Pre-Petition Arbitration Agreements in Bankruptcy And *Hays and Co. v. Merrill Lynch.*

I. INTRODUCTION

As our society comes closer to a realization that litigation is only one of many methods of dispute resolution, the role of alternative dispute resolution is bound to increase. Arbitration has already emerged as a strong federal concern which is no longer prepared to yield easily to other federal interests. The Federal Arbitration Act[1] (the FAA) is experiencing a rebirth after recent decisions of the Supreme Court. These decisions turned this "dark horse" among the congressional enactments into a "fighting vehicle" capable of "winning" against such potent opponents as federal concerns arising under the antitrust laws, the securities laws, and the Racketeer Influenced and Corrupt Organizations Act.[2] No victory will, however, be complete until the FAA successfully "takes on" the federal bankruptcy law. That time appears to have arrived.

The federal bankruptcy law may come into conflict with the FAA within a bankruptcy proceeding where the debtor in possession, or the trustee,[3] attempts to resolve a dispute regarding a bankruptcy-related matter which arises under a pre-petition contract containing an arbitration clause. First, a conflict between the FAA and the Bankruptcy Code (the Code) may arise because a stay of the bankruptcy proceeding pending arbitration could interfere with the efficient administration of the bankruptcy estate. Second, a conflict may also arise because enforcing a valid arbitration clause could interfere with the general bankruptcy principle that, for liquidation or rehabilitation of the debtor to be successful, the value of the bankruptcy estate must be maximized. Surprisingly, courts analyzing the conflict between the FAA and the Code have completely overlooked this second source of conflict even though the idea is lurking whenever executory contracts in bankruptcy are discussed.[4]

Courts and commentators have spent much time analyzing the problem of enforcement of arbitration clauses against the trustee. Most

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1. 9 U.S.C. §§ 1-208 (1988).

2. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 814 F.2d 844 (1st Cir. 1987), *on remand from*, 473 U.S. 614 (1985) (claims arising under federal antitrust law); Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989) (claims arising under the Securities Act of 1933); Shearson/Am. Express,Inc. v. McMahon, 482 U.S. 220 (1987) (claims arising under the Securities Exchange Act of 1934 and RICO).

3. The term trustee will hereinafter include the debtor in possession.

4. *E.g.*, Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

discussions focus on a conflict between the bankruptcy interest in having bankruptcy-related matters resolved in a single proceeding[5] and the FAA's mandate to stay the bankruptcy proceeding and proceed with arbitration.[6] As a result, courts unanimously held, prior to *Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[7] that a decision to compel or deny arbitration was left to the sound discretion of the bankruptcy judge.[8] The courts based their decisions on the view that arbitration occupied a position of lesser importance than bankruptcy in the hierarchy of federal concerns. In addition, they considered arbitrators as incapable of addressing complex issues and arbitration as ill-equipped to handle disputes arising under the complex laws.

Inspired by the Supreme Court's decision in *Shearson/Am. Express, Inc. v. McMahon*,[9] which requires courts to rigorously enforce arbitration agreements even in situations where a party to the agreement raises a claim founded on statutory rights, the Third Circuit reversed its seminal decision in *Zimmerman v. Continental Airlines, Inc.*[10] and held in *Hays* that the district court was without discretion to deny the enforcement of an arbitration clause.[11] Moreover, the Third Circuit found that the Code and the FAA were not in conflict as to whether to enforce, against the trustee, a pre-petition arbitration agreement to resolve a dispute over a bankruptcy-related matter.[12]

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5. To have bankruptcy-related matters resolved in a single proceeding has long been considered synonymous with the efficient administration of the bankruptcy estate. S. REP. NO. 989, 95th Cong., 2d Sess., *reprinted in* 1978 U.S.C.C.A.N. 5787, 5803-04.

6. *See, e.g.*, Zimmerman v. Continental Airlines, Inc., 712 F.2d 55 (3d Cir. 1983), *cert. denied*, 464 U.S. 1038 (1984) (*Zimmerman* and its progeny is still followed in every jurisdiction that addressed the issue except in its own); Yochum, *Arbitration Agreements in Bankruptcy: A Mutant is Loose (Again!), Symptoms are Showing, A Palliative is Suggested*, 19 STETSON L.REV. 137 (1989); William E. Deitrick, *The Conflicting Policies Between Arbitration and Bankruptcy*, 40 BUS. LAW. 33 (1984); D. James Mackall, Comment, *Balancing Section 3 of the United States Arbitration Act and Section 1471 of the Bankruptcy Reform Act of 1978: A Bankruptcy Judge's Exercise of "Sound Discretion"*, 53 U. CIN. L. REV. 231 (1984); Carolyn C. Markason, Note, *Arbitration Agreements in Bankruptcy Proceedings: The Clash Between Policies and the Proper Forum for Resolution — Zimmerman v. Continental Airlines, Inc.*, 57 TEMP. L.Q. 855 (1984).

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

8. *See, e.g.*, In re Guild Music Corp., 100 B.R. 624 (Bankr. D. R.I. 1989); In re Wm. S. Newman Brewing Co., Inc., 87 B.R. 236 (Bankr. N.D. N.Y. 1988); In re Double TRL, Inc., 65 B.R. 993 (Bankr. E.D. N.Y. 1986); In re Continental Airline Corp., 60 B.R. 472 (Bankr. S.D. Tex. 1986).

9. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987).

10. *Zimmerman*, 712 F.2d 55.

11. *Hays*, 885 F.2d 1149. In *Hays*, a securities broker moved the court to compel a Chapter 11 trustee to arbitrate the trustee's claim against the broker. The claim arose out of a pre-petition contract containing an arbitration clause.

12. *Id.* at 1161.

This Note will discuss enforcement against trustees of pre-petition arbitration agreements with respect to issues that, upon filing of a petition, become matters related to the bankruptcy case rather than matters exclusively within the bankruptcy court's jurisdiction. Part II of this Note will examine the FAA's policy in favor of arbitration as well as the general principle of the bankruptcy law that for liquidation or rehabilitation of the debtor to be successful, the value of the bankruptcy estate must be maximized. Part II will also demonstrate that the Code may indeed come into conflict with the FAA. Part III will examine the Third Circuit's decision in *Hays*, focusing on arbitration of bankruptcy-related matters. Furthermore, Part III will analyze and critique the Third Circuit's holdings and its reasoning. Finally, Part IV will articulate a test to resolve the conflict between the Code and the FAA.

II. PRE-PETITION AGREEMENT TO ARBITRATE AND THE BANKRUPTCY CODE: DO THE FEDERAL ARBITRATION ACT AND THE BANKRUPTCY CODE CONFLICT?

A. Arbitration Agreements within the FAA

To provide a speedy and inexpensive alternative to litigation, Congress enacted the FAA. By enacting the FAA, Congress intended to "revers[e] centuries of judicial hostility to arbitration agreements. . . ."[13] Section 2 of the FAA accomplishes this purpose by placing arbitration agreements "upon the same footing as other contracts."[14] It provides that arbitration agreements shall be "valid, irrevocable, and enforceable except for such grounds as exist at law or in equity for the revocation of any contract."[15] Section 3 of the FAA requires a court, upon application, to stay its proceedings if an issue before the court is subject to a valid arbitration agreement.

The plain language of the FAA allows no exceptions to its stay provisions. Until recently, however, the courts were quick to modify the FAA by having it yield to other federal concerns arising under the federal antitrust laws,[16] the securities laws,[17] or actions brought under the

13. Scherk v. Alberto-Culver Co., 417 U.S. 506, 510-11 (1974).

14. *Id.* (quoting from H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2, (1924)).

15. 9 U.S.C. § 2 (1988).

16. *Mitsubishi Motors Corp.*, 723 F.2d 155; Applied Digital Tech., Inc. v. Continental Casualty Co., 576 F.2d 116 (7th Cir. 1978).

Racketeer Influenced and Corrupt Organizations Act.[18] The courts based such modified readings of the FAA in part on the belief that arbitrators were not able to properly apply complex laws, and additionally on the belief that arbitration was inadequately equipped to handle the resolution of disputes arising under such laws.[19]

Recent years have witnessed a major change in the significance attached to those policies underlying the FAA and its impact on other federal concerns. The Supreme Court eliminated the implied exception to the FAA in the area of arbitration of disputes arising out of securities laws.[20] The Court expressly repudiated its view that arbitrators are incapable of addressing complex issues and that arbitration is ill-equipped to handle disputes arising under complex laws.[21] The recent decisions of the Supreme Court in the area of securities law cast doubt on whether other implied exceptions to the FAA will survive much longer.[22]

In *McMahon*, the Supreme Court reexamined the enforceability of contractual agreements to arbitrate disputes between customers and brokers arising under the federal securities laws. The Court held that the FAA establishes a federal policy favoring arbitration, which requires the courts to rigorously enforce arbitration agreements.[23] It further held that this duty is not diminished when a party bound by the agreement raises a claim founded on statutory rights. The Supreme Court went on to say that, like any other statutory directive, the FAA's mandate may be overridden by a contrary congressional command.

Thus, to defeat the application of the FAA, a party opposing arbitration must demonstrate that Congress intended to make an exception to the FAA for claims arising under some other federal statute. Congress' intention to make an exception to the FAA must be discernible from the text, the history, or the inherent conflict between arbitration and the underlying purposes of the statute.[24]

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17. Wilko v. Swan, 346 U.S. 427 (1953).

18. S.A. Mineracao Da Trindade-Samitri v. Utah Int'l Inc., 576 F. Supp. 566 (S.D. N.Y. 1983), *aff'd*, 745 F.2d 190 (2d Cir. 1984).

19. *Wilko*, 346 U.S. 427, 430.

20. Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989).

21. *McMahon*, 482 U.S. 220, 231-33 (1987).

22. *Rodriguez de Quijas*, 490 U.S. 477 (claims arising under the Securities Act of 1933); *McMahon*, 482 U.S. 220 (claims arising under the Securities Exchange Act of 1934).

23. *McMahon*, 482 U.S. 220.

24. *Id.*

B. The Bankruptcy Code

For those who are obsessed with logic and clarity, perhaps the best way to construct a clear and logical edifice of bankruptcy law is to establish several general principles. The next step would be to design a means to implement these general principles. The Code represents a means and is not simply a statement of such principles. One of the general principles of bankruptcy law is that for liquidation or rehabilitation of the debtor to be successful, the value of the bankruptcy estate must be maximized.

1. Rejection of Executory Contracts.

The Code provides a number of vehicles to arrive at the maximum value for the bankruptcy estate. These vehicles are designed to relieve the bankruptcy estate from certain obligations of the debtor or liens against the property, or to avoid particular transfers that are damaging to the estate. Because contracts are the major means through which business activities have been conducted for centuries, a policy that does not allow a trustee to dispose of performance on certain types of contracts that happen to be burdensome to the bankruptcy estate would in most circumstances stand in the way of maximizing the value of the bankruptcy estate. Therefore, it must come as no surprise that the Code allows the trustee either to assume or reject executory contracts of the debtor.[25] This rejection constitutes a breach of the contract[26] and is subject to the Bankruptcy Court's approval.[27]

In deciding whether to approve the rejection of an executory contract most courts apply the business judgement rule.[28] Under this rule, a trustee may reject an executory contract if the rejection is advantageous to the bankruptcy estate.[29] Applying the business judgment rule, most

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25. 11 U.S.C. § 365(a) (1988).

26. 11 U.S.C. § 365(g) (1988).

27. 11 U.S.C. § 365(a) (1988).

28. 2 COLLIER ON BANKRUPTCY ¶ 365.03 (15th ed. 1990). A much stricter standard applies, however, to the rejection of collective bargaining agreements because of the "special nature" of such contracts. N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984); 11 U.S.C. § 1113 (1988).

29. A minority of the courts will allow the trustee to reject an executory contract only if the contract must result in an actual loss to the bankruptcy estate. 2 COLLIER ON BANKRUPTCY ¶ 365.03 (15th ed. 1990). A few courts require a showing that rejection will benefit the general unsecured creditors. *E.g.*, Infosystems Technology, Inc. v. Logical Software, Inc., Bankr. L. Rep. (CCH) ¶¶ 71,899, 71,900, (D. Mass. June 25, 1987). For a detailed discussion of standards governing rejection of executory contracts in bankruptcy, *see* Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding 'Rejection'*, 59 U. COLO. L. REV. 845, 895-901 (1988).

courts will not second-guess the trustee's decision to reject an executory contract unless the decision involved bad faith or a gross abuse of discretion.[30] In addition, the bankruptcy court is a court of equity. As a result, the Code grants broad equitable powers to the bankruptcy judge.[31]

2. Arbitration Clause as an Executory Contract.

Although the Code allows a trustee to assume or reject executory contracts,[32] it does not define the term "executory contract." Most courts follow the definition suggested by Professor Countryman: An executory contract is one where the obligations of both the bankrupt and the other party to the contract are thus-so-far unperformed and where the failure of either party to complete performance would constitute a material breach excusing performance by the other party.[33] Professor Countryman's definition is known as the material breach test.

Some courts are willing to overlook performance by the nondebtor party, and consider the contract executory if the debtor has a significant obligation yet to be performed other than payment of money.[34] Other courts examine the purpose of the rejection and base their decision of whether to enforce the executory contract on the possibility of the accomplishment of such an objective.[35] In short, if a rejection of a contract benefits the bankruptcy estate, then the contract is executory. Finally, one commentator who has written extensively in this field, suggests that the time has come to extend the trustee's power that allows one to assume or reject an executory contract to all bankruptcy contracts.[36]

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30. Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1046 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986). In re Bildisco, 682 F.2d 72, 79 (3d Cir. 1982), *aff'd sub nom* N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984); 2 COLLIER ON BANKRUPTCY ¶ 365.03 (15th ed. 1990).

31. Bankruptcy courts are courts of equity. 11 U.S.C.A. § 105 note 5 (West Supp. 1991) (Equitable Considerations).

32. The trustee cannot discard an arbitration clause just because the trustee was not a party to the agreement. The trustee succeeds to all contractual rights and obligations of the debtor. In addition, the Code provides the trustee with certain powers which enable the trustee to deal with the debtor's contracts and property in a manner not available to the debtor. *E.g.*, *N.L.R.B.*, 465 U.S. 513, 528 (1983) (rejecting a theory that a trustee is a "new entity"); *see also* Westbrook, *The Coming Encounter: International Arbitration and Bankruptcy*, 67 MINN. L. R. 595, 618-19 (1983).

33. Countryman, *Executory Contracts in Bankruptcy*, Part I, 57 MINN. L. REV. 439, 460 (1973).

34. In re Oxford Royal Mushroom Prods., Inc., 45 B.R. 792 (E.D. Pa. 1985); In re Norquist, 43 B.R. 224 (Bankr. E.D. Wash. 1984).

35. In re Jolly, 574 F.2d 349 (6th Cir. 1978), *cert. denied*, 439 U.S. 929 (1978).

36. *See* Westbrook, *supra* note 4, at 230.

Addressing the legislative history of the term "executory contract," the Supreme Court observed:

> The Bankruptcy Code furnishes no express definition of an executory contract, [*see*] 11 U.S.C. § 365(a) (1982 ed.), but the legislative history of § 365(a) indicates that Congress intended the term to mean a contract "on which performance remains due to some extent on both sides." H.R.Rep. No. 95-595, p. 347 (1977); [*see*] S.Rep. No. 95-989, p. 58 (1978).[37]

The notion that a contract is executory if performance remains due on both sides is consistent with the material breach test suggested by Professor Countryman.

Courts and commentators often encounter problems in properly applying the material breach test to a contract containing an arbitration clause. They are extremely reluctant to find a contract executory, and thus to allow the trustee to reject such a contract, where the only obligation that remains is a promise to arbitrate disputes. Their reasoning is either unclear or does not go further than state that the contract does not satisfy the material breach test because a failure to arbitrate disputes is simply not a material breach.[38]

The material breach test is easily satisfied in the situation where the only unperformed obligation under the contract is a promise to arbitrate disputes. The failure of either party to submit to arbitration constitutes a material breach because performance by the other party would be excused.

On the other hand, regardless of whether a contract containing an arbitration clause is executory, the trustee may reject the arbitration clause because it represents a separate executory contract. Much confusion in the application of the material breach test appears to result from the lack of clear understanding that a contract containing an arbitration clause is in fact actually two separate contracts. Thus, before discussing the application of the material breach test to a pre-petition contract containing an arbitration clause, it is necessary to explore how many contracts are actually present in such a case written document.

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37. *N.L.R.B.*, 465 U.S. 513, 522 n.6.

38. *E.g.*, In re Monge Oil Corp., 83 B.R. 305, 308 (Bankr. E.D. Pa. 1988); Yochum, *Arbitration Agreements in Bankruptcy: A Mutant is Loose (Again!), Symptoms are Showing, a Palliative is Suggested*, 19 STETSON L. REV. 137, 154 n.64 (1989).

Suppose two parties entered into a contract. Because the parties failed to provide for the arbitration of the disputes arising out of that contract, they later enter into a separate arbitration agreement. Here, this separate arbitration agreement is undoubtedly an executory contract because it satisfies the material breach test, *i.e.*, the obligations of both parties are unperformed and the failure of either party to complete performance would constitute a material breach, excusing performance by the other party.

Consider a slightly more complicated situation where a contract contains an arbitration clause. Under state law, "[t]he mere fact that a transaction is evidenced by one document is not alone sufficient to require the result that there is a single entire contract and not several separate contracts."[39] The intentions of the parties control the issue of whether there is a single contract or several separate contracts.[40]

Although the question of severability is ordinarily one of state law, arbitration clauses within the FAA's coverage[41] are, as a matter of federal law, separable "from the contracts in which they are imbedded" unless the parties to the contract agree otherwise.[42] Under the doctrine of severability adopted by the Supreme Court in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*,[43] an arbitration clause represents an independent contractual obligation of the parties. As such, it is a "classic executory contract" because an arbitration clause satisfies Professor Countryman's material breach test, *i.e.*, obligations of both parties to arbitrate disputes

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39. Cohen v. Johnson, 91 F. Supp. 231, 236 (M.D. Pa. 1950) A case applying Pennsylvania law has been chosen to support the proposition in the text because the *Hays* case is a Third Circuit decision.

40. Shinn v. Bodine, 60 Pa. 182 (1869).

41. To be within the FAA's coverage, an arbitration clause must be either a part of a maritime transaction or a contract in commerce, or must deal with controversies arising out of such transactions. 9 U.S.C. § 2 (1988).

42. Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 402-04 (1967) (Prima Paint Corporation ("Prima") filed an action in a federal court for rescission of the contract containing an arbitration clause. In addition, Prima sought to enjoin Flood & Conklin from proceeding with arbitration. Prima alleged that it had been fraudulently induced into entering into the contract. The central issue of the case was whether a claim of fraud in the inducement of the entire contract was to be resolved by a federal court, or whether the matter had to be referred to arbitrators. *Id.* at 402. Having adopted the view of the Court of Appeals for the Second Circuit that an arbitration clause, as a matter of federal law, is separable from the entire contract in which it is embedded, the Supreme Court held that the claim of fraudulent inducement had to be submitted to arbitration.); *See also* Dougherty v. Mieczkowski, 661 F. Supp. 267, 273 (D. Del. 1987); Continental Service Life & Health Ins. Co. v. A. G. Edwards & Sons, Inc., 664 F. Supp. 997, 999 (M.D. La. 1987).

43. Hirshman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 VA. L. REV. 1305, 1322-23 (1985); Westbrook, *The Coming Encounter: International Arbitration and Bankruptcy*, 67 MINN. L. REV. 595, 623 (1983); Yochum, *Arbitration Agreements in Bankruptcy: A Mutant is Loose (Again!), Symptoms are Showing Palliative is Suggested*, 19 STETSON L. REV. 137, 143 (1989).

are so unperformed that the failure of either party to arbitrate would constitute a material breach excusing performance by the other party.

Because an arbitration clause is an executory contract, the trustee may reject the contract if such a rejection benefits the bankruptcy estate and falls within the trustee's sound business judgment.[44] Thus, the next question is how the rejection of an arbitration clause could benefit the bankruptcy estate. Specifically, how could rejection benefit the estate when it is well recognized that arbitration is a less costly and more expedient method of dispute resolution than litigation?

Undoubtedly, arbitration has its advantages. On the other hand, the FAA does not provide for discovery in arbitration proceedings.[45] Moreover, the pretrial discovery procedures of the Federal Rules of Civil Procedure are not available to the parties in arbitration.[46] If the trustee asserts a cause of action on the pre-petition contract that requires substantial discovery to be a success, then the trustee may want to reject the contract.

C. Conflict between the FAA and the Code

The conflict between the FAA and the Code arises because these two congressional commands may work in opposite directions. Maximizing the value of the bankruptcy estate may require the trustee to reject a pre-petition agreement to arbitrate; whereas, the policy in favor of arbitration will demand enforcement of such an agreement.

The rejection of an arbitration clause will constitute a breach of contract. As a result, the nonbreaching party will have a claim against the bankruptcy estate. Possible damages will include the difference between a prospective recovery in a court of law, where the full pretrial discovery is available, and a prospective award in an arbitration proceeding, where, at best, only limited discovery is available. This claim will be treated as a pre-petition claim relating back to the date immediately before the filing of petition.[47] Most importantly, a court will not render the remedy of specific performance against the trustee on such a claim because granting such a remedy would strip the trustee from her statutory power to reject executory contracts.

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44. *See* COLLIER ON BANKRUPTCY, *supra* note 28.

45. JAMES W. MOORE, J. D. LUCAS & KENT SINCLAIR, JR., 7 MOORE'S FEDERAL PRACTICE ¶ 81.05[7] (1990 & 1991 Supp.).

46. Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co., 20 F.R.D. 359 (S.D. N.Y. 1957); Katsoris, *The Arbitration of Public Securities Dispute*, 53 FORDHAM L. REV. 279, 287 n.52 (1984-85).

47. 11 U.S.C §§ 365(g)(1), 502(g) (1988).

On the other hand, the FAA's mandate, which has been strengthened by the recent decisions of the Supreme Court, is clear: Arbitration agreements must be enforced.[48] Under section 3 of the FAA, the nonbreaching party will be entitled to the specific performance of the arbitration clause.

III. HAYS AND CO. V. MERRILL LYNCH

The preceding discussion establishes a framework for analyzing the issue of enforcement against the trustee of pre-petition arbitration agreements in bankruptcy by exploring certain tensions between the FAA and the Code. It also provides a vehicle to uncover flaws in the Third Circuit's analysis of this issue.

In *Hays*, Monge Oil Corporation (Monge) entered into a Customer Agreement with Merrill Lynch to invest in certain securities. Monge allegedly advised Merrill Lynch that investments in the corporate accounts were only to be in "long-term good quality" securities.[49] The Customer Agreement contained an arbitration clause requiring all disputes between the parties, arising out of their brokerage relationship, to be resolved through arbitration.[50]

Several years after the accounts were established, Monge filed for relief under Chapter 11. Hays & Co. (Hays) was subsequently appointed trustee for Monge. Hays thereafter filed an action in the district court against Merrill Lynch alleging, *inter alia*, claims under the Securities Act of 1933 and the Securities and Exchange Act of 1934, as well as common law claims for breach of contract, breach of fiduciary duties, gross negligence, and conversion.[51] Merrill Lynch moved the district court to stay the proceedings before the court and to compel arbitration of Hays' claims.

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48. *Rodriguez de Quijas*, 490 U.S. 477; *McMahon*, 482 U.S. 220.

49. *Hays*, 885 F.2d 1149, 1150.

50. The Customer Agreement provided for arbitration to be conducted under the provisions of the Constitution and Rules of the Board of Governors of the New York Stock Exchange, Inc., or pursuant to the Code of Arbitration Procedure of the National Association of Securities Dealers, Inc. *Id.* at 1153. Discovery procedures under the NYSE Constitution and the NASD Code are practically the same, and they are very limited indeed. THE CODE OF ARBITRATION PROCEDURE OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., *reprinted in* NASD SECURITIES DEALERS MANUAL 3711 (CCH 1990). THE CONSTITUTION AND THE RULES OF THE BOARD OF GOVERNORS OF THE NEW YORK STOCK EXCHANGE *reprinted in* 2 N.Y.S.E. GUIDE 4301 (CCH 1984).

51. *Hays*, 885 F.2d 1149, 1150.

The district court denied Merrill Lynch's motion. Relying on the Third Circuit's decision in *Zimmerman*,[52] the court held that it had discretion to nullify a mandatory arbitration clause where policies underlying the FAA and the Code were in conflict.[53] Merrill Lynch appealed the district court's ruling to the United States Court of Appeals for the Third Circuit.

To determine whether the Code implicitly modifies the FAA, the Third Circuit proceeded to apply the standard enunciated by the Supreme Court in *McMahon*.[54] The Third Circuit concluded that the trustee in *Hays* did not meet the burden of showing that Congress had intended to make an exception to the FAA.[55] The trustee knew of no provision in the text of the Code that made arbitration clauses unenforceable. Similarly, neither did the Third Circuit.[56] Furthermore, the trustee was unable to prove that the legislative history of the Code evidenced Congress' intent to make an exception to the FAA.[57]

Finding no language in the text of the Code or its legislative history to support the contention that Congress had intended an exception to the FAA, the trustee was left to argue that a purpose of the Code would be offended if arbitration were to be compelled here. According

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52. *Zimmerman*, 712 F.2d 55. Prior to *Zimmerman*, the courts approached the problem of whether to enforce arbitration agreements in bankruptcy in a manner that lacked methodology. Since *Zimmerman*, every jurisdiction dealing with the enforcement of arbitration clauses in bankruptcy cites *Zimmerman* and uses its methodology. In *Zimmerman*, the debtor sued on a pre-petition contract containing an arbitration clause. The defendant demanded a stay of the bankruptcy proceeding pending arbitration. To resolve a conflict, or what at the time appeared to be a conflict, between the two federal concerns, the *Zimmerman* court analyzed the importance of the purposes underlying the FAA and the Bankruptcy Reform Act of 1978. The Third Circuit noted in *Zimmerman* that the Bankruptcy Reform Act of 1978 had expanded the jurisdiction of the bankruptcy court in order to eliminate the serious delays, expense, and duplications associated with the dichotomy between summary and plenary jurisdiction. The court reasoned further that stays of proceedings pending arbitration, required by the FAA, could result in delays, expenses, and duplications similar to those previously experienced in bankruptcy proceedings because of the dichotomy between plenary and summary jurisdiction. The *Zimmerman* court went on to say that, although arbitration was a fundamental federal concern, it did not occupy a position of similar importance in the hierarchy of federal concerns as did bankruptcy. The Third Circuit concluded that the Bankruptcy Reform Act of 1978 must be read to modify implicitly the FAA. As a result, the Third Circuit held in *Zimmerman* that, when the debtor sued on a contract containing an arbitration clause and the other party to the contract demanded a stay of the bankruptcy proceeding pending arbitration, the decision of whether to grant a stay was left to the sound discretion of the bankruptcy judge.

53. In re Monge Oil Corp., 83 B.R. 305.

54. To defeat the application of the FAA, it must be demonstrated that, with respect to a particular federal concern, Congress intended to make an exception to the FAA. Congress' intention must be evidenced by the text, legislative history, or purposes of the other statute. *McMahon*, 482 U.S. 220.

55. *Hays*, 885 F.2d 1149, 1158.

56. *Id.* at 1157.

57. *Id.*

to the trustee in *Hays*, the efficient administration of the bankruptcy estate was such a purpose.

Indeed, concerns over the efficient administration of the bankruptcy estate prompted Congress to enact the Bankruptcy Reform Act of 1978. To eliminate delays, expense, and duplication associated with the then existing dichotomy between summary and plenary jurisdiction and to facilitate the efficient administration of the bankruptcy estate, Congress expanded the jurisdiction of the bankruptcy court to have all bankruptcy matters resolved in a single proceeding.[58]

The *Hays* court was not, however, receptive to this argument because the trustee failed to demonstrate that enforcing the arbitration clause would have any adverse impact on the efficient administration of the bankruptcy estate. Moreover, the court suggested that limitations on the jurisdiction of the bankruptcy courts imposed by the Bankruptcy Amendments and Federal Judgeship Act of 1984 indicated an erosion in Congress' intent to have all bankruptcy-related matters resolved in a single bankruptcy proceeding.

A contrary reading of the "1984 Amendments" has been suggested by several commentators.[59] Faced with a constitutional problem,[60] Congress did not abandon its goal of eliminating inefficiency in the bankruptcy system. Accordingly, the purpose of the "1984 Amendments" was not to undercut the strong bankruptcy policy of having bankruptcy-related matters adjudicated in a single proceeding, but rather their purpose was to bring federal bankruptcy law into compliance with constitutional requirements.

As the Third Circuit applied the *McMahon* standard to the case at bar, it found no indication of Congress' intent to make an exception to the FAA with respect to bankruptcy-related claims brought by the trustee. The Third Circuit would, however, allow an exception if enforcement of the arbitration clause was to seriously jeopardize one of the purposes of the Code.[61] Finally, the Third Circuit reversed the district court's holding

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58. S. REP. NO. 989, 95th Cong., 2d Sess., *reprinted in* 1978 U.S.C.C.A.N. 5787, 5803, 6010.

59. Yochum, *Arbitration Agreements in Bankruptcy: A Mutant is Loose (Again!), Symptoms are Showing, A Palliative is Suggested*, 19 STETSON L. REV. 135, 155 (1989); Markason, Note, *Arbitration Agreements in Bankruptcy Proceedings: The Clash Between Policies and the Proper Forum for Resolution - Zimmerman v. Continental Airlines, Inc.*, 57 TEMP. L.Q. 855, 883 (1984).

60. As Congress expanded the jurisdiction of the bankruptcy courts to reduce serious delay, expense, and duplication, it did not, however, confer the Article III judicial status on the bankruptcy judges. Absence of the Article III judicial status for the bankruptcy judges created a major constitutional problem. As a result, the Supreme Court held the expanded jurisdiction of the bankruptcy courts unconstitutional. N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

61. *Hays*, 885 F.2d 1149, 1161.

that the district court had discretion to enforce the pre-petition arbitration agreement against the trustee.

The Third Circuit's analysis in *Hays* is based on a policy argument. Nevertheless, the court failed to consider that maximizing the value of the estate, which is required for successful liquidation and rehabilitation of the debtor, bears significantly on the issue of whether to enforce a pre-petition arbitration clause against the trustee. As a result, the *Hays* court overlooked the impact of section 365(a) of the Code on the factual situation in *Hays*.[62]

If the Third Circuit had analyzed the problem of enforcement of arbitration clauses in bankruptcy from the perspective of maximizing the benefit to the estate, which allows the trustee to reject executory contracts, then the Third Circuit may have found a clear mandate in the Code to deny enforcement of the arbitration clause.[63] Thus, the *Hays* court would have been left with two clear conflicting congressional commands.

The Third Circuit's analysis is also troublesome because it changes the standard of review on appeal. In *Zimmerman*, the decision to stay the bankruptcy proceeding and enforce the arbitration clause against the trustee was left to the court's discretion.[64] Therefore, the standard of review on appeal was whether the court's exercise of discretion was arbitrary, capricious, or unreasonable.

After *Hays*, at least in the Third Circuit, the decision to enforce or deny enforcement of an arbitration clause will no longer be a discretionary one. The standard of review on appeal becomes the search for a simple

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62. The trustee sought to reject the Customer Agreement with Merrill Lynch in the bankruptcy court. The official committee of unsecured creditors supported the trustee's motion. To determine whether the Customer Agreement was an executory contract, the bankruptcy judge applied the material breach test of Professor Countryman and held that the Customer Agreement was not executory. In re Monge Oil Corp., 83 B.R. 305. It seems, however, that the material breach test is easily satisfied here. Under the Customer Agreement, the only unperformed obligation of either party was to arbitrate disputes. These obligations to arbitrate disputes were so far unperformed that if either party failed to arbitrate, the other would be excused from arbitrating. In addition, regardless of whether the Customer Agreement is executory, the arbitration clause, as a separate contract, is clearly an executory contract. The arbitration clause easily satisfies the material breach test. For a detailed discussion of the executoriness of an arbitration clause as a separate contract, *see supra*, note 38 and accompanying text at 12-14. The decision of the bankruptcy judge was not appealed. If the Third Circuit had realized its importance, then the court could have considered this issue on its own motion because its power on appeal to review conclusions of law is plenary.

63. If the Third Circuit or the lower court had inquired into the very limited discovery procedure permitted under the Customer Agreement, they may have found that lack of full discovery made a significant difference with respect to at least some causes of action asserted by the trustee in *Hays*. The lower court could have estimated the dollar amount the trustee in *Hays* was to collect, if the trustee proceeded either in court or with arbitration.

64. *Zimmerman*, 712 F.2d 55.

legal error. This change in the standard of review on appeal will, in all likelihood, encourage more litigation.

The Supreme Court in *McMahon* appears to have taken away the bankruptcy judge's discretion to resolve a conflict between the FAA and the Code.[65] As a result, the *Hays* court held that the bankruptcy court did not have discretion to grant or deny enforcement of the arbitration clause. The *Hays* court had to follow the standard enunciated by the Supreme Court in *McMahon*, however, the *Hays* court could have preserved the bankruptcy judge's discretion in striking a balance between the FAA and the Code.

IV. RESOLUTION OF THE CONFLICT

Suppose that a conflict between the FAA and the Code does exist, and the situation is such that a nondebtor requests the Bankruptcy Court to enforce a valid pre-petition arbitration agreement with respect to a bankruptcy-related claim against a trustee. Additionally, the trustee had exercised sound business judgement and rightfully rejects the arbitration agreement.[66] The major question thus becomes how the conflict between the two important federal concerns ought to be resolved.

Prior to recent decisions by the Supreme Court which interpreted the FAA as imposing on the courts a duty to rigorously enforce arbitration agreements, the decision of whether to enforce an arbitration agreement as to bankruptcy-related matters was left to the sole discretion of the bankruptcy judge. Often this discretion was exercised in a manner strongly biased in favor of bankruptcy concerns.

The new philosophy of the Supreme Court toward arbitration clearly rejects such a lopsided approach disfavoring arbitration. Echoing the Supreme Court's new philosophy, the Third Circuit observed in *Hays* that "[w]e can no longer subscribe to a hierarchy of congressional concerns that places the bankruptcy law in a position of superiority over

65. Under *McMahon*, the court must ascertain whether Congress intended to make an exception to the FAA. If the court finds that Congress intended no exception to the FAA, then the federal bankruptcy law must yield to the FAA. Otherwise, the conflict between the FAA and the Code must be resolved in favor of the Code. The standard does not allow for any discretion on the part of the bankruptcy judge to resolve the conflict. For a contrary reading of *McMahon*, *see* In re Chorus Data Systems, Inc., 122 B. R. 845, 851 (Bankr. D. N.H. 1990). For a discussion of the standard, *see supra*, notes 13-24 and accompanying text at 5-8.

66. As to standards for rejection, *see supra* notes 25-31 and accompanying text at 9-10.

th[e] [Arbitration] Act."[67] However, resolution of the conflict between the FAA and the Code will not be an easy task in the post-*McMahon* world.

If the test articulated by the *Hays* court is then taken literally to allow enforcement of arbitration clauses against the trustee unless such enforcement *seriously* jeopardizes the objectives of the Code, then bankruptcy concerns are downgraded to a second-rate status. But, it does not appear from *McMahon* that the Supreme Court is willing to go that far in eliminating the skepticism towards arbitration.[68]

Any attempt to resolve the conflict must take into account a strong policy in favor of arbitration enunciated in recent Supreme Court decisions, as well as the preservation of the integrity of the fundamental policies underlying the Code. An accommodation of the two federal interests can be accomplished by increasing the threshold at which the mandate of the FAA, which requires enforcement of arbitration agreements, yields to the Code's fundamental concerns of successful liquidation or rehabilitation of the debtor. Such an accommodation will allow a bankruptcy judge some discretion in striking a balance between the FAA and the Code. However, the bankruptcy judge's discretion should only be exercised after a meaningful threshold requirement has been met by the party opposing arbitration.

One way to increase the threshold is to require compliance with a stricter standard than the business judgement rule. A stricter standard has already been instituted as a response to the rejection of collective bargaining agreements in bankruptcy proceedings.[69] The special nature of collective bargaining agreements created a tension between the trustee's power to reject executory contracts and judicial concerns over the rights of employees.[70]

At present, the standard of the business judgment rule is easy to satisfy. Most courts will not second-guess the trustee unless the trustee's decision involves bad faith or gross negligence.[71] A stricter standard may require the trustee to show, for example, that a proceeding in court will likely result in a significant benefit to the bankruptcy estate. If the trustee fails to meet this "revised business judgment test" then the arbitration

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67. *Hays*, 885 F.2d 1149, 1161.

68. Under *McMahon*, the FAA's mandate to enforce arbitration may be overridden by a contrary congressional command if Congress intended to make an exception to the FAA. Congress' intent must be discernible from the text, history, or purposes of the contrary congressional command. *McMahon*, 482 U.S. 220, 227. To infer Congressional intent, the Supreme Court, however, does not require a showing of a serious infringement on the objectives of some other statute.

69. Collective bargaining agreements are executory contracts. *N.L.R.B.*, 465 U.S. 513.

70. *See* COLLIER ON BANKRUPTCY, *supra* note 28.

71. *See* COLLIER ON BANKRUPTCY, *supra* note 28.

clause must be enforced. If, however, the trustee succeeds in meeting the requirements of the test, then the bankruptcy court will exercise its equitable powers[72] and grant its approval of the trustee's decision to reject the arbitration clause.

V. CONCLUSION

Lack of discovery in arbitration will continue to be a source of tension between the FAA and the Bankruptcy Code in a situation where the trustee attempts, within the bankruptcy proceeding, to resolve a dispute regarding a bankruptcy-related matter and arising under a pre-petition contract containing an arbitration clause. With respect to certain causes of action, recovery depends to a great extent on the availability of discovery. As to these causes of action, the Code requires the trustee to reject the pre-petition arbitration agreement and to seek recovery in court, so as to maximize the benefit to the bankruptcy estate. At the same time, the FAA requires the bankruptcy court to issue a stay of the proceeding and to proceed with arbitration.

Unfortunately, the Third Circuit in *Hays* overlooked the conflict. As a result, it did not offer any direction for analysis in this area which will, undoubtedly, witness much more litigation in the near future.

Any resolution of the conflict between the FAA and the Bankruptcy Code must reflect the new philosophy of the Supreme Court towards arbitration. To require the trustee to meet a stricter standard than that of the business judgment rule, before the trustee can reject an arbitration clause contained in a pre-petition contract, is not only in line with this new philosophy, but also preserves the integrity of the Bankruptcy Code.

Zach Zunshine

72. *See* 11 U.S.C.A. § 105 note 5 (West Supp. 1991)(Equitable Considerations).