“THE ABC’S OF ACB’S” – Arbitration Clauses in Bankruptcy Court

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You’ve decided that your business will fare better if you put a mandatory arbitration clause into all of your contracts. You want to be fair to your counterparty, so you choose to arbitrate under the Federal Arbitration Act. That way, everyone knows the rules and the choices available at the time your bargain is struck.

Then disaster strikes. Your counterparty files bankruptcy. It’s a chapter 11 as the counterparty intends to reorganize. Your problem is that you haven’t been paid because of a pending, unresolved disagreement that you’ve been trying to work out. You are owed an amount that hurts not just your profit margin but your ability to purchase inventory in an amount to supply your customers and you’re concerned that if you don’t get paid soon, your business will find its own path to bankruptcy in the all-too-near future.

But you have that arbitration clause! Can’t you just call the counterparty debtor, demand arbitration and get out from under the bankruptcy? Well – is anything ever that easy? So what CAN you do?

The tension between the Federal Arbitration Act and Bankruptcy is decades old so you may assume that, by now, we’d all know which one takes precedence over the other. Not so. Each situation is addressed on its own set of facts and the outcome of whether you arbitrate or litigate depends on the analysis of the facts by the presiding bankruptcy judge.

Here is a bird’s-eye view of three factors that may inform your decision of whether to seek arbitration.

1 – The automatic stay, 11 U.S.C. § 362

Once a bankruptcy is filed, virtually all actions to collect a debt from the debtor or its property are subject to the automatic stay – a temporary injunction intended to provide the debtor with a breathing spell in which to organize its financial affairs. Thus, even a demand for arbitration, which is a step in the process of collecting a debt, could violate the stay. As sanctions can be imposed for stay violations, they are not to be treated with disdain. The first step you need to take is to file a motion with the court seeking to compel arbitration.

The legal premise for such a motion starts with the Federal Arbitration Act (“FAA”), which specifies that an agreement to use arbitration to settle a dispute that arises from the agreement is valid, irrevocable and enforceable except on grounds that would enable the contract itself to be revoked. 9 U.S.C. § 2. The United States Supreme Court opined as early as 1983 in *Moses H. Cone Mem. Hospital v. Mercury Construction Corp., 4*60 U.S. 1, 24 (1983), that the FAA created a strong federal policy favoring arbitration agreements. By 1985, that Court instructed federal courts to enforce arbitration agreements when possible. *Dean Witter Reynolds, Inc. v. Byrd,* 470 U.S. 213, 221 (1985). The Court wrote: “We agree . . . that the Arbitration Act requires district courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums. Accordingly, we reverse the decision not to compel arbitration.” *Id.* 460 U.S. at 217.

Because the FAA authorizes a party to an arbitration agreement to move for an order compelling arbitration, the burden to show that enforcement was not intended by Congress on the circumstances of the particular dispute falls on the party opposing arbitration. In bankruptcy, that is typically the debtor or trustee. Only where the court determines that arbitration conflicts with bankruptcy policy does it not send the dispute to arbitration.

2 – Core versus non-core proceedings, 28 U.S.C. § 157

One of the factors a bankruptcy court will consider in whether the arbitration agreement comports with bankruptcy policy and should be enforced is whether the dispute is "core" or "non-core." A "core" proceeding is one which exists only because of the bankruptcy. A "non-core" proceeding is one that arises in, arises under or is related to a bankruptcy. Traditionally, bankruptcy courts entered final orders in all core matters but issued only advisory opinions for the district court's review in non-core matters. Although *Stern v. Marshall,* 131 S. Ct. 2594 (2011), and its progeny, *Executive Benefits Ins. Agency v. Arkison,* 134 S. Ct. 2165 (2014), have thrown some doubt into the adjudicative authority of a bankruptcy court to enter final orders even in some proceedings that may be "core," for the purpose of determining whether arbitration or litigation will ensue, the distinction is still meaningful. If a matter is core, there is strong incentive that only the bankruptcy court should hear and determine the matter. If it is non-core, generally, but with exceptions, there is less likelihood that a conflict between the FAA and bankruptcy policy will be found.

3 – When to file a motion to compel arbitration

The typical situation in which the issue of where to have the matter decided (that is, in the bankruptcy court or by arbitration) arises in an adversary proceeding. An adversary proceeding is a formal litigation process in which a complaint is filed and a summons is issued, compelling a defendant to respond. The issue also could come up in a contested motion proceeding which does not usually bear the same level of formality as an adversary proceeding. In either case, the better practice is to move to compel arbitration early in the process, before the parties and the judge have invested substantial time and resources in the litigation. However, there is no hard and fast rule regarding timing. To the extent that a court will honor the provision of the FAA that says the arbitration clause is irrevocable and enforceable, filing the request later may not automatically generate a denial. However, to the extent that there is any equitable factor involved by which the court has the discretion to rule one way or the other, logic suggests that the more invested in the litigation the parties and the court are, the less likely the motion will be granted and the more likely the proceeding will stay where it began – in the bankruptcy court.

Conclusion

If your contract contains an arbitration clause that you want to enforce in a bankruptcy proceeding, file a motion and ask the bankruptcy court to compel arbitration and do so as early in the process as you can. The party defending that motion will likely have to show a conflict between the FAA and bankruptcy, which is not easy. However, if the matter is not "core," the court may be more inclined to enforce the arbitration clause than if the matter is "core."

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