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Circuit Split in Enforceability of Arbitration Clauses in Bankruptcy Left Unresolved

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In a recent summary opinion, the Supreme Court denied certiorari review of a decision, Continental Insurance Co. v. Thorpe Insulation Co. *(In re Thorpe Insulation Co.), 671 F.3d 1011 (9th Cir. 2012), where the Ninth Circuit had affirmed a lower court's decision refusing to enforce an arbitration clause in a settlement agreement between a debtor and an insurer. In doing so, the Supreme Court declined an opportunity to resolve what many believe to be an important and significant circuit split on the standard for the enforceability of arbitration clauses in bankruptcy proceedings.*

A Developing Split on the Enforceability of Arbitration Clauses in Bankruptcy

The Federal Arbitration Act, 9 U.S.C. §§ 1-307, represents a federal policy in favor of enforcing arbitration agreements. The Supreme Court has held that courts are generally obligated to enforce arbitration clauses absent a countervailing federal statute. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987). However, this policy inevitably comes into conflict with the Bankruptcy Code, which is grounded on a policy of centralized dispute resolution. Congress has not offered any legislative guidance on how to reconcile these competing policies. As a result, the courts have been left to determine when arbitration clauses are enforceable in bankruptcy.

The Fifth Circuit was the first to address this issue. In *In re National Gypsum Co.*, 118 F.3d 1056 (5th Cir. 1997), it articulated a two-part inquiry for determining whether an arbitration clause is enforceable. The court should first look to the source of the claim to be arbitrated—does it derive from the Bankruptcy Code or non-bankruptcy law? Rights derived from the Bankruptcy Code must be adjudicated by the bankruptcy court, not in arbitration. For non-bankruptcy rights, the court should then determine whether arbitration would conflict with the broad principles underlying the Bankruptcy Code, "including the goal of centralized resolution of purely bankruptcy issues, the need to protect creditors and reorganizing debtors from piecemeal litigation, and the undisputed power of a bankruptcy court to enforce its own orders." *Id.* at 1069. In 2006 the Third Circuit adopted this two-part test. *In re Mintze*, 434 F.3d 222, 231-32 (3d Cir. 2006). By contrast, the Second and Fourth Circuits have focused solely on the second part of the *National*

Gypsum test, namely, "whether there is an inherent conflict between arbitration and the underlying purposes of the bankruptcy laws." *In re White Mountain Mining Co., LLC*, 403 F.3d 164, 169 (4th Cir. 2005); see *also In re U.S. Lines, Inc*., 197 F.3d 631, 640 (2d Cir. 1999) ("In exercising its discretion over whether, in core proceedings, arbitration provisions ought to be denied effect, the bankruptcy court must still carefully determine whether any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing an arbitration clause.").

The Ninth Circuit's Decision in *Continental Insurance*

At issue in *Continental Insurance* was the enforceability of an arbitration clause in a settlement agreement between Continental and the debtor. The debtor, an insulation manufacturer and distributor facing mass asbestos-related litigation, had settled a coverage dispute with Continental in 2003, prior to its bankruptcy filing. As part of its reorganization, the debtor sought to channel current and future asbestos-related claims into a trust created pursuant to § 524(g) of the Bankruptcy Code. Insurers that settled with the debtor were released from coverage for future claims, but the plan allowed claimants, with the trust's permission, to sue non-settling insurers directly. Continental, which did not settle, argued that this plan violated its earlier settlement agreement, and that the dispute should therefore be arbitrated pursuant to its 2003 agreement with the debtor. The bankruptcy court denied Continental's motion to compel arbitration.

The Ninth Circuit affirmed and appeared to apply the Fifth Circuit's *National Gypsum* test. It first noted that, despite what Continental had argued, the claim to be arbitrated did not arise out of non-bankruptcy law. While the arbitration clause was contained in a prepetition agreement, the root issue was whether the debtor's plan of reorganization, and specifically the trust created pursuant to § 524(g), breached the 2003 settlement agreement. As such, the issue was "whether the manner in which someone has administered a bankruptcy estate gives rise to a claim for damages" and therefore, "as a matter of fundamental bankruptcy policy," could only be decided by a Bankruptcy Court. *Continental Ins*., 671 F.3d at 1022. Noting that the specific purpose of § 524(g) is to "consolidate a debtor's asbestos-related assets and liabilities into a single trust for the benefit of asbestos claimants," the Ninth Circuit found that allowing Continental's claim to be arbitrated would conflict both with this specific policy as well as the Bankruptcy Code's general policy of centralization.

How Deep Is the Divide?

Continental appealed the Ninth Circuit's decision to the Supreme Court, arguing in its petition for certiorari that the Court needed to address the split between the Second, Fourth, and Ninth Circuits on the one hand and the Third and Fifth Circuits on the other. Petition for Writ of Certiorari at 3*, Continental Ins. Co. v. Thorpe Insulation Co*., No. 11-1310 (April 30, 2012). Continental drew on the work of the many commentators who have highlighted this split. See, e.g., Paul F. Kirgis, *Arbitration, Bankruptcy, and Public Policy: A Contractarian Analysis*, 17 Am. Bankr. Inst. L. Rev 503, 517-20 (2009); Alan N. Resnick, *The Enforceability of Arbitration Clauses in Bankruptcy*, 15 Am. Bankr. Inst. L. Rev. 183 (2007). However, the divide may not be as deep as Continental framed it. All of the circuits that have addressed the issue agree that courts may not refuse to enforce arbitration clauses in non-core matters. *See Continental Ins*., 671 F.3d at 1021 (collecting authorities). Core matters, which are set out by statute, are matters that invoke substantive rights provided by the Bankruptcy Code or only exist in the context of a bankruptcy case—they "arise under" the Bankruptcy Code. Non-core matters are "related to" a bankruptcy case, and may affect or be affected by the bankruptcy case. In addition, the circuits on both sides of the split agree that courts may refuse to enforce arbitration clauses where arbitration would conflict with the policies underlying the Bankruptcy Code. *See id.; Mintze*, 434 F.3d at 231; *White Mountain Mining*, 403 F.3d at 169-70; *U.S. Lines*, 197 F.3d at 640; *Nat'l Gypsum*, 118 F.3d at 1069-70.

The split, then, is not as deep as it first appears. The circuits differ over the enforceability of arbitration clauses in core matters where the rights to be vindicated arise solely out of non-bankruptcy law. The Third, Fifth, and Ninth Circuits do not allow courts to refuse to enforce arbitration in such circumstances, while the Second and Fourth Circuits appear to allow it. While there may well be instances where this split would lead to different outcomes in different forums, *Continental Insurance* does not appear to be such a case. Though the dispute involved Continental's rights under a prepetition settlement agreement, the specific issue was whether that agreement was breached by the debtor's plan of reorganization, and thus involved an issue of the administration of the debtor's estate. As such, *Continental Insurance* was not an ideal case for exploring and resolving this circuit split. The Supreme Court may have denied certiorari for this reason, though it gave no guidance in its summary opinion. Until the Supreme Court takes up the issue and settles once and for all the proper standard for determining the enforceability of arbitration clauses in bankruptcy proceedings, contracting parties should be aware that arbitration clauses may be treated differently depending on where their counterparty commences a bankruptcy case.

In any event, the issue of the enforceability of arbitration clauses in bankruptcy may well end up before the Court in the near future. Given the agreement among the circuits about the enforceability of arbitration clauses in non-core matters, the issue only arises in core matters. But after the Court's decision in *Stern v. Marshall*, 564 U.S. __, 131 S. Ct. 2594 (2011), bankruptcy courts may no longer constitutionally decide certain core matters, despite the dictates of 28 U.S.C. § 157. In a case where the claim subject to an arbitration clause could not be constitutionally decided under *Stern v. Marshall*, but arbitration of the claim would conflict with the principles underlying the Bankruptcy Code, the doctrines would be at loggerheads. Because *Stern v. Marshall* was a constitutional holding, litigation of that claim in the bankruptcy court might have to yield to the arbitration clause, even where the bankruptcy court would otherwise refuse to enforce the arbitration clause under *National Gypsum* and its progeny.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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