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## An International Approach to Breaking the Core of the Bankruptcy Code and FAA Conflict

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# AN INTERNATIONAL APPROACH TO BREAKING THE CORE OF THE BANKRUPTCY CODE AND FAA CONFLICT

## INTRODUCTION

Arbitration has become the resolution method of choice for parties in international business transactions over the past decade. Arbitration's popularity is evident today with an increase of cases at major arbitral institutions, such as the International Chamber of Commerce's International Court of Arbitration, which received 599 requests for arbitrations in 2007, an almost twenty-fold increase in the past fifty years.<sup>1</sup> Additionally, a survey of eighty-two large corporations found that 88% of corporate counsel have used arbitration at least once, with 38% of the disputes arising from commercial transactions.<sup>2</sup> Businesses gravitate towards arbitration because of its ability to provide "a neutral, speedy[,] and expert dispute resolution process, largely subject to the parties' control, in a single, centralized forum, with internationally-enforceable dispute resolution agreements and decisions."<sup>3</sup> These features are viewed as promoting cost mitigation,<sup>4</sup> something parties are extremely sensitive to in this economy.

Commercial arbitration has roots in the Antiquity period of Greece and other prominent civilizations.<sup>5</sup> The practice continued to develop throughout Europe's history,<sup>6</sup> and "[c]onsistent with America's role in the development of state-to-state arbitration in the eighteenth century, arbitration was widely used to resolve commercial (and other) disputes during Colonial times and the early

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<sup>1</sup> See 1 GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION 69 (2009). In 2007, a total of 3,235 arbitration cases were filed amongst the various arbitral institutions, up 132% from 1993. *Id.*

<sup>2</sup> PRICEWATERHOUSECOOPERS, INTERNATIONAL ARBITRATION: CORPORATE ATTITUDES AND PRACTICES 2008, at 2, 5 (2008), available at [http://www.pwc.co.uk/eng/publications/international\\_arbitration\\_2008.html](http://www.pwc.co.uk/eng/publications/international_arbitration_2008.html).

<sup>3</sup> 1 BORN, *supra* note 1, at 71.

<sup>4</sup> *Id.* at 84 ("It has long been said that arbitration offers a cheaper, quicker means of dispute resolution than national court proceedings.").

<sup>5</sup> GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION: CASES AND MATERIALS 10 (2011). ("Archaeological research reports that clay tablets from contemporary Iraq recite a dispute between one Tulpunnaya and her neighbor, Killi, over water rights in a village near Kirkuk, which was resolved by arbitration (with Tulpunnaya being awarded ten silver shekels and an ox) . . . Arbitration was no less common in ancient Greece for the resolution of commercial and other 'private' disputes than for state-to-state disputes.").

<sup>6</sup> *Id.* at 13–20, 25–26 (noting the development of arbitration in Europe from the Middle Ages through the early twentieth century).

years of the Republic.”<sup>7</sup> However, during the nineteenth century, judges would ordinarily refuse to recognize arbitration agreements because of “concern[s] about private agreements ‘ousting’ the courts of jurisdiction, skepticism about the adequacy and fairness of the arbitral process[,] and suspicions that arbitration agreements were often the product of unequal bargaining power.”<sup>8</sup> The Federal Arbitration Act (FAA) was enacted in 1925 to govern arbitrations and enforcement actions in the United States,<sup>9</sup> with the specific objective to eliminate any judicial interference in the enforcement of such agreements.<sup>10</sup> This new federal statute was ardently supported by the business community, which had lobbied hard for arbitration reform.<sup>11</sup> Despite the FAA, courts were hesitant to embrace arbitration agreements, highlighted best by the Supreme Court’s decision in *Wilko v. Swan*, which declined to enforce an arbitration agreement in a securities fraud action under the Securities Act of 1933.<sup>12</sup>

The enforceability of arbitration agreements in international commercial contracts was formally established when the United States agreed to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) in 1970.<sup>13</sup> By the 1970s, the Supreme Court was ready to reverse its negative stance on arbitration, starting with *Scherk v. Alberto-Culver Co.*, which held the international arbitration agreement enforceable for a claim under the Securities Exchange Act of 1934 brought by a German party against an American party.<sup>14</sup> Next, in *Mitsubishi Motors Corp.*

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<sup>7</sup> *Id.* at 20.

<sup>8</sup> 1 BORN, *supra* note 1, at 133.

<sup>9</sup> See Federal Arbitration Act, Pub. L. No. 68-401, 43 Stat. 883, 883 (1925) (“An Act To make valid and enforceable written provisions or agreements for arbitration of disputes arising out of contracts, maritime transactions, or commerce among the States or Territories or with foreign nations.”).

<sup>10</sup> See Paul F. Kirgis, *Arbitration, Bankruptcy, and Public Policy: A Contractarian Analysis*, 17 AM. BANKR. INST. L. REV. 503, 511 (2009) (defining the three primary goals of the FAA as: (1) making agreements to arbitrate enforceable, (2) enforcing arbitral awards, and (3) making awards final by limiting judicial review).

<sup>11</sup> 1 BORN, *supra* note 1, at 133. The business community viewed litigation as “expensive, slow and unreliable,” which led New York to enact an arbitration statute in 1920 recognizing the enforceability of arbitration agreements in New York courts. *Id.*

<sup>12</sup> *Wilko v. Swan*, 346 U.S. 427, 435–38 (1953), *overruled by* *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477 (1989); *see also* Kirgis, *supra* note 10, at 512 (“The [*Wilko*] Court focused on the inadequacy of arbitration as a substitute for formal adjudication.”).

<sup>13</sup> See Lindsay Biesterfeld, Note, *Parties to International Commercial Arbitration Agreements Beware: Bankruptcy Trumps Supreme Court Precedent Favoring Arbitration of International Disputes*, 2006 J. DISP. RESOL. 273, 279. “Congress incorporated the Convention into the United States Arbitration Act. The United States Arbitration Act requires the courts to recognize and enforce arbitration agreements between parties to an international commercial contract.” *Id.* at 279–80 (footnote omitted).

<sup>14</sup> *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 508–09, 519–20 (1974); *see also* Fred Neufeld, *Enforcement of Contractual Arbitration Agreements Under the Bankruptcy Code*, 65 AM. BANKR. L.J. 525, 532 (1991). *Scherk* did not overrule *Wilko*, but the Supreme Court noted “that the refusal to enforce arbitration

*v. Soler Chrysler-Plymouth, Inc.*, the Supreme Court expanded the enforceability of international commercial arbitration clauses to actions alleging violation of the Sherman Act.<sup>15</sup> In *Shearson/American Express, Inc. v. McMahon*, the Court found no congressional intent to impede arbitration in claims under both RICO and the 1934 Securities Act.<sup>16</sup> Lastly, the Supreme Court overruled *Wilko* in *Rodriguez de Quijas v. Shearson/American Express, Inc.*, expressing that *Wilko* “was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions.”<sup>17</sup> These decisions are the key to gleaning insight into whether the Supreme Court would enforce arbitration in bankruptcy, given that “[t]he four statutory areas that federal appellate courts [had] carved out as exceptions to the Arbitration Act [were] securities law, antitrust law, RICO, and bankruptcy law.”<sup>18</sup> At the same time that the Supreme Court was adopting “a radically pro-arbitration agenda,”<sup>19</sup> Congress was making large substantive changes to the federal bankruptcy law.<sup>20</sup>

The National Bankruptcy Act of 1898 created the first modern and permanent uniform bankruptcy law and bankruptcy courts.<sup>21</sup> However, the bankruptcy courts had limited jurisdiction and were only able to address issues involving case administration, the debtor’s property, other areas allowed by the 1898 Act, or where the parties had consented to the court’s jurisdiction; all other disputes were decided by either state or district courts.<sup>22</sup> This resulted in

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clauses in international agreements ‘would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international agreements.’” Neufeld, *supra*, at 532–33 (quoting *Scherk*, 417 U.S. at 517).

<sup>15</sup> *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 636–40 (1985); *see also* Neufeld, *supra* note 14, at 535.

<sup>16</sup> *See Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 238, 242 (1987); *see also* Neufeld, *supra* note 14, at 537 (“Regarding the 1934 Act claims, the Court said that *Wilko v. Swan* only made sense at a time when arbitration was seen as inadequate to enforce the statutory rights afforded by the federal securities laws.”).

<sup>17</sup> *Rodriguez de Quijas*, 490 U.S. at 484–85; *see also* Neufeld, *supra* note 14, at 537–38.

<sup>18</sup> Neufeld, *supra* note 14, at 535. Thus, bankruptcy is the only exception that the Supreme Court has yet to address.

<sup>19</sup> Kirgis, *supra* note 10, at 512.

<sup>20</sup> *See* Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (codified as amended at 11 U.S.C. §§ 101–1330 (2006)).

<sup>21</sup> Patrick M. Birney, L.L.M. Thesis, *Reawakening Section 1334: Resolving the Conflict Between Bankruptcy and Arbitration Through an Abstention Analysis*, 16 AM. BANKR. INST. L. REV. 619, 640 (2008); *see also* Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978).

<sup>22</sup> Birney, *supra* note 21, at 641.

an inefficient and costly adjudication process,<sup>23</sup> which was finally resolved by the Bankruptcy Reform Act of 1978. The Bankruptcy Code originally granted bankruptcy courts jurisdiction over all proceedings, whether arising under or related to the Code.<sup>24</sup> There was, however, one shortcoming: the Bankruptcy Reform Act did not grant the newly created bankruptcy judges Article III status.<sup>25</sup> This omission led to a major setback when the Supreme Court in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.* held that non-Article III judges could not rule upon state-created rights, effectively repealing the 1978 Bankruptcy Code's extensive jurisdiction over bankruptcy proceedings.<sup>26</sup>

Congress took action after the *Marathon* ruling to draft a new amendment protecting the Bankruptcy Code's comprehensive jurisdiction over bankruptcy proceedings.<sup>27</sup> One proposal was to give the bankruptcy judges Article III status, but the majority of legislators worried that this would violate the doctrine of federalism.<sup>28</sup> Instead, Congress addressed the issue in the 1984 Amendments to the Bankruptcy Code by granting bankruptcy courts "original and exclusive" jurisdiction over bankruptcy cases and original, but not exclusive, jurisdiction over civil cases arising under or related to the Code.<sup>29</sup> Essentially, this created a two-tier structure: for bankruptcy actions, bankruptcy courts may enter judgments arising under the Code, but for actions only related to the Code, "bankruptcy court[s] may make only proposed findings of fact and conclusions of law, to be submitted to the district court for it to enter orders or judgments," unless the parties consent otherwise.<sup>30</sup> The former are known as "core" proceedings while the latter "noncore"

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<sup>23</sup> See Mette H. Kurth, Comment, *An Unstoppable Mandate and an Immovable Policy: The Arbitration Act and the Bankruptcy Code Collide*, 43 UCLA L. REV. 999, 1007 (1996) ("The distinction between summary and plenary proceedings was vague, and parties frequently litigated the issue. If the court determined that a proceeding was plenary, it would have to be heard by a district court. The resulting protracted litigation and bifurcated proceedings imposed costly delays on bankruptcy cases.").

<sup>24</sup> Bankruptcy Reform Act § 241(a), 92 Stat. at 2668–69, *invalidated by* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982); Kurth, *supra* note 23, at 1007–08.

<sup>25</sup> Birney, *supra* note 21, at 645 ("The 1978 Bankruptcy Act did not confer Article III status on the bankruptcy judges because they were not accorded life tenure.").

<sup>26</sup> *Id.* (citing *Marathon Pipe Line*, 458 U.S. at 87).

<sup>27</sup> Kurth, *supra* note 23, at 1008.

<sup>28</sup> *Id.*

<sup>29</sup> Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 101(a), 98 Stat. 333, 333 (codified at 28 U.S.C. § 1334(a)–(b) (2006)); Kurth, *supra* note 23, at 1008–09.

<sup>30</sup> See Kirgis, *supra* note 10, at 510; *see also* 28 U.S.C. § 157(b)–(c), *invalidated as applied in* Stern v. Marshall, 131 S. Ct. 2594 (2011).

proceedings.<sup>31</sup> Because core proceedings have never been exclusively defined, bankruptcy courts have wide discretion in this determination, ultimately affecting which court has jurisdiction over the proceeding.<sup>32</sup>

Due to the nature of recent transactional disputes, businesses are not only filing more frequently for arbitration, but also for bankruptcy,<sup>33</sup> making the collision between arbitration agreements and the Bankruptcy Code recurrent and prominent. For instance, arbitration calls for the dispute to be settled by a separate tribunal whereas a bankruptcy proceeding demands that all of the debtor's disputes be centralized.<sup>34</sup> Because the Supreme Court has yet to consider the enforceability of arbitration agreements in bankruptcy proceedings, the circuit courts have been left to interpret this issue.<sup>35</sup> While the circuit courts have applied some rules consistently, others are left purely to the court's discretion, creating a split in interpretations.<sup>36</sup>

This Note will focus on the enforceability of arbitration clauses in bankruptcy proceedings under the FAA, New York Convention, and chapter 11 of the Bankruptcy Code, using international approaches as support. It will begin by identifying the current foundational analyses used in this controversial area and explaining why arbitration agreements should not always be enforced in core bankruptcy proceedings in Part I. Next, the Note will outline in Part II why the current regime is flawed and in need of an overhaul. Lastly, the Note will recommend in Part III a viable solution that is in the best interests of the parties, FAA, and Bankruptcy Code.

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<sup>31</sup> See 28 U.S.C. § 157(b) (full nonexclusive list of core proceedings); Kirgis, *supra* note 10, at 510 (“Section 157(b)(2) [. . .] gives a nonexclusive list of the matters considered core proceedings, including objections to a creditor's proof of claim, preference actions, counterclaims against persons filing claims against the estate, and challenges to the automatic stay or to the discharge of debts. Matters that do not raise bankruptcy issues, such as breach of contract or fraud actions brought on behalf of the debtor by a [t]rustee against a third-party, are considered noncore proceedings.” (footnote omitted)).

<sup>32</sup> See Matthew Dameron, Note, *Stop the Stay: Interrupting Bankruptcy To Conduct Arbitration*, 2001 J. DISP. RESOL. 337, 340 (“The effect of the core and non-core distinction in the arbitration context is that a bankruptcy judge has exclusive jurisdiction over the issue if it is a core proceeding.”).

<sup>33</sup> See *U.S. Bankruptcy Courts—Bankruptcy Cases Commenced, Terminated and Pending During the 12-Month Periods Ending March 31, 2010 and 2011*, U.S. COURTS, [www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2011/0311\\_f.pdf](http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2011/0311_f.pdf) (noting that bankruptcy filings have increased overall from March 2010 to March 2011 by 2.6%, from 1,531,997 to 1,571,183, and pending cases have increased by 3.7% during that same period, from 1,596,990 to 1,656,179).

<sup>34</sup> See *infra* Part I.B.

<sup>35</sup> Kirgis, *supra* note 10, at 517.

<sup>36</sup> See *id.* at 517–18.

## I. IF IT AIN'T BROKE, DON'T FIX IT: WHY CORE BANKRUPTCY PROCEEDINGS SHOULD NOT ALWAYS BE COMPELLED TO ARBITRATE

### A. *Enforcing Arbitration in Bankruptcy Proceedings Today*

Bankruptcy law has two overarching goals: to provide a debtor with a “fresh start” and to provide creditors with “an equitable distribution of the debtor’s nonexempt assets.”<sup>37</sup> Once a debtor files for bankruptcy, the court imposes an automatic stay to halt any other judicial proceedings against the debtor or the debtor’s property.<sup>38</sup> The stay benefits debtors by giving them time to organize their finances and benefits creditors by protecting their interests in repayment.<sup>39</sup> Both courts and legislative history have indicated that the automatic stay applies to arbitration proceedings, notwithstanding certain situations where the automatic stay may be lifted.<sup>40</sup> Once the automatic stay is implemented, a creditor must file a proof of claim with the bankruptcy court to recover their losses.<sup>41</sup> However, if a party wishes to continue with its claims against the debtor outside of bankruptcy, including any arbitrable claims the creditor may have, it must file a petition with the bankruptcy court to lift the stay.<sup>42</sup> The court may lift the stay for cause,<sup>43</sup> if the party requesting exclusion from the stay meets the required burden of proof and provides a cause.<sup>44</sup> It is important to note that the automatic stay does not apply if the debtor is the plaintiff, which allows the parties to pursue arbitration.<sup>45</sup> It is the determination of when an automatic stay should be lifted when the debtor is the defendant that is difficult.

The courts have fashioned various methods for determining when a court should consider lifting the stay and allowing arbitration to be compelled, but

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<sup>37</sup> *Id.* at 505 (“Bankruptcy creates a process in which creditors as a group can receive the highest possible return, while ensuring that no creditor benefits unfairly at the expense of others.”).

<sup>38</sup> 11 U.S.C. § 362 (2006) (describing how the automatic stay functions); Kirgis, *supra* note 10, at 505 (“The automatic stay forecloses any attempt to collect on a pre-petition debt, the pursuit of any lawsuit to collect a debt, the repossession of the debtor’s assets, as well as virtually any other action that would allow a creditor to improve its position with respect to other creditors.”).

<sup>39</sup> Dameron, *supra* note 32, at 338.

<sup>40</sup> *Id.* at 338–39 (“Some of the exceptions to the automatic stay include criminal proceedings, actions to establish paternity, and proceedings to modify or establish child support or maintenance.”).

<sup>41</sup> Kirgis, *supra* note 10, at 505–06.

<sup>42</sup> 11 U.S.C. § 362(c)–(d); *see also* Dameron, *supra* note 32, at 339.

<sup>43</sup> 11 U.S.C. § 362(d)(1).

<sup>44</sup> *Id.* § 362(d)(1), (g).

<sup>45</sup> Kurth, *supra* note 23, at 1015; *see also* 11 U.S.C. § 362(a) (stopping only actions against the debtor, the “property of the debtor,” or the “property of the estate”).

there are two general methods that seem to take precedence. In the first, some courts consider the matter left entirely to the bankruptcy court's "sound discretion," leaving it to conduct a factor-based analysis appraising the competing interests of the FAA and the Bankruptcy Code.<sup>46</sup> Many courts at present, however, use the second: determining initially whether the matter touches upon a core or noncore matter, and then appraising whether there is an inherent conflict between arbitration and the Bankruptcy Code.<sup>47</sup> The rest of this section will focus on this second test.

In *McMahon*, the Supreme Court took the pivotal step of providing a framework (the "*McMahon* test") to determine when a claim arising under a federal statute is nonarbitrable.<sup>48</sup> In the *McMahon* test,

a party claiming that an agreement to arbitrate a statutory claim is not enforceable must prove [c]ongressional intent to make an exception to the FAA from either 1) the text of the statute, 2) the legislative history of the statute, or 3) an inherent conflict between arbitration and the purposes of the statute.<sup>49</sup>

*Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* was the first case to apply the *McMahon* test to determine the enforceability of an arbitration agreement in a noncore bankruptcy proceeding.<sup>50</sup> The Third Circuit held that because bankruptcy courts do not have exclusive jurisdiction over noncore proceedings, there is no inherent conflict, and thus arbitration agreements are enforceable in noncore proceedings.<sup>51</sup> Once a bankruptcy proceeding has been

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<sup>46</sup> See, e.g., *Wm. S. Newman Brewing Co. v. C. Schmidt & Sons, Inc.* (*In re Wm. S. Newman Brewing Co.*), 87 B.R. 236, 241 (Bankr. N.D.N.Y. 1988) (using factors related to the value of arbitration versus adjudication by a court of law); see also Kurth, *supra* note 23, at 1017–19 (listing cases leaving the issue to the "sound discretion" of the bankruptcy courts); *infra* Part II.A.2.

<sup>47</sup> See, e.g., Kirgis, *supra* note 10, at 517–20 (noting, and criticizing, the "current framework" of focusing on the core/noncore distinction and the use of the *McMahon* test).

<sup>48</sup> See Kirgis, *supra* note 10, at 518–19; see also *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226–27 (1987) ("The Arbitration Act, standing alone, therefore mandates enforcement of agreements to arbitrate statutory claims. Like any statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command. The burden is on the party opposing arbitration, however, to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue. If Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent 'will be deducible from [the statute's] text or legislative history,' or from an inherent conflict between arbitration and the statute's underlying purposes." (citations omitted)).

<sup>49</sup> Biesterfeld, *supra* note 13, at 281. Most cases will be examined under the inherent/irreconcilable prong of the *McMahon* test. *Id.* at 281.

<sup>50</sup> *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1156 (3d Cir. 1989); Biesterfeld, *supra* note 13, at 281.

<sup>51</sup> See *Hays & Co.*, 885 F.2d at 1157–58; see also Biesterfeld, *supra* note 13, at 282. In any case, absent the consent of the parties, the determinations of the bankruptcy courts of noncore claims would need to be

determined as noncore, arbitration agreements are likely to be enforced, because the court will lift the automatic stay.<sup>52</sup>

As for core bankruptcy proceedings, the *McMahon* test—and specifically its third prong requiring an inherent conflict to avoid enforcement—is the usual standard that courts use to determine the enforceability of arbitration clauses.<sup>53</sup> Nevertheless, interpretations differ. “The Third and Fifth Circuits have held that a bankruptcy court has discretion to refuse to enforce an arbitration clause if the proceedings are based on the Bankruptcy Code provisions and arbitration would inherently conflict with the purposes of the Code.”<sup>54</sup> The Second and Fourth Circuits have gone a step further and added that arbitration agreements are also unenforceable if they would “necessarily jeopardize the objectives of the Bankruptcy Code.”<sup>55</sup> Many lower courts distinguish core cases based on whether the debtor or the trustee is pursuing or resisting the enforcement of the arbitration clause.<sup>56</sup> Whatever the method, arbitration agreements face an uphill battle for enforcement if they touch upon a core matter.<sup>57</sup>

### B. Centralized Claims

“The federal bankruptcy statutory scheme permits the modification of the rights of debtors and creditors, and one purpose of its structure is to centralize

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reviewed by the district courts. *See* 28 U.S.C. § 157(c) (2006). This is because “[n]oncore claims do not rest on substantive rights created by bankruptcy [l]aw . . . Accordingly, [bankruptcy judges] have no discretion to refuse to compel arbitration if a district court judge could not refuse to compel arbitration when hearing the same claims in a nonbankruptcy context.” Kirgis, *supra* note 10, at 517–18.

<sup>52</sup> *See* Biesterfeld, *supra* note 13, at 282 (“[V]irtually every circuit agrees with the underlying premise of *Hays* that once a proceeding is classified as non-core, the likelihood of avoiding enforcement of an arbitration agreement under the *McMahon* test significantly decreases.”).

<sup>53</sup> *See, e.g.*, *Mintze v. Am. Gen. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222, 231 (3d Cir. 2006); *Gandy v. Gandy (In re Gandy)*, 299 F.3d 489, 495 (5th Cir. 2002); *see also* Kirgis, *supra* note 10, at 519 (“Lower courts in bankruptcy cases have used the *McMahon* language to create a test for when a court has discretion to refuse to enforce an arbitration clause to a core claim in bankruptcy. They treat the question as one of a clash between the FAA and the Bankruptcy Code, and purport to determine whether Congress intended to preclude arbitration of core matters.”).

<sup>54</sup> Kirgis, *supra* note 10, at 519.

<sup>55</sup> *See id.* at 520 (quoting *MBNA Am. Bank v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006)).

<sup>56</sup> *See* Kurth, *supra* note 23, at 1023 & n.167.

<sup>57</sup> *See, e.g.*, Kirgis, *supra* note 10, at 520 (“[I]f so inclined, [judges in bankruptcy] seem to have fairly broad power to refuse to enforce arbitration, at least of core claims.”); Biesterfeld, *supra* note 13, at 283 (“District courts in the Fourth Circuit agree that the likelihood of an inherent conflict between the purposes of the Amended Bankruptcy Code and the FAA are greater when the dispute involves an agreement to arbitrate a core proceeding.”).

disputes regarding a debtor's assets and liabilities in the bankruptcy courts."<sup>58</sup> The bankruptcy system benefits from this single forum because it produces uniform results stemming from Congress's intention that bankruptcy judges have both subject matter and in personam jurisdiction to preside over bankruptcy cases.<sup>59</sup> The automatic stay supports this single-forum procedure by limiting the ability of parties to litigate outside of the bankruptcy proceedings unless they meet the obligations under § 362(d) to lift the stay.<sup>60</sup>

### 1. *Protecting Creditors*

Centralized claims are extremely important in bankruptcy proceedings because they enable creditors to receive equitable distribution for their claims.<sup>61</sup> This distribution policy acts as an underlying guarantee to parties entering into business agreements that they will have a claim for recovery in case of a bankruptcy filing. Otherwise, "[i]n a world of individual actions, each creditor knows that if he waits too long, the debtor's assets will have been exhausted by the demands of the quicker creditors and he will recover nothing."<sup>62</sup> Additionally, creditors only need to file a proof of claim and can thereby estimate their chances of recovery depending on the claim's secured or unsecured status;<sup>63</sup> they can then incorporate their likelihood of recovering into their future business plans to ensure their own success and survival. Centralized control over all claims also reveals any counterfeit claims against

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<sup>58</sup> Birney, *supra* note 21, at 657 (citation omitted).

<sup>59</sup> Alan N. Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 183, 183–84 (2007). Indeed, "one of the core features of the bankruptcy reforms was to allow the bankruptcy court to centralize all disputes concerning property of the debtor's estate so that reorganization can proceed efficiently, unimpeded by uncoordinated proceedings in other arenas." *Id.* at 184 (quoting *U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n (In re U.S. Lines, Inc.)*, 197 F.3d 631, 640 (2d Cir. 1999)) (internal quotation marks omitted).

<sup>60</sup> See Birney, *supra* note 21, at 667–68 ("The collective proceeding is best exemplified by the two-fold purpose of the automatic stay provisions of [§] 362 of the Bankruptcy Code: (1) to give the debtor a 'breathing spell' from collection efforts and permit a repayment or reorganization plan; and, (2) to provide creditors protection against other creditors' actions or collection attempts."); see also 11 U.S.C. § 362(d) (2006) (listing grounds on which a court can lift a stay).

<sup>61</sup> See Birney, *supra* note 21, at 666–67.

<sup>62</sup> *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1203 (9th Cir. 2005), quoted in Birney, *supra* note 21, at 667.

<sup>63</sup> See Kirgis, *supra* note 10, at 506 ("Creditors filing proofs of claim are then sorted into different classes, depending on their interests and the nature of the debts. Secured creditors are in the best position, because they are entitled to value of their collateral. Unsecured creditors are placed in a priority structure in which certain types of claims are given a preference over others. Priority claims, such as marital support obligations, taxes, and employee wage claims, are paid in full before lower categories of claims are paid at all. General unsecured creditors are paid last, receiving *pro rata* share of whatever is left after claims with higher priority are paid." (footnotes omitted)).

the debtor's estate.<sup>64</sup> For these reasons, it is crucial that the estate is protected and managed to maximize its value for the repayment of creditors.<sup>65</sup>

To protect the potential vulnerability of creditors in bankruptcy proceedings, Congress enacted various levels of protection within the Code.<sup>66</sup> However, this protection scheme in chapter 11 reorganizations comes into conflict with the FAA, which was originally intended to address "simple questions of law, not statutory or constitutional issues," but has since grown to apply broadly in both federal and state courts.<sup>67</sup> It is therefore difficult to reconcile the objectives of the two regimes and their diverging practices.

These differing objectives of bankruptcy and arbitration at times lead the methods of enforcement in one to be at odds with those in the other. First, the Bankruptcy Code permits nonparties, such as the Securities and Exchange Commission, the creditors' committee, or any creditor, to appear in a bankruptcy proceeding and raise any issues that party may have.<sup>68</sup> The reasoning for this stems from the fact that, "[i]n litigation, anyone with a sufficient interest to protect may bring suit, and there are many mechanisms for interested third parties, those who might be adversely affected by the court's decision, to intervene or be joined."<sup>69</sup> However, arbitration is an exclusive process that only allows signatories to the agreement to participate in the proceedings, and because the hearings are private, outside parties will have little information as to how or why the award was reached.<sup>70</sup> Nonparty creditors who have an interest in the claim are unable to participate and protect their rights during these private arbitration proceedings, while they would be able to do so in centralized bankruptcy proceedings.<sup>71</sup> Forcing these excluded nonparty creditors to accept the results of the arbitration "diminish[es] their

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<sup>64</sup> See Jay Lawrence Westbrook, *The Coming Encounter: International Arbitration and Bankruptcy*, 67 MINN. L. REV. 595, 606 (1983).

<sup>65</sup> See Kirgis, *supra* note 10, at 506. ("The estate can include almost any type of asset, and these assets must be managed so that they produce the greatest possible return to the creditors."). For instance, in a chapter 11 bankruptcy, "the debtor retains its assets and continues to function, paying off the debts over time to the greatest extent feasible." *Id.*

<sup>66</sup> See Note, *Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act*, 117 HARV. L. REV. 2296, 2307 (2004).

<sup>67</sup> Birney, *supra* note 21, at 632–35 (quoting Margaret L. Moses, *Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress*, 34 FLA. ST. U. L. REV. 99, 112 (2006)).

<sup>68</sup> 11 U.S.C. § 1109 (2006).

<sup>69</sup> Marianne B. Culhane, *Limiting Litigation over Arbitration in Bankruptcy*, 17 AM. BANKR. INST. L. REV. 493, 495–96 (2009). This allows the interests of multiple parties to be addressed. *Id.*

<sup>70</sup> See *id.* at 496.

<sup>71</sup> See *id.*

baseline procedural rights under the FAA<sup>72</sup> and raises additional due process concerns.<sup>73</sup> Therefore, the scope of consent to enter arbitration may need to be extended to these nonparties as well or they should not be bound by the arbitration award.<sup>74</sup>

Second, bankruptcy affords protection to creditors without requiring any affirmative action on their behalf, and “the bankruptcy judge has certain obligations that may not be waived, even by unanimous party agreement.”<sup>75</sup> On the other hand, arbitration is a contractual agreement, which allows the parties to structure the arbitration to their liking;<sup>76</sup> this allows the parties, if they wish, to waive certain procedural protections.<sup>77</sup> In addition, bankruptcy judges are highly specialized and are trained to balance the rights of creditors and debtors in complex bankruptcy claims.<sup>78</sup> However, arbitrators may be less familiar with the relevant law and may possibly be biased towards certain creditors.<sup>79</sup> The combination of untrained and partial arbitrators coupled with the lack of adequate protections can produce results that are inconsistent and even contrary to identical cases decided by bankruptcy judges.<sup>80</sup> Hence, “arbitration deprives creditors of the protections afforded by a neutral judicial officer[] and leads to a systematic bias in favor of the creditor who is able to remove himself from the adjudicatory scheme.”<sup>81</sup>

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<sup>72</sup> Note, *supra* note 66, at 2309.

<sup>73</sup> *See id.* (“Thus, the due process concerns that mandate consent by the parties have just as much force with respect to these nonparties.”).

<sup>74</sup> *Id.* (“[A]lthough the FAA requires consent to be bound by an arbitration award, the Code has modified this background law by creating a system that will bind creditors through determinations of others’ rights regardless of nonparty status; this modification suggests the need to depart from a formalistically narrow definition of whose consent is required for arbitration.”).

<sup>75</sup> *See id.* at 2307 & n.71 (“For example, the bankruptcy judge must ensure that the filing is made in good faith and must execute this responsibility even if all parties have unanimously agreed to the good faith of the filing. Similarly, the judge must reject party attempts to contract for certain outcomes in bankruptcy; for example, since the Code is intended to protect the creditors and thus cannot be waived by debtors, pre-filing waivers of the automatic stay are invalid.” (citation omitted)).

<sup>76</sup> *See* 1 BORN, *supra* note 1, at 82–83.

<sup>77</sup> *See, e.g., id.* at 83–84 (“More generally, parties are typically free to agree upon the existence and scope of discovery or disclosure, the modes for presentation of fact and expert evidence, the length of the hearing, the timetable and other matters.”).

<sup>78</sup> *See* Culhane, *supra* note 69, at 496 (“Arbitration substitutes arbitrators, who are less skilled in the relevant law and possibly inclined to favor particular creditors, for experienced and expert bankruptcy judges.”).

<sup>79</sup> *See id.*

<sup>80</sup> *See* Phillips v. Congelton, L.L.C. (*In re* White Mountain Mining Co.), 403 F.3d 164, 169 (4th Cir. 2005).

<sup>81</sup> Note, *supra* note 66, at 2308.

Third, trustees in bankruptcy proceedings protect creditors by maximizing the value of the estate and to this end are endowed with certain powers, such as pursuing any claims against third parties.<sup>82</sup> In contrast, allowing arbitration to proceed may actually harm the value of the estate for the other creditors who are not parties to the arbitration agreement.<sup>83</sup> Creditors can willingly choose to omit arbitration clauses in their credit agreements, preferring other methods of dispute resolution, and yet their recovery may still be jeopardized by an arbitral award.<sup>84</sup> To illustrate this risk, assume the following scenario: Creditor 1 is allowed to compel arbitration, wins, and then has the tribunal determine the value of his award.<sup>85</sup> Creditor 2, who did not enter into arbitration, will have his recovery affected by Creditor 1's award because "[t]he estate is . . . distributed pro rata among the creditors; thus, the larger [Creditor 1's] recovery, the smaller the recovery of [Creditor 2]."<sup>86</sup> The situation for Creditor 2 can get even worse if he is a general unsecured creditor. Based on the priority system of distribution in bankruptcy, if Creditor 1 is a priority creditor, he will recover the full amount of the arbitral award before Creditor 2 can recover anything, potentially leaving Creditor 2 with nothing.<sup>87</sup>

While public policy favors centralization in bankruptcy proceedings,<sup>88</sup> some courts have noted that this is still not enough for them to avoid the enforcement of arbitration agreements:

The policies of centralized resolution of claims and a generalized prohibition against piecemeal litigation are present in any core bankruptcy proceeding, and . . . these weaker policies underlying the Bankruptcy Code must yield to the stronger federal policy favoring the enforcement of valid arbitration agreements.<sup>89</sup>

Current trends in the decisions of the Supreme Court and the mandates found in the FAA strongly support the enforcement of arbitration agreements in all

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<sup>82</sup> See Kirgis, *supra* note 10, at 507. "The Code itself also confers power on [t]rustees and DIPs to pursue claims designed to protect the corpus of the bankruptcy estate." *Id.* This includes the "power to avoid preferential transfers and the power to avoid fraudulent conveyances." *Id.*

<sup>83</sup> See Note, *supra* note 66, at 2307.

<sup>84</sup> *Id.*

<sup>85</sup> See *id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Michael D. Fielding, *Elevating Business Above the Constitution: Arbitration and Bankruptcy Proofs of Claims*, 16 AM. BANKR. INST. L. REV. 563, 600 (2008).

<sup>89</sup> *In re Farmland Indus., Inc.*, 309 B.R. 14, 21 (Bankr. W.D. Mo. 2004), *quoted in* Fielding, *supra* note 88, at 600 (alteration in original).

scenarios.<sup>90</sup> In fact, even arguments refusing to compel arbitration when specialized knowledge is not required or all creditors could not participate have been uniformly rejected in favor of arbitration.<sup>91</sup>

## 2. *Promotes Efficiency and Lower Costs*

Congress's intent in drafting the Bankruptcy Code was to ensure an efficient and speedy system because "delay only operates to devalue assets, hinder financial rehabilitation, and prevent [the] exercise of rights."<sup>92</sup> In fact, "[t]he efficiency of the mechanisms for resolving distress can be measured by the loss in asset value incurred in the process of the asset and debt restructuring."<sup>93</sup> It can be difficult for a struggling debtor to reach a settlement to appease each creditor in a private restructuring because there are many creditors with divergent interests<sup>94</sup> or to avoid the effects of "piecemeal litigation" such as arbitration.<sup>95</sup> Bankruptcy law circumvents the inefficiencies of piecemeal litigation "so that reorganization can proceed efficiently, unimpeded by uncoordinated proceedings in other arenas."<sup>96</sup>

Parties who want to compel arbitration in bankruptcy proceedings do so because they believe it lowers unnecessary costs and delay.<sup>97</sup> However, this

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<sup>90</sup> See Neufeld, *supra* note 14, at 526–27, 532–39; see also *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1748–53 (2011) (preempting California rule prohibiting waiver of class arbitration in contracts of adhesion).

<sup>91</sup> Neufeld, *supra* note 14, at 557 ("Many of the arguments against arbitration relied upon by the bankruptcy courts have been rejected by the Supreme Court, albeit not in bankruptcy cases. Those rejected arguments include: that federal statutory rights are not amenable to resolution in arbitration; that arbitration agreements may be ignored when they cause additional cause and delay; that arbitration is enforced only when an arbitrator's specialized knowledge is required; that whenever arbitrable claims are intertwined with nonarbitrable claims the judicial forum wins out; and that the existence of parties to the underlying dispute who are not parties to the arbitration agreement means that the judicial forum is preferable.").

<sup>92</sup> H.R. REP. NO. 95-595, at 13 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 5975.

<sup>93</sup> Edith S. Hotchkiss et al., *Bankruptcy and the Resolution of Financial Distress*, in 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 235, 239 (B. Espen Eckbo ed., 2008) ("A number of factors related to the structure of the firm's claims and to the institutional framework governing the process for restructuring contribute to these costs.").

<sup>94</sup> See *id.* at 243 ("Impediments to reaching a settlement in a private restructuring include information asymmetries that arise between poorly informed outside creditors and better informed managers or insiders of the firm; holdout problems when the firm's debt is held by a large number of diffuse creditors; and various conflicts of interest exacerbated when a firm has multiple layers of creditors.").

<sup>95</sup> See *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co.)*, 403 F.3d 164, 170 (4th Cir. 2005), cited in *Birney, supra* note 21, at 663.

<sup>96</sup> *Id.* at 170 (quoting *Shugrue v. Air Line Pilots Ass'n, Int'l (In re Ionosphere Clubs, Inc.)*, 922 F.2d 984, 989 (2d Cir. 1990)), cited in *Birney, supra* note 21, at 663.

<sup>97</sup> See 1 BORN, *supra* note 1, at 84 ("It has long been said that arbitration offers a cheaper, quicker means of dispute resolution than national court proceedings.").

may not always be the case, and international arbitrations are especially worrisome because they have the potential to be more expensive than judicial forums and persist for years.<sup>98</sup> Furthermore, “litigating disputes over the enforceability of arbitration clauses deprives parties of the primary benefits of arbitration: efficiency, speed, and avoidance of costs associated with litigation in the court system.”<sup>99</sup> A debtor who is opposed to a creditor’s request to compel arbitration may spend time and money fighting the motion, which delays both the recovery of other creditors and prevents the debtor from reorganizing.<sup>100</sup> This process can also greatly reduce the value of the debtor’s estate.<sup>101</sup>

The bankruptcy process is already longer than most other forms of federal litigation because there is an additional level of review—after a determination in the bankruptcy court, a decision can be appealed to a district court or bankruptcy appellate panel, and then further to the circuit court of appeals.<sup>102</sup> Appealing a decision to compel arbitration creates yet another layer of review, which again delays all other proceedings.<sup>103</sup> The creation of additional litigation and needless review when courts are required to make decisions on a case-by-case basis leads to results unpredictable and inconsistent in their outcomes and therefore runs contrary to the principles of efficiency in both the FAA and Bankruptcy Code.<sup>104</sup> Because the Code already promotes efficiency and cost savings,<sup>105</sup> these factors alone are not sufficient to compel arbitration for core proceedings.<sup>106</sup>

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<sup>98</sup> Jay Lawrence Westbrook, *International Arbitration and Multinational Insolvency*, 29 PENN ST. INT’L L. REV. 635, 641 (2011). In international disputes, parties prefer court proceedings as they may be in fact more efficient and less costly. *Id.*

<sup>99</sup> Resnick, *supra* note 59, at 212.

<sup>100</sup> *Id.* “Money spent on tangential dispute resolution is money not available to creditors. Time spent that delays the resolution of the bankruptcy is time in which the debtor cannot move forward . . .” Kirgis, *supra* note 10, at 528.

<sup>101</sup> See Kirgis, *supra* note 10, at 528.

<sup>102</sup> Resnick, *supra* note 59, at 212 (“In [most] core proceedings, . . . parties may appeal to the district court or, if available in the particular jurisdiction, the bankruptcy appellate panel, and then to the court of appeals. In non-core proceedings, unless all parties consent to determination by the bankruptcy court, the bankruptcy judge issues proposed findings of fact and conclusions of law that may be reviewed de novo by the district court, whose decision may be appealed to the court of appeals.” (footnote omitted)).

<sup>103</sup> See *id.* at 213 (“Moreover, the Arbitration Act provides that a court order refusing a stay in proceedings in which an issue is referable to arbitration may be appealed as of right.”).

<sup>104</sup> See *id.*

<sup>105</sup> See, e.g., 11 U.S.C. § 1121(b) (2006) (preventing a multitude of competing plans for the first 120 days by giving the debtor an exclusive right to file a plan during this period); *id.* § 1122(a) (allowing the plan proponent flexibility in classifying the treatment a plan gives to claim or interest holders by only requiring that the class of claims or interests be “substantially similar” to one another); *id.* § 1122(b) (allowing plan

In spite of all this, “a refusal to allow any arbitration for fear of fractionalized litigation could impede efficiency goals by congesting the bankruptcy courts with needless litigation.”<sup>107</sup> Moreover, under current case law, courts have discretion not to compel arbitration if a party would not be able to effectively pursue its legal rights, such as when the costs of arbitration may be too high, as considered in *Green Tree Financial Corp.—Alabama v. Randolph*.<sup>108</sup> The Fourth Circuit formally adopted a test to determine whether high arbitration costs would impede a claimant’s right of action in *Bradford v. Rockwell Semiconductor Systems, Inc.*<sup>109</sup> Essentially, the *Bradford* test compares the costs incurred in arbitration to those in litigation for the specific case and weighs the party’s ability to pay.<sup>110</sup> Applying this test to a bankruptcy proceeding, if the costs of arbitration outweigh those incurred in a centralized bankruptcy proceeding, then the arbitration agreement should likely not be enforced.

One approach in reviewing costs that would not compromise any rights under the Bankruptcy Code would involve shifting the burden of proof to the party seeking arbitration to show that the costs of arbitrating would be reasonable.<sup>111</sup> Debtors or trustees should then be allowed to challenge this cost analysis.<sup>112</sup> If the third party cannot meet this burden or if the trustees succeed in their challenge, then arbitration could be reasonably denied from the

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proponent to classify smaller claims together “as reasonable and necessary for administrative convenience”); *id.* § 1127(d) (not requiring a claim or interest holder to revote their treatment each time a plan is modified by the plan proponent).

<sup>106</sup> *Cf.* Kurth, *supra* note 23, at 1029–30 (“When parties include arbitration agreements in a contract, they are usually assuming that arbitration is more expedient than litigation. In bankruptcy courts, however, the procedures are already streamlined to achieve swift, expedient results. Thus, arbitration is not necessarily more expedient than resolution in the bankruptcy forum.” (footnote omitted)).

<sup>107</sup> *Id.* at 1030.

<sup>108</sup> Kirgis, *supra* note 10, at 526; *see also* *Green Tree Fin. Corp.—Ala. v. Randolph*, 531 U.S. 79, 90 (2000) (“It may well be that the existence of large arbitration costs could preclude a litigant such as Randolph from effectively vindicating her federal statutory rights in the arbitral forum.”).

<sup>109</sup> *Bradford v. Rockwell Semiconductor Sys., Inc.*, 238 F.3d 549, 556 (4th Cir. 2001); Kirgis, *supra* note 10, at 526.

<sup>110</sup> *Bradford*, 238 F.3d at 556; *see also* Kirgis, *supra* note 10, at 527. “In analyzing this issue, reviewing courts should consider the costs of litigation as the alternative to arbitration, as in *Bradford*, but they must weigh the potential costs of litigation in a realistic manner.” *Morrison v. Circuit City Stores, Inc.*, 317 F.3d 646, 664 (6th Cir. 2003) (en banc).

<sup>111</sup> *See* Kirgis, *supra* note 10, at 528–29. This is contrary to the original *Bradford* test, which held the burden to be on the party seeking to avoid the enforcement of the arbitration agreement. *See Bradford*, 238 F.3d at 557.

<sup>112</sup> *See* Kirgis, *supra* note 10, at 530.

beginning without allowing further appeals. Protecting the estate justifies changing the burden of proof.

### C. Arbitration Agreements Are Executory Contracts

Defined by common law, an executory contract is “a contract in which at least one party has not yet fully performed.”<sup>113</sup> There is no universally accepted definition for executory contracts in bankruptcy law.<sup>114</sup> Instead, most courts have adopted the following definition proposed by Professor Vern Countryman: “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”<sup>115</sup> Nonexecutory contracts may neither be assumed nor rejected and endure during the bankruptcy proceeding.<sup>116</sup>

On the other hand, the trustee is allowed to assume or reject any executory contract with the court’s permission under § 365.<sup>117</sup> Rejecting an executory contract is appropriate if it leads to “(1) enlarging the value of property of the estate, (2) furthering the rehabilitation of the debtor, and (3) protect[ing] . . . creditors.”<sup>118</sup> These three examples are again a reflection of the policies underlying centralized claims, i.e., the protection of creditors and the

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<sup>113</sup> Kurth, *supra* note 23, at 1012.

<sup>114</sup> *Id.* (“Most states define an executory contract as a contract in which at least one party has not yet fully performed. It is generally agreed that the bankruptcy law does not incorporate this common state-law definition, but the bankruptcy courts have not yet come to a consensus over the proper definition of an executory contract.”).

<sup>115</sup> Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973), quoted in part in Kurth, *supra* note 23, at 1012.

<sup>116</sup> Kurth, *supra* note 23, at 1012 (“Examples of nonexecutory contracts include contracts that have fully terminated before the bankruptcy petition, contracts that create security interests, and financing leases that are deemed secured transactions.”). Additionally, in *Hays*, the appellate court noted that district courts did not have discretion to refuse enforcement of arbitration clauses when nonexecutory contracts are binding on the trustee or DIP. See *id.* at 1022 (citing *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1153, 1155–56 (3d Cir. 1989)).

<sup>117</sup> 11 U.S.C. § 365(a) (2006). Kurth outlines many of the practical consequences of assuming or rejecting an executory contract:

When a contract is assumed, it becomes binding on the bankruptcy estate. If the trustee breaches a contract after assuming it, the injured party can assert a damage claim that will be entitled to priority as a postpetition administrative expense. Rejection of a contract, however, constitutes a breach of contract relating back to the date that the bankruptcy petition was filed. This leaves the injured party with a prepetition damage claim rather than an administrative claim.

Kurth, *supra* note 23, at 1013 (footnotes omitted).

<sup>118</sup> Kurth, *supra* note 23, at 1013 (citing *In re Booth*, 19 B.R. 53, 57–61 (Bankr. D. Utah 1982)).

value of the estate. Section 502 further protects creditors by not providing preferential treatment for a creditor whose contract has not been assumed and is breached postpetition.<sup>119</sup> This is done by including any unsecured contract, whether breached prepetition or postpetition, with the claims of other general unsecured creditors, which entitles the creditor to a pro rata distribution of the estate.<sup>120</sup> If this rule was not in place, “any contract breached pre-petition would be treated as an administrative expense entitled to § 507(a)[(2)] priority; the creditor would receive the full value of his claim before any payment could be made to the general unsecured creditors.”<sup>121</sup> This limits the incentive for a debtor to breach its contracts prepetition for preferred creditors.<sup>122</sup>

As for arbitration agreements, the principle of separability “establishes the arbitration as a severable contract whose rejection is independent of the container contract; the executory nature of the contracts are determined separately, and the trustee may reject one, both, or neither of the contracts.”<sup>123</sup> Because of this doctrine, arbitration agreements must first be deemed as stand-alone executory contracts under Countryman’s definition<sup>124</sup> for the trustee to be able to reject them.<sup>125</sup> Analyzing arbitration agreements show that they readily fit this definition of executory contracts. First, there is an unperformed obligation because the parties have not yet arbitrated and resolved their disputes at the time a bankruptcy is filed because of the automatic stay.<sup>126</sup> Second, failing to arbitrate constitutes a material breach under section 2 of the FAA, which mandates that arbitration agreements “shall be valid, irrevocable, and enforceable,”<sup>127</sup> and therefore if arbitration does not take place, it is a breach of the agreement.<sup>128</sup>

Under the executory analysis, the trustee may choose to assume arbitration agreements if they create value for the estate, a core tenet of bankruptcy.<sup>129</sup> However, if the trustee chooses to reject the arbitration agreement as an executory contract in accordance with the requirements of § 365, the

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<sup>119</sup> See 11 U.S.C. § 502(g).

<sup>120</sup> Note, *supra* note 66, at 2313 n.89.

<sup>121</sup> *Id.* (discussing 11 U.S.C § 507(a)(1) (2000), which granted priority claims for administrative expenses under § 503(b) and whose present form is codified at § 507(a)(2)); see also 11 U.S.C. § 507(a)(2) (2006).

<sup>122</sup> See Note, *supra* note 66, at 2313 n.89.

<sup>123</sup> *Id.* at 2314.

<sup>124</sup> Countryman, *supra* note 115, at 460.

<sup>125</sup> See Note, *supra* note 66, at 2314–15.

<sup>126</sup> See *id.* at 2315.

<sup>127</sup> See 9 U.S.C. § 2 (2006).

<sup>128</sup> See Note, *supra* note 66, at 2315–16.

<sup>129</sup> See Kirgis, *supra* note 10, at 509.

bankruptcy court should refuse to compel arbitration.<sup>130</sup> The creditor would still then benefit from the protections granted under § 502 in their recovery.<sup>131</sup> This approach mirrors the courts' desire to shift discretion to the trustee in arbitrability determinations and away from the judicial system.<sup>132</sup>

Some scholars take this a step further and suggest that a trustee should have the option to assume or reject any contract, regardless of its executory status.<sup>133</sup> This is similar to the current law in the United Kingdom under the Insolvency Act of 1986. Section 349A(2) provides, "If the trustee in bankruptcy adopts the contract, the arbitration agreement is enforceable by or against the trustee in relation to matters arising from or connected with the contract."<sup>134</sup> Otherwise, the trustee can refuse to adopt the contract with the included arbitration agreement, and a court will only review whether there is a matter that should be referred to arbitration if an allowed party petitions the court.<sup>135</sup>

Furthermore, this argument is supported by bankruptcy's power to alter, impair, or modify contractual obligations as noted by the Supreme Court in the pre-Code case, *Ashton v. Cameron County Water Improvement District Number One*.<sup>136</sup> Because arbitration clauses are just like any other privately

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<sup>130</sup> See Note, *supra* note 66, at 2316–17.

<sup>131</sup> See 11 U.S.C. § 502(b), (g)(1) (allowing a claim that is rejected under § 365 to be treated as an allowed or disallowed claim "as if such claim had arisen before the date of the filing of the petition" and limiting the bases on which a court can reject the claim); see also Kirgis, *supra* note 10, at 509 ("If [an executory contract] is rejected, then the other party to the contract is entitled to damages, to be paid out of the estate upon distribution on the same basis as any other unsecured claim.").

<sup>132</sup> Note, *supra* note 66, at 2316–17.

<sup>133</sup> Kurth, *supra* note 23, at 1013 ("Professors Andrew and Westbrook have developed a more theoretical approach. They suggest that executoniness does not matter at all. Instead, they argue that, subject to court approval, the trustee may assume or reject any contract, whether executory or not. The trustee decides whether the estate benefits more from performance or breach. Under this approach, assumption is equivalent to performing the contract, and rejection is equivalent to a breach of contract with a subsequent obligation to pay damages." (citing Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991); Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 231, 250–51 (1989))).

<sup>134</sup> Insolvency Act, 1986, c. 45, § 349A(2) (U.K.), as amended by Arbitration Act, 1996, c. 23, § 46, sch. 3 (U.K.).

<sup>135</sup> *Id.* § 349A(3) ("If the trustee in bankruptcy does not adopt the contract and a matter to which the arbitration agreement applies requires to be determined in connection with or for the purposes of the bankruptcy proceedings—(a) the trustee with the consent of the creditors' committee, or (b) any other party to the agreement, may apply to the court which may, if it thinks fit in all the circumstances of the case, order that the matter be referred to arbitration in accordance with the arbitration agreement.").

<sup>136</sup> *Ashton v. Cameron Cnty. Water Improvement Dist. No. One*, 298 U.S. 513, 530 (1936); Birney, *supra* note 21, at 658; see also Sec. Pac. Fin. Corp. v. Barto (*In re Barto*), 8 B.R. 145, 149 (1981) ("It is the especial

agreed-upon contractual term, “the power of bankruptcy courts to interfere with the contractual relations between the parties and to change, modify[,] or impair contractual obligations of their contracts apply equally to arbitration clauses.”<sup>137</sup> Section 365 therefore properly allows trustees to modify and impair creditors’ contractual obligations by rejecting arbitration agreements.

#### D. Choice of Law and Enforceability

Arbitration is specifically attractive to parties in international business transactions due to the “pro-enforcement regime” behind it.<sup>138</sup> The New York Convention is one of the key laws governing international arbitration,<sup>139</sup> thus far, there are 146 contracting countries.<sup>140</sup> The Convention’s basic tenets are the recognition and enforcement of foreign arbitral awards by participating states.<sup>141</sup> These two principles infuse arbitration proceedings with predictability that any awards rendered shall be enforceable. Without the presence of such an international doctrine, recognition of foreign awards would be endangered if subject to the local laws of each jurisdiction.<sup>142</sup> While the treaty does supplant local law in recognition and enforceability, it does not solve all issues in attempting to enforce an international arbitration award. In

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purpose of all bankruptcy legislation to interfere with the relationship between the parties concerned—to change, modify, or impair the obligation of their contracts.” (citing *Ashton*, 298 U.S. 513)).

<sup>137</sup> Birney, *supra* note 21, at 658. The Bankruptcy Code and surrounding case law demonstrate that Congress has the authority to modify contractual agreements, as seen from:

(1) congressional intent to temporarily or permanently enjoin a party’s right to enforce its contractual rights and security interests; (2) the reshuffling of creditors’ believed priorities and the consequential fair and equitable distribution of a debtor’s property to those creditors; (3) the potential subordination of a party’s claim against a debtor; (4) the assumption or rejection of a party’s executory contract; (5) the negation of *ipso facto* clauses; and (6) the impairment or, in some instances, the outright stripping of a lien holder’s security interest in the debtor’s property interest.

*Id.* at 659–60 (footnotes omitted).

<sup>138</sup> 1 BORN, *supra* note 1, at 76–78.

<sup>139</sup> See Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 3, available at <http://treaties.un.org/doc/publication/UNTS/Volume%20330/v330.pdf>; see also *The New York Convention*, NEW YORK ARBITRATION CONVENTION, <http://www.newyorkconvention.org> (last visited Mar. 26, 2012) (noting the Convention is applicable to “the recognition and enforcement of foreign arbitral awards and the referral by a court to arbitration” (emphasis omitted)).

<sup>140</sup> Contracting States, NEW YORK ARBITRATION CONVENTION, <http://www.newyorkconvention.org/new-york-convention-countries> (last visited Mar. 26, 2012).

<sup>141</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *supra* note 139, art. I., ¶ 1.

<sup>142</sup> See 1 BORN, *supra* note 1, at 78. Such a system provides for more efficient and binding resolution to parties’ disputes. See *id.*

many countries, bankruptcy proceedings still “override most other laws and sweep[] into its embrace virtually all legal matters related to the debtor,” creating substantial tension between the policies favoring the reordering of the debtor’s affairs and the policies favoring the enforcement of arbitration awards.<sup>143</sup> Choice of law conflicts are one such issue created by this tension.

A few of the choice of law issues that arise when arbitration meets bankruptcy are “the applicable insolvency law, the law applicable to halting the arbitration, and the law governing the ultimate enforceability of the arbitration agreement or award, in the insolvency court or elsewhere.”<sup>144</sup> An analysis of two cases involving the Polish company Elektrim S.A. illustrates these choice of law problems. Elektrim S.A. entered into an investment contract with Vivendi Universal S.A. governed by Polish law, which required that arbitration take place in London under English law.<sup>145</sup> Vivendi filed for arbitration against Elektrim in 2003 for breach of contract.<sup>146</sup> In 2007, a Polish bankruptcy court declared Elektrim bankrupt, and “Polish bankruptcy law provides that any arbitration clause entered into by the bankrupt company loses its legal effect when bankruptcy is declared, and any pending arbitration proceedings are discontinued.”<sup>147</sup> Vivendi argued that English law governed the status of the arbitration, which would allow the proceedings to continue.<sup>148</sup> The London arbitral tribunal decided it had jurisdiction to hear the case and ruled in favor of Vivendi, and Elektrim sought to have the award set aside.<sup>149</sup> In that action, the English court had to decide whether local law (English law) or the law of the insolvency court (Polish law) governed the continuance/halting of the arbitration.<sup>150</sup> Here, the English court determined that the EU Regulation left the consideration of whether to halt the arbitration to the local, in this case English, law.<sup>151</sup> For the last issue of which law to apply for the enforceability of the arbitration agreement, the court applied local

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<sup>143</sup> Westbrook, *supra* note 98, at 635. Noting this issue, Professor Westbrook has stated: “[This] collision between an increasing number of multinational arbitrations and an increasing number of multinational insolvencies constitutes the irresistible force meeting the immovable object.” *Id.*

<sup>144</sup> *Id.* at 643.

<sup>145</sup> *English Justice Refuses to Set Aside Award Against Bankrupt Company*, MEALEY’S INT’L ARB. REP., Oct. 2008, at 7, 7; *see also* Syska v. Vivendi Universal S.A., [2008] EWHC 2155 (Comm) 677, [1]–[2] (Eng.), *aff’d*, [2009] EWCA Civ 677.

<sup>146</sup> *Id.* (noting that the breach of contract claim was premised on Elektrim’s purported interference or failure to acquire an interest for Vivendi in PTC, a Polish mobile telephone company).

<sup>147</sup> *Id.*

<sup>148</sup> *See* Westbrook, *supra* note 98, at 637.

<sup>149</sup> *English Justice Refuses*, *supra* note 145, at 7.

<sup>150</sup> Westbrook, *supra* note 98, at 644.

<sup>151</sup> *Id.* at 644–45.

law, “even though the court recognized that the Polish proceeding was the ‘main’ proceeding under the EU Regulation and that Polish law would hold the arbitration clause extinguished by the insolvency.”<sup>152</sup> Notwithstanding the unenforceability of the arbitration clause if the matter had originally been determined under Polish law, the Warsaw Court of Appeals upheld Vivendi’s award during a subsequent enforcement action in Poland.<sup>153</sup>

In contrast, Elektrim’s second arbitration, which took place in Switzerland, resulted in an opposite ruling.<sup>154</sup> The Swiss Supreme Court dismissed the arbitration because “[w]hile the Polish insolvency rules did not operate directly in Switzerland, under Swiss conflicts principles, the law of the insolvency jurisdiction should control, and thus, the arbitration should be halted as against the insolvent debtor.”<sup>155</sup> These two cases highlight how choosing the governing law in international disputes affected by bankruptcy not only affects whether arbitration will be permitted to proceed; more importantly, whether the award rendered will then be “conclusive and enforceable.”<sup>156</sup> “[A] jurisdiction’s choice of law decision about arbitration should be closely linked to its policy on recognition and cooperation in insolvency matters.”<sup>157</sup> If the policies of that jurisdiction reflect a “modified universalism” approach towards bankruptcy—that is, a dedication to coordinating insolvencies across jurisdictional lines to the greatest degree possible<sup>158</sup>—this will increase the likelihood of enforceable awards, especially when the debtor does not have property in the jurisdiction.<sup>159</sup> For this reason, a bankruptcy court in the United States needs to take care in compelling arbitration under the current framework in order to ensure any award rendered will be enforceable domestically under the FAA or internationally under the New York Convention. It is imprudent to switch to a framework that compels arbitration in all bankruptcy proceedings; for instance, if a party tries to enforce the award in a foreign jurisdiction with

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<sup>152</sup> See *id.* at 637.

<sup>153</sup> Ania Farren & Sara Nadeau-Seguin, *Enforcement of the LCIA Award in Elektrim v Vivendi*, PLC ARBITRATION, <http://arbitration.practicallaw.com/9-381-7476> (last visited Mar. 25, 2012).

<sup>154</sup> See *id.* at 637–38; see also *Vivendi S.A. v. Deutsche Telekom AG*, Bundesgericht [BGer] [Federal Supreme Court] Mar. 31, 2009, 28 ASA BULL. 104 (Switz.).

<sup>155</sup> See Westbrook, *supra* note 98, at 637–38.

<sup>156</sup> *Id.* at 638.

<sup>157</sup> *Id.* at 648.

<sup>158</sup> *Id.* at 643.

<sup>159</sup> See *id.* at 648 (“If a local court permits arbitration to go forward to an award and enforces that award against local assets, then it has moved away from an international system back to the traditional territorial regime in insolvency matters. If it refuses to enforce against local assets and sends the arbitration award claimant to the insolvency court, and that court refuses to accept the award as conclusive, the arbitration will have cost everyone concerned much time and money for nothing.”).

more restrictive conditions for enforcing arbitral awards in bankruptcy, that jurisdiction could vacate the award under Articles V(2)(a) or Article V(2)(b) of the New York Convention.<sup>160</sup> Such an arbitration would therefore have been a waste of time and money for all parties.<sup>161</sup>

To avoid such adverse results, the current application of the core/noncore distinction and the *McMahon* test should be continued. This approach mirrors how other countries treat the conflict. For example, Lebanon reviews an arbitration agreement made before the debtor's bankruptcy filing: "such [an] agreement cannot be applied if it ensues from disputes related to or arising out of the bankruptcy or from disputes that would not have arisen except by cause of bankruptcy, or from disputes on which the bankruptcy has a legal effect."<sup>162</sup> Additionally, under the Italian Bankruptcy Act, the insolvency court must hear all actions that specifically "originate from the extraordinary administration [of the bankruptcy]"; however, other bodies, including arbitrators, can hear actions that "have a merely occasional relationship" with the insolvency.<sup>163</sup> Considering the differentiation, then, between core and noncore issues guarantees that any award rendered from an enforced arbitration agreement in the United States will be enforceable internationally under the New York Convention in countries that have the same or even laxer policies. It also ensures that any award rendered in a foreign country using a *McMahon*-esque test will be enforceable in the United States under the New York Convention.

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<sup>160</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *supra* note 139, art. V., ¶ 2; see also Albert Jan van den Berg, *The New York Convention of 1958: An Overview*, INT'L COUNCIL FOR COM. ARB., 19 (Apr. 15, 2009), [http://www.arbitration-icca.org/media/0/12125884227980/new\\_york\\_convention\\_of\\_1958\\_overview.pdf](http://www.arbitration-icca.org/media/0/12125884227980/new_york_convention_of_1958_overview.pdf) ("Article V(2)(a) permits a court to refuse enforcement of an award on its own motion if the subject matter of the difference is not capable of settlement by arbitration under its law . . . . Article V(2)(b) allows a court to refuse enforcement of an award on its own motion if the enforcement of the award would be contrary to the public policy of the country where the enforcement is sought.").

<sup>161</sup> Westbrook, *supra* note 98, at 648.

<sup>162</sup> Mahkamat al-Darajat al-Ula [Court of First Instance], Beirut, 19 Mar. 2008, 2 INT'L J. ARAB ARB. 86, 87 (2008) (Leb.).

<sup>163</sup> See Tribunale [Court of First Instance], Lodi, 13 Feb. 1991, 21 Y.B. COM. ARB. 580, 582–83 (1996) (internal quotation marks omitted); see also Luigi Fumagalli, *Mandatory Rules and International Arbitration: an Italian Perspective*, 16 ASA BULL. 43, 55 n.33 (1998) ("The Tribunale . . . held that the issues under examination did not fall within the *vis attractiva* of the insolvency court (pursuant to Art. 24 of the Italian bankruptcy Act, all actions arising out of insolvency proceedings must be brought before the Tribunale that declared the bankruptcy). Hence, no Italian provision hindered the arbitration panel from deciding the dispute.").

## II. A SPLINTERED SYSTEM: WHY REFORM IS NEEDED

While the current distinction between core and noncore proceedings provides centralization, trustee empowerment, and a higher probability of enforcement, the distinction does not adequately address the serious discrepancies in its application. This shortcoming is magnified by the business' shift from litigation to arbitration, with the former hampering the move.

### A. *Split in the Circuit Courts*

The circuit courts have taken different approaches, applying the core/noncore distinction, the *McMahon* test, or their own “sound discretion” tests.<sup>164</sup> These tests have created inconsistent results. For example, some circuits have disavowed the core versus noncore distinction while others have used the *McMahon* test subjectively in reaching decisions.<sup>165</sup> Concurrently, circuit courts are adopting the Supreme Court’s proarbitration view and thus are compelling arbitration to go forward in the context of bankruptcy proceedings.<sup>166</sup> According to Professor Grant Gilmore, “It is a fairly reliable rule of thumb that, when courts with some regularity begin to assign patently absurd reasons for the decisions, the decisions themselves are sound and the underlying rule of law has fallen out of touch with reality.”<sup>167</sup> Such is the case here where courts are enforcing arbitration agreements more frequently despite constantly tweaking or modifying the current restricting rule.

#### 1. *Core Versus Noncore Split*

Defining what is a core versus noncore claim has been difficult for courts and has resulted in disparate classifications. For example, it is hard to predict whether a court will find a breach of contract as a core or noncore

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<sup>164</sup> See, e.g., Jeremy J. Jacobs, Comment, *The FAA Versus the Bankruptcy Code: Further Application of McMahon’s “Inherent Conflict” Inquiry in MBNA America Bank v. Hill*, 31 AM. J. TRIAL ADVOC. 175, 182–83 (2007) (“[The Fourth Circuit in *In re White Mountain Mining Co.*] seemed to provide an easily applicable test, directing courts to provide two showings in an effort to fulfill *McMahon*’s ‘inherent conflict’ inquiry: a showing that a core proceeding is involved in both bankruptcy and arbitration, and a showing that enforcement of an agreement to arbitrate disputes would hinder efforts by the debtor to obtain relief through the bankruptcy process.”).

<sup>165</sup> See *infra* Part II.A.1–2.

<sup>166</sup> See *infra* Part II.A.1.

<sup>167</sup> I GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 20.1 (1965), quoted in Kurth, *supra* note 23, at 1027.

proceeding.<sup>168</sup> The court in *In re Brookhaven Textiles, Inc.* held that a breach of contract was a core proceeding and did not compel arbitration.<sup>169</sup> On the other hand, a breach of contract where the defendant is a creditor who had not filed a proof of claim or counterclaim is considered to be a noncore proceeding,<sup>170</sup> which compels arbitration. However, courts still frequently find exceptions, as plainly admitted by the Bankruptcy Appellate Panel for the Ninth Circuit Court of Appeals. In *In re Gurga*, the court held that “even if an issue is traditionally a core proceeding, arbitration should be allowed to continue if the issue does not implicate the right to bankruptcy, the right to a discharge, or some other substantive right created in the Bankruptcy Code.”<sup>171</sup> The courts’ disagreement on how to properly classify a claim as core or noncore is alarming because granting arbitration often hinges on this one determination.

Some courts have begun taking the position that the distinction is not even necessary. The Third Circuit in *In re Mintze* held that only where a claim turned on a bankruptcy issue did the core and noncore distinction apply.<sup>172</sup> Under the court’s analysis, the distinction does not determine whether a bankruptcy court can refuse to enforce an arbitration agreement but “merely

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<sup>168</sup> Dameron, *supra* note 32, at 352 (“[T]here are various holdings on when a breach of contract claim is a core or non-core proceeding. These holdings are very fact specific and the slightest change in circumstances can affect the determination of a breach of contract claim as a core or non-core proceeding.”).

<sup>169</sup> See *Brookhaven Textiles, Inc. v. Avondale Mills, Inc.* (*In re Brookhaven Textiles, Inc.*), 21 B.R. 204, 206–07 (Bankr. S.D.N.Y. 1982); Dameron, *supra* note 32, at 341 (“The court [in *In re Brookhaven Textiles*] stated it had authority to decide the breach of contract issue because it: (1) did not involve a dispute that required special expertise of an arbitrator, and (2) the outcome of the case would affect the estate’s assets. Even though the arbitration did not implicate bankruptcy law, the court determined the breach of contract case was a core proceeding under the Bankruptcy Code. This narrow definition of a core proceeding has been followed in other cases.”).

<sup>170</sup> Dameron, *supra* note 32, at 342; see also Andrew M. Campbell, *Action for Breach of Contract as Core Proceeding in Bankruptcy Under 28 U.S.C.S. § 157(b)*, 123 A.L.R. FED. 103, 131 (1995) (“The court in *Hays* held, in an adversary proceeding in which the defendant had not filed a proof of claim or counterclaimed against the estate of the debtor[,] that a count by the trustee in bankruptcy alleging prepetition breach of contract was not a core proceeding[] under 28 USCS § 157(b) which the Bankruptcy Court, by referral from the District Court, had the power to hear and determine because it did not involve the administration of the estate, the allowance of claims, the voidance of fraudulent transfers or preferences, dischargeability, priorities of liens or confirmation of a plan, and did not involve substantive rights created by the bankruptcy laws or proceedings which could not exist outside of bankruptcy.” (citation omitted)).

<sup>171</sup> Dameron, *supra* note 32, at 341 (citing *MCI Telecomms. Corp. v. Gurga* (*In re Gurga*), 176 B.R. 196, 199 (B.A.P. 9th Cir. 1994)). If the matter to be arbitrated is a bankruptcy matter, then the court should deem it a core proceeding and not allow arbitration to proceed. *Id.* (citing *In re Guild Music Corp.*, 100 B.R. 624, 628 (Bankr. D.R.I. 1989)).

<sup>172</sup> See *Birney*, *supra* note 21, at 653; see also *Mintze v. Am. Gen. Fin. Servs., Inc.* (*In re Mintze*), 434 F.3d 222, 229–31 (3d Cir. 2006).

determines whether the bankruptcy court has the jurisdiction to make a full adjudication.”<sup>173</sup> This ruling had the drastic effect of changing how the *McMahon* test is applied, which up until then had primarily been relevant only if the bankruptcy court decided a proceeding was core.<sup>174</sup> The Third Circuit mandated that courts “applying *McMahon* [are] to disregard the core/noncore distinction and distinguish between actions which ‘derive[] from the debtor[,] and bankruptcy actions that the Bankruptcy Code created for the benefit of the creditors of the estate.’”<sup>175</sup> Accordingly, after applying the *McMahon* test in this new context, the Third Circuit found no inherent conflict and held that arbitration was the proper venue for resolution of this dispute.<sup>176</sup>

Further, in *MBNA America Bank, N.A. v. Hill*, the Second Circuit took the same approach as the Third Circuit in *In re Mintze*.<sup>177</sup> It applied a *de novo* standard of review “rather than a fact finder standard of review . . . , allow[ing] the circuit court to take a vastly different inquiry”<sup>178</sup> and to arrive at a different result than the lower courts. The court stressed that “the outcome of the *McMahon* analysis does not hinge upon a simple classification of proceedings as core and noncore[, but rather] . . . ‘requires a particularized inquiry into the nature of the claim and the facts of the specific bankruptcy.’”<sup>179</sup> After analysis of the core claim, the court overturned the bankruptcy court’s decision denying arbitration because continuing with the arbitration did not conflict with the goals of the Bankruptcy Code.<sup>180</sup>

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<sup>173</sup> *In re Mintze*, 434 F.3d at 229.

<sup>174</sup> *See supra* Part I.A.

<sup>175</sup> Jacobs, *supra* note 164, at 186 (second and third alterations in original) (quoting *In re Mintze*, 434 F.3d at 230). If a claim is “derived from the debtor,” the bankruptcy court does not have discretion to allow or reject arbitration. If the claim is “for the benefit of the creditors,” then the bankruptcy court may refuse to enforce arbitration agreements. *See id.* (quoting *In re Mintze*, 434 F.3d at 230).

<sup>176</sup> Birney, *supra* note 21, at 653 (“[B]ecause the bankruptcy court was not being called upon to adjudicate bankruptcy issues in the *Mintze* adversary proceeding, it could find no inherent conflict between arbitration of the debtor’s claims and the underlying purposes of the Bankruptcy Code.” (footnote omitted) (citing *In re Mintze*, 434 F.3d at 231–32 (3d Cir. 2006)).

<sup>177</sup> *See* Jacobs, *supra* note 164, at 188–90; *see also* *MBNA Am. Bank, N.A. v. Hill*, 436 F.3d 104, 107–10 (2d Cir. 2006).

<sup>178</sup> Jacobs, *supra* note 164, at 188–89. The circuit courts must first determine that the bankruptcy court had discretion in its determination of the particular issue before deciding whether it had used that discretion properly. *See id.* at 189; *see infra* Part II.C.

<sup>179</sup> Jacobs, *supra* note 164, at 189 (quoting *Hill*, 436 F.3d at 108). The inquiry is based upon three factors: the Code’s centralization function, avoiding “piecemeal” litigation, and the bankruptcy court’s enforcement of its jurisdiction. The “overwhelming presence of these considerations” will show that Congress intended the Code to override other dispute resolution methods, such as arbitration. *Id.*

<sup>180</sup> *Id.* at 190–91 (“First, the court noted the bankruptcy case was closed and discharged, thus arbitration of Hill’s claims would not interfere with the objective of the automatic stay provision . . . . Second, the court

The Fifth Circuit came to a similar conclusion in *In re National Gypsum Co.*, where the court held “that nonenforcement of an otherwise applicable arbitration provision turns on the underlying nature of the proceeding, *i.e.*, whether the proceeding derives exclusively from the provisions of the Bankruptcy Code and, if so, whether arbitration of the proceeding would conflict with the purposes of the Code.”<sup>181</sup> Based on this analysis, the court concluded an inherent conflict is present between the Code and the FAA only where the claim arises from the Code.<sup>182</sup>

These circuit decisions are part of “[t]he movement toward partially divesting bankruptcy courts of authority in the context of enforcing arbitration agreements, both in core and noncore proceedings.”<sup>183</sup> This movement follows the Supreme Court’s overall proarbitration view.<sup>184</sup> Only the First Circuit has precluded the enforcement of arbitration agreements in all core proceedings,<sup>185</sup> a fair example of which can be seen in *In re Guild Music Corp.*<sup>186</sup> Most other courts continue to use the core versus noncore distinction in some capacity in deciding whether to compel arbitration.<sup>187</sup>

## 2. *Misapplication of the McMahon and Sound Discretion Tests*

The *McMahon* test determines if arbitration can be compelled for a claim arising under a federal statute.<sup>188</sup> The third prong of the test allows lower courts to decide whether there is a conflict between a core bankruptcy proceeding and arbitration. In this way, the third prong essentially functions as a “conflicts of purposes test.”<sup>189</sup> However,

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noted Hill’s choice to treat her claim as a class action undermined any possible assertions that there was an indispensable interest in keeping the claim in the bankruptcy arena.” (citing *Hill*, 436 F.3d at 108)).

<sup>181</sup> *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Management Corp.* (*In re Nat’l Gypsum Co.*), 118 F.3d 1056, 1067 (5th Cir. 1997); *see also* Note, *supra* note 66, at 2301.

<sup>182</sup> Note, *supra* note 66, at 2301.

<sup>183</sup> *See Birney, supra* note 21, at 654.

<sup>184</sup> *See supra* Introduction.

<sup>185</sup> *See Biesterfeld, supra* note 13, at 284.

<sup>186</sup> *In re Guild Music Corp.*, 100 B.R. 624, 628 (Bankr. D.R.I. 1989); Neufeld, *supra* note 14, at 545–46.

<sup>187</sup> *See Resnick, supra* note 59, at 212 (“Most courts, but not all, have distinguished between core and noncore proceedings for the purpose of applying *McMahon*, though they have not adopted per se rules and have focused instead on the particular issues in dispute and factual circumstances to determine on a case-by-case basis whether compulsive arbitration is inconsistent with the underlying policies of the Bankruptcy Code.” (citation omitted)); *see also supra* Part I.A.

<sup>188</sup> Kirgis, *supra* note 10, at 524.

<sup>189</sup> Biesterfeld, *supra* note 13, at 288.

[i]nstead of using the conflict of purposes test to weigh the purposes of bankruptcy against the purposes of arbitration, . . . a court can misuse the test by focusing on how arbitration would conflict with the purposes of bankruptcy instead of weighing those purposes against the purposes of arbitration, as the Supreme Court intended.<sup>190</sup>

This intention can be gleaned from the language of the FAA itself, which states that arbitration agreements “shall be valid, irrevocable, and enforceable” unless there is something at law or in equity to revoke them.<sup>191</sup> The Fourth Circuit in *In re White Mountain Mining Co.* committed the aforementioned error by focusing only on those policies protecting bankruptcy proceedings while completely ignoring the strong congressional policies and precedent favoring arbitration.<sup>192</sup> The underlying purpose of the test is not for bankruptcy courts to decide what the best forum for an arbitrable dispute is.<sup>193</sup>

On the other hand, certain courts do not even use the *McMahon* test in deciding whether to compel arbitration. Instead these courts apply what has been dubbed the “sound discretion” standard.<sup>194</sup> The court in *In re Guy C. Long, Inc.* allowed arbitration to proceed after applying a four-factor test:

(1) [T]he arbitration would not jeopardize the debtor’s ability to formulate a bankruptcy plan or weaken the debtor’s financial situation; (2) the dispute did not implicate bankruptcy issues; (3) the breach of contract litigation was initiated by the debtor against the noncreditor; and (4) the dispute would be solved more quickly in arbitration.<sup>195</sup>

However, the factors weighed by the courts differ depending on whether the debtor or creditor is the claimant and what the overall effect on the estate would be.<sup>196</sup> The Bankruptcy Court for the Middle District of Florida

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<sup>190</sup> *Id.*

<sup>191</sup> See 9 U.S.C. § 2 (2006); see also Kirgis, *supra* note 10, at 524 (“If a claim is arbitrable and is covered by a written arbitration agreement, a court must enforce the agreement unless some legal defense applicable to contracts in general would allow for the revocation of the agreement to arbitrate.”).

<sup>192</sup> Biesterfeld, *supra* note 13, at 288 (citing Phillips v. Congelton (*In re White Mountain Mining Co.*), 403 F.3d 164, 169–70 (4th Cir. 2005)).

<sup>193</sup> Kirgis, *supra* note 10, at 524.

<sup>194</sup> Kurth, *supra* note 23, at 1017–19 (discussing cases leaving the issue to the “sound discretion” of the bankruptcy courts).

<sup>195</sup> Dameron, *supra* note 32, at 343 (citing Guy C. Long, Inc. v. Park Plaza Dev. Corp. (*In re Guy C. Long, Inc.*), 90 B.R. 99, 102–03 (E.D. Pa. 1988)). The court held that when the four factors are met, the inherent conflict between the FAA and Code is weakened. *Id.*; see also *In re Guy C. Long, Inc.*, 90 B.R. at 102–03.

<sup>196</sup> Dameron, *supra* note 32, at 350; see also Kurth, *supra* note 23, at 1032–33 (discussing the factors used by the Bankruptcy Court for the Northern District of New York, which were: “(1) the scope of the arbitration

shortened the analysis in *In re Bicoastal Corp.* and allowed a core claim to continue to arbitration for an expert arbitrator to rule on whether a balance sheet conformed with generally accepted accounting principles in defense contracts, a complex issue not arising from the Code.<sup>197</sup> These discrepancies in choosing and administrating the *McMahon* or sound discretion tests arise from the discretion of judges and thus lead to unpredictable results which are difficult to reconcile with one another. This lack of a uniform mandate from the Supreme Court additionally encourages abuse on the part of overworked judges: “Anecdotal evidence suggests that bankruptcy judges routinely enforce arbitration agreements, for both noncore and core claims, as a way to clear matters off the docket.”<sup>198</sup>

### B. *Enforcing International Arbitration Agreements*

One of the dangers of not enforcing arbitration agreements is the discouragement of international business transactions. The Supreme Court considered this problem in *Scherk*, opining that not enforcing arbitration agreements in the international context “would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international agreements.”<sup>199</sup> International parties choose arbitration because of its predictability, which allows parties to circumvent litigation in foreign jurisdictions with unfamiliar laws. The predictability is replaced with uncertainty and inconsistency when arbitration is not compelled because the Code is allowed to somehow trump the FAA.<sup>200</sup> The Supreme Court has tried to alleviate this problem by enforcing international arbitration even if the agreement would be unenforceable in domestic arbitrations.<sup>201</sup> However, this solution in and of itself has created a two-fold problem: (1) an arbitrary distinction between international and domestic arbitrations and (2) noncompliance by the lower courts.

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agreement, (2) the need for special expertise, (3) whether the nature and extent of the litigation would make the judicial forum preferable to arbitration, and (4) the qualifications of the arbitrator” (citing *Wm. S. Newman Brewing Co. v. C. Schmidt & Sons, Inc. (In re Wm. S. Newman Brewing Co.)*, 87 B.R. 236, 241 (Bankr. N.D.N.Y. 1988)).

<sup>197</sup> Kurth, *supra* note 23, at 1025; *see also In re Bicoastal Corp.*, 111 B.R. 999, 1002–03 (Bankr. M.D. Fla. 1990) (basing its decision primarily on the benefits of arbitration’s truncated procedures and having an arbitrator who is an expert in the field).

<sup>198</sup> Kirgis, *supra* note 10, at 520.

<sup>199</sup> *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 517 (1974), *quoted in* Neufeld, *supra* note 14, at 533.

<sup>200</sup> *See Biesterfeld*, *supra* note 13, at 289.

<sup>201</sup> *Id.*; *see also id.* at 281 (“The [Supreme] [C]ourt in *Mitsubishi* declared that international arbitration agreements would be enforced even when a different result would be reached in a domestic tribunal.”).

### 1. *International Versus Domestic Arbitration Agreements*

“To date the bankruptcy courts have treated international arbitration as a special situation based on the desire to be perceived as a fair and equal player in the global marketplace.”<sup>202</sup> Because of this concern, courts are more willing to compel arbitration where foreign parties are involved.<sup>203</sup> It may be the case that international cases that are compelled to arbitrate are identical to domestic cases where arbitration is halted and parties are forced to adjudicate in the bankruptcy forum. These conflicting results are unfair to domestic parties, who end up being treated less favorably than foreigners in their own jurisdiction. The policy arguments for enforcing arbitration should apply equally in the domestic context as in the international context because it ultimately affects *all* business transactions the same. Accordingly, arbitration in domestic cases should also be freely granted so as to be on par with their international equivalents.

The extent of this *de facto* “hall pass” to international arbitration agreements is evident, as some courts bypass any traditional analysis and instead simply follow the Supreme Court’s decision in *Scherk*. For example, in *In re Hart Ski Manufacturing Co.*, the bankruptcy court enforced arbitration by relying on *Scherk* for the proposition that “[f]ederal law and federal policy unequivocally support the enforcement of private arbitration agreements entered into by citizens of the United States and foreign nationals.”<sup>204</sup> Other courts, such as the Bankruptcy Appellate Panel for the Ninth Circuit in *In re Mor-Ben Insurance Markets Corp.*, have used a form of the *McMahon* test to compel arbitration in international agreements.<sup>205</sup> The court held that, “[a]bsent a [c]ongressional mandate to preclude arbitration in the bankruptcy context, or a compelling situation seriously affecting the rights of creditors in a bankruptcy, a valid clause in an international trade agreement to arbitrate a dispute must be enforced.”<sup>206</sup>

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<sup>202</sup> Neufeld, *supra* note 14, at 557.

<sup>203</sup> See HOWARD J. STEINBERG, BANKRUPTCY LITIGATION § 5:349 (2d ed. 2007), available at Westlaw BKRLIT (“Courts have been particularly apt to enforce arbitration clauses contained in international agreements. Due to the potential effect on international commerce, international arbitration agreements are even more favored than domestic arbitration agreements.”).

<sup>204</sup> *Hart Ski Mfg. Co. v. Maschinefabrik Hennecke, GmbH* (*In re Hart Ski Mfg. Co.*), 18 B.R. 154, 161 (Bankr. D. Minn. 1982); Neufeld, *supra* note 14, at 553–54.

<sup>205</sup> See *Mor-Ben Ins. Mkts. Corp. v. Trident Gen. Ins. Co.* (*In re Mor-Ben Ins. Mkts. Corp.*), 73 B.R. 644, 648–49 (B.A.P. 9th Cir. 1987); Neufeld, *supra* note 14, at 555 (“The [*Mor-Ben*] court applied the analysis first elaborated in *Mitsubishi* and later developed in *McMahon* . . .”).

<sup>206</sup> *In re Mor-Ben Ins. Mkts. Corp.*, 73 B.R. at 649, quoted in Neufeld, *supra* note 14, at 555.

Another likely possibility is that international arbitrations in bankruptcy proceedings are treated differently not just because of their effect on business but also because bankruptcy courts lack the proper jurisdiction. For a court to mandate the automatic stay, both in personam jurisdiction over the parties and in rem jurisdiction over the estate are required.<sup>207</sup> If the property of the debtor is outside the United States, it is extremely difficult for the court to exercise in rem jurisdiction.<sup>208</sup> The only way for bankruptcy courts to protect the debtor's assets domestically against foreign creditors requires in personam jurisdiction over those creditors, which it may lack as demonstrated in the pre-Code case, *Fotochrome, Inc. v. Copal Co.*<sup>209</sup>

Fotochrome, incorporated in New York, entered into a distribution agreement with Copal, a Japanese company, where Fotochrome was to buy and distribute Copal's cameras; the deal contained an arbitration clause.<sup>210</sup> A dispute arose, leading the parties to accuse one other of violating the contract; shortly thereafter, Copal pursued arbitration in Japan as required by the arbitration clause.<sup>211</sup> Before arbitration proceedings concluded, Fotochrome filed chapter XI, and the court issued a stay against continuing arbitration; however, the "arbitral tribunal determined that it was not bound by the stay and proceeded to issue an arbitral award in favor of Copal for over \$600,000."<sup>212</sup> Fotochrome challenged the award, and the referee in the bankruptcy court ruled that because of the stay restricting the arbitration proceedings from commencing, the bankruptcy court could reconsider the merits of the claim.<sup>213</sup> The district court reversed and the Second Circuit affirmed on the key point that a stay is not effective against a foreign creditor such as Copal who does not meet the minimum contacts requirement to establish in personam jurisdiction.<sup>214</sup> Therefore, such arbitral awards are binding and are

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<sup>207</sup> David P. Stromes, Note, *The Extraterritorial Reach of the Bankruptcy Code's Automatic Stay: Theory vs. Practice*, 33 BROOK. J. INT'L L. 277, 284 (2007).

<sup>208</sup> See *id.* ("In actuality, the courts of the country in which the property is physically located are the only entities that can determine what will happen to that property.")

<sup>209</sup> See *Fotochrome, Inc. v. Copal Co.*, 517 F.2d 512, 516-17 (2d Cir. 1975); Stromes, *supra* note 207, at 284.

<sup>210</sup> Westbrook, *supra* note 98, at 602.

<sup>211</sup> *Fotochrome, Inc.*, 517 F.2d at 514 ("Copal claimed damages of \$631,501 for Fotochrome's breach of conditions in the contract and its failure to pay for delivered cameras; Fotochrome claimed damages of \$828,582 for Copal's failure to meet the delivery schedule and for its manufacture of defective cameras.")

<sup>212</sup> Westbrook, *supra* note 98, at 602.

<sup>213</sup> *Id.*

<sup>214</sup> *Id.* at 602-03; see also *Fotochrome, Inc.*, 517 F.2d at 515-16, 520 ("Nor can it be argued that the stay must have affected the arbitration because of the Bankruptcy Court's jurisdiction over the debtor's assets.")

unreviewable on their merits by the bankruptcy courts.<sup>215</sup> Even if a court does find it has in personam jurisdiction, it will be hard to enforce any sanctions against the foreign party.<sup>216</sup>

## 2. *Noncompliance with Scherk*

While *Scherk* strongly implies that international commercial arbitration agreements should be enforced in spite of subsequent bankruptcy proceedings, not all courts have fully embraced this theory. For example, in *In re United States Lines, Inc.*, the Second Circuit had to decide whether “to compel foreign arbitration of the trustee’s adversary proceeding seeking a declaratory judgment as to the debtor’s rights in certain insurance policies.”<sup>217</sup> The court recognized the importance of *Mitsubishi* and even explicitly admitted that there is a strong policy favoring the enforcement of arbitration agreements in the international context.<sup>218</sup> However, after deeming the dispute a core proceeding, the court refused to compel arbitration, “[a]pparently fearing that arbitration might produce a result leaving the estate barren.”<sup>219</sup> A similar analysis occurred in *In re White Mountain Mining Co.*, where the Fourth Circuit refused to compel the international arbitration agreement because “the issues to be addressed in the proceedings would directly affect the reorganization process as well as ascertain ‘the extent of equity holders in the entity.’ Accordingly, the court determined ‘the core proceeding trumped the arbitration . . . .’”<sup>220</sup>

Thus, courts are still using the core and noncore distinction as a way to refuse to compel international commercial arbitration agreements. Doing so, these courts ignore the potentially harmful effects on business transactions, in

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<sup>215</sup> *Fotochrome, Inc.*, 517 F.2d at 516.

<sup>216</sup> See, e.g., *Stromes*, *supra* note 207, at 285–86 (“Because Andrea [Shipping, one of the defendants,] was not a U.S.-based entity, the U.S. court was limited with regard to the sanctions it could realistically enforce against Andrea. Any sanctions that the court did impose would only be effective if Andrea had assets physically located in the United States—otherwise, Andrea (absent a court order from its country of incorporation) would have no incentive to submit to sanctions of a U.S. court.” (footnotes omitted) (discussing *Lykes Bros. S.S. Co. v. Hanseatic Marine Serv., GmBH (In re Lykes Bros. S.S. Co.)*, 207 B.R. 282 (Bankr. M.D. Fla. 1997))).

<sup>217</sup> José Rosell & Harvey Prager, *International Arbitration and Bankruptcy: United States, France and the ICC*, 18 J. INT’L ARB. 417, 419 (2001); see also Kirgis, *supra* note 10, at 540.

<sup>218</sup> *U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass’n (In re U.S. Lines, Inc.)*, 197 F.3d 631, 639 (2d Cir. 1999).

<sup>219</sup> Kirgis, *supra* note 10, at 540 (citing *In re U.S. Lines, Inc.*, 197 F.3d at 638–41).

<sup>220</sup> *Jacobs*, *supra* note 164, at 182 (footnote omitted) (quoting *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co.)*, 403 F.3d 164, 167 (4th Cir. 2005)).

spite of the Supreme Court's expressed and unequivocal concerns.<sup>221</sup> These erratic and sometimes negative results may make foreign parties weary of entering into any sort of an agreement with a United States business. Domestic businesses are also forced to think twice before spending time negotiating over a potentially unenforceable arbitration clause.

### C. *Monitoring Discretion*

Bankruptcy proceedings have three guaranteed levels of review: the bankruptcy court in the first instance, an appeal to the district court, and lastly an appeal to the circuit court.<sup>222</sup> Circuit courts are concerned over possible abuses of discretion by the bankruptcy judges in their rulings compelling or denying arbitration and therefore have advanced standards of review for how the issue should be appraised. For example, in *In re White Mountain Mining Co.*, the circuit court reviewed the bankruptcy court's determination for an abuse of discretion by considering the lower court's findings of fact under the clearly erroneous standard.<sup>223</sup> However, the Third Circuit in *In re Mintze* decided that it first must determine whether the bankruptcy court had any discretion to exercise before they determined whether such discretion was in fact abused, applying the de novo standard to this initial inquiry.<sup>224</sup> In the analysis outlined by the Third Circuit, "if the bankruptcy court ha[d] properly considered the conflicting policies in accordance with the law, [the court of appeals was to] acknowledge the [bankruptcy court's] exercise of discretion and show due deference to its determination that arbitration [would] seriously jeopardize a particular core bankruptcy proceeding."<sup>225</sup> If the appellate court

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<sup>221</sup> See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 516–17 (1974) ("A parochial refusal by the courts of one country to enforce an international arbitration agreement would not only frustrate these purposes [orderliness and predictability in international business transactions, preventing undue submission to hostile or ignorant forums], but would invite unseemly and mutually destructive jockeying by the parties to secure tactical litigation advantages . . . [T]he dicey atmosphere of such a legal no-man's-land would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international commercial agreements.").

<sup>222</sup> See Resnick, *supra* note 59, at 212. If the circuit has established one, the parties can also take their appeal to the circuit's bankruptcy appellate panel. See 28 U.S.C. § 158(b)(1) (2006).

<sup>223</sup> See *In re White Mountain Mining Co.*, 403 F.3d at 169–70; see also Jacobs, *supra* note 164, at 185.

<sup>224</sup> Jacobs, *supra* note 164, at 185 (citing *Mintze v. Am. Gen. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222, 228 (3d Cir. 2006)).

<sup>225</sup> *Id.* at 188–89 (alterations in original) (quoting *MBNA Am. Bank v. Hill*, 436 F.3d 104, 107 (2d Cir. 2006)) (internal quotation marks omitted).

finds an abuse of discretion, it can reverse the decision<sup>226</sup> and ultimately compel the arbitration.

Most often, the abuse of discretion stems from bankruptcy judges' unfounded mistrust of other adjudicatory forums such as arbitration. The Supreme Court in *Mitsubishi* said, "By agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum."<sup>227</sup> Bankruptcy judges often have difficulty accepting this premise; for them, the question comes down to which forum is most qualified to hear the case.<sup>228</sup> Judges deem these two forums—the arbitral and the judicial—as having competing interests, and therefore judges choose the courts to shield bankruptcy issues from arbitrators.<sup>229</sup> Even though the Supreme Court "has made it abundantly clear that fears about arbitral competence are not grounds for refusing to enforce otherwise valid arbitration agreements,"<sup>230</sup> arbitrators still possess a stigma as unprepared or incompetent to deal with issues that will affect complex bankruptcies.<sup>231</sup> No matter the ripple effect that arbitral awards may have on other creditors and the judicial system, strong congressional policy<sup>232</sup> and Supreme Court precedent favoring arbitration in a host of settings<sup>233</sup> compel a similar enforcement of arbitration agreements in

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<sup>226</sup> Kurth, *supra* note 23, at 1033 n.230 ("An appellate court may reverse these decisions only if the bankruptcy judges abused their discretion.").

<sup>227</sup> *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 473, 628 (1985), *quoted in* Kirgis, *supra* note 10, at 540.

<sup>228</sup> Kirgis, *supra* note 10, at 525.

<sup>229</sup> *See id.* ("[Judges] conclude that the only way to protect bankruptcy is to prevent the arbitration process from going forward in cases with the potential to significantly impact the bankruptcy proceedings.").

<sup>230</sup> *Id.* at 540.

<sup>231</sup> *See, e.g.,* Culhane, *supra* note 69, at 496 ("Arbitration substitutes arbitrators, who are less skilled in the relevant law and possibly inclined to favor particular creditors, for experienced and expert bankruptcy judges.").

<sup>232</sup> *See, e.g.,* 9 U.S.C. §§ 2–4 (2006) (making arbitration agreements "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract" and requiring courts to stay trials or enforce valid arbitration agreements if either party petitions the court).

<sup>233</sup> *See, e.g.,* *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1748–53 (2011) (allowing waiver of class arbitration in contracts of adhesion); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484–85 (1989) (allowing arbitration of claim under Securities Act of 1933); *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 238, 242 (1987) (allowing arbitration of claims under RICO and Securities Exchange Act of 1934); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628–29, 638–40 (1985) (allowing arbitration of antitrust claims arising from international commercial contract); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 515–20 (1974) (allowing arbitration of claims under Securities Exchange Act of 1934 in international commercial contract).

bankruptcy. As appellate courts move in the direction of the Supreme Court's proarbitration policy,<sup>234</sup> the abuse of discretion test is vitally important.

Where an abuse of discretion is found and arbitration is eventually compelled, any past bankruptcy proceeding turns out to be both inefficient and costly, with the parties having spent time and money going through the adjudicatory process all the way to the court of appeals and, after a determination that the claim is arbitable, needing to spend even more time and money on arbitration. On the other hand, prevention of abuse may be a futile process if the circuit judges share the same negative opinions of arbitration as the lower court judges. This results in parties spending time and money going through appeals in vain.

Instead of trying to prevent abuse at the bankruptcy court level, district courts and circuit courts should concentrate their efforts on reviewing arbitral awards for errors as more disputes, both in the bankruptcy and nonbankruptcy setting, are shifting towards arbitration.<sup>235</sup> In addition to the statutory grounds outlined in section 10 of the FAA for vacating an arbitral award,<sup>236</sup> courts have also invoked the doctrine of "manifest disregard of the law" as an extrastatutory method of review.<sup>237</sup> Simply, this standard requires more than just a mere error in the application of the law; rather, the mistake must have been so obvious that a reasonable arbitrator would have easily seen it.<sup>238</sup> Furthermore, courts have also noted that the word "disregard" requires that the arbitrator knew of a binding and applicable legal principle but chose to ignore it regardless.<sup>239</sup> While there is no set test under this doctrine, "[m]ost [courts] require evidence of a conscious decision by the arbitrator to decide contrary to a clearly applicable governing rule, making the test extremely difficult to satisfy."<sup>240</sup> The losing party in arbitration will often seek judicial review under this doctrine; however, in most cases it is futile.<sup>241</sup> The other nonstatutory ground for vacating arbitral awards is public policy; however, many cases suggest "an extremely narrow ground for public policy review of arbitral

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<sup>234</sup> See, e.g., *Mintze v. Am. Gen. Fin. Servs., Inc. (In re Mintze)*, 434 F.3d 222, 230–32 (3d Cir. 2006).

<sup>235</sup> See *Kirgis*, *supra* note 10, at 540 ("This process—of allowing arbitration to proceed and then reviewing the award on public policy grounds—would give effect to the FAA, respect the parties' contractual commitments, and still allow a Bankruptcy Court to protect the integrity of the bankruptcy system.")

<sup>236</sup> See 9 U.S.C. § 10 (2006); see also *infra* note 258 and accompanying text.

<sup>237</sup> See *Kirgis*, *supra* note 10, at 531–32.

<sup>238</sup> See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986).

<sup>239</sup> See *id.*

<sup>240</sup> *Kirgis*, *supra* note 10, at 531–32.

<sup>241</sup> *Id.*

awards: [a]n award may be vacated on public policy grounds only if a party can show that the award contravenes a specific rule of law.”<sup>242</sup>

Recently, the continued viability of these nonstatutory grounds of review has been questioned after the Supreme Court’s decision in *Hall Street Associates v. Mattel, Inc.*<sup>243</sup> The Court held that judicial review of arbitral awards should be conducted using sections 10 and 11 of the FAA exclusively.<sup>244</sup> However, the Court did not clearly reject or accept the nonstatutory grounds of review.<sup>245</sup> As arbitration continues to grow, it only becomes more imperative for the enforcing courts to establish a proper system of review to ensure that arbitral awards are free from error or abuse instead of concentrating their efforts on abuse of discretion in bankruptcy proceedings.

### III. RESOLVING THE CONFLICT: ARBITRATION TRUMPS THE CODE

The current framework for trying to resolve the conflict between the FAA and the Code is convoluted, with tests, factors, and distinctions that lead to inconsistent results among the circuits.<sup>246</sup> While there are valid concerns about not adjudicating all creditor claims in one centralized proceeding,<sup>247</sup> these do not outweigh the need for uniformity. The way to end the conflict and allow for parties to achieve the best results is to lift the automatic stay and enforce parties’ bargained for arbitration agreements in all bankruptcy proceedings. In making the arbitration agreement, the parties have demonstrated the intent to settle all disputes through arbitration, regardless of any future bankruptcy filings. The Ninth Circuit recognized this in *In re Mor-Ben Insurance Markets Corp.*, stating, “[T]he fact that these [breach of contract] issues arise in the context of a bankruptcy does not invalidate the agreement of the parties to have the dispute heard by an arbitrator . . . .”<sup>248</sup> At the conclusion of the properly

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<sup>242</sup> *Id.* at 532–33 (citing *E. Associated Coal Corp. v. United Mine Workers of Am.*, 531 U.S. 57 (2000); *United Paperworkers Int’l Union v. Misco, Inc.*, 484 U.S. 29 (1987)).

<sup>243</sup> Kirgis, *supra* note 10, at 533–34.

<sup>244</sup> *Id.*

<sup>245</sup> *Id.*; *see also* *Hall St. Assocs. v. Mattel, Inc.*, 552 U.S. 576, 584–86, 590–91 (2008). The Court implied that manifest disregard might be read as an alternative way of discussing FAA sections 10 and 11 and did not specifically address the public policy exception. Kirgis, *supra* note 10, at 533–34.

<sup>246</sup> *See supra* Part II.A–B.

<sup>247</sup> *See supra* Part I.B.

<sup>248</sup> *Mor-Ben Ins. Mkts. Corp. v. Trident Gen. Ins. Co. (In re Mor-Ben Ins. Mkts. Corp.)*, 73 B.R. 644, 648 (B.A.P. 9th Cir. 1987).

compelled arbitration, the award should proceed to the bankruptcy court for enforcement<sup>249</sup> and final confirmation of the award amount.

Brazil's Superior Court of Justice came to the same conclusion, adopting a policy of unequivocally compelling arbitration even in the face of bankruptcy proceedings in the "landmark" case involving Interclínicas Planos de Saúde SA and Saúde ABC Servicos Medicos Hospitalares Ltda.<sup>250</sup> The court outlined several reasons for this position. First, the court pressed the point that at the time commercial parties agree to arbitrate future disputes, they do so in their full capacity and therefore these agreements are not invalidated after bankruptcy is filed.<sup>251</sup> Second, the court determined that arbitration affords parties all the same rights and defenses as they would have in bankruptcy proceedings: "The arbitration can go forward and the procedural rights of the entity in liquidation are in no way harmed, because the rules applicable to arbitration proceedings fully protect the due process rights of the parties."<sup>252</sup> There is no reason why a debtor and creditor could not fruitfully participate in arbitration proceedings just as they would in litigation.<sup>253</sup> Indeed, "arbitration . . . increasingly resemble[s] litigation, with its extensive discovery and motion practice"<sup>254</sup> and the provision of some form of evidence rules.<sup>255</sup> Third, because the debtor can bring all suitable defenses against this claim in

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<sup>249</sup> See Kirgis, *supra* note 10, at 538–39 ("When a Bankruptcy Court compels arbitration of a claim disputed in the bankruptcy proceeding, it becomes the court to which the parties apply for enforcement in the first instance . . . [At this point,] the Bankruptcy Court should normally enter the award as a judgment or refer it to the district court for entry as a judgment. But [the court] also has the power to review the award to determine, among other things, whether the award is in violation of public policy.").

<sup>250</sup> Arnaldo Wald & Rodrigo Garcia Da Fonseca, *Arnaldo Wald and Rodrigo Garcia Da Fonseca on the "Interclínicas Case": Brazil's Superior Court of Justice Rules on the Arbitrability of Disputes Involving Bankrupt Companies and Reaffirms the Principle of Kompetenz-Kompetenz*, 2008 LEXISNEXIS EMERGING ISSUES ANALYSIS 2780, at 4–5 (2008).

<sup>251</sup> *Id.* at 4 ("Another relevant issue pointed in Justice Andrighi's opinion is that, in the case at hand, the arbitration clause was agreed to before the decree of the extrajudicial liquidation of the company. There can be no doubt that it was a valid contractual provision at the time it was agreed to, entered into between two companies in a commercial setting.").

<sup>252</sup> *Id.* Given that the party can be protected adequately in arbitration, it should not be allowed to avoid arbitrating by claiming a breach its due process rights. See Jennifer Kirby & Denis Bensaude, *A View from Paris*, MEALEY'S INT'L ARB. REP., Aug. 2009, at 1, 6 ("Where a party refuses to participate in arbitral proceedings, the French Supreme Court explained, that party is both estopped from arguing that the proceedings breached due process and must be considered to have waived its right to complain on this score.").

<sup>253</sup> See Wald & Garcia Da Fonseca, *supra* note 250, at 4.

<sup>254</sup> Kirgis, *supra* note 10, at 534.

<sup>255</sup> See, e.g., COMMERCIAL ARBITRATION RULES & MEDIATION PROCEDURES R-31(b) (Am. Arbitration Ass'n 2009), available at <http://www.adr.org/sp.asp?id=22440> ("The arbitrator shall determine the admissibility, relevance, and materiality of the evidence offered and may exclude evidence deemed by the arbitrator to be cumulative or irrelevant.").

arbitration just as it would in litigation, this protects the value of the estate for the other creditors.<sup>256</sup> Lastly, protection is ultimately available to the parties through the enforcement action.<sup>257</sup>

At this enforcement stage, the party opposing the award can invoke all the available defenses against enforcement. In domestic arbitrations, section 10 of the FAA provides numerous grounds for district courts to vacate the award.<sup>258</sup> Similarly, for international arbitrations, Article V of the New York Convention provides grounds for which enforcement may be refused.<sup>259</sup> “The German courts have repeatedly held that the catalogue of grounds for refusal outlined in Article V of the New York Convention is exhaustive.”<sup>260</sup> Even though courts are limited to their review of the award under these two statutes,<sup>261</sup> they “have found several non-statutory grounds for vacating awards because of decisional errors committed by the arbitrator,” such as the manifest disregard of the law and public policy exceptions that still exist in some form today.<sup>262</sup> Accordingly, parties have various legal avenues through which they can rectify any mistakes arising from the arbitration and do not need bankruptcy law to shield them.<sup>263</sup>

If a bankruptcy judge determines there are no grounds on which to vacate the arbitration award, the next step would be to confirm the amount of the award, which is similar to the procedure in France. There, an arbitral tribunal

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<sup>256</sup> See Wald & Garcia Da Fonseca, *supra* note 250, at 4.

<sup>257</sup> See *id.* (“The ruling of the Superior Court of Justice in the *Interclínicas* Case stresses, moreover, that Arbitral Tribunals do not have the legal power to enforce their own awards, which need to be taken to court in case the loser resists compliance, and there are legal remedies available to the parties to correct any possible wrongdoings in the arbitration.”).

<sup>258</sup> 9 U.S.C. § 10(a) (2006).

<sup>259</sup> See Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *supra* note 139, art. 5, ¶ 1 (“1. Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that: . . . (c) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced . . .”).

<sup>260</sup> Wolfgang Kühn, *Current Issues on the Application of the New York Convention—A German Perspective*, 25 J. INT’L ARB. 743, 754 (2008) (“The Brandenburg Court of Appeal, for example, had to face the question whether the opening of bankruptcy proceedings constituted a ground for refusal of enforcement. It answered the question in the negative, as none of the grounds for refusal outlined in Article V applied, and therefore the enforcement was granted.”).

<sup>261</sup> 9 U.S.C. § 2.

<sup>262</sup> Kirgis, *supra* note 10, at 531; see also *supra* Part II.C.

<sup>263</sup> See Wald & Garcia Da Fonseca, *supra* note 250, at 5.

may allow the arbitration to continue while the debtor is involved in bankruptcy proceedings, but in some cases it may be hesitant to render an award ordering payment.<sup>264</sup> Instead, the tribunal decides the validity and value of the award, and the court enforces it.<sup>265</sup> Applying this concept in American bankruptcy proceedings, the bankruptcy judge would be able to confirm the arbitrator's award amount or reject it if it too heavily skews the recovery of the other creditors. This balanced and simple review system is preferable to the current confusing framework because it allows the parties to arbitrate as they contracted for, protects third party creditors' recovery, and advances bankruptcy law to meet the Supreme Court's jurisprudence favoring arbitration for disputes under federal statutes.

### CONCLUSION

"Parties enter into arbitration agreements because they recognize that they cannot foresee all possible eventualities and disputes that might arise, and that it would not be efficient to provide for all eventualities even if they could be anticipated."<sup>266</sup> Parties cannot foresee the possibility that they will one day end up in bankruptcy proceedings and the arbitration agreement they agreed to will be invalidated. Many courts recognize the need to compel arbitration but only if it meets their standards under the core versus noncore distinction, *McMahon* test, or sound discretion.<sup>267</sup> However, these mechanisms have serious drawbacks and lead to inconsistent results.<sup>268</sup> The bankruptcy regime generally fails to acknowledge the overall shift in favor of arbitration, which has serious effects on domestic and international business transactions. Bankruptcy law is once again in need of reform: as litigation is fading and arbitration is taking center stage as the primary means of dispute resolution, it must be made clear that such agreements are to be enforced in bankruptcy proceedings.

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<sup>264</sup> Rosell & Prager, *supra* note 217, at 433.

<sup>265</sup> *See id.*

<sup>266</sup> Kirgis, *supra* note 10, at 543.

<sup>267</sup> *See supra* Part I.A.

<sup>268</sup> *See supra* Part II.A.

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