Bankruptcy Battleground: Even "Core" Disputes May Be Subject to Arbitration

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Whether an arbitration clause in a contract will be enforced by the bankruptcy courts in accordance with the Federal Arbitration Act (the "FAA") has been the focus of numerous court decisions in recent times. The consensus among most courts addressing the issue has been that a bankruptcy court can adjudicate a dispute otherwise subject to binding arbitration if the dispute falls within the court's "core" jurisdiction. Even so, rulings recently handed down by the Second and Third Circuit Courts of Appeal suggest that the scope of a bankruptcy court's retained discretion in this area may be even less broad than is generally understood. *MBNA America Bank, N.A. v. Hill* and *Mintze v. American General Financial Services Inc. (In re Mintze)* stand for the proposition that arbitration is the favored means of resolving disputes — even those that fall within the bankruptcy court's "core" jurisdiction.

The Federal Arbitration Act

The FAA provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." A court has the power to stay a proceeding if it determines that an issue is subject to arbitration. In addition, a court may order litigants to proceed to arbitration in the event that one or more parties to an arbitration agreement refuses to comply with it.

Congress declared a strong federal policy in favor of arbitration when it enacted the FAA. The FAA's mandate may be overridden, however, if a party opposing arbitration can demonstrate

that "Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." In *Shearson/Am. Exp., Inc. v. McMahon*, the Supreme Court ruled that such Congressional intent can be discerned in one of three ways: (i) the text of the statute; (ii) the statute's legislative history, or (iii) "an inherent conflict between arbitration and the statute's underlying purposes."

Arbitration in Bankruptcy Proceedings

When arbitration law meets bankruptcy law, an inherent conflict exists between two strong policies: the policy favoring enforcement of arbitration agreements and the policy favoring centralized resolution of disputes involving a debtor and its assets in the bankruptcy court. In the seminal case of *Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc.*, the Third Circuit Court of Appeals held that, confronted with claims falling within the scope of a pre-bankruptcy arbitration agreement, a bankruptcy court must enforce arbitration of "non-core" claims asserted by a trustee, unless the trustee can demonstrate that the purpose of the Bankruptcy Code somehow conflicts with enforcement of an arbitration clause.

A matter falls within a bankruptcy court's "core" jurisdiction if it either invokes a substantive right created by federal bankruptcy law or could not exist outside of a bankruptcy case. By contrast, "non-core" matters generally involve disputes that have only a tenuous relationship to a bankruptcy case and would in all likelihood have been litigated elsewhere but for the broad nexus created by the debtor's bankruptcy filing. If a dispute is core, a bankruptcy court can adjudicate it, subject to appeal. The court may also hear non-core disputes, provided they are "related" to the bankruptcy case, but must submit proposed findings to the district court for approval, unless the litigants agree otherwise. The distinction between core and non-core

matters is a crucial, yet not necessarily determinative, one in defining a bankruptcy court's discretion when confronting an arbitrable dispute.

In *In re National Gypsum Co*., the Fifth Circuit addressed whether a bankruptcy court should compel arbitration in "core" matters. According to the Court of Appeals, the core nature of a dispute is insufficient to create the kind of inherent conflict with the FAA that would permit a bankruptcy court to refuse to enforce an arbitration agreement. It ultimately ruled that if a cause of action arises entirely from rights conferred by the Bankruptcy Code (*i.e.*, is core), the bankruptcy court retains significant discretion to determine whether arbitration is inconsistent with the purposes of the Bankruptcy Code. The Second Circuit Court of Appeals subsequently followed this approach in a tandem of carefully reasoned decisions.

The Second and Third Circuits recently had an opportunity to reexamine the conflict between the Bankruptcy Code and the FAA in *MBNA America* and *Mintze*.

The Second Circuit's Ruling in *MBNA America*

Kathleen Hill maintained a bank account at MBNA America Bank, N.A. In 1999, she obtained an unsecured consumer loan from the bank. MBNA validly amended the credit account agreement governing the loan in 2000 to include a mandatory arbitration provision. After Hill began to fall behind in making payments on the loan, she authorized MBNA to debit her bank account directly each month.

Hill filed a chapter 7 petition in 2001. Although MBNA received notice of the filing and the existence of the automatic stay, it continued to withdraw funds from Hill's account to apply toward her debt. Hill sued MBNA in the bankruptcy court, claiming that MBNA willfully

violated the automatic stay and was unjustly enriched by its actions. She styled the litigation as a class action brought on behalf of herself as well as other similarly situated debtors.

MBNA sought to stay or dismiss the proceeding based upon the arbitration clause contained in Hill's credit account agreement. The bankruptcy court denied MBNA's motion, concluding that it was the "most appropriate forum to adjudicate the matter." MBNA appealed the ruling to the district court, which reversed in part. According to the district court, although the bankruptcy court did not abuse its discretion in refusing to dismiss or stay the litigation concerning Hill's core stay violation claims, it should not have denied arbitration of the unjust enrichment claim because it was "arbitrable and non-core." Hill, however, had agreed to abandon the unjust enrichment claim if it were held to be arbitrable. Even so, MBNA appealed the district court's ruling concerning the stay violation claims to the Second Circuit.

The Second Circuit reversed. It faulted the lower courts' conclusion that allowing arbitration to go forward "would seriously jeopardize the objectives of the [Bankruptcy] Code in light of the fact that the automatic stay serves the same function as an injunction." Hill's estate, the Second Circuit explained, had been fully administered so that she no longer needed the protection of the automatic stay, and resolution of her claim would have no impact on her estate. The court also noted that, as a purported class action, Hill's claims lacked the direct connection to her own bankruptcy case that would weigh in favor of refusing to compel arbitration.

Finally, the Second Circuit observed that a stay is not so "closely related to an injunction that the bankruptcy court is uniquely able to interpret and enforce its provisions." According to the court, although "the automatic stay is surely an important provision of the Bankruptcy Code, there is no indication from the statute that any dispute relating to an automatic stay should categorically be

exempt from resolution by arbitration." It accordingly reversed the rulings below and remanded the case with directions to grant MBNA's motion to stay the proceedings in favor of arbitration.

The Third Circuit's Ruling in *Mintze*

Ethel Mintze obtained a home equity loan from American General Consumer Discount Company ("AGF") in 2000. The loan bore an annual interest rate of just over 13 percent. The loan agreement contained an arbitration clause providing that "all claims and disputes arising out of, in connection with, or relating to [the] loan" must "be resolved by binding arbitration." Mintze filed a chapter 13 case in 2001 after falling behind on the payments.

After filing for bankruptcy, Mintze sued AGF, claiming that it induced her to enter into an illegal and abusive home equity loan. She sought rescission of AGF's mortgage under the Truth in Lending Act ("TILA") and asserted claims under various federal and state consumer protection laws. AGF responded by filing a motion to compel arbitration of the dispute. Noting that the parties had agreed that the dispute was core, the bankruptcy court determined that it had discretion to deny enforcement of the arbitration clause and ruled that it was best situated to resolve the dispute because resolution of the rescission claim would impact Mintze's chapter 13 plan and distributions to her creditors. The district court affirmed on appeal. AGF appealed to the Third Circuit.

The Third Circuit reversed. Examining whether a bankruptcy court has any discretion to adjudicate an arbitrable dispute, it rejected Mintze's argument that the rule of law articulated in *Hays* applies only to non-core proceedings. According to the court, *Hays* and other similar decisions indicate that the *McMahon* standard must be satisfied before a bankruptcy court has discretion to deny enforcement of an arbitration clause even in cases involving core disputes. In

other words, the party opposing arbitration is obligated to prove that there is an "inherent conflict between arbitration and the Bankruptcy Code" that manifests Congress' intent to preclude waiver of judicial remedies for the statutory rights at issue.

The Third Circuit ruled that no such conflict existed in the case before it. Mintze, the court explained, did not assert any statutory claims that were created by the Bankruptcy Code in her suit against AGF — her claims were based on the TILA and several federal and state consumer protection laws. With no bankruptcy issue to be decided in the litigation, the Third Circuit concluded that the bankruptcy court erred when it determined it had discretion to deny enforcement of the loan agreement's arbitration provision.

Outlook

MBNA America and *Mintze* do not represent a steep departure from prior case law determining under what circumstances a bankruptcy court retains the discretion to adjudicate arbitrable disputes. Non-core disputes that fall within the scope of an arbitration agreement clearly deprive the court of any discretion to refuse to defer to arbitration, and the fact that a dispute is core does not automatically mean that the court can adjudicate the dispute. Instead, the court must carefully examine the nature of the dispute to determine whether its resolution by an arbitrator would seriously undermine the objectives of the Bankruptcy Code.

Even so, we are left to consider what kinds of core proceedings satisfy that standard. *MBNA America* indicates that claims based upon violations of the automatic stay do not, largely because they involve the interpretation and enforcement of a statute, and "[a]rbitration is presumptively an appropriate and competent forum for federal statutory claims." Many kinds of core proceedings, however, arguably fall into the same category. For example, avoidance causes of

actions are adjudicated in accordance with rules expressly spelled out in the Bankruptcy Code. In addition, something as basic to the administration of the bankruptcy estate as determining the allowed amount of a creditor's claim generally does not require application of substantive bankruptcy law. Time will tell whether courts will rely on these precedents to remove a broad range of core matters from the centralized forum of the bankruptcy courts to be resolved in piecemeal arbitration proceedings.

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

Mintze v. American General Financial Services Inc. (In re Mintze), 434 F.3d 222 (3d Cir. 2006).

Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 227 (1987).

Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989).

In re National Gypsum Co., 118 F.3d 1056 (5th Cir. 1997).

Crysen/Montenay Energy Co. v. Shell Oil Co. and Scallop Petroleum Co. (In re Crysen/Montenay Energy Co.), 226 F.3d 160 (2d Cir. 2000), *cert. denied*, 532 U.S. 920 (2001).

United States Lines, Inc. v. American S.S. Owners Mut. Prot. & Indem. Ass'n, Inc. (In re United States Lines, Inc.), 197 F.3d 631 (2d Cir. 1999), *cert. denied*, 529 U.S. 1038 (2000).