

When Worlds Collide: The Enforceability of Arbitration Agreements in Bankruptcy

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Many franchise agreements contain very broad arbitration clauses that require binding arbitration of virtually all disputes between the franchisor and franchisee. Although some of the perceived benefits of arbitration are debatable, many franchisors prefer to arbitrate disputes with their franchisees because of arbitration's informal hearing procedures and limited discovery, the privacy of the proceedings and outcomes, and the limited judicial review of arbitration awards.¹ However, what becomes of the arbitration clause if the franchisee files a petition under the Bankruptcy Code? Will the bankruptcy court enforce the arbitration provision? Or does the Bankruptcy Code somehow abrogate the arbitration rights that the parties freely negotiated before bankruptcy? In other words, what happens when the Bankruptcy Code and the Federal Arbitration Act collide?



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This article examines the enforceability of an arbitration clause in the bankruptcy context. The reader should be aware at the outset, however, that there is no clear-cut answer as to whether any particular arbitration clause will be enforced. Instead, it is a fact-specific question that courts typically address on a case-by-case basis. This article discusses the general principles that arise out of the case law and provides suggested strategies for maximizing the probability that the arbitration clause will be enforced in bankruptcy.

The Federal Arbitration Act

The Federal Arbitration Act (FAA)² displays a clear and unmistakable federal policy in favor of arbitration.³ The FAA was enacted to combat judicial hostility to arbitration agreements.⁴ Under the FAA, arbitration agreements are enforceable notwithstanding any state law that purports to invalidate arbitration.⁵ Thus, Section 2 of the FAA specifically validates arbitration clauses:

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A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Decisions construing the FAA leave no uncertainty as to its scope and breadth. For example, the U.S. Supreme Court held that the words *involving commerce* are broader than the words *in commerce* and reflect Congress's intent to "exercise [its] commerce power to the full."⁶ Further, arbitration is not necessarily limited to contractual claims. Arbitration clauses can be drafted to require arbitration of statutory claims as well, provided that there is no congressional intent to exclude the specific statutory claims from arbitration.⁷

Section 3 of the FAA requires that a court presiding over an arbitrable issue "shall" stay the action upon application by a party until the arbitration has been conducted in accordance with the parties' agreement.⁸ The first task of a court asked to stay litigation pending arbitration is to determine whether there is an arbitration agreement.⁹ If there is an agreement to arbitrate, the court must consider whether the claims are arbitrable under the agreement.¹⁰ Any doubts concerning the scope of arbitrability should be resolved in favor of arbitration.¹¹ The presumption in favor of arbitration is most evident in judicial treatment of so-called broad arbitration clauses, where the parties agree to arbitrate all disputes arising under, or in relation to, a contract. Thus, the courts will rule in favor of arbitration when, for example, parties have agreed to arbitrate "[a]ny dispute, controversy or claim arising out of or in relation to or in connection with this Agreement or the operations carried out under this Agreement, including without limitation any dispute as to the validity, interpretation, enforceability or breach of this Agreement."¹² The courts have held that such broad arbitration clauses are not limited to claims that literally arise under the contract "but rather embrace all disputes between the parties having a significant relationship to the contract, regardless of the label attached to the dispute."¹³ To be arbitrable under a broad arbitration clause, the dispute need only "touch matters" covered by the clause.¹⁴

In sum, franchise agreements can include extremely broad arbitration clauses covering all claims arising under, or even touching upon, the franchisor-franchisee

relationship. What happens to those bargained-for rights should the franchisee declare bankruptcy? As discussed below, the franchisor's arbitration rights are not necessarily lost and may still be enforced notwithstanding the bankruptcy filing.

Tension Between the Bankruptcy Code and the FAA

A fundamental goal of the Bankruptcy Code¹⁵ is the centralization of all disputes concerning the debtor. Under the framework established by the Bankruptcy Code and the federal statutes governing the jurisdiction of the bankruptcy courts, virtually all disputes concerning the debtor are to be resolved by the bankruptcy court. Of course, an arbitration clause directly conflicts with the goal of centralization because it seeks to remove an issue concerning the debtor from the bankruptcy court's domain. An arbitration clause instead requires any issue within its scope to be resolved in an arbitration forum. Notwithstanding this underlying tension between the Bankruptcy Code and the FAA, the Bankruptcy Code does not necessarily abrogate a nondebtor's contractual right to arbitration. Instead, the courts will attempt to balance the clear public policy in favor of arbitration with the policies underlying the Bankruptcy Code.

In considering the enforceability of arbitration clauses in bankruptcy proceedings, courts apply standards similar to those used to determine whether federal statutory claims are arbitrable. In *Shearson/American Express, Inc. v. McMahon*,¹⁶ the U.S. Supreme Court held that to avoid arbitration of a federal statutory claim, a party must establish congressional intent to create an exception to the FAA. In *McMahon*, the Supreme Court held that intent can be found in one of three ways: (1) in the statute's text, (2) in the statute's legislative history, or (3) through "an inherent conflict between arbitration and the statute's underlying history."¹⁷ Neither the Bankruptcy Code nor its legislative history contains any reference to an exception to the FAA. As a result, courts considering whether to enforce an arbitration clause in the bankruptcy context have focused on the third prong of the *McMahon* test, namely, whether there is an inherent conflict between the Bankruptcy Code and the FAA. The party objecting to arbitration bears the burden of demonstrating "that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue."¹⁸ Thus, "there must be a demonstrated specific conflict between enforcing an arbitration clause and the textual provisions and/or purposes of the Bankruptcy Code to justify the exercise of discretion by a bankruptcy court in refusing to enforce an arbitration clause."¹⁹

The Core Versus Noncore Distinction

In applying the inherent conflict test, many courts have concentrated upon whether the claim sought to be arbitrated is "core" or "noncore." The core/noncore distinction is exceedingly important because it is generally recognized that the bankruptcy court does not have discretion to deny arbitration of noncore proceedings.²⁰ In contrast, the bankruptcy court has discretion to deny enforcement of an arbi-

tration clause when the claim sought to be arbitrated is a core claim.²¹

Core proceedings involve matters that arise either under the Bankruptcy Code or only in bankruptcy cases.²² Unfortunately, neither the Bankruptcy Code nor any of its related statutory provisions define exactly what a core proceeding is. Instead, 28 U.S.C. § 157 contains a nonexclusive list of fifteen core matters. These fall into four general categories: (a) proceedings concerning the administration of the estate,²³ (b) proceedings involving the trustee's or debtor-in-possession's avoidance powers,²⁴ (c) proceedings involving property of the estate,²⁵ and (d) a catchall category.²⁶

The statute itself neither defines nor provides examples of noncore proceedings. Instead, a noncore proceeding is generally defined as a proceeding other than a core proceeding that is "otherwise related to a case under title 11."²⁷ For example, the Third Circuit has noted that if the proceeding "does not involve a substantive right created by the bankruptcy laws and would exist outside of bankruptcy, it is a noncore proceeding even though it may be related to bankruptcy."²⁸ Accordingly, the following have been held to be noncore proceedings: (a) a debtor's claim for a tax refund brought following entry of the discharge,²⁹ (b) a debtor's claim for anticipatory breach of a prepetition contract based upon postpetition events,³⁰ and (c) actions to enforce a covenant not to compete contained in a prepetition contract.³¹ Common to each is that the action is not based on a right found in the Bankruptcy Code, and the action could have been brought in another court but for the bankruptcy.

Courts will allow arbitration of noncore claims because arbitration of these claims will not interfere with the Bankruptcy Code or its objectives or policies. As one bankruptcy court opined, arbitration of noncore matters is consistent with the Bankruptcy Code's "mandate to enforce a valid pre-petition, non-executory contract, the presence of a strong federal policy favoring arbitration, and the absence of a serious conflict with the objectives of the Bankruptcy Code."³² The courts have thus compelled arbitration of noncore claims such as (a) a debtor's claim that its prepetition franchise agreement had been improperly terminated,³³ (b) a debtor's claim for moneys allegedly due under a prepetition settlement agreement,³⁴ and (c) the debtor's claim for breach of prepetition oil purchase contracts.³⁵

In contrast, the bankruptcy court may deny enforcement of an arbitration clause when the claim sought to be arbitrated is a core claim and the arbitration will interfere with the bankruptcy process or affect rights granted by the Bankruptcy Code. The test for determining whether a core proceeding can be arbitrated has been described by one court as follows: "[The court] must carefully determine whether any underlying purpose of the Bankruptcy Code would be adversely affected by enforcing an arbitration clause and [the court] should enforce such a clause unless the effect would seriously jeopardize the objectives of the Code."³⁶ Another court opined that the court may decline to compel arbitration of a core proceeding "only if it finds that enforcement of the arbitration clause would conflict with the policies of the Bankruptcy Code, or where the dispute underlying the arbitration is

based on rights created by the Bankruptcy Code.”³⁷ Accordingly, when determining whether to allow arbitration of a core claim, the court will consider, among other factors, “whether arbitration would be consistent with the purpose of the 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.”³⁸

Although the bankruptcy court arguably has the discretion to deny arbitration of all core claims, courts have been more willing to deny arbitration when the claim concerns rights conferred by the Bankruptcy Code (as opposed to rights originating from the debtor’s prepetition contractual relationships). Underlying these decisions is the concern that arbitration of bankruptcy rights will more directly conflict with the objectives of the Bankruptcy Code. As one court noted, “[t]here can be little dispute that where a core proceeding involves adjudication of federal bankruptcy rights wholly divorced from inherited contractual claims, the importance of the federal bankruptcy forum provided by the Code is at its zenith.”³⁹ Accordingly, courts have refused to allow arbitration of such core matters as (a) avoidance claims brought by a debtor-in-possession under Sections 544, 548, and 550 of the Bankruptcy Code;⁴⁰ (b) a proceeding seeking a declaration that an action to recover pre-confirmation debts violated a discharge injunction;⁴¹ and (c) an action to liquidate claims arising out of the debtor’s rejection of an executory contract.⁴² In contrast, courts have allowed arbitration of such core claims as (a) the debtor’s objection to a proof of claim,⁴³ (b) a debtor’s action for a declaratory judgment as to the enforceability of a prepetition agreement,⁴⁴ (c) a debtor’s action for a determination that it was entitled to the release of funds escrowed under a prepetition purchase agreement,⁴⁵ and (d) a former employee’s breach of contract claim against the debtor where the former employee filed a proof of claim based on contractual rights.⁴⁶

The decision in *In re Farmland Industries, Inc.*,⁴⁷ where the court allowed arbitration of an objection to a proof of claim (one of the specifically enumerated core proceedings),⁴⁸ demonstrates the difficulties in reconciling those cases in which arbitration of core claims was permitted with those cases in which arbitration was not permitted. In *Farmland Industries*, the court rejected an apparent request to study the facts of analogous cases, noting:

[T]here are a panoply of cases dealing with the intersection of bankruptcy proceedings and arbitration agreements, often reaching contrary outcomes. Each case, however, turns on its own particular facts and on the exercise of the bankruptcy court’s discretion; thus, an in-depth analysis of analogous cases is of little value to the matter presently before the Court.⁴⁹

The fact-specific nature of the inquiry does not mean that case law is not helpful in determining whether a bankruptcy court should compel arbitration of a franchise dispute. To the

contrary, since January 1, 2006, three U.S. Courts of Appeal—the Eleventh Circuit, the Second Circuit, and the Third Circuit—have addressed the conflict between the FAA and the Bankruptcy Code. In each of these three decisions, the appellate court focused on whether arbitration would conflict with the policies and objectives of the Bankruptcy Code. In fact, in all three cases, the courts of appeals held that the arbitration clause should have been enforced. In contrast, a 2005 decision from the Fourth Circuit suggests that arbitration will not be compelled if doing so would hamper the debtor’s legitimate efforts to reorganize.

LESSONS LEARNED

Eleventh Circuit

In the most recent circuit court decision addressing the enforceability of an arbitration provision in bankruptcy, the Eleventh Circuit held that the bankruptcy court erred by denying a general contractor’s motion to compel arbitration with the debtor. The Eleventh Circuit so held because “the debtor’s claim was not a core proceeding and arbitration of the claim would not inherently conflict with the underlying purposes of the Bankruptcy Code.”⁵⁰ In *In re Electric Machinery Enterprises, Inc.*, Whiting-Turner, a general contractor, entered into a subcontract with the debtor, Electric Machinery Enterprises, Inc., (EME), to provide electrical work on a theme park. EME later filed for bankruptcy and brought an adversary proceeding in bankruptcy court, alleging that Whiting Turner owed money under the subcontract. Whiting Turner moved to compel arbitration.⁵¹ The bankruptcy court determined that the matter was a core proceeding and denied Whiting-Turner’s motion to compel arbitration. The district court affirmed, and Whiting-Turner appealed.

On appeal, the Eleventh Circuit began its analysis by discussing the strong federal policy established by the FAA and acknowledging that “‘questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration.’”⁵² Nonetheless, the court noted that “[l]ike any statutory directive the Arbitration Act’s mandate may be overridden by contrary congressional command.”⁵³ The Eleventh Circuit found no indication within the Bankruptcy Code’s text or legislative history that Congress intended to create a bankruptcy exception to the FAA. Accordingly, the court applied the third prong of the *McMahon* test, i.e., whether an inherent conflict exists between arbitration and the underlying purposes of the Bankruptcy Code.⁵⁴

The Eleventh Circuit acknowledged that other courts addressing the inherent conflict issue had distinguished between core and noncore proceedings and had held that “bankruptcy courts do not have discretion to decline to enforce an arbitration agreement relating to a non-core proceeding.”⁵⁵ However, the court observed that “even if a proceeding is determined to be a core proceeding, the bankruptcy court must still analyze whether enforcing [the] arbitration agreement would inherently conflict with the underlying purposes of the Bankruptcy Code.”⁵⁶ The Eleventh Circuit held that the contractual claim asserted by EME

against Whiting-Turner was not a core proceeding but further noted that, even if it was, there was no evidence that arbitrating EME's claim would present an inherent conflict with the underlying purposes of the Bankruptcy Code. The Eleventh Circuit therefore ordered the dispute to arbitration.

Second Circuit

In *MBNA America Bank, N.A. v. Hill*,⁵⁷ the Second Circuit held that the bankruptcy court did not have discretion to deny arbitration of an adversary proceeding even though it was a core proceeding. This case involved a dispute between the Chapter 7 debtor and MBNA America Bank (MBNA) after MBNA withdrew money from the debtor's account pursuant to an agreed arrangement for repayment of a loan. The debtor filed an adversary proceeding (a purported class action) against MBNA alleging that MBNA's continued withdrawals from her bank account constituted a willful violation of the automatic stay in violation of 11 U.S.C. § 362(h).⁵⁸ MBNA moved to stay the action and compel arbitration pursuant to an arbitration provision in the parties' credit account agreement.

The bankruptcy court denied MBNA's motion to stay or dismiss the adversary proceeding in favor of arbitration, and the district court affirmed. Both courts concluded that the debtor's § 362 claim was core and that the bankruptcy court was the most appropriate forum to adjudicate the matter. The district court concluded that permitting arbitration of the alleged automatic stay violation would "seriously jeopardize the objectives of the Bankruptcy Code."⁵⁹

On appeal, the Second Circuit recognized that the "Bankruptcy Code and the Arbitration Act often present conflicts of 'near polar extremes: bankruptcy policy exerts an inexorable pull towards centralization while arbitration policy advocates a decentralized approach toward dispute resolution.'"⁶⁰ Like the Eleventh Circuit, the Second Circuit noted that bankruptcy courts generally do not have discretion to refuse to compel arbitration of noncore bankruptcy matters or matters that simply "related to" bankruptcy cases. As to these matters, the Second Circuit observed, the presumption in favor of arbitration usually "trumps" the lesser interest of the bankruptcy courts in adjudicating noncore proceedings.⁶¹ Like the Eleventh Circuit, the Second Circuit concluded that

even as to core proceedings, the bankruptcy court will not have discretion to override an arbitration agreement unless it finds the proceedings are based on provisions of the Bankruptcy Code that "inherently conflict" with the Arbitration Act or that arbitration of the claims would "necessarily jeopardize" the objectives of the Bankruptcy Code.⁶²

The standard articulated by the Second Circuit requires "a particularized inquiry into the nature of the claim and the facts of the specific bankruptcy."⁶³ The Second Circuit identified the following objectives of the Bankruptcy Code as relevant to the inquiry: (1) the "centralized resolution of purely bankruptcy issues," (2) "the need to protect creditors and debtors from piecemeal litigation," and (3) "the undisputed power of a bankruptcy court to enforce its own orders."⁶⁴ The debtor's claim under 11 U.S.C. § 362(h) for violation of the automatic stay was

clearly a core proceeding because it was a claim that invoked substantive rights created by the federal bankruptcy law and, by its nature, could arise only in the context of a bankruptcy case.⁶⁵ Nonetheless, the court held that arbitration of the debtor's claims would not jeopardize the objectives of the Bankruptcy Code for several reasons. First, the debtor's estate had been fully administered and her debts discharged. Second, as a purported class action, the debtor's claims lacked a direct connection to her own bankruptcy case. Finally, a stay was not so closely related to an injunction that the bankruptcy court was uniquely able to interpret and enforce its provisions.

Third Circuit

Within two weeks of the *MBNA* decision, the Third Circuit issued an opinion addressing the conflict between arbitration and the Bankruptcy Code and ostensibly rejecting the core/noncore distinction as a basis for determining whether to enforce an arbitration clause. Nonetheless, the Third Circuit's analysis of the issue is very similar to that espoused by the Second Circuit.

In *Mintze v. American General Financial Services, Inc. (In re Mintze)*,⁶⁶ the Third Circuit reversed the bankruptcy and district courts and held that a bankruptcy court lacks the "discretion to deny enforcement of [an] arbitration" agreement because the "FAA mandates enforcement of arbitration . . . unless Congressional intent to the contrary is established."⁶⁷ In reaching its decision, the *Mintze* court built on and extended the standard articulated by the Third Circuit more than a decade earlier in *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*⁶⁸ In *Hays*, the Third Circuit held that a claim by an estate against a third party based entirely on state law arising out of a contract with a binding arbitration clause was a noncore claim.⁶⁹ Finding no conflict between the policies of the FAA and the Bankruptcy Code, the *Hays* court concluded that the federal policy in favor of arbitration mandated enforcement of the arbitration clause.⁷⁰

In *Mintze*, the debtor tried to distinguish *Hays* by arguing that it applied primarily to noncore proceedings. The Third Circuit explicitly rejected that argument and held that the *Hays* standard applied equally to core and noncore proceedings.⁷¹ The Third Circuit reasoned that the distinction between core and noncore proceedings, although relevant to determining the ultimate authority of the bankruptcy court, did "not affect whether a bankruptcy court ha[d] [] discretion to deny enforcement of an arbitration agreement."⁷²

The Third Circuit's decision in *Mintze* is based on the proposition that the FAA mandates enforcement of arbitration agreements even as to federal statutory claims unless the party opposing arbitration can "establish congressional intent to create an exception to the FAA's mandate with respect to a party's statutory claims."⁷³ Finding no evidence of congressional intent "to preclude a waiver of judicial remedies for the statutory rights at issue," the Third Circuit focused on the third prong of the *McMahon* test: whether there was an inherent conflict between arbitration and the Bankruptcy Code.⁷⁴ Finding that the debtor had failed to raise any statutory claims created by the Bankruptcy Code, the Third Circuit determined that the debtor could not establish any "inherent conflict between arbitration of the debtor's federal and state consumer protection issues and the underlying purposes of the Bankruptcy

Code.”⁷⁵ Accordingly, it held “that the Bankruptcy Court lacked the authority and discretion to deny enforcement of the arbitration provision”⁷⁶ in the parties’ contract.

In short, the Second, Third, and Eleventh Circuits apply essentially the same analysis in determining whether a matter in bankruptcy should proceed to arbitration. The standard in all three circuits is whether the arbitration will conflict with the policies and objectives of the Bankruptcy Code. The Third Circuit has expressly rejected wholesale reliance on the core versus non-core distinction. Noncore proceedings are nevertheless more likely to be subject to arbitration because arbitration of those claims will not generally conflict with the Bankruptcy Code.

Fourth Circuit

In contrast to the foregoing decisions of the Second, Third, and Eleventh Circuits, the Fourth Circuit’s 2005 opinion in *Phillips v. Congelton, L.L.C. (In re White Mountain Mining Co., L.L.C.)*⁷⁷ suggests the circumstances in which a court is most likely to deny a motion to compel arbitration. The debtor, White Mountain, along with one of its owners, Joseph Phillips, began mining operations in May 2001. Over the next year and a half, Phillips advanced \$10.6 million of his own money to the debtor. The debtor’s other owner, Congelton, L.L.C., asserted that Phillips had misrepresented White Mountain’s prospects and financial condition when he induced Congelton’s predecessor to purchase one-half of the company. Congelton commenced an arbitration seeking a determination that Phillips’s advances should be treated as contributions to capital rather than as loans. Meanwhile, Phillips filed an involuntary bankruptcy against White Mountain and commenced an adversary proceeding seeking a declaration that the money he had advanced should be treated as a loan.

Congelton filed a motion in the adversary proceeding seeking to arbitrate Phillips’s claims in accordance with an arbitration clause in the parties’ sale and operating agreements. The agreements provided for binding arbitration to take place in London. The bankruptcy court and district court both denied arbitration and also denied motions for a stay pending appeal on the basis that the arbitration would seriously interfere with the debtor’s efforts to reorganize. The bankruptcy court held a trial in the adversary proceeding and determined that Phillips’s advance of \$10.6 million to White Mountain was a loan. Congelton appealed, arguing that the bankruptcy court and district court erred in failing to enforce the arbitration agreement. It also contended that both courts were divested of jurisdiction to try the adversary proceeding once Congelton appealed the denial of arbitration.

At the outset, the Fourth Circuit addressed the first prong of the *McMahon* analysis, i.e., whether the text of the Bankruptcy Code reveals congressional intent “to limit or prohibit waiver [through arbitration agreements] of [the bankruptcy] forum” for the litigation of core proceedings. After recognizing the competing arguments in favor of arbitral and bankruptcy court forums for core issues, the court declined to resolve whether “the statutory text itself demonstrates congressional intent to override arbitration for core claims because this case can be decided under *McMahon*’s third line of analysis—whether congressional intent is deducible ‘from an inherent conflict between arbitration and the statute’s underlying purposes.’”⁷⁸ The Fourth Circuit found the inherent

conflict in *White Mountain* to be clear because the adversary proceeding and the arbitration involved the core issue of whether Phillips’s advances to the debtor were debt or equity.

The Fourth Circuit found persuasive the bankruptcy court’s findings

that an ongoing arbitration proceeding in London would (1) make it very difficult for the debtor to attract additional funding because of the uncertainty as to whether Phillips’s claim was debt or equity, (2) undermine creditor confidence in the debtor’s ability to reorganize, (3) undermine the confidence of other parties doing business with the debtor, and (4) impose additional costs on the estate and divert the attention and time of the debtor’s management (even though the debtor was not a named party in the arbitration, the proceeding would necessarily involve the debtor’s personnel and business records).⁷⁹

In this case, the court noted, “resolution of the debt-equity issue was critical to” the debtor’s plan to reorganize, and the bankruptcy court planned to “resolve the adversary proceeding on an expedited basis.”⁸⁰ Resolution in the bankruptcy court, the Fourth Circuit observed, would “allow all creditors, owners and parties in interest to participate [in a centralized proceeding] at a minimum of cost.”⁸¹ On that basis, it upheld the bankruptcy court’s decision not to compel arbitration.

Although recognizing that bankruptcy courts have less discretion to compel arbitration of a core matter, the Fourth Circuit’s decision in *White Mountain* highlights the type of situation that will most likely result in an order denying a motion to compel arbitration. If the proceeding is a core proceeding and the debtor can persuasively argue that the dispute will hamper the debtor’s legitimate efforts to reorganize, a party will have difficulty compelling arbitration. Two other facts tipped the balance against arbitration in *White Mountain*. First, the bankruptcy court had already decided the dispute before the matter was decided by the Fourth Circuit. Second, the arbitration was to take place in London. That forum would not only impose significant costs (although that fact was not explicitly mentioned by the court) but also would make it more difficult for all creditors, owners, and interested parties to participate. Given these facts, the Fourth Circuit opinion is not surprising and not in conflict with the decisions by the other circuits.

Arbitration in Franchise Bankruptcies

There are few reported decisions addressing the enforceability of arbitration clauses in the context of a franchise or distributor bankruptcy. However, two decisions, *In re Hemphill Bus Sales, Inc.*,⁸² and *Slipped Disc Inc. v. CD Warehouse, Inc. (In re Slipped Disc, Inc.)*,⁸³ warrant discussion.

In *Hemphill Bus Sales*, the debtor was a distributor of school buses pursuant to a contract containing a broad arbitration clause. The manufacturer moved for relief from the automatic stay to arbitrate whether the distribution contract had been validly terminated prepetition. The manufacturer argued that the matter was simply one of state contract and statutory law and was therefore noncore. The bankruptcy court rejected these arguments and held that the matter was core and that arbitration would conflict with the purpose and objectives of the Bankruptcy Code.⁸⁴ Accordingly, the court refused to allow the matter to be arbitrated.

Central to the holding in *Hemphill Bus Sales* was the court's consideration of the effect that resolution of the dispute would have on the debtor's ability to successfully reorganize. In its ruling, the court cited testimony that the debtor would lose approximately \$1 million if the distribution contract were terminated retroactively.⁸⁵ The court therefore held that "the resolution [of the dispute] is integral to the Debtor's successful reorganization."⁸⁶ Moreover, the court rejected the manufacturer's argument that only its interests and the debtor's interests were to be considered in determining whether to allow arbitration. Instead, the court held that the interests of the debtor's creditors also had to be considered: "The interests of the creditors of this estate in the outcome of this dispute is a legal interest which, given that the determination of the dispute directly affects the Debtor's ability to reorganize, overrides either [the manufacturer's] or the Debtor's individual rights under the arbitration clause."⁸⁷

The court found that the interests of the creditors necessitated the creditors' representation at the resolution of the dispute:

Determinations respecting such an asset are of too great an importance to the creditors of the estate to be conducted absent representation of those creditors' interests. The creditors of this estate whose interests are paramount in the bankruptcy court are not parties to the [d]istribution [c]ontract or the arbitration clause. . . . This Court strongly agrees with [In re Continental Airlines Corp., 64 B.R. 865 (Bankr. S.D. Tex. 1986)] that the bankruptcy court is better equipped than an arbitration panel to take cognizance of the interests, in a reorganization, of both the debtor and the creditors.⁸⁸

Although the court in *Hemphill Bus Sales* refused to allow arbitration of what was arguably a noncore claim, the court in *Slipped Disc* allowed arbitration of a claim that, strictly speaking, was a core proceeding. In *Slipped Disc*, the debtor franchisee initiated an adversary proceeding against its franchisor, claiming that the franchisor had breached the franchise agreement by granting another franchise within the debtor's exclusive franchise territory. The debtor argued that the adversary proceeding was a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(C) because it constituted a counterclaim by the estate against a creditor (the franchisor) that had filed a proof of claim.

The bankruptcy court rejected the debtor's characterization of its claim as a core proceeding. In so doing, the court held that *core* is to be restrictively defined when determining whether to enforce an arbitration clause in bankruptcy.⁸⁹ The court held that in such situations, the definition of *core* should be restricted to issues that exclusively involve bankruptcy matters.⁹⁰ Claims that do not implicate substantive rights granted by the Bankruptcy Code are noncore and suitable for arbitration even if the claims are asserted against a creditor that has filed a proof of claim and therefore technically fall within the statutory definition of *core*.⁹¹

Hemphill Bus Sales is an example where the bankruptcy court took a nominal noncore state law claim, arising under the debtor's prepetition contract, and characterized it as core because of the importance of the claim to the debtor's ability to reorganize. The continuing viability of a franchise agreement is often integral to a debtor's ability to reorganize. As a result, the court's rationale in *Hemphill Bus Sales* could be used by other courts to defeat a fran-

chisor's effort to arbitrate its disputes with debtor franchisees. In contrast, the *Slipped Disc* court permitted arbitration by taking a restrictive view of what constitutes a core proceeding. Franchisors will generally have a proof of claim in a franchisee bankruptcy. Accordingly, the rationale for the decision in *Slipped Disc* can be cited by franchisors to diminish the relative importance of the proof of claim in the analysis of the enforceability of the arbitration clause. Taken together, these cases demonstrate the uncertain enforceability of an arbitration agreement in a franchisee bankruptcy.

Practical Considerations

No matter how well an arbitration agreement is drafted, there will be times when it will be trumped by bankruptcy law. For example, a bankruptcy court will likely not allow arbitration of an otherwise arbitrable matter where resolution of the dispute could affect the probability of a successful reorganization. Nonetheless, based upon the cases discussed in this article, a number of practical considerations can be identified to increase the likelihood that the arbitration agreement will be enforced.

First, the franchisor should refrain from including within the arbitration agreement prearbitration requirements. For example, some franchise agreements require arbitration only after the parties have engaged in informal settlement discussions and then formal mediation. These prearbitration requirements can substantially increase the time before an arbitration award is rendered. Similarly, provisions that allow a lengthy period of time in which the parties can designate their arbitrators will increase the time it will take the parties to arbitrate their dispute. Since franchisor-franchisee disputes are many times an integral factor in whether the debtor will successfully reorganize, effort should be made to streamline the contractual arbitration process so that the arbitration can be concluded as expeditiously as possible.

Second, the arbitration agreement should contain specific reference to the enforcement of the agreement in the bankruptcy context. A prepetition acknowledgement by the debtor of the enforceability of the arbitration agreement in bankruptcy is unlikely to be dispositive. Nonetheless, such an acknowledgement will at least provide support for the franchisor that seeks to hold its franchisee to the franchisee's prepetition promises.

Third, the franchisor should ensure that it does not waive its arbitration rights. The franchisor whose franchisee files for bankruptcy protection must necessarily participate in the bankruptcy process. Nevertheless, the franchisor should, in all filings and court appearances, clearly and unequivocally preserve its arbitration rights. All filings should contain a reservation of arbitration rights, and counsel should reserve those rights on the record at court hearings. Moreover, the franchisor should move as expeditiously as possible to exercise its arbitration rights. Such prompt action negates any argument that the franchisor has waived its arbitration rights by inaction.

Fourth, the franchisor should not allow the debtor to compress the time period available for confirmation of its plan of reorganization. For example, if the postpetition financing negotiated by the debtor is available for only a limited period of time, this would require the debtor to propose and confirm its plan of reorganization on an expedited basis. In such a situation, the bankruptcy court could refuse to allow arbitration because the arbitration

would likely not be concluded before the confirmation deadline, thus affecting the ability of the debtor to successfully reorganize. Accordingly, the franchisor should object to any attempt by the debtor to approve postpetition financing that provides for a limited or compressed confirmation period.

Fifth, to the extent that disputes likely to arise under a franchise agreement will involve technical or other specialized knowledge, the arbitration agreement should provide for an arbitration panel comprised of practitioners with such technical or specialized knowledge. The bankruptcy courts are more likely to allow arbitration when the parties have negotiated for a specialized panel.

The franchisor can never be sure if the bankruptcy court will enforce the arbitration agreement. Nonetheless, these practical considerations will assist the franchisor in enforcing its arbitration rights.

Endnotes

1. Although arbitration is perceived as less expensive than traditional litigation, that is not always the case. The costs of arbitration can easily exceed the costs of litigation. In addition to attorney fees and the cost of expert witnesses, the parties to an arbitration are typically responsible for the fees of their arbitrators. These fees can be significant, especially if there is a three-member arbitration panel. Moreover, many arbitrations are typically held in private facilities (as opposed to public courthouses), which, depending on the location, may also charge significant rent. Cost considerations are among the many reasons that the decision to include an arbitration provision in a franchise agreement should be considered carefully.

2. 9 U.S.C. § 1 et seq. (2007).

3. *See, e.g., Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984) (“Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.”).

4. *See, e.g., Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 225–26 (1987) (citing *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510–11 (1974)).

5. *See, e.g., Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 892 (9th Cir. 2002) (noting that the FAA established “a federal common law of arbitrability which preempts state law disfavoring arbitration”); *Bondy’s Ford, Inc. v. Sterling Truck Corp.*, 147 F. Supp. 2d 1283, 1286 (M.D. Ala. 2001) (noting that “the FAA preempts state law that conflicts with the FAA” and that a statute that prohibits binding arbitration was therefore preempted by the FAA).

6. *See Allied-Bruce Terminix Cos., Inc. v. Dobson*, 513 U.S. 265, 273–77 (1995).

7. *See Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 627 (1985).

8. *See, e.g., Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985) (noting that the courts “shall direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed”) (citing 9 U.S.C. §§ 3, 4). A court may compel arbitration only if it “would have jurisdiction under Title 28 in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties.” *See* 9 U.S.C. § 4.

9. *See, e.g., Mitsubishi Motors*, 473 U.S. at 626.

10. *See, e.g., Pennzoil Exploration & Prod. Co. v. Ramco Energy Ltd.*, 139 F.3d 1061, 1066–67 (5th Cir. 1998).

11. *See, e.g., Drews Distrib., Inc. v. Silicon Gaming, Inc.*, 245 F.3d 347,

349 (4th Cir. 2001) (“As a matter of law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.”) (internal citations omitted); *see also Shubert v. Wellspring Media, Inc. (In re Winstar Commc’ns, Inc.)*, 335 B.R. 556, 562 (Bankr. D. Del. 2005) (“When determining both the existence and the scope of an arbitration agreement, there is a presumption in favor of arbitrability. An order to arbitrate the particular grievance should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute.”) (citations omitted).

12. *See Pennzoil Exploration*, 139 F.3d at 1067.

13. *Id.*; *see also Prima Paint Corp., v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 397–98 (1967) (labeling as “broad” a clause requiring arbitration of “[a]ny controversy or claim arising out of or relating to this Agreement”); *Nauru Phosphate Royalties, Inc. v. Drago Daic Interests, Inc.*, 138 F.3d 160, 165 (5th Cir. 1998) (holding that when parties agree to an arbitration clause governing “[a]ny dispute . . . arising out of or in connection with or relating to this Agreement,” they “intend the clause to reach all aspects of the relationship”) (citation omitted).

14. *See, e.g., Mitsubishi Motors*, 473 U.S. at 625 n.13; *Louis Dreyfus Negoce S.A. v. Blystad Shipping & Trading, Inc.*, 252 F.3d 218, 225 (2d Cir. 2001) (stating that “when parties use expansive language in drafting an arbitration clause, presumably they intend all issues that ‘touch matters’ within the main agreement to be arbitrated”) (citing *Genesco, Inc. v. T. Kakiuchi & Co.*, 815 F.2d 840, 846 (2d Cir. 1987).

15. 11 U.S.C. § 101 et seq. (2007).

16. 482 U.S. 220 (1987).

17. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 227 (1987) (citing *Mitsubishi*, 473 U.S. at 632–37).

18. *See Karter Gandy Ltd. P’ship v. Gandy (In re Gandy)*, 299 F.3d 489, 495 (5th Cir. 2002) (citation omitted).

19. *In re Chorus Data Sys., Inc.*, 122 B.R. 845, 851 (Bankr. D.N.H. 1990).

20. *See, e.g., Crysen/Montenay Energy Co. v. Shell Oil Co. (In re Crysen/Montenay Energy Co.)*, 226 F.3d 160, 166 (2d Cir. 2000) (noting that “bankruptcy courts generally do not have discretion to decline to stay non-core proceedings in favor of arbitration”); *Cooker Rest. Corp. v. Seelbinder (In re Cooker Rest. Corp.)*, 292 B.R. 308, 312 (S.D. Ohio 2003) (“This Court finds that in non-core proceedings in which the parties do not dispute the making of an agreement to arbitrate, a bankruptcy court is without jurisdiction to deny a motion to stay the proceedings and compel arbitration.”); *In re Farmland Indus., Inc.*, 309 B.R. 14, 18 (Bankr. W.D. Mo. 2004) (“In fact, courts widely accept that the bankruptcy court must stay its own proceedings to allow arbitration to continue in non-core matters because allowing arbitration in non-core matters is unlikely to conflict with the underlying policies of the Bankruptcy Code.”).

21. *See, e.g., Farmland Indus.*, 309 B.R. at 21–22.

22. *See, e.g., Cibro Petroleum Prods., Inc. v. City of Albany (In re Winimo Realty Corp.)*, 270 B.R. 108, 119 (S.D.N.Y. 2001) (citing 28 U.S.C. § 157(b)); *see also Sanders Confectionary Prods., Inc. v. Heller Fin., Inc.*, 973 F.2d 474, 483 (6th Cir. 1992) (stating that a core proceeding “either invokes a substantive right created by federal bankruptcy law or one which could not exist outside of the bankruptcy”).

23. The first category includes (a) “matters concerning the administration of the estate”; (b) “allowance or disallowance of claims against the estate or exemption from property of estate, and estimation of claims . . . for purposes of” confirming a plan; (c) “orders in respect to obtaining credit”; (d) “motions to terminate, annul, or modify the automatic stay”; (e) “determinations as to the dischargeability of particular debts”; (f) “objections to discharges”; and

(g) “confirmations of plans.” See 28 U.S.C. § 157(b)(2)(A), (B), (D), (G), (I), (J), (L).

24. The second category includes (a) “proceedings to determine, avoid, or recover preferences”; and (b) “proceedings to determine, avoid, or recover fraudulent conveyances.” See 28 U.S.C. § 157(b)(2)(F), (H).

25. The third category includes (a) “orders to turn over property of the estate”; (b) “determinations of the validity, extent, or priority of liens”; (c) “orders approving the use or lease of property, including the use of cash collateral”; and (d) “orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate.” See 28 U.S.C. § 157(b)(2)(E), (K), (M), (N).

26. The catchall category includes (a) “counterclaims by the estate against persons filing claims against the estate”; and (b) “other proceedings affecting the liquidation of the assets of the estate or the adjustment of either the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims.” See 28 U.S.C. § 157(b)(2)(C), (O).

27. 28 U.S.C. § 157(c)(1).

28. *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1156–57 n.9 (3d Cir. 1989) (citation omitted).

29. *Dunmore v. United States*, 358 F.3d 1107 (9th Cir. 2004).

30. *Orion Pictures Corp. v. Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095 (2d Cir. 1993).

31. *Sun Healthcare Group, Inc. v. Levin* (*In re Sun Healthcare Group, Inc.*), 267 B.R. 673 (Bankr. D. Del. 2000).

32. See *In re Farmland Industries, Inc.*, 309 B.R. 14, 19 (Bankr. W.D. Mo. 2004).

33. *Barber-Greene Co. v. Zeco Co.* (*In re Barber-Greene*), 17 B.R. 248 (Bankr. D. Minn. 1982).

34. *Cooker Rest. Corp. v. Seelbinder* (*In re Cooker Rest. Corp.*), 292 B.R. 308 (S.D. Ohio 2003).

35. *Crysen/Montenay Energy Co. v. Shell Oil Co.* (*In re Crysen/Montenay Energy Co.*), 226 F.3d 160 (2d Cir. 2000).

36. *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149, 1161 (3d Cir. 1989).

37. See *Shubert v. Wellspring Media, Inc.* (*In re Winstar Commc’ns, Inc.*), 335 B.R. 556, 565 (Bankr. D. Del. 2005).

38. *Id.*

39. *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp.* (*In re Nat’l Gypsum Co.*), 118 F.3d 1056, 1068 (5th Cir. 1997).

40. *Karter Gandy Ltd. P’ship v. Gandy* (*In re Gandy*), 299 F.3d 489 (5th Cir. 2002).

41. *Nat’l Gypsum*, 118 F.3d 1056.

42. *In re Mirant Corp.*, 316 B.R. 234 (Bankr. N.D. Tex. 2004).

43. *In re Farmland Indus.*, 309 B.R. 14 (Bankr. W.D. Mo. 2004).

44. *Cibro Petroleum Prods., Inc. v. City of Albany* (*In re Winimo Realty Corp.*), 270 B.R. 108 (S.D.N.Y. 2001).

45. *SFC New Holdings, Inc. v. Earthgrains Co.* (*In re GWI, Inc.*), 269 B.R. 114 (Bankr. D. Del. 2001).

46. *Phico Group, Inc. v. Persofsky* (*In re Phico Group, Inc.*), 304 B.R. 170 (Bankr. M.D. Pa. 2003).

47. 309 B.R. 14.

48. See 28 U.S.C. § 157(b)(2)(B).

49. *Farmland Indus.*, 309 B.R. at 20, n.4 (citation omitted).

50. NAT’L ARBITRATION FORUM, BANKRUPTCY COURT ERRED BY NOT ORDERING ARBITRATION WHERE THERE WAS NO INHERENT CONFLICT WITH THE BANKRUPTCY CODE (2007), http://adrforum.com/adr_CaseDetails.asp?caseid=771; see also *Whiting-Turner Contracting Co. v. Elec. Mach.*

Enters., Inc. (*In re Elec. Mach. Enters., Inc.*), 479 F.3d 791 (11th Cir. 2007).

51. NAT’L ARBITRATION FORUM, *supra* note 50.

52. *Elec. Mach. Enters.*, 479 F.3d at 796 (citing *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991)).

53. *Id.* at 795.

54. *Id.* at 796 (citing *Mintze v. Am. Gen. Fin. Serv., Inc.* (*In re Mintze*), 434 F.3d 222, 231 (3d Cir. 2006)).

55. *Id.* at 796.

56. *Id.*

57. 436 F.3d 104 (2d Cir. 2006).

58. In 2005, 11 U.S.C. § 362(h) was redesignated as 11 U.S.C. § 362(k).

59. *MBNA*, 436 F.3d at 107.

60. *Id.* at 108 (citing *U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass’n, Inc.* (*In re U.S. Lines, Inc.*), 197 F.3d 631, 640 (2d Cir. 1999)).

61. *MBNA*, 436 F.3d at 108.

62. *Id.* (citations omitted).

63. *Id.*

64. *Id.* (quoting *Ins. Co. of N. Am. v. NGC Settlement Trust & Asbestos Claims Mgmt. Corp.* (*In re Nat’l Gypsum Co.*), 118 F.3d 1056, 1069 (5th Cir. 1997)).

65. *Id.* at 108–09 (citing *Banque Nationale de Paris v. Murad* (*In re Housecraft Indus. USA, Inc.*), 310 F.3d 64, 70 (2d Cir. 2002); *Wood v. Wood* (*In re Wood*), 825 F.2d 90, 96–97 (5th Cir. 1987)).

66. 434 F.3d 222 (3d Cir. 2006).

67. The court noted that it did not generally address issues raised for the first time on appeal but that it would do so because of the public importance of the issue. *Id.* at 232. The court further recognized the issue’s importance by rejecting the parties’ stipulation that the bankruptcy court had discretion to grant the relief requested because the question was a question of law. As a result, the court was not bound by any of the parties’ stipulations on those issues. *Id.* at 228.

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

69. *Id.* at 1155–57.

70. *Id.* at 1156.

71. *Mintze*, 434 F.3d at 230–31.

72. *Id.* at 228–29. In a core proceeding, a bankruptcy court has the power to hear, decide, and enter final orders, but in noncore proceedings, the bankruptcy court is allowed only to make proposed findings of fact and proposed conclusions of law, which it submits to the district court. 28 U.S.C. §§ 157(b)(1), (c)(1).

73. *Mintze*, 434 F.3d at 229.

74. *Id.* at 231

75. *Id.* at 231–32.

76. *Id.*

77. 403 F.3d 164 (4th Cir. 2005).

78. *Id.* at 168 (citing *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 227 (1987)).

79. *White Mountain*, 403 F.3d at 170.

80. *Id.*

81. *Id.* at 170.

82. *In re Hemphill Bus Sales, Inc.*, 259 B.R. 865 (Bankr. E.D. Tex. 2001).

83. 245 B.R. 342 (Bankr. N.D. Iowa 2000).

84. *Hemphill Bus Sales*, 259 B.R. at 871.

85. *Id.* at 870 n.8.

86. *Id.* at 870.

87. *Id.*

88. *Id.* at 872.

89. *Slipped Disc, Inc. v. CD Warehouse, Inc. (In re Slipped Disc, Inc.)*, 245 B.R. 342, 345 (Bankr. N.D. Iowa 2000) (“While the present adversary proceeding is indeed a core proceeding under § 157(b)(2)(C), it is not a core proceeding in the same manner as that term is used in cases dealing with enforcement of arbitration clauses.”).

90. *Id.*; see also *Nu-Kote Imperial, Ltd. v. Nu-Holding, Inc. (In re Nu-Kote)*, 257 B.R. 855, 864–65 (Bankr. M.D. Tenn. 2001) (court rejected wholesale reliance on the core versus noncore analysis and looked at whether the claims or defenses asserted were created by the Bankruptcy Code or were “inherited contractual claims derivative of the prebankruptcy agreements”).

91. *Slipped Disc*, 245 B.R. at 345.