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Second Circuit Rules Arbitration Clause Not Enforceable in Bankruptcy Case

by Deborah A. Reperowitz

There exists a split among bankruptcy courts regarding the enforceability of binding arbitration provisions.[1] In 1985, the United States Supreme Court stated that the Federal Arbitration Act "mandates" that district courts enforce signed arbitration agreements. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985). On March 9, 2018, however, the Second Circuit Court of Appeals cast aside this mandate and affirmed the bankruptcy court's refusal to enforce a mandatory arbitration provision contained in a credit card agreement. *Anderson v. Credit One Bank, N.A. (In re Anderson)*, 884 F.3d 382 (2d Cir. 2018).

In *Anderson*, the Second Circuit attempted to balance the conflicting policies of the Federal Arbitration Act, which favors arbitration, and the United States Bankruptcy Code, which favors centralizing the resolution of debtor/creditor disputes in the bankruptcy court. The facts of the case are straightforward. Anderson failed to pay his credit card debt to Credit One Bank. Credit One sold the account and properly reported to credit reporting agencies that the account had been sold and "charged off.[2] Subsequently, Anderson filed a Chapter 7 bankruptcy petition and obtained a discharge. Thereafter, Credit One refused Anderson's request to amend the credit report to reflect the discharge. Anderson reopened his bankruptcy case and commenced a putative class action against Credit One, alleging that its refusal to amend the credit report violated his discharge. Under the Bankruptcy Code, a discharge "operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor." 11 U.S.C. Section 524(a)(2).

Credit One moved to enforce the arbitration provision contained in Anderson's cardholder agreement. The Bankruptcy Court, as affirmed by the District Court and the Second Circuit, denied the request. In so doing, the Second Circuit articulated the two-step test to be applied by a bankruptcy court to determine the enforceability of an arbitration provision. First, the bankruptcy court must decide whether the matter is a "core" or a "non-core" proceeding. Second, if the matter is non-core, arbitration provisions generally should be enforced. If, however, the matter is a core proceeding, the bankruptcy court must carefully consider the nature of the claim and the facts of the particular case to determine whether arbitration would "create a 'severe conflict' with the purposes of the Bankruptcy Code." *Anderson*, 884 F.3d at 387, *quoting MBNA America Bank, N.A. v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006). If such a severe conflict is presented, the bankruptcy court has the "discretion to conclude that 'Congress intended to override the Arbitration Act's general policy of favoring the enforcement of arbitration agreements.'" *Anderson*, 884 F.3d at 387. [citations omitted].

Section 157 of the Bankruptcy Code contains a nonexhaustive list of matters that constitute core proceedings. 28 U.S.C. Section 157(b)(2). In *Anderson*, the parties agreed that their dispute was a core proceeding. *Anderson*, 884 F.3d at 388. Accordingly, the bankruptcy court was called upon to determine whether enforcing the arbitration provision

in Anderson's credit card agreement would create a severe conflict with the purposes of the Bankruptcy Code.

The Second Circuit noted that the federal policy favoring arbitration could be overridden by contrary congressional intent. *Id*. Although the Second Circuit seemingly acknowledged that congressional intent could be established through statutory language or legislative history or from an inherent conflict between arbitration and the underlying purposes of the discharge order, the Court refused to consider arguments regarding the statutory text and legislative history, since they were not raised below. *Id*. at 388-89. Instead, the Second Circuit determined that it "need only consider whether there is an 'inherent conflict between arbitration' and the Bankruptcy Code." *Id*. at 389 [citations omitted].

The Second Circuit discussed the importance of the discharge injunction to the bankruptcy process and the bankruptcy court's right to enforce its own orders, and it concluded that arbitration of an alleged discharge order violation would "'seriously jeopardize' a particular core bankruptcy proceeding" because "1) the discharge injunction is integral to the bankruptcy court's ability to provide debtors with the fresh start that is the very purpose of the Code; 2) the claim involves an ongoing bankruptcy matter that requires continuing court supervision; and 3) the equitable powers of the bankruptcy court to enforce its own injunctions are central to the structure of the Code." *Id*. at 390. Ultimately, the Second Circuit determined that arbitration of Anderson's claim would "present the sort of inherent conflict with the Bankruptcy Code that would overcome the strong congressional preference for arbitration" and determined that the bankruptcy court did not abuse its discretion by refusing to enforce the arbitration provision in Anderson's cardholder agreement.

While the *Anderson* case may at first appear to mark a departure from previous New York bankruptcy cases that have enforced arbitration provisions, it may simply reflect a narrow exception to the general rule that arbitration provisions are enforceable in bankruptcy. The Court's focus upon the importance of the fresh start concept to the bankruptcy process and its conclusion that the discharge injunction is critical to this fresh start suggest that the Court's refusal to enforce the arbitration provision is limited to the facts before it. *Id*. at 390-91. Moreover, the Second Circuit spent significant time distinguishing, but not criticizing or reversing, the prior seminal decision rendered by the Second Circuit in *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006), in which the Second Circuit enforced an arbitration agreement with respect to a stay-violation claim.

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[1] See Michael J. Lichtenstein and Sara A. Michaloski, "The Enforcement of Arbitration Agreements in Bankruptcy Proceedings," Pratt's Journal of Bankruptcy Law, May 2017. (Historically, bankruptcy courts have enforced arbitration agreements in the Second, Third and Eleventh circuits, while bankruptcy courts in the Fourth, Ninth and Washington, D.C., circuits have declined to enforce such agreements.)

[2] Federal regulations require banks to "charge off" debt that is more than 180 days past due. *Anderson*, 884 F.3d, at 386, n. 2 [citation omitted].

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