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Part IV. Recent Developments

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An Update on the Applicability of Arbitration Clauses in Bankruptcy Cases

The Federal Arbitration Act (the "FAA")[1] concerns the enforcement of arbitration clauses in federal courts. This update will examine recent case authority on the interplay between the FAA and the Bankruptcy Code.

Arbitration, in most instances, involves a contract. Parties cannot be forced to arbitrate issues to which they did not agree, therefore, the first determination of a Court, faced with this issue, is to decide whether the parties at hand actually agreed to arbitrate their dispute.[2] Once the Court rules that an arbitration agreement should be enforced, that is that the parties agreed to arbitrate their dispute, the Court must then make the decision as to whether this agreement to arbitrate should be enforced.[3]

In the case of In re First Thermal Systems, Inc.,[4] a supplier, which had purchased a Chapter 11 debtor's assets, initiated an adversary proceeding for the unpaid sums due under service agreements between the supplier and a purchaser that had requested service for equipment purchased from the debtor pre-petition. The buyer moved to compel arbitration based upon an arbitration clause in the agreement, but the Court held that the purchaser was not able to show that the contract had a binding agreement to arbitrate disputes. The arbitration clause was located on the back of the contract form and the front of that form did not refer to any terms on the back. This contract had been faxed between the parties and had been negotiated on an emergency basis over the telephone. Under these facts, the Court held that the equipment purchase agreement did not contain an enforceable arbitration clause.

The FAA applies only to transactions involving interstate or foreign commerce,[5] and maritime transactions. If the transaction between the parties does not meet the requirements for the application of the FAA, then the court must look to the state law related to arbitration.[6] In applying the FAA, interstate commerce is given a broad definition in order to promote arbitration.[7] A transaction may be found to involve interstate commerce based upon the multi state nature of the parties,[8] even where such a connection was not anticipated.

In In re Dunes Hotel Associates,[9] the Court had no trouble in finding that the hotel management agreement contained the necessary connection with interstate commerce to enforce the arbitration clause found within it. The Court held, that, even though the signing parties to a hotel management agreement were both South Carolina companies, they were formed by their out of state parent companies to operate a hotel and real estate investment business on a national and international scale; and that the property at issue was a nationally known destination resort with guests from all over the United States.

Courts apply the FAA even if the subject matter of the dispute is found by the arbitrators to have had the barest nexus with interstate commerce.[10] In Bacashihua v. U.S. Postal Service,[11] the Court applied the FAA because a postal worker, although not individually involved in interstate commerce, belonged to a class of workers who, taken as a group, engaged in interstate

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commerce. In Crawford v. West Jersey Health Systems (Voorhees Div.),[12] the Court held that the defendant's treatment of out of state patients and receipt of supplies from out of state sellers satisfied the FAA's interstate commerce requirement even though the subject dispute was between a New Jersey doctor and her former employers, all of which were New Jersey medical service providers.

The FAA embodies Congress' intent to enforce contractual arbitration clauses in order to provide speedy dispute resolution without delay and obstruction in the courts.[13] On its face, 9 U.S.C. § 3 dictates that a Bankruptcy Court stay an adversary proceeding when one party has identified an enforceable arbitration provision concerning its dispute.[14] 9 U.S.C. § 4 provides that any party that is aggrieved by the alleged refusal of another to arbitrate under a written arbitration agreement is entitled to petition a federal District Court for an order compelling arbitration.[15]

Arbitration has been given a favored status and deference by the Supreme Court and the lower courts. The FAA, therefore, has been held to have established a federal policy favoring arbitration.[16] This federal policy is considered to be strong and requires a rigorous enforcement of agreements to arbitrate.[17] This strong policy has been put into effect as a means of dispute resolution.[18] This liberal policy in favor of arbitration[19] has been used as a means to reduce the costliness and delays of litigation, and is even a stronger policy in the context of international transactions.[20]

Under this case law, the FAA's purpose is to validate and make enforceable contractual arbitration clauses.[21] This means that an arbitration clause, which is a kind of specialized forum selection clause,[22] should be enforceable with the same strength as any other type of contractual term.[23] Therefore, arbitration clauses ought to be enforceable in bankruptcy cases.[24]

The FAA is not omnipotent. The strong federal policy that favors the rigorous enforcement of arbitration clauses may be overridden by a countervailing policy which is manifested in another federal statute.[25] The Bankruptcy Code is such a federal statute.[26]

> The Arbitration Act, standing alone, … mandates enforcement of agreements to arbitrate statutory claims. Like any statutory directive, the Arbitration Act's mandate may be overridden by contrary congregational command. The burden is on the party opposing arbitration, however, to show that Congress intended to preclude waiver of judicial remedies for the statutory rights at issue. If congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent will be deducible from [the statutes] text or legislative history or from an inherent conflict between arbitration and the statutes underlying purposes.[27]

In bankruptcy cases, it is important for courts to decide whether the underlying purposes of the Bankruptcy Code would be adversely affected by enforcing an arbitration clause; and thus the appropriate enquiry for a Bankruptcy Court in such circumstances is whether the text or purposes of the Bankruptcy Code would be violated so dramatically by enforcing an arbitration clause in the particular factual circumstances of the case that it can fairly be said that Congress would not have intended the Bankruptcy Code to be overridden by the FAA. Where the federal policy in favor of arbitration inherently conflicts with and jeopardizes another federal policy to protect the rights of creditors, a case by case balancing of hardships ought to be performed.[28]

Congress set up the Bankruptcy Code as a way of providing debtors with an efficient, cost effective way of obtaining a fresh start and for dispute adjudication. Congress' goal in the Bankruptcy Reform Act of 1978 was to reduce unnecessary delays, expenses, and duplications of effort in bankruptcy cases.[29] It sought to distribute all of the debtor's property and assets in a

timely way and reorganized or liquidated in such a manner that all of the creditors receive repayment, in part or in full, of the sums they are owed as much as possible.[30]

The dynamic between the FAA and the Bankruptcy Code has been met head on by two of the federal circuits, the Third and the Fifth. The Third Circuit was the first to address this issue in Zimmerman v. Continental Airlines, Inc.[31] In that case, the bankruptcy Trustee had commenced a breach of contract claim against Continental Airlines in Bankruptcy Court. The underlying contract had an arbitration clause. Relying on this clause, Continental Airlines filed a motion with the Court to stay the bankruptcy proceedings pending arbitration. Cognizant of the conflict between the FAA and the Bankruptcy Code, the Bankruptcy Court utilized a balancing test to resolve the dispute. On the one hand, the Court found that the FAA established a strong federal policy favoring arbitration, a policy that Congress had adopted in order to make certain that enforcement of arbitration agreements would be fast and unhampered. On the other hand, the Bankruptcy Court did acknowledge that the Bankruptcy Reform Act of 1978 had expanded bankruptcy jurisdiction so as to eliminate bifurcated proceedings and reduce litigation delay and expense. This efficiency was needed as a result of the precariousness of the bankruptcy estate and the important part that bankruptcy proceedings have with respect to the free market. While assisting arbitration is also an interest of federal courts, the Bankruptcy Court did not think that arbitration had a position of that importance. It concluded that, Congress must have meant for the Bankruptcy Code to modify the FAA by leaving the decision to stay bankruptcy proceedings in pending arbitration to the sound discretion of the Bankruptcy Court. The Court reasoned that the need for an expeditious bankruptcy administration may, in some cases, trump the policy in favor of the enforceability of arbitration clauses, at least where the Bankruptcy Court employed its sound discretion against arbitration.[32]

The Third Circuit took a different approach in Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.[33] In this subsequent case, the Third Circuit held that the 1984 Amendments and the later Supreme Court cases favoring arbitration modified Zimmerman v. Continental Airlines, Inc. In Hays & Co, the bankruptcy Trustee had filed an action against Merrill Lynch for breach of a prepetition contract. Merrill Lynch then filed a motion to stay the trustee's action and compel arbitration by virtue of an arbitration clause in the contract. Because neither the Trustee nor the remaining creditors were parties to the arbitration agreement, the District Court concluded that they were not bound by it and thus, denied Merrill Lynch's motion to stay.

On appeal, the Third Circuit observed that non-executory contracts are binding on the Trustee and that federal policy strongly favors arbitration contracts. As a result, the Third Circuit did not believe that the District Court had the discretion to refuse to enforce the arbitration clause.[34] While it acknowledged that core matters might be subject to arbitration, nothing in the wording of the Bankruptcy Code indicated that Congress meant for arbitration clauses to be unenforceable in a non-core adversary proceeding brought to enforce a claim brought by the estate. The 1984 Amendments did away with the prior rules consolidating all bankruptcy matters before one tribunal. According to the Court of Appeals, the Bankruptcy Code, as amended, does not conflict with the FAA so as to allow a lower court to deny enforcement of an arbitration clause in a non-core adversary proceeding brought by the Trustee.[35]

The Third Circuit, in this later case, had held that the national policy favoring arbitration had become stronger, while the 1984 Amendments to the Bankruptcy Code which had been instigated by the decision of Northern Pipeline Const. Co. v. Marathon Pipeline Co.[36] had weakened the policy of focusing all issues concerning bankruptcy cases just in the Bankruptcy Courts. The Court reasoned that in non-core proceedings, which arose out of the 1984 Bankruptcy Code Amendments, where District Courts, rather than the Bankruptcy Courts, had the power to enter final orders unless the parties consented to allow the Bankruptcy Court to do so, the Bankruptcy Courts had minimal discretion to refuse to enforce valid arbitration clauses. Therefore, the Third Circuit reasoned that, as to core matters a Bankruptcy Court was entitled to use its discretion, as directed in Zimmerman v. Continental Airlines, Inc., supra, in determining whether to send that core matter to arbitration.[37]

There are a number of Third Circuit cases, of recent vintage, which have followed this rule of law. In In re CGE Ford Heights, L.L.C.,[38] the chapter 11 debtor brought an adversary proceeding for the defendant's alleged breach of a tire supply agreement,

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and the defendant moved for an order staying litigation pending arbitration pursuant to an arbitration clause in the parties' contract. The Bankruptcy Court held that the adversary proceeding was non-core in nature, and that, as a result, it had no authority to deny the enforcement of that contractual clause. The Court concluded that the potential of receiving inconsistent or contradictory rulings did not seriously jeopardize any objective of the Bankruptcy Code and that a federal court should not substitute its own views of economy and efficiency for those of Congress.[39]

A chapter 11 debtor hospital brought an adversary proceeding against its insurer in In re Sacred Heart Hospital of Norristown,[40] claiming entitlement to adjustments of prior medicare reimbursement. The Bankruptcy Court held that the dispute would, at least initially, be referred to arbitration due to the fact that the debtor had requested a jury trial, and that a jury trial would have to occur in the District Court and not the Bankruptcy Court. The Court approved the request for arbitration. Later, when the Chapter 11 debtor sought to vacate the decision of the arbitrators on the issues of the insurers liability to the debtor for depreciation of the debtor hospital's facility, the Bankruptcy Court held that the arbitration award was not reviewable based upon the debtor's allegation that the arbitrators misconstrued the applicable contract where the debtor did not allege fraud, misconduct, corruption or any other form of irregularity.[41]

In re Day,[42] involved three unrelated bankruptcy cases in which a city housing authority objected to the confirmation of the Chapter 13 plans of the debtors, public housing tenants, who had filed their cases *pro se* within six (6) years of their having filed Chapter 7 cases in which they previously obtained discharges. Each of the debtors had objected to the claims filed by the housing authority. The Bankruptcy Court ruled, among other things, that the arbitration clauses in the debtors' leases did not require the Bankruptcy Court to defer its claims allowance process to an arbitration procedure established for public housing tenants in a pending federal class action against the housing authority. The Court based its decision on the fact that the claims allowance process is considered to be amongst the most fundamental of core bankruptcy contested matters and, therefore, the Bankruptcy Court continued to retain the magnified discretion to deny the enforcement of the arbitration clauses. The Bankruptcy Court pointed out that the decision in Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. limited its ruling to non-core matters. Core proceedings, on the other hand, still had enhanced importance under the Bankruptcy Code.

> … The exercise of our discretion is mandated by the fact that we are able to determine the claims now, allowing us to immediately move to the issue of confirmation of the Debtors' plans. Deferring allowance of the claims to arbitration would likely result in delays of several months before we would be able to rule on confirmation and thus significantly delay the progress of these cases. It is, moreover, especially critical to rule on confirmation as soon as possible since the Debtors' plans appear to pay far too little to be presently confirmable. The Debtors require the guidance of a confirmation ruling as soon as possible to permit them to propose confirmable plans and still have sufficient time remaining to perform under them.[43]

Not every jurisdiction follows Hays. In the Fifth Circuit, the seminal decision is Matter of National Gypsum Co.[44] There, the Fifth Circuit held that the Bankruptcy Court had the discretion to refuse to enforce an arbitration clause on the grounds that the arbitration was inconsistent with 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.[44] In that case, successor to a Chapter 11 debtor brought an adversary proceeding against the debtor's liability insurer seeking a declaratory judgment to recover certain preconfirmation debts. The insurer filed a motion to stay the proceeding in favor of arbitration. The Bankruptcy Court denied the motion to stay.

On appeal, the Fifth Circuit ruled that the declaratory judgment action was a core proceeding; that whether the Bankruptcy Court should order arbitration of a core bankruptcy issue, pursuant to a contractual arbitration clause, turns on the underlying nature of the proceeding; and that the Bankruptcy Court did not abuse its discretion in refusing to stay the declaratory judgment action.

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It pointed out that the Court did not consider whether a Bankruptcy Court has discretion to enforce an applicable arbitration clause where core bankruptcy issues are involved in Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., but that other courts had found the distinction between core and non-core helpful. The Fifth Circuit did not find this distinction to be persuasive because it dealt strictly with the identification of jurisdiction within bankruptcy proceedings. It disagreed with the Third Circuit's conclusion that all core bankruptcy proceedings are premised on provisions of the Bankruptcy Code that inherently conflict with the FAA; and did not believe that arbitration in such proceedings necessarily jeopardized the objectives of the Bankruptcy Code.[45] For this reason, the Court ruled that the distinction between core and non-core matters, while being of assistance, was too broad to be determinative when deciding whether to enforce an arbitration clause in a bankruptcy case. The Fifth Circuit pointed out that in a very common type of creditor initiated core proceeding, a motion to lift the automatic stay, Bankruptcy Courts have consistently permitted arbitration to continue in spite of there being core bankruptcy jurisdiction. In these contexts, courts have regularly referred matters to arbitration where the disputes would not involve matters of bankruptcy law.[46]

In rejecting a bright-line rule that would make the determination to enforce an arbitration clause turn solely or whether the preceding were core or non-core, the Fifth Circuit relied on In re Statewide Realty Co.[47] There, the debtor had objected to claims advanced by Hilton International under a rejected management agreement, and Hilton had sought relief from the automatic stay to resolve a claim pursuant to an arbitration provision. Pointing out that its discretion to deny enforcement of an otherwise applicable arbitration provision relied upon a finding that arbitration would conflict with the provisions or purposes of the Bankruptcy Code, the Bankruptcy Court distinguished Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. as follows.

> The fact that the matter before the court is a core proceeding does not mean that arbitration is inappropriate. The description of a matter as a core proceeding simply means that the Bankruptcy Court has the jurisdiction to make a full adjudication. However, merely because the court has the authority to render a decision does not mean it should do so. The discussion in *Hays* regarding core and non-core proceedings is not read by this court as suggesting that core proceedings may not be subject to arbitration. Rather it appears that the *Hays* court sought to distinguish between actions derived from the debtor, and therefore, subject to the arbitration agreement, and bankruptcy actions in essence created by the Bankruptcy Code for the benefit of ultimately of creditors of the estate and therefore not encompassed by the arbitration agreement.[48]

The Fifth Circuit placed a great deal of weight on the reasoning found in In re Statewide Realty Co., and held that distinguishing between those actions derived from the debtor and those created by the Bankruptcy Code explains the usual reticence to permit arbitration of actions brought to adjudicate bankruptcy rights. There could be no dispute according to the court, that where a core proceeding involves the adjudication of bankruptcy rights wholly apart from claims based on a contract, the importance of the bankruptcy tribunal provided by the Bankruptcy Code is paramount. These actions are not within the parameters of most arbitration provisions, but, with an enforceable arbitration provision, the adjudication of these actions outside of Bankruptcy Court might in numerous cases present the sort of conflict with the purpose and provisions of the Bankruptcy Code which should not be allowed.

> We think that, at least where the cause of action is not derivative of the prepetition legal or equitable rights possessed by a debtor, but rather is derived entirely from the federal rights conferred by the Bankruptcy Code, a bankruptcy court retains significant discretion to assess 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 the Bankruptcy Court to enforce its own orders.[49]

There have been some recent decisions by lower courts in the Second Circuit on the applicability of arbitration clauses in bankruptcy cases. In In re Manshul Construction Corp.,[50] a Chapter 7 Trustee brought an adversary proceeding to recover

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fraudulent conveyances from defendants and parties that had entered into a stipulation restricting the alienation of certain assets and expenditures by the defendants, and permitting the defendants to pay eighty percent (80%) of certain legal fees. The defendants' former attorneys moved for an order to enforce the stipulation, and for an order fixing and imposing a charging lien on assets of the defendants. The Bankruptcy Court held that the fee dispute between the adversary defendants and the defendants' former attorneys was a core proceeding over which the Bankruptcy Court had jurisdiction; that the Bankruptcy Court would enforce the arbitration clause in the retainer agreement between the defendants and their former lawyer; and that the arbitration clause was not superceded by the stipulation. In reaching this decision, the Bankruptcy Court held that arbitration would be the most desirable way to resolve the dispute. In coming to this decision the Court considered the state of its docket and whether or not the motion was more likely to be expeditiously handled before the Bankruptcy Court or an arbitrator. The Bankruptcy Court also looked at the possibility that otherwise privileged matter which the Bankruptcy Court would prefer not to hear, might be revealed at a hearing in front of it.[51]

In In re Caldor, Inc.-NY,[52] the Chapter 11 debtor/tenant brought an adversary proceeding against an assignee of its landlord's interest in a shopping center lease, seeking recovery of alleged prepetition overpayment of additional rent to the assignee and to the assignee's predecessor in interest. The assignee moved to compel arbitration or, in the alternative, for summary judgment. The Bankruptcy Court held that the matter was a core proceeding and that the enforcement of the parties' valid arbitration agreement was not warranted. In reaching its decision, the Bankruptcy Court ruled that the dispute was within its core jurisdiction, and that it implicated important aspects of the Bankruptcy Code and significant estate assets and did not require an arbitrator.[53]

In In re United States Lines, Inc.,[54] the Chapter 11 debtor/shipping companies' reorganization trust, created under the debtors' confirmed plan to administer asbestos related personal injury claims filed by the debtors' employees, brought a post confirmation adversary proceeding against the debtors' foreign and domestic maritime insurers for a declaration of rights under the debtors' pre-petition protection and indemnity policies and for a award of compensatory and punitive damages based on the insurers alleged wrongful refusal to adjust or settle claims. The foreign insurers moved to compel arbitration. The Court held that the trust's adversary proceedings, involving state law regarding breach of contract claims arising from pre-petition contracts, were non-core proceedings, that the trust had failed to establish a conflict between the Bankruptcy Code and the FAA that would warrant non-enforcement of the applicable arbitration provisions in these proceedings.

> While courts have disagreed about how and whether to apply that standard in the context of core proceedings, there is a strong consensus that, in the context of non-core matters, Bankruptcy Courts are without discretion to deny enforcement of applicable arbitration clauses absent some showing that the text, purpose, or history of the bankruptcy code precludes enforcement of arbitration. See *Hays* at 1156–1157; *National Gypsum*, 118 F.3d at 1066 ...[55]

Finally, In re Barney's,[56] the assignee of contracts in arbitration proceedings commenced by the Chapter 11 debtors in possession moved to stay the debtors' adversary proceedings in favor of arbitration under the FAA. The wholly owned subsidiary of the assignee's majority shareholder (which received royalty and fee payments due the debtors under contract from the assignee pursuant to a loan and pledge agreement) moved to stay the adversary proceeding or to abstain pending resolution of the arbitration proceeding under the Bankruptcy Court's inherent powers. The Bankruptcy Court ruled that it would not stay the adversary proceeding under the FAA and that it would not stay or abstain from deciding the adversary proceeding pending resolution of the debtors' arbitration proceeding. In reaching this decision, the Court held that the causes of action alleged in the adversary complaint fell within its core jurisdiction, because they focused on the extent of the debtors' property rights. Therefore, the Bankruptcy Court thought it should be the forum where those matters were resolved.[57]

One recent Bankruptcy Court decision, from the Eleventh Circuit, seems to ignore or, at least, reach a different decision from the case law set forth herein above. In In re Knepp,[58] Chapter 13 debtors filed an adversary proceeding against the creditor that

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financed the purchase of an automobile, the company that insured the vehicle, and the company that provided the service contract for the vehicle, seeking a determination as to the validity and extent of liens and alleging that the defendants had engaged in fraud and civil conspiracy and violated the Alabama Mini-Code. The debtors also sought certification as a class action. The defendants filed motions to stay proceedings and compel arbitration, seeking enforcement of an arbitration clause contained in the buyers' order signed by the debtors when they purchased the vehicle. The Bankruptcy Court denied the motions to compel arbitration and held, among other things, that the arbitration clause did not deprive the debtors of access to the Bankruptcy Courts, and thus was void as against public policy; and that inclusion of a mandatory arbitration clause created an inherent conflict with the Bankruptcy Code.

In coming to this conclusion, the Bankruptcy Court stated that courts have long held that pre-dispute agreement to waive benefits given by the bankruptcy laws to be void as against public policy. It concluded that debtors have an inviolate right of access to Bankruptcy Courts to seek rehabilitation so that the Congressional policy of providing the honest, but unfortunate debtor a fresh start can be effectuated,[59] and that the inclusion of this mandatory arbitration clause created an inherent conflict with the Bankruptcy Code. The Bankruptcy Court noted that the Bankruptcy Code provides for one court to resolve all disputes affecting the administration of a bankruptcy estate and that the policy is to centralize all disputes for the benefit of all parties in interest.

> The bankruptcy system is designed for swift adjudication of commercial disputes. It requires that parties have access to the courts, similar to the dispute resolution process in the Magnuson-Moss Act. The Code allows a detailed system of claims allowance, estimation of claims, recovery and administration of assets, confirmation and discharge. If parties to consumer contracts and contracts for delivery of services to the public can insist on arbitration and impose a stay on the proceedings in bankruptcy court, the whole bankruptcy system, with an estimated one and one-half million main cases filed per year plus the larger number of ancillary disputes, would grind to a halt. The court finds that there is an inherent conflict between the FAA and the Bankruptcy Code.[60]

The court in Knepp went on to reason that a debtor that has filed a bankruptcy petition in most instances cannot afford arbitration fees. Funds used to pay for arbitration fees result in correspondingly smaller amounts to pay under a plan to creditors. The existence of these actual conflicts permits a Bankruptcy Court to exercise its discretion and deny arbitration.[61]

This focusing on the lack of bargaining strength of consumers is further cited in the Bankruptcy Judge's historical overview of the FAA. He believes that the purpose of the FAA was to allow merchants to negotiate a method to resolve disputes in a non-judicial forum; and that when two equally sophisticated parties bargain at arm's length to submit disputes to arbitration, that agreement should be enforceable. But, troubling questions appear when one party lacks the sophistication and bargaining power of the other. The Bankruptcy Judge posits the following questions: How does a policy rigorously favoring arbitration effect a consumer contract when the arbitration agreement is buried in the fine print of a long, prolix document; how does this federal policy apply to a consumer transaction when all contracts in the market include an arbitration agreement and the consumer can only opt for the transaction with the arbitration agreement or give up the product or service; how does this policy apply to the employee working under a manual requiring binding arbitration. The Bankruptcy Judge believes that the answer is crystal clear. The consumer is left with no choice. He must give up certain of his rights or not obtain the product or service desired. The Bankruptcy Judge then compared the FAA to kudzu, which was brought to this country for specific agricultural purposes and thought at first to be beneficial but which was later to become what many consider to be a "creeping monster." Similarly, arbitration, standing alone, seemed to be trouble-free when applied only to negotiated commercial contracts, but it has developed negative side effects when it becomes a common everyday event.[62]

According to this Bankruptcy Judge, the use of arbitration clauses in form contracts is experiencing popular and widespread appeal. Historically, the western legal tradition has permitted a weak or disadvantaged member of society a means to file a complaint in an accessible way to get before a court in order to be heard. Arbitration, on the other hand, requires an initial payment of a minimum of $500 to more than $7,000 and daily costs of hundreds of dollars with no guarantee of due process, no right to a trial by jury, no right to an independent impartial judge and no right to discovery.[63]

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The Bankruptcy Court then went on to point out how arbitration clauses violate specific contractual rights. First, the Supreme Court has often ruled that Congress is restricted in its power to limit access of parties to a trial by jury.[64] Along these lines, the Alabama Supreme Court has held that any arbitration agreement is a waiver of a party's right under the Seventh Amendment of the United States Constitution to a trial by jury and, notwithstanding the policy favoring arbitration, there is nothing in the FAA that allows such a waiver unless it is made knowingly, willingly and voluntarily.[65]

The Bankruptcy Court goes on to point out that the specific enforcement of arbitration contracts for the purchase of consumer goods or services is plagued by a number of problems dealing with the Seventh Amendment. Contracts with arbitration clauses appear more and more often. Consequently, consumers are finding it harder and harder to obtain products and /or services without giving up their rights to a jury trial. Large portions of specific markets, such as automobile sales and financing, are subject to this and are thus unavailable to consumers who don't want to cede their rights to a jury trial.[66]

The Bankruptcy Judge then embarked on an economic analysis, explaining that the enforced waiver to the right of a trial by jury results in a fiscal penalty to the consumer because it deprives the consumer of the benefit of his bargain, in addition to the time he spent and the expense he incurred in negotiating it. A number of consumer credit transactions with agreements to arbitrate are comprised of two separate and distinct agreements. Take the credit sale of a new automobile. For the most part, it is undertaken between the consumer and the dealership's salesman and may often take hours, if not days, to negotiate. Although terms central to both parties may be involved in these negotiations, arbitration does not often come up, and is probably not thought about.[67]

After the buyer and the salesman iron out what the buyer believes to be the contract for the sale of the vehicle, the buyer is given a pre-printed written contract. Such an agreement does not just recite the provisions which the consumer and the salesman talked about, but frequently also contains an arbitration clause that was never discussed and which dealers consider to be non-negotiable. At this late stage in the game, the consumer is confronted with the prospect that in order to be able to purchase the intended automobile, and receive the benefit of his previously negotiated bargain, he must waive his right to a jury trial or else his prior efforts to obtain the vehicle become a nullity. Faced with this "Hobson's choice", the consumer agrees to the arbitration clause and signs the pre-printed contract form which is put in front of him.[68]

This second agreement, where the consumer agreed to the arbitration clause that is only put in front of him when the negotiating is over, is an amendment of the first agreement and is a new contract, subject to the rules regarding consideration and mutual assent. The consumer must either sign the contract and waive his Seventh Amendment right to a jury trial or start the negotiations all over again. It is true that some constitutional rights can be waived, such as the rights guaranteed by the Fourth Amendment (freedom from unreasonable search and seizures), the Fifth Amendment (freedom from forced self incrimination) and the Sixth Amendment (the right to legal counsel in criminal proceedings). While a person may waive his Fourth Amendment right by consenting to a search without a warrant, the consent is required to be voluntary and the only result of the waiver is that the evidence found may properly be admitted at trial. A person in police custody may waive its Fifth and Sixth Amendment rights too. But before this happens, the individual must be given a warning as per Miranda vs. Arizona.[69] This waiver must be made voluntarily, knowingly and intelligently and the only result of the waiver is that any statement given will be admissible into evidence.[70]

The Bankruptcy Court then reasoned that the waiver of rights guaranteed by the Fourth, Fifth and Sixth Amendments is not punitive while the specific enforcement of an arbitration clause that a consumer must give in to is punitive. Therefore, the Bankruptcy Judge held that in a consumer transaction case involving a contract containing an arbitration clause, unless there is a showing that the consumer entered into the arbitration agreement voluntarily, the contract will be unenforceable as an encroachment on the right to trial by jury.[71]

> If the offeror of consumer goods or services intends to insist upon the arbitration of disputes arising out of its consumer transactions, it must clearly integrate the arbitration requirement with the terms of the transaction that

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the consumer would consider essential, such as the price of the goods or services and the size and number of the payments. In other words, the consumer must be apprised of his right to a trial by jury and must be given an opportunity to accept or reject arbitration in a manner similar to the choice commonly given consumers either to purchase or refuse credit life or disability insurance. Such a procedure is merely analogous to the warning given pursuant to *Miranda vs. Arizona*, 384 U.S. 436, 86 S.Ct. 1602, 16 L.Ed.2d. 694 (1966), to ensure that other enumerated rights under the Bill of Rights have been voluntarily waived. This would provide one way in which objective evidence as to the level of volition could be demonstrated.[72]

CONCLUSION

The Third Circuit's approach toward the applicability of arbitration clauses in bankruptcy cases seems to be the test of choice among Bankruptcy Courts, if for no other reason than the fact that it is so easy to apply. The distinction between core and non-core proceedings is one which Bankruptcy Courts make virtually all of the time and is thus a known quantity. The Fifth Circuit's rejection of this jurisdictionally based test gives the Bankruptcy Judge a great deal more discretion in whether or not the subject arbitration clause will be enforced. The fact that Matter of National Gypsum Company, supra, is not as old as Hays vs. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra has resulted in there being fewer cases that have analyzed the Fifth Circuit's rationale. Finally, with respect to consumer transactions, the case of In re Knepp, supra, seems to have thrown a "monkey wrench" into the arbitration clause analysis. Under this case, in order for an arbitration clause to be enforceable in a bankruptcy case involving a consumer transaction, there must be a showing that the consumer entered into the arbitration agreement "eyes open" and voluntarily.

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Footnotes

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1 9 U.S.C. §§ 1 et. seq.

2 In re After Six, Inc., 167 B.R. 35, 41 (E.D. Pa. 1994).

3 In re Home Exp., Inc., 226 B.R. 657, 658 (Bankr. N.D. Cal. 1998).

4 In re First Thermal Systems, Inc., 182 B.R. 510 (Bankr. E.D. Tenn. 1995).

5 In re Sacred Heart Hosp. of Norristown, 200 B.R. 826, 831 (Bankr. E.D. Pa. 1996).

Section 2. Validity, irrevocability and enforcement of agreements to arbitrate.

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, an enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2.

6 In re Sacred Heart Hospital of Norristown, 200 B.R. at 831. See also Erie R. Co. v. Tompkins, 304 U.S. 64, 58 S. Ct. 817, 82, 82 L. Ed. 1188, 114 A.L.R. 1487 (1938).

7 In re Dunes Hotel Associates, 194 B.R. 967, 992 (Bankr. D.S.C. 1995).

8 In re Dunes Hotel Associates, 194 B.R. 967 (Bankr. D.S.C. 1995); Allied-Bruce Terminix Companies, Inc. v. Dobson, 513 U.S. 265, 115 S. Ct. 834, 843, 130 L. Ed. 2d 753 (1995).

9 In re Dunes Hotel Associates, 194 B.R. 967 (Bankr. D.S.C. 1995).

10 In re Sacred Heart Hospital of Norristown, 200 B.R. at 831.

11 Bacashihua v. U.S. Postal Service, 859 F.2d 402, 405, 129 L.R.R.M. (BNA) 2620, 110 Lab. Cas. (CCH) ¶ 10919 (6th Cir. 1988).

12 Crawford v. West Jersey Health Systems (Voorhees Div.), 847 F. Supp. 1232, 1240, 64 Fair Empl. Prac. Cas. (BNA) 853 (D.N.J. 1994).

13 In re Pate, 198 B.R. 841, 846 (Bankr. S.D. Ga. 1996).

Section 3. Stay of proceedings where issue therein referable to arbitration.

If any suit or any proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 3.

14 In re U.S. Lines, Inc., 220 B.R. 5, 12 (S.D.N.Y. 1997), rev'd on other grounds, 197 F.3d 631, 35 Bankr. Ct. Dec. (CRR) 187 (2d Cir. 1999), cert. denied, 2000 WL 175458 (U.S. 2000).

15 Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination.

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, 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, for an order directing that such arbitration proceed in the manner provided for in such agreement. Five days' notice in writing of such application shall be served upon the party in default. Service thereof shall be made in the manner provided by the Federal Rules of Civil Procedure. The court shall hear the parties, and upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement. The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed. If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to trial thereof. If no jury trial be demanded by the party alleged to be in default, or in the matter in dispute is within admiralty jurisdiction, the court shall hear and determine such issue. Where such issue is raised, the party alleged to be in default may, except in cases of admiralty, on or before the return day of the notice of application, demand a jury trial of such issue, and upon such demand the court shall make an order referring the issue or issues to a jury in the manner provided by the Federal Rules of Civil Procedure, or may specially call a jury for that purpose. If the jury finds that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury finds that an agreement for arbitration was made in writing and that there is a default

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in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof.

In re Caldor, Inc.-NY, 217 B.R. 121, 128 (Bankr. S.D.N.Y. 1998).

16 In re Home Express, Inc., supra at 658; Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 24, 103 S. Ct. 927, 74, 74 L. Ed. 2d 765 (1983); In re Pate, supra at 846.

17 In re After Six, Inc., 167 B.R. 35 (E.D. Pa. 1994).

18 In re Caldor, Inc.-NY, supra at 128.

19 In re Dunes Hotel Associates, 194 B.R. 967 (Bankr. D.S.C. 1995). In re Sacred Heart Hospital of Norristown, 200 B.R. at 832.

20 In re United States Lines, Inc., 220 B.R. at 12.

21 In re Interactive Video Resources, Inc., 170 B.R. 716, 721 (S.D. Fla. 1994).

22 In re N. Parent, Inc., 221 B.R. 609, 62 n13 (Bankr. D. Mass. 1998).

23 In re Day, 208 B.R. 358, 369 (Bankr. E.D. Pa. 1997).

24 In re CGE Ford Heights, L.L.C., 208 B.R. 825, 827, 30 Bankr. Ct. Dec. (CRR) 1049 (Bankr. D. Del. 1997).

25 In re Barney's, Inc., 206 B.R. 336, 343 (Bankr. S.D.N.Y. 1997); In re Caldor, Inc.-NY, supra at 129.

26 In re Barney's, Inc., 206 BR at 343. In re Caldor, Inc.-NY, supra at 129. See also Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221, 105 S. Ct. 1238, 1243, 84 L. Ed. 2d 158, Blue Sky L. Rep. (CCH) ¶ 72172, Fed. Sec. L. Rep. (CCH) ¶ 91953 (1985).

27 Shearson/American Exp., Inc. v. McMahon, 482 U.S. 220, 226–227, 107 S. Ct. 2332, 2337–2338, 96 L. Ed. 2d 185, Fed. Sec. L. Rep. (CCH) ¶ 93265, R.I.C.O. Bus. Disp. Guide (CCH) ¶ 6642 (1987). See also Rodriguez de Quijas v. Shearson/American Exp., Inc., 490 U.S. 477, 483, 109 S. Ct. 1917, 1921, 104 L. Ed. 2d 526, Fed. Sec. L. Rep. (CCH) ¶ 94407 (1989).

28 In re After Six, Inc., 167 B.R. 35 (E.D. Pa. 1994); In re Chorus Data Systems, Inc., 122 B.R. 845, 851 (Bankr. D.N.H. 1990).

29 In re Pate, supra at 846.

30 In re After Six Incorporated, 167 B.R. at 41–42. In re LeMaire, 898 F.2d 1346, 1352, 20 Bankr. Ct. Dec. (CRR) 521, 22 Collier Bankr. Cas. 2d (MB) 1008, Bankr. L. Rep. (CCH) ¶ 73296 (8th Cir. 1990). Penn Terra Ltd. v. Department of Environmental Resources, Com. of Pa., 733 F.2d 267, 271, 11 Bankr. Ct. Dec. (CRR) 1202, 10 Collier Bankr. Cas. 2d (MB) 949, 20 Env't. Rep. Cas. (BNA) 2185, Bankr. L. Rep. (CCH) ¶ 69827, 14 Envtl. L. Rep. 20475 (3d Cir. 1984). In re Elsinore Shore Associates, 66 B.R. 723, 735, 15 Bankr. Ct. Dec. (CRR) 420, 15 Collier Bankr. Cas. 2d (MB) 1128, Bankr. L. Rep. (CCH) ¶ 71553 (Bankr. D.N.J. 1986). In re Continental Airlines, Inc., 148 B.R. 207, 211, 141 L.R.R.M. (BNA) 2934, Bankr. L. Rep. (CCH) ¶ 75091 (D. Del. 1992). In re Keniston, 85 B.R. 202, 216, Bankr. L. Rep. (CCH) ¶ 72281 (Bankr. D.N.H. 1988).

31 Zimmerman v. Continental Airlines, Inc., 712 F.2d 55, 57–59, 10 Bankr. Ct. Dec. (CRR) 1187, 8 Collier Bankr. Cas. 2d (MB) 1202, Bankr. L. Rep. (CCH) ¶ 69304, 1984 A.M.C. 606, 72 A.L.R. Fed. 881 (3d Cir. 1983).

32 In re Zimmerman v. Continental Airlines, Inc., supra at 56–60. In re Sacred Heart Hosp. of Norristown, 181 B.R. 195, 201–202 (Bankr. E.D. Pa. 1995). In re Day, supra at 369.

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33 Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1155–1157, 19 Bankr. Ct. Dec. (CRR) 1344, Bankr. L. Rep. (CCH) ¶ 73091, Fed. Sec. L. Rep. (CCH) ¶ 94568 (3d Cir. 1989).

34 Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra at 1156–1160.

35 Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra at 1156–1158.

36 Northern Pipeline Const. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598, 6 Collier Bankr. Cas. 2d (MB) 785, Bankr. L. Rep. (CCH) ¶ 68698 (1982).

37 In re Sacred Heart Hospital of Norristown, 181 B.R. 202. In re Day, supra at 369.

38 Supra at 827.

39 In re CGE Ford Heights, L.L.C., 208 B.R. 827, 828, 30 Bankr. Ct. Dec. (CRR) 1049 (Bankr. D. Del. 1997).

40 In re Sacred Heart Hospital of Norristown, 181 B.R. at 204–205.

41 200 B.R. at 831–833.

42 In re Day, supra at 369–370.

43 In re Day, supra at 370.

44 Matter of National Gypsum Co., 118 F.3d 1056, 31 Bankr. Ct. Dec. (CRR) 237, 38 Collier Bankr. Cas. 2d (MB) 722 (5th Cir. 1997).

44 In re National Gypsum Company, supra at 1069.

45 In re National Gypsum Company, supra at 1066–1067.

46 In re National Gypsum Company, supra at 1067–1068.

47 In re Statewide Realty Co., 159 B.R. 719, 722 (Bankr. D.N.J. 1993).

48 In re National Gypsum Company, supra at 1068, citing In re Statewide Realty Co., supra at 724.

49 Matter of National Gypsum Company, supra at 1069.

50 In re Manshul Const. Corp., 225 B.R. 41 (Bankr. S.D.N.Y. 1998).

51 In re Manshul Construction Corp., supra at 48–49.

52 In re Caldor, Inc.-NY, 217 B.R. 121, 128 (Bankr. S.D.N.Y. 1998).

53 In re Caldor, Inc.-NY, supra at 129–130.

54 In re United States Lines, Inc., 220 B.R. at 12–13.

55 In re United States Lines, Inc., 220 B.R. at 12–13. See also In re U.S. Lines, Inc., 199 B.R. 465, 474, 1998 A.M.C. 923 (S.D.N.Y. 1996).

56 supra at 343.

57 In re Barney's, Inc., supra at 343.

58 In re Knepp, 229 B.R. 821 (Bankr. N.D. Ala. 1999).

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59 In re Knepp, supra at 842–843, citations omitted.

60 In re Knepp, supra at 845.

61 In re Knepp, supra at 845.

62 In re Knepp, supra at 828.

63 In re Knepp, supra at 828.

64 In re Knepp, supra at 828. See also Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 51–52, 109 S. Ct. 2782, 106, 106 L. Ed. 2d 26, 19 Bankr. Ct. Dec. (CRR) 493, 20 Collier Bankr. Cas. 2d (MB) 1216, Bankr. L. Rep. (CCH) ¶ 72855, 18 Fed. R. Serv. 3d 435 (1989).

65 In re Knepp, supra, at 828. Allstar Homes, Inc. v. Waters, 711 So. 2d 924, 929 (Ala. 1997).

66 In re Knepp, supra at 828–829.

67 In re Knepp, supra at 829.

68 In re Knepp, supra at 829.

69 Miranda v. Arizona, 384 U.S. 436, 86 S. Ct. 1602, 16, 16 L. Ed. 2d 694, 10 A.L.R.3d 974 (1966).

70 In re Knepp, supra at 829–830.

71 In re Knepp, supra at 829–830.

72 In re Knepp, supra at 830 citing Allstar Homes, Inc. vs. Waters, supra at 933–935 (Cook, J., concurring specially).

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