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Arbitration Limitation: Ninth Circuit Holds That a Bankruptcy Court May Refuse to Enforce an Arbitration Clause

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Clients often raise questions concerning the enforceability of arbitration clauses in bankruptcy proceedings. While this topic has been hotly debated for many years, a recent Ninth Circuit opinion, *In re Thorpe Insulation Co.,* 671 F.3d 1011 (9th Cir. 2012), reminds us that arbitration clauses are not sacrosanct and can be struck down by the court.

For several decades, Thorpe distributed and installed asbestos-containing products. After many thousands of claims for asbestos-related injuries and deaths were brought against it, Thorpe entered into an agreement (the Agreement) with one of its insurers, Continental Insurance Company (Continental), relating to those claims. Thorpe and Continental agreed to arbitrate disputes regarding the Agreement. A few years later, daunted by the many claims against it, Thorpe filed for Chapter 11 bankruptcy, with the goal of confirming a plan of reorganization pursuant to section 524(g) of the Bankruptcy Code, which provides a unique mechanism for consolidating a debtor's asbestos-related assets and liabilities into a single trust for the benefit of present and future asbestos claimants. In preparation for the bankruptcy filing, some insurers of Thorpe agreed to assign certain rights against other insurers, including Continental, to Thorpe and the trust to be established under § 524(g), an assignment which Continental believed breached the Agreement. Continental filed a proof of claim in the case, and Thorpe objected to it. Continental then moved to compel arbitration.

The bankruptcy court denied Continental's motion to compel arbitration and disallowed its claim, stating it had "discretion in an appropriate case not to send [the issue] to arbitration." The District Court upheld this decision, which was then reviewed *de novo* by the Ninth Circuit Court of Appeals. This Court, too, agreed, analyzing the topic as a matter of first impression in the Ninth Circuit.

The Federal Arbitration Act[1] establishes "a liberal federal policy favoring arbitration agreements." *Thorpe,* at 1020 (citation omitted). However, "the Arbitration Act's mandate may be overridden by a contrary congressional command." *Id.* Finding that the Bankruptcy Code itself does not reflect such a congressional intent, the Court then examined "whether there is an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code."

As a threshold matter, the Court considered, as have other circuits weighing in on the same issue, the distinction between core and non-core proceedings. "In non-core proceedings," explained the Court, "the bankruptcy court generally does not have discretion to deny enforcement of a valid prepetition arbitration agreement…. In core proceedings, by contrast, the bankruptcy court, at least when it sees a conflict with bankruptcy law, has discretion to deny enforcement of an arbitration agreement." *Id.* at 1021 (citations omitted). This distinction is driven by the fact that non-core proceedings "are unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration, whereas core proceedings implicate more pressing bankruptcy concerns." *Id.* (citations omitted). In this case, Continental filed a proof of claim for its state law breach of contract claim. Allowance or disallowance of a proof of claim is a core matter of the bankruptcy court. Moreover, Continental's claim affected assets in the 524(g) trust and the rights of other creditors — the asbestos claimants. Therefore, it

"directly impacted the administration of the bankruptcy estate," and was a core matter in the bankruptcy.

But not all core bankruptcy proceedings conflict with arbitration to such a degree that would warrant a refusal to enforce an arbitration clause. Adopting a standard employed by other circuits,[2] the Court explained that "a bankruptcy court has discretion to decline to enforce an otherwise applicable arbitration provision only if arbitration would conflict with the underlying purposes of the Bankruptcy Code." *Id.* at 1021. The Court agreed with the bankruptcy court's determination that resolving Continental's claim in any forum other than a bankruptcy court would "conflict with fundamental bankruptcy policy," since the claim was "inextricably intertwined" with the bankruptcy and required a determination of whether "the manner in which someone has administered a bankruptcy estate gives rise to a claim for damages," a determination which should only be made by a bankruptcy court. *Id.* at 1022.

Continental's claim is a challenge to Thorpe's efforts to seek relief under Section 524(g) and seek confirmation of a 524(g) plan. Congress intended § 524(g) to serve as a mechanism for bankruptcy courts to oversee complex asbestos-related cases, which involve multiple insurers and numerous asbestos claimants. A claim that impacts the bankruptcy proceeding at that level must be resolved in the bankruptcy court, not in arbitration. Arbitration, explained the Court, would conflict with congressional intent, because it would "so fracture the plan confirmation process that one could never say for sure when it could be brought to conclusion for the benefit of the debtor and all creditors. To a certainty, in such a case the bankruptcy court would lose control over the timing of the reorganization because it would not have control over the timing of the arbitrations." *Id.* at 1023.

While this opinion, a matter of first impression in the Ninth Circuit, is consistent with other circuit courts that have considered this issue, it serves as a stark reminder that even artfully worded arbitration clauses may be struck down by a bankruptcy court under certain circumstances. When drafting or faced with an arbitration clause, management and practitioners alike would be wise to consult knowledgeable bankruptcy counsel about the implications such clause may ultimately have.

If you have any questions about this decision or its implications, please call your principal Mintz Levin attorney or one of the attorneys noted on this advisory.

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Endnotes

[1] 9 U.S.C. § 1 *et seq.*

[2] Applying similar tests, other circuit courts have found grounds to override arbitration clauses in some cases. *See, e.g., In re White Mountain Mining*, 403 F.3d 164 (4th Cir. 2005)*; In re U.S. Lines, Inc., 197 F.3d 631(2d Cir. 1999); In re Nat'l Gypsum,* 118 F.3d 1056 (5th Cir. 1997). In other circumstances, courts have found that there was no ground for refusing to enforce an arbitration clause. *See, e.g., In re Elec. Mach. Enters.,* 479 F.3d 791, 796 (11th Cir. 2007); *In re Mintze,* 434 F.3d 222 (3d Cir. 2006).