AMERICAN BANKRUPTCY INSTITUTE

2019 Winter Leadership Conference

The Intersection of the Federal Arbitration Act and the Bankruptcy Code: Whose Discretion Is It, and What Does It Mean to the Future of Bankruptcy?

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CONCURRENT SESSION

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ABI Winter Leadership Conference 2019: Intersection of Bankruptcy and Arbitration

I. The Tension Between the FAA and the Bankruptcy Code

The Federal Arbitration Act (FAA) directs courts to stay proceedings that are subject to agreements to arbitrate, "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2.

28 U.S.C. § 157(b) states that "bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11, or arising in a case under title 11. . . ."

Recent Supreme Court decisions have thrown into question the extent to which bankruptcy courts must enforce agreements to arbitrate claims and other issues, even where such issues are core bankruptcy issues.

II. Prior to these Recent Supreme Court Cases, Circuits Agreed That a Conflict with the Bankruptcy Code's Purposes Could Override an Arbitration Provision

Although the circuits that have looked at the question differ on the extent to which core claims may or may not be arbitrable, all of the circuits agreed that, under *Shearson/Am. Express, Inc. v McMahon*, bankruptcy courts had some discretion in denying arbitration on the basis that arbitration of a claim would conflict with the purposes of the Bankruptcy Code.

Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987)

- Prior to the Supreme Court's decisions of the past 14 months, lower courts had been guided by the framework set forth in *McMahon*, which examined whether claims brought under the Securities Act of 1934 and the Racketeer Influenced Corrupt Organization Act (RICO) were outside of the purview of the FAA.

- The *McMahon* Court found that, while "[t]he Arbitration Act, standing alone, . . . mandates enforcement of agreements to arbitrate statutory claims," that mandate "may be overridden by a contrary congressional command." *Id.* at 226.

- The Court identified three ways that such a contrary congressional command could be determined: (1) the text of the statute, (2) the legislative history, or (3) "the statute's underlying purposes." *Id.* at 227.

Since *McMahon*, at least five circuits have looked to *McMahon* to determine whether arbitration agreements were enforceable in bankruptcy cases. All of them agree that, as to non-core proceedings, arbitration agreements are enforceable, but the courts have developed tests for evaluating whether arbitration of core proceedings may conflict with the Bankruptcy Code's underlying purposes under *McMahon*.

A. Second Circuit

U.S. Lines, Inc. v. Am. Steamship Owners Mut. Prot. & Indem. Assoc., Inc. (In re U.S. Lines, Inc.), 197 F.3d 631, 641 (2d Cir. 1999)

- Affirmed denial of arbitration of declaratory judgment action regarding amounts payable under insurance contracts.

- "Where the bankruptcy court has properly considered the conflicting policies in accordance with law, we acknowledge its exercise of discretion and show due deference to its determination that arbitration will seriously jeopardize a particular core bankruptcy proceeding."

MBNA America Bank, N.A. v. Hill, 436 F.3d 104, 108 (2d Cir. 2006)

- "[E]ven as to core proceedings, the bankruptcy court will not have discretion to override an arbitration agreement unless it finds (1) that the proceedings are based on provisions of the Bankruptcy Code that 'inherently conflict' with the Arbitration Act or (2) that arbitration of the claim would 'necessarily jeopardize' the objectives of the Bankruptcy Code." (reversing denial of arbitration of debtor claim against creditor-bank for willful violation of automatic stay).

B. Third Circuit

Mintze v. Am. Gen. Fin. Svcs, Inc. (In re Mintze), 434 F.3d 222, 231-32 (3d Cir. 2006)

- The *McMahon* standard "requires congressional intent 'to preclude a waiver of judicial remedies for the statutory rights at issue.'"

- Found arbitration agreement enforceable with respect to rescission claim on prepetition loan agreement where debtor "failed to raise any statutory claims that were created by the Bankruptcy Code."

C. Fourth Circuit

Moses v. CashCall, Inc., 781 F.3d 63, 84 (4th Cir. 2015) (J. Gregory, concurring)

- As to core matters, "the discretion to deny arbitration should be limited to cases where arbitration would 'substantially interfere with the debtor's efforts to reorganize.'"

- Reversed denial of arbitration of debtor's non-core money damages counterclaim.

- "[S]ubstantial interference occurs when the resolution of the claim will necessarily effect reorganization in a significant way, and arbitration will thus inherently conflict with the purposes of [the] Bankruptcy Code."

D. Fifth Circuit

Gandy v. Gandy (In re Gandy), 299 F.3d 489, 495 (5th Cir. 2002)

- Affirmed denial of arbitration of avoidance claims.
- "A bankruptcy court does possess discretion . . . to refuse to enforce an otherwise applicable arbitration agreement when the underlying nature of a proceeding derives exclusively from the provisions of the Bankruptcy Code and the arbitration of the proceeding conflicts with the purpose of the Code." (emphasis added)
- That is, courts may deny arbitration of core claims if such claims are derived from bankruptcy rights created by the Bankruptcy Code.

E. Ninth Circuit

Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir. 2012)

- "Even in a core proceeding, the *McMahon* standard must be met – that is, a bankruptcy court has discretion to decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code." *Id.* at 1021 (emphasis added).
- The Court agreed that the alleged breaches of the settlement agreement were "'inextricably intertwined' with [Thorpe's] bankruptcy." The Court found a conflict between arbitration here and the underlying purposes of the Bankruptcy Code: "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."

See also:

- *Ackerman v. Eber (In re Eber)*, 687 F.3d 1123, 1131 (9th Cir. 2012) (arbitration of whether prepetition claims were dischargeable "would conflict with important bankruptcy principles").
- *In re EPD Inv. Co., LLC*, 821 F.3d 1146, 1150 (9th Cir. 2016) (arbitration of trustee's fraudulent conveyance, subordination, and disallowance causes of action "conflicted with Bankruptcy Code purposes of having bankruptcy law issues decided by bankruptcy courts; of centralizing resolution of bankruptcy disputes; and of protecting parties from piecemeal litigation") (citing *Thorpe*, 671 F.3d at 1022-23).
- Recently (after the three Supreme Court decisions discussed below), a District Court affirmed a bankruptcy court decision denying a motion to compel arbitration. *Midland Funding LLC v. Thomas*, Civil Action No. 5:18-cv-00128 (W.D. Va. Aug. 13, 2019) (slip op.). The *Midland* court, following *McMahon*, held that claims of alleged violations of

Bankruptcy Rule 3001 would conflict with the purposes of the Bankruptcy Code because giving the arbitrator "authority over the claim-filing process would substantially interfere with plaintiffs' efforts to reorganize their financial affairs in bankruptcy." The court also held that the bankruptcy court retaining jurisdiction over the Fair Debt Collection Practices Act claims was appropriate because such claims "boil down to a determination of whether Midland has complied with the procedural rules governing bankruptcy proceedings."

III. Recent Arbitration Decisions of the Supreme Court

Epic Systems Corp. v. Lewis, 138 S. Ct. 1612 (May 21, 2018)

- Facts: Employers and employees entered into employment contracts that provided for individualized arbitration proceedings to resolve employment disputes between the parties. Employees attempted to bring class action proceedings under the Fair Labor Standards Act (FLSA), arguing that the National Labor Relations Act (NLRA) mandated that employees have the right to act collectively, and that such mandate took such agreements out of the purview of the FAA via the FAA's savings clause.

- Justice Gorsuch wrote the opinion on behalf of the 5-justice majority, finding that arbitration agreements in employment contracts limiting disputes to individualized arbitration were enforceable.

- The Court indicated its inclination to find "harmony over conflict in statutory interpretation" between, in this case, the FAA and the NLRA. *Id.* at 10.

- The Court rejected the employees' argument that the NLRA-created right to "engage in . . . concerted activities for the purpose of collective bargaining or other mutual aid or protection" extended to class action and other collective legal proceedings. *Id.* at 12.

- Rather, the Court noted that the NLRA did not speak specifically to class and collective action proceedings and held that the NLRA did not render agreements to procced by individualized arbitration unenforceable. *Id.* at 14.

Henry Schein, Inc. v. Archer & White Sales, Inc., 586 U.S. __ (Jan. 8, 2019)

- Facts: A dental equipment manufacturer sought to enforce an arbitration provision contained in its contract with its distributor, who had filed a complaint alleging violations of federal and state antitrust law that sought both money damages and injunctive relief. The contract excluded actions seeking injunctive relief from the arbitration provision. The District Court and the Fifth Circuit both agreed that the District Court could resolve the threshold question of arbitrability, without referring the matter to the arbitrator, where the argument for arbitration was "wholly groundless."

- In Justice Kavanaugh's first authored opinion from the Supreme Court bench, a unanimous Court held that, where parties had delegated not only the merits of a particular

dispute but also "'gateway' questions of arbitrability, such as whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy," federal courts could not impose a "wholly groundless" exception to the FAA whereby federal courts could "short-circuit the process and decide the arbitrability question themselves."

- The Court rejected respondent's argument that, "as a practical and policy matter, it would be a waste of the parties' time and money to send the arbitrability question to an arbitrator if the argument for arbitration is wholly groundless," on the grounds that the FAA contains no such "wholly groundless" exception. *Id.* at *7.

New Prime, Inc. v. Oliveira, No. 17-340, slip op. (Jan. 15, 2019)

- Facts: Interstate trucking company sought enforcement of a mandatory arbitration provision contained in an operating agreement with one of its drivers who filed a class action alleging that the trucking company denied its drivers lawful wages.

- *New Prime* provides an example of when the Supreme Court will find that a dispute or agreement to arbitrate falls outside the reach of the FAA: when the exception is clearly set forth in the Act itself. *New Prime*, authored by Justice Gorsuch, held that because section 1 of the FAA stated that "'nothing herein' may be used to compel arbitration in disputes involving the 'contracts of employment' of 'workers engaged in foreign or interstate commerce,'" the FAA did not give the district court authority to order arbitration on a dispute arising out of a dispute between an interstate trucking company and one of its drivers.

- Note that the Ninth Circuit, and other courts of appeal, have uniformly "found no evidence in the text of the Bankruptcy Code or in the legislative history suggesting that Congress intended to create an exception to the FAA in the Bankruptcy Code." *Ackerman v. Eber*, 687 F.3d at 1129.

IV. Selected Cases Since *Epic Systems*, *Henry Schein, Inc.*, and *New Prime*

After the three Supreme Court decisions discussed above, a District Court affirmed a bankruptcy court decision denying a motion to compel arbitration. *Midland Funding LLC v. Thomas*, Civil Action No. 5:18-cv-00128 (W.D. Va. Aug. 13, 2019) (slip op.). The *Midland* court, following *McMahon*, held that claims of alleged violations of Bankruptcy Rule 3001 would conflict with the purposes of the Bankruptcy Code because giving the arbitrator "authority over the claim-filing process would substantially interfere with plaintiffs' efforts to reorganize their financial affairs in bankruptcy." The court also held that the bankruptcy court retaining jurisdiction over the Fair Debt Collection Practices Act claims was appropriate because such claims "boil down to a determination of whether Midland has complied with the procedural rules governing bankruptcy proceedings."

On September 24, 2019, the Middle District of Florida's Judge Steven Merryday affirmed Bankruptcy Judge Roberta Colton holding that a Verizon consumer phone contract's arbitration provision would not be enforced in the face of a contempt motion brought in

the bankruptcy court by the debtor after receiving Verizon's collection letter, which letter was sent to the debtor after his discharge and without permission of the bankruptcy court. The District Court noted the cell phone contract's arbitration provision did not address such a scenario. Moreover, the bankruptcy court has the inherent authority to enforce bankruptcy discharge injunctions. ABI's Bill Rochelle addressed this case and supplied some thoughtful analysis in his October 2, 2019 Daily Wire.

V. Should *Epic Systems*, *Henry Schein, Inc.*, and *New Prime* Change Our Thinking About Arbitrability in Bankruptcy?

- Parties and appellate courts have tried to identify the federal statutes that may be exceptions to the Federal Arbitration Act:
  - Securities
  - Antitrust
  - RICO
  - NLRA
  - FLSA
- The Supreme Court has found all these statutory claims to be arbitrable, but it has not addressed bankruptcy.
- As Justice Gorsuch wrote in *Epic Systems*, "[i]n many cases over many years, this Court has heard and rejected efforts to conjure conflicts between the Arbitration Act and other federal statutes. In fact, this Court has rejected *every* such effort to date." *Epic Sys. Corp.,* 138 S. Ct. at *16 (emphasis in original).
- The Supreme Court has emphasized that the FAA promotes efficiency and respect for parties' contracts. *Epic Systems* at *8.
- There is a tension between the centralization of claims, which courts have found is a purpose of the Bankruptcy Code, and the decentralization of claims achieved through arbitration.
- In *Thorpe*, the Court outlined that the "purposes of the Bankruptcy Code include 'centralization of disputes concerning a debtor's legal obligations' and 'protecting creditors and reorganizing debtors from piecemeal litigation.'" 671 F.3d at 1022-23. Thus, the *Thorpe* court 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."
- The *Thorpe* court indicated that permitting separate arbitrations on different prepetition claims to proceed would "fracture the plan confirmation process" and cause a bankruptcy court to "lose control over the timing of the reorganization because it would not have control over the timing of the arbitrations." *Id.* at 1024.

- It is not clear that the Supreme Court would be persuaded by "[p]ragmatic concerns such as these" – which the *Thorpe* court found "pose a serious conflict between arbitration, normally a benign and efficient form of dispute resolution, and the underlying purposes of the Bankruptcy Code, which are tailored to the needs of debtors and creditors."

- What *Epic Systems* and *Henry Schein* make clear is that a conflict between the FAA and the purpose or spirit of a federal statute such as the Bankruptcy Code is not necessarily sufficient for a dispute under that federal statute to be taken out of the FAA's reach.