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When arbitration meets bankruptcy: Considering arbitration options in the wake of a growing rise in corporate insolvencies

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OCTOBER 6, 2020

The economic hardships brought about by the COVID-19 pandemic have impacted companies globally, leading many to consider both in-court and out-of-court restructurings.

Because this trend will likely continue as the long-term effects of COVID-19 play out, companies with arbitration clauses in their commercial agreements may wish to consider the impact of insolvency on their options for pursuing pending or future arbitrations.

In *In re Bethlehem Steel Corp.*, the U.S. Bankruptcy Court for the Southern District of New York acknowledged that the federal policies underlying the U.S. Bankruptcy Code, which "exerts an inexorable pull towards centralization" of claims, can conflict with those underlying the Federal Arbitration Act (FAA), which "advocates a decentralized approach towards dispute resolution."

> The decision to lift the stay is ultimately a matter of the bankruptcy court's discretion, though federal circuit courts have held that a stay of an arbitration involving a noncore matter generally must be lifted.

Under the Bankruptcy Code, 11 U.S.C. § 362(a), the initiation of insolvency proceedings results in an automatic stay of all civil proceedings brought against the debtor, including claims brought in arbitration. (Claims pursued on behalf of the debtor are not subject to the automatic stay, though counterclaims brought against the debtor in those proceedings may be.)

An arbitration counterparty may ask a bankruptcy court to lift the stay, which the court is permitted to do under the Bankruptcy Code "for cause." 11 U.S.C. § 362(d)(1).

In considering whether to lift a stay and allow an arbitration to proceed, a bankruptcy court conducts a four-part inquiry to determine whether

(1) the parties agreed to arbitrate,

(2) the dispute falls within the arbitration clause,

(3) the claims involve "core" or "noncore" bankruptcy matters, and

(4) the court should stay any nonarbitral claims pending the outcome of the arbitration.

A core bankruptcy matter invokes rights created by federal bankruptcy law or that would otherwise exist only in bankruptcy, or that would affect a core bankruptcy function.

The decision to lift the stay is ultimately a matter of the bankruptcy court's discretion, though federal circuit courts have held that a stay of an arbitration involving a noncore matter generally must be lifted.

The balance is particularly weighted in favor of arbitration in the international context, with the *Bethlehem Steel* court determining that "with respect to international agreements, the Court has less discretion to deny motions to arbitrate than it does with respect to domestic agreements."

DECIDING WHETHER TO LIFT THE BANKRUPTCY STAY

The Federal Rules of Bankruptcy Procedure require a creditor to register its claim with the bankruptcy court by filing a proof of claim, regardless of whether the claim will be pursued in bankruptcy court or arbitration. Filing a claim does not amount to a waiver of an arbitration agreement.

After filing the claim, a creditor may petition the court to lift the stay and allow arbitration to proceed.

Parties may consider various factors in deciding whether to file such a petition, including the nature of the insolvency proceeding itself: For example, in a prepackaged bankruptcy, which is typically resolved in a matter of months, general unsecured claims (including pending arbitration claims) are typically unimpaired by the debtor's plan, in which case the counterparty will be permitted to proceed with the arbitration following the debtor's emergence from bankruptcy.

The status of the arbitration may also be relevant: Where an arbitration is not yet underway, a party may wish to consider how quickly the arbitration can be resolved and the likelihood of receiving a favorable ruling prior to the conclusion of the bankruptcy proceedings.

More broadly, arbitration claimants may wish to consider the nature of the claim and the likelihood of obtaining a more favorable result in arbitration. In a typical Chapter 11 bankruptcy proceeding, all claims that have not been allowed or adjudicated are considered general "disputed" unsecured claims and may be given an estimated value.

Regardless of whether the claim has been resolved in arbitration or before the bankruptcy court, the priority of payment provisions of the Bankruptcy Code still apply.

If a party does not seek relief from the stay or if the bankruptcy court denies the motion to lift the stay, then the court will resolve the claim. The court may hold an evidentiary hearing, in which it will hear evidence and seek to arrive at a fair value.

If the claim is resolved by arbitration, on the other hand, the creditor may file an amended proof of claim based on the award, which will replace the estimated value assigned by the bankruptcy court. The debtor may seek to avoid the arbitration award by asserting bases to vacate or refuse enforcement of the award.

Assuming no bases for *vacatur* or nonenforcement exist, the resolved claim will be designated "undisputed" and "liquidated."

Regardless of whether the claim has been resolved in arbitration or before the bankruptcy court, the priority of payment provisions of the Bankruptcy Code still apply, and the creditor will only be entitled to receive a pro rata share of any distributions provided to the applicable class of claims under the debtor's Chapter 11 plan.

The choice of arbitration by two contracting parties reflects agreement to a neutral, out-of-court forum, with disputes resolved by one or more arbitrators who may come from different legal traditions or have particular, specialized experience.

Therefore, the resolution of those disputes before the bankruptcy court may fall well outside the expectations or desires of the creditor. The creditor will need to balance its interest in proceeding in arbitration against the more streamlined resolution the insolvency proceedings may offer.

CONSIDERATIONS WITH RESPECT TO FOREIGN PROCEEDINGS

While all of the above considerations are relevant to both domestic and international arbitrations, additional forces are at play when an arbitration involves a party not located in the United States or when the arbitration is seated outside the United States, thus giving rise to an "international" arbitration under the FAA.

If an arbitration continues in contravention of a stay of proceedings or otherwise threatens the purpose of bankruptcy proceedings, bankruptcy courts have the discretion to issue orders to enjoin arbitration proceedings seated in the United States or abroad.

However, where the arbitration is seated outside the United States (and thus not subject to U.S. arbitration or bankruptcy law), and the arbitration claimant or counterparty is a non-U.S. party, questions exist as to whether the arbitrators must obey the injunction and whether an arbitration award rendered in violation of a stay may nonetheless be enforced in the United States.

In the 1975 decision in *Fotochrome, Inc. v. Copal Co.* that remains relevant today, the U.S. Court of Appeals for the Second Circuit enforced an arbitration award that had been rendered in violation of the automatic bankruptcy stay, finding that a bankruptcy court has authority to stay an international arbitration only if it has *in personam* jurisdiction over the foreign party.

Where the arbitration is seated outside the United States, and the arbitration claimant or counterparty is a non-U.S. party, questions exist as to whether an arbitration award rendered in violation of a stay may nonetheless be enforced in the United States.

In the *Fotochrome* arbitration proceeding, the Tokyo-seated arbitral tribunal was notified of the bankruptcy stay but declined to follow it, ultimately issuing an award in favor of a Japanese company and against a U.S. company in insolvency.

Because the Japanese company did not have sufficient minimum contacts with the United States, the Second Circuit held that the bankruptcy court did not have jurisdiction to stay the arbitration or to void the award rendered in violation of the stay, and permitted its enforcement.

Similar international enforcement considerations arise where a party that wants to pursue arbitration confronts a debtor involved in insolvency proceedings in a country other than the United States.

In the United States, a stay of litigation and arbitration proceedings will come into force only if the foreign insolvency is recognized in the United States under Chapter 15 of the Bankruptcy Code, in which case all of the relief available under 11 U.S.C. § 362 — including the stay of legal proceedings — is available to the debtor.

But this is far from a universal approach: The laws regarding whether arbitration may continue in light of pending insolvency proceedings vary widely across jurisdictions, with some countries declining to stay arbitration at all and others doing so without any option for lifting the stay.

In some countries, enforcement of an arbitration award issued in contravention of an insolvency stay may be denied as contrary to the public policy.

The wide variance in approaches among jurisdictions has resulted in several well-known examples of arbitration awards being enforced against an insolvent debtor in some countries but not in others.

Accordingly, companies considering their options for pursuing cross-border arbitrations against an insolvent debtor must consider the relevant laws in at least three regimes: the seat of the arbitration, the place in which the debtor has declared insolvency and any countries in which enforcement of the award may ultimately be sought.

This article was published on Westlaw Today on October 6, 2020.

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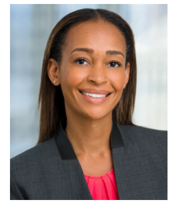


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