharge, she sued a lender in a putative class action, asserting the lender's willful violation of the automatic stay and seeking damages under Code § 362(h). The bankruptcy court, finding that it was the more appropriate forum, denied the lender's motion to compel arbitration. The district court affirmed, noting that arbitration would "seriously jeopardize the objectives of the Bankruptcy Code." *Id*. at 107.

Reversing, the Second Circuit explained that "arbitration of [the debtor's] claim would not seriously jeopardize the objectives of the Bankruptcy Code because (1) [the debtor's] estate has now been fully administered and the debts have been discharged, so she no longer requires protection of the automatic stay and resolution of the claim would have no effect on her bankruptcy estate; (2) as a purported class action, [the debtor's] claims lack the direct connection to her own bankruptcy case that would weigh in favor of refusing to compel arbitration; (3) a stay is not so closely related to an injunction that the bankruptcy court is uniquely unable to interpret and enforce its provisions." *Id*. at 109.

5. The Third Circuit has now apparently rejected the premise that enforcement of an arbitration clause turns on whether the proceeding is core or non-core. *In re Mintze*, 434 F.3d 222 (3d Cir. 2006). The issue in *Mintze*, said the court, was whether the party opposing arbitration can establish a statutory intention to preclude that procedure.

A lender in *Mintze* filed a claim in the debtor's Chapter 13 case. The debtor then sued the lender, alleging that it had induced her to enter into an illegal home equity loan resulting in a mortgage on her home. She sought to rescind the mortgage under the Federal Truth In Lending Act, plus other state and federal consumer protection laws. The lender moved to compel arbitration based on an arbitration clause in its loan agreement. Because the matter was admittedly core, the bankruptcy core denied arbitration, reasoning that rescission of the mortgage would affect the debtor's Chapter 13 plan and any distribution to other creditors.

The Third Circuit disagreed, finding no inherent conflict between the Code's purposes and the Arbitration Act, and reasoning that the debtor's statutory claims were based on state or federal consumer protection laws, but not on any claims under the Code. "With no bankruptcy issue to be decided by the bankruptcy court, we cannot find an inherent conflict between arbitration of *Mintze's* federal and state consumer protection issues and the underlying purposes of the Bankruptcy Code." *Id*. at 231-32.

6. The bankruptcy/arbitration case law is thus unpredictable, making litigation costly and time-consuming, particularly when two rounds of appeals are considered. Even if courts were to agree on one consistent approach, parties would still retain their appellate rights. *See generally* Alan N. Resnick, "The Enforceability of Arbitration Clauses in Bankruptcy," 15 *Am. Bankr. Inst. L. Rev.*, 183, 214 (2007) ("Congress should adopt a general rule that contractual arbitration clauses are unenforceable in core proceedings, regardless of whether" the claims are derivative or intented to benefit creditors).

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