ALERTS

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, held the U.S. Court of Appeals for the Second Circuit on March 7, 2018. *In re Anderson*, 2018 U.S. App. LEXIS 5703, *20 (2d Cir. March 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 for lenders in business reorganization cases when they have bargained for arbitration agreements.

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). As the Court stressed,

"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 "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). 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. *Accord*, *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011); *American Express Co. v. Italian Colors Restaurant*, 133 S. Ct. 2304, 2309-2310 (2013) (arbitration "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" Code, or "arising in or related to" bankruptcy cases). The bankruptcy jurisdiction scheme thus gives the bankruptcy judge discretion to determine whether a "core" proceeding 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. *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 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. 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. "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. As the Second Circuit stressed in *Hill*, 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. That agreement contained an arbitration clause providing for arbitration of any controversy or dispute, including those related to "credit reporting," "collections matters" as well as claims for "injunctive or declaratory relief." Also, the arbitrator hearing the case had to be an experienced lawyer or a "former judge who must apply applicable substantive law consistent with the Arbitration Act." That arbitrator could award a party damages or other relief provided for under applicable law.

Anderson defaulted on his credit card account and failed to repay the bank 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 under applicable law. Consistent with industry practice and 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. Following industry practice, the bank also told the credit reporting agencies that Anderson's debt had been charged off and sold to another lender.

Anderson filed a Chapter 7 bankruptcy petition two years later in the Southern District of New York, and shortly obtained a standard form discharge order. He told the bank of his bankruptcy discharge and asked it to direct the credit reporting agencies to remove from his credit report any notation that his loan had been charged off. Because the bank's charge-off was accurate, regardless of Anderson's bankruptcy discharge, the bank declined. Federal regulators overseeing credit providers do not expect a bank to update the current status of an account after selling it to a third party. Instead, the bank need only provide information to a credit bureau that the account has been sold.

Anderson obtained the re-opening of his bankruptcy case several months later. He then sued the bank on behalf of himself and a putative class, challenging the bank's credit reporting practices with respect to the charged off credit card debt that had been discharged in his bankruptcy case. Essentially, he alleged that by failing to furnish updates to the credit reporting agencies reflecting post-sale bankruptcy discharges on its

former credit card accounts, the bank intended to coerce payment on a discharged debt, purportedly violating the bankruptcy court's discharge injunction.

The bank moved for an order compelling arbitration of the debtor'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 also explained that the debtor's claims arose from a discharge injunction, an affirmative order of the bankruptcy court. It thus found 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 and injunction crafted by Congress and issued by the bankruptcy court 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, in the words of the court, requires continuing "supervision; and . . . the equitable powers of the bankruptcy court [are required] to enforce its own injunctions. . . ." *Id.* at *15.

First, reasoned the court, because of the primary importance of a bankruptcy discharge to the debtor, "arbitration of Anderson's claim presents an inherent conflict with the . . . Code." *Id.* at *15. Second, "Anderson's claims center on alleged violations of a discharge injunction that was still eligible for active enforcement." *Id.* at *16. To distinguish this case from its earlier decision in *Hill*, the court said that "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, reasoned the court, "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.

Third, the court said, a discharge injunction requires the "unique expertise" of the bankruptcy court "in interpreting its own injunctions and determining when they have been violated." *Id.* at *17. Only "the bankruptcy court . . . possesses the power and unique expertise to enforce" the discharge injunction. *Id.* at *18.

Finally, the court was not concerned with Anderson's class action. Although the class action issue was relevant in *Hill*, "the putative class members [in *Anderson*] are all allegedly victims of willful violations of the discharge injunction issued by the bankruptcy court . . . . [These debtors face] a continuing disruption of [their] ability to obtain their fresh starts." *Id.* at *20. Because the bankruptcy court, in the Second Circuit's view, considered "the conflicting policies," it had "properly" exercised its discretion. *Id.*

Comments

1. 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.

2. 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. 28 U.S.C. §§ 1334 (a) & (e). Congress gave bankruptcy courts non-exclusive jurisdiction over § 524 claims. 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 turns on whether the alleged act merely sought "to collect" a discharged debt. In *Anderson*, the arbitrator would be a lawyer or former judge.

3. Courts should "rigorously enforce" arbitration agreements according to their terms, consistent with the intent of Congress when it enacted the Arbitration Act. *Italian Colors,* 133 S.Ct. at 2309-10. This duty to enforce arbitration agreements is unflagging, and "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, enforceable pursuant to the" Arbitration Act); *McMahon*, 482 U.S. at 226 ("duty to enforce arbitration agreements is not diminished when a party bound by an agreement raises a claim founded on statutory rights"). In other words, the Arbitration Act requires courts to 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. *Mitsubishi Motors*, 473 U.S. at 634, 637 (enforced agreement to arbitrate claims brought under Sherman Anti-Trust Act, finding no evidence in text or legislative history of anti-trust laws evincing congressional intent to preclude arbitration of anti-trust claims; rejected notion that "fundamental importance" of anti-trust laws justified a departure from Arbitration Act; "so long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function"; no reason to "assume" that arbitration would not "provide an adequate mechanism" for enforcing

anti-trust laws; "absent such a showing," arbitration provision had to be enforced; "we decline to indulge the presumption that the parties and arbitral body conducting a proceeding will be unable or unwilling to retain competent, conscientious and impartial arbitrators."); *Gilmer*, 500 U.S. at 24-25, 27-30 (enforced agreement to arbitrate claims brought under Age Discrimination Employment Act ("ADEA"); neither text nor legislative history evinced congressional intent to preclude waiver of judicial remedies; "Congress . . . did not explicitly preclude arbitration or other nonjudicial resolution of claims, even in its recent amendments"; "arbitration is consistent with Congress' grant of concurrent jurisdiction over ADEA claims to state and federal courts"; no "inherent conflict" between arbitration and ADEA's underlying purposes; although ADEA designed to "further important social policies," no "inherent inconsistency between those policies . . . and enforcing agreements to arbitrate age discrimination claims"; the Court also peremptorily rejected unsubstantiated "challenges to the adequacy of arbitration procedures" — including, the competency of arbitrators and availability of equitable relief in arbitration — explaining that "[s]uch generalized attacks on arbitration 'res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants,' and, as such, they are 'far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.'"); *Greentree Fin'l Corp – Alabama v. Randolph*, 531 U.S. 79, 90-91 (2000) (claims under Truth in Lending Act and Equal Credit Opportunity Act held arbitrable; refused to invalidate arbitration agreement); *Compu Credit Corp. v. Greenwood*, 132 S. Ct. 665, 672 (2012) (claims under Credit Repair Organizations Act held arbitrable; neither text nor legislative history showed intent to override Arbitration Act).

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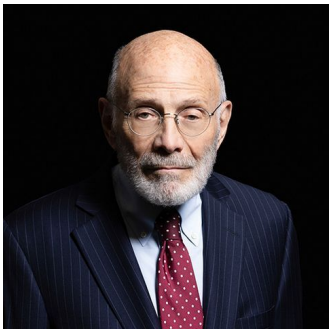

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