Why High Court's Schein Decision Is Dangerous For Debtors

By Shane Ramsey

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Shane Ramsey

The policies and objectives underlying bankruptcy and arbitration laws are not easily reconcilable. To make matters more complex, these bodies of law are constantly changing, and, at times, in conflicting ways. In recent years, the courts have reformed and solidified their acceptance of arbitration, which now enjoys almost unfettered acceptance as a form of dispute resolution.

This solidification became more pronounced on Jan. 8, 2019, when the United States Supreme Court issued its opinion in Henry Schein Inc. v. Archer and White Sales Inc.,[1] in which the court struck down an exception that had allowed courts to decide whether a claim belongs in arbitration. In so doing, the court has further defined the allocation of power between arbitral tribunals and courts by eliminating a ground by which parties could seek to avoid arbitration.

Before turning to the Supreme Court's decision in Schein, discussion of the current state of the law is warranted.

The Current State of Bankruptcy Jurisprudence on the Enforceability of Arbitration Agreements

The Conflict Between the Bankruptcy Code and FAA Policy

One primary benefit of the bankruptcy process is the ability to centralize all relevant claims, actions and disputes within the purview of a single court.[2] This is most evident with Sections 362 and 541 of the Bankruptcy Code.[3] Section 362 — the automatic stay provision prevents most ongoing or future litigation from progressing in any other forum during bankruptcy so that all creditors and claimants may be treated equally.[4] Importantly, once the automatic stay is triggered, enforceability of an arbitration agreement falls within the scope of the stay and is thus subject to the determination of the bankruptcy court.[5]

Section 541 of the Bankruptcy Code centralizes all property at issue in a bankruptcy case under the jurisdiction of the bankruptcy court, creating a bankruptcy "estate."[6] This forces all creditors with interest in the debtor's property — now the estate's property — to come before the bankruptcy court.

Valid mandatory arbitration provisions threaten the bankruptcy court's ability to exercise its jurisdiction over the entirety of the bankruptcy estate. From the time Congress passed the Federal Arbitration Act, or FAA, courts have gradually afforded more power, and given greater deference, to valid arbitration provisions pursuant to the FAA. The Supreme Court in Shearson/American Express v. McMahon went so far as to state that the FAA "mandates enforcement of agreements to arbitrate statutory claims."[7] This mandate, however, is not absolute and may be challenged by a party opposing arbitration. A party opposing arbitration has the burden of demonstrating a congressional exception to the enforcement of arbitration by establishing: (1) statutory text containing an exception; (2) legislative history of a statute demonstrating an exception; or (3) an inherent conflict between the purpose of the statute at issue and arbitration.[8] Questions regarding arbitrability must be analyzed with an understanding that federal policy favors arbitration.[9]

The conundrum facing bankruptcy courts arises from conflicting federal ideologies: the federal interest to provide debtors with a fresh start through the framework of the Bankruptcy Code versus federal policy under the FAA favoring arbitration. The question becomes: Whether allowing a debtor to proceed with arbitration will provide a non-bankruptcy forum jurisdiction to potentially reduce the value of the estate to the detriment of all creditors.

Core vs. Non-Core Proceedings

Enforceability of an arbitration provision in bankruptcy is generally determined by examining whether or not the proceeding will be deemed "core" or "non-core" for bankruptcy purposes. 28 U.S.C. § 157 provides a non-exhaustive list of "core proceedings."[10] Core proceedings are those that arise under the Bankruptcy Code or within a bankruptcy case.[11] In contrast, non-core proceedings are those that could exist outside of bankruptcy but are nevertheless related to the bankruptcy.[12]

Arbitration in Bankruptcy — Non-Core Proceedings

Keeping in mind the precedent establishing the federal policy in favor of arbitration set by the United States Supreme Court in McMahon, the U.S. Court of Appeals for the Third Circuit addressed the conflict between the Bankruptcy Code and the FAA with respect to non-core proceedings in Hays & Co. v. Merrill Lynch Pierce Genner & Smith Inc.[13] In Hays & Co., the Third Circuit established that courts must carefully determine whether the Bankruptcy Code would be adversely affected by enforcing an arbitration arrangement.[14] Specifically, the Hays & Co. court looked at whether enforcement of an arbitration clause would "seriously jeopardize the objectives of the code."[15] Ultimately, the Third Circuit held that because the arbitration clause was enforceable as a non-executory contract, and because it was being utilized regarding a non-core adversary proceeding arising out of a district court dispute, the arbitration clause should be enforced because such enforcement was in line with the tenets of McMahon and not antagonistic to the Bankruptcy Code.[16]

In the wake of the Hays decision, courts around the country largely agreed that arbitration agreements regarding non-core claims are enforceable because there is no inherent conflict between the arbitration agreement and the purpose of the code.[17] Some courts, however, prefer to determine each claim on its face.

Arbitration in Bankruptcy — Core Proceedings

For core proceedings, the Fifth Circuit took the lead in its National Gypsum decision.[18] The Fifth Court stated that arbitrability in a core proceeding is determined by whether the proceeding derives exclusively from the Bankruptcy Code and if arbitration would conflict with the purposes of the code — including the goal of centralized resolution of purely bankruptcy issues.[19] In those matters, the court asks two questions: Whether the bankruptcy court has discretion to deny arbitration, which is a question of law, or if so, whether the court abused that discretion.[20]

This test leaves numerous issues of interpretation. Accordingly, not all circuits have followed the National Gypsum test with regard to their interpretation and application of McMahon as it relates to core proceedings.

Where Courts Currently Stand

The Third and Fifth Circuits, for example, have established a narrower test than that in

National Gypsum, holding that a bankruptcy court has the discretion to refuse to enforce an arbitration agreement when the underlying nature of the proceeding derives from the code and arbitration of that claim will conflict with the code.[21] For example, if the proposed arbitration represents half of the estate.

The Eleventh Circuit puts a greater emphasis on the determination of a core or non-core proceeding. If a proceeding does not invoke a substantive right created by federal bankruptcy law — i.e. a right that would exist outside of bankruptcy — it is non-core and is subject to arbitration. The Eleventh Circuit has also found that even core proceedings may be subject to arbitration if there is no evidence that arbitration inherently conflicts with the code.[22]

The Sixth Circuit seems to follow McMahon strictly, though there is no definitive Sixth Circuit precedent on the matter. In In re Wade, the Sixth Circuit found that the proper question is whether there is an inherent conflict between the FAA and the code.[23] If there is a conflict, the court has discretion to deny arbitration. If there is no inherent conflict, the court must compel arbitration and does not have discretion to decide the issue.[24] Case law in the Sixth Circuit prior to McMahon held that allowing arbitration, or allowing another tribunal to exercise jurisdiction, was a matter of judicial discretion.[25]

The Second and Fourth Circuits have construed McMahon more broadly. Both circuits have held that denying arbitration due to potential interference with reorganization and/or a confirmed plan is within the discretion of the court.[26] The Second Circuit, in MBNA America Bank N.A. v. Hill, held that a bankruptcy court has the discretion to override arbitration only if it finds that the proceedings are based on provisions of the code that inherently conflict with the FAA or if arbitration of a claim would necessarily jeopardize the objectives of the code.[27]

The Fourth Circuit, in line with the Second Circuit, has concluded that a bankruptcy court has the discretion to reject an arbitration agreement when the arbitration has the potential to adversely affect the bankruptcy. In other words, denying arbitration is permitted in those cases where the resolution of a claim through arbitration will substantially interfere with reorganization in some significant way, thus inherently conflicting with the purposes of the code.

Finally, the Ninth Circuit has adopted the broadest approach of all. In Continental Ins. Co. v.

Thorpe Insulation Co., the court found that a bankruptcy court has discretion to decline arbitration only if arbitration would conflict with the underlying purposes of the code.[28] The purpose of the code, the court continued, includes centralization of disputes concern a debtor's legal obligations and protecting creditors and reorganizing debtors from piecemeal litigation. The core or non-core distinction is not dispositive and may deny arbitration even for non-core matters in furtherance of the McMahon standard.[29]

How the Supreme Court's Decision in Schein May Change All of This

In Schein, the court held that courts may not override a contract that delegates to arbitrators the question of whether a claim must be arbitrated or litigated, even if the arbitration bid was "wholly groundless," saying this exception to arbitrability is inconsistent with the FAA.

The court concluded that courts do not have the authority to override a decision by the parties to delegate the question of whether a dispute must be arbitrated or litigated to an arbitrator.

The court, in substance, said that it had already decided the question in its 2010 decision in Rent-A-Center West Inc. v. Jackson, where the court ruled that the parties may agree by contract that an arbitrator, not the court, will resolve threshold arbitrability questions, not just the merits of the dispute.[30]

According to the court, "some federal courts nonetheless will short-circuit the process" by deciding the arbitrability question if the demand for arbitration is "wholly groundless."[31] Those courts, he said, adopted the "wholly groundless" exception to Rent-A-Center "to block frivolous attempts to transfer disputes from the court system to arbitration."[32]

The court held that courts "may not decide the arbitrability issue" if "a valid agreement exists, and if the agreement delegates the arbitrability issue to an arbitrator."[33]

The decision is significant because it eliminates the ability of parties to argue that a matter should remain in court if the opposing party's arbitration bid is wholly groundless — an argument that was routinely used by parties seeking to avoid arbitration.

The decision also has significant implications for parties in bankruptcy court.

If applied rigorously in bankruptcy cases, the decision could effectively change the current state of the law. Assume a debtor is party to a pre-bankruptcy agreement providing that all disputes between it and the creditor are subject to arbitration (even disputes arising after bankruptcy) and the agreement further provided for the arbitrator to decide whether any such disputes were arbitrable, even following bankruptcy. In such a scenario, the court's holding in Schein would seem to prevent bankruptcy judges from barring creditors from initiating arbitrations over "core" issues — thereby preventing the bankruptcy judge from barring arbitration if there was a "severe conflict" with bankruptcy law. What's more, Schein could be read to mean that a bankruptcy court cannot bar a creditor from initiating arbitration against a debtor, even if the arbitration request is frivolous.

Such a result will inevitably lead to Chapter 11 debtors defending dozens of arbitrations, giving the bankruptcy judges little ability control the case and implement the purpose of the Bankruptcy Code.

Further guidance from the court will be necessary to clarify this potential harmful impact on the bankruptcy process.

Shane Ramsey is a partner at Nelson Mullins Riley & Scarborough LLP.

[1] 139 S.Ct. 524 (January 8, 2019).

[2] In re White Mountain Mining Co., 403 F.3d 164, 170 (4th Cir. 2005); In re Thorpe Insulation Co., 671 F.3d 1011, 1022 (9th Cir. 2012)).

[3] 11 U.S.C. § 362; 11 U.S.C. § 541.

[4] See, e.g., C.H. Robinson Co. v. Paris & Sons, Inc., 180 F. Supp. 2d 1002, 1016 (N.D. Iowa 2001) (discussing and citing legislative history of § 362, S. Rep. No. 95-989, at 54-55 (1978), as reprinted in 1978 U.S.C.C.A.N. 5787, 5840-41); Official Comm. of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines Inc.), 928 F.2d 565, 573 (2d Cir. 1991).

[5] 11 U.S.C. 362(a)(1) ("the commencement or continuation…of a judicial, administrative, or other action or proceeding"); See also ACandS, Inc. v. Travelers Cas. & Sur. Co., 435 F.3d 252, 259 (3d Cir. 2006) ("The scope of the automatic stay is broad and covers all proceedings against a debtor, including arbitration."

[6] 11 U.S.C. § 541.

[7] Shearson/American Express v. McMahon, 482, U.S. 220, 226 (1987).

[8] Id. at 226-7.

[9] Id.

[10] 28 USC § 157.

[11] Stern v. Marshall, 564 U.S. 462, 474-5 (2011).

[12] Id. at 470.

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

[14] Id. at 1161.

[15] Id.

[16] See id.

[17] See, e.g., Gandy v. Gandy (In re Gandy), 299 F.3d 489 (5th Cir. 2002) ("[I]t is generally accepted that a bankruptcy court has no discretion to refuse to compel the arbitration of

matters not involving ‘core’ bankruptcy proceedings ....”); Ins. Co. of N. Am. v. NGC Settlement Tr. & Asbestos Claims Mgmt. Corp. (In re Nat’l Gypsum Co.), 118 F.3d 1056, 1066 (5th Cir. 1997) (“With respect to derivative, noncore matters ... Hays makes eminent sense. ... Indeed, in this regard it has been universally accepted.”); Crysen/Montenay Energy Co. v. Shell Oil Co. (In re Crysen/Montenay Energy Co.), 226 F.3d 160, 166 (2d Cir. 2000) (“The Third Circuit’s Hays decision-- holding that district courts must stay non-core proceedings in favor of arbitration--is generally accepted.”); The Whiting-Turner Contracting Co. v. Elec. Mach. Enters., Inc. (In re Elec. Mach. Enters., Inc.), 479 F.3d 791, 796 (11th Cir. 2007) (“In general, bankruptcy courts do not have the discretion to decline to enforce an arbitration agreement relating to a non-core proceeding.”); In re TP, Inc., 479 B.R. 373, 382 (Bankr. E.D.N.C. 2012) (“[I]f the matter is noncore, it is generally referred to arbitration consistent with the policy in favor of arbitration ....”).

[18] Ins. Co. of N. Am. v. NGC Settlement Tr. & Asbestos Claims Mgmt. Corp. (In re Nat’l Gypsum Co.), 118 F.3d 1056 (5th Cir. 1997)

[19] Id. at 1069.

[20] Moses v. CashCall Inc., 718 F.3d 63, 84-5 (4th Cir. 2015)

[21] See Gandy v. Gandy (In re Gandy), 299 F.3d 489, 496 (5th Cir. 2002); see also Mintze v. Am. Gen. Fin. Svcs., Inc., 434 F.3d 222, 226 (3d Cir. 2006).

[22] In re Elec. Mach. Enterprises, Inc., 479 F.3d 791, 797 (11th Cir. 2007)

[23] 523 B.R. 594, 603 (Bankr. W.D. Tenn. 2014).

[24] Id.; see also In re No Place Like Home, Inc., 559 B.R. 863, 871 (Bankr. W.D. Tenn. 2016)

[25] In re Muskegon Motor Specialties Co., 313 F.2d 841, 842 (6th Cir. 1963).

[26] See In re Relativity Fashion, LLC, 696 Fed. App’x 26, 30 (2nd Cir. 2017); In re White Mountain Mining Co., LLC, 403 F.3d 164 (4th Cir. 2005).

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

[28] 671 F.3d 1011, 1021 (9th Cir. 2012).

[29] Id.

[30] 561 U. S. 63, 68−70 (2010).

[31] 139 S.Ct. 524, 527-528

[32] Id. at 528.

[33] Id.