# So You Want to Submit Your Preference Action to Binding Arbitration? Think Again

By

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It seems like a simple enough proposition – your company has just been sued for the return of certain transfers made by a debtor within the 90 days of filing its bankruptcy petition and you would like to submit the action to binding arbitration in accordance with your contract with the debtor. Unfortunately, according to the recent decision in *In re Bethlehem Steel*, bankruptcy courts have the right to deny such a request.

In *In re Bethlehem Steel*, four international creditors were sued for the return of alleged preferential transfers and sought to invoke their rights to binding arbitration under their contracts with the debtor. Their motivation was obvious – move the actions to a forum in which the trier of fact has a better understanding of their particular industry, a forum that is more cost-effective in which to litigate and one in which the trier is more understanding of their probable prepetition losses and reluctance to return funds to the non-operating debtor's estate.

The creditors moved to compel arbitration and the liquidating trust opposed the motions. The bankruptcy court denied the motions on the grounds that the preference claims were in the nature of statutory claims that could be pursued only by a trustee, debtor-in-possession or other estate representative, and that the preference claims were not claims of the debtor. The court also found that, even assuming the claims were arbitrable, the court could and would exercise its discretion to deny arbitration.

The *Bethlehem* court addressed the steps taken when analyzing an arbitration provision. First, the court must determine whether the parties agreed to arbitrate, which it found; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; and fourth, if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to stay the balance of the proceedings pending arbitration.

In support of its position that preference claims are outside of the scope of the arbitration provisions, the *Bethlehem* court simply found that while the debtor was a party to these broad arbitration provisions that covered all types of disputes between the parties, the trust, creditors, or their representatives were not. The creditors' response was that there are many instances where estate representatives stand in the shoes of the debtor and are bound by such prepetition contracts. But the court found that such matters are always derivative of the debtor's rights, and acknowledged that such derivative claims may be subject to arbitration. However, with respect to fraudulent transfer and preference claims, they are statutory claims created in favor of creditors that can only be prosecuted by a trustee or debtor-in-possession (or authorized representative).

In other words, claims asserted by the trustee under section 544(b) are not derivative of the bankrupt. They are creditor claims that the Bankruptcy Code authorizes the trustee to assert on their behalf. The Supreme Court has made it clear that it is the *parties* to an arbitration agreement who are bound by it and whose intentions

must be carried out. Thus there is no justification for binding creditors to an arbitration clause with respect to claims that are not derivative from one who was a party to it.

Addressing its discretionary power to deny arbitration, the court recognized that preference claims are "core" proceedings, but that even core proceedings are not automatically subject to the court's discretionary power to stay arbitration. The court went on to acknowledge that federal policy favoring recognition of arbitration agreements is particularly strong for international agreements. However, the court found that there is a "severe conflict" between policies underlying arbitration agreements and the conduct of this bankruptcy proceeding such that "Congress intended to override the Arbitration Act's general policy favoring enforcement of arbitration agreements." In the end, even a foreign creditor's rights to arbitrate will not be recognized in the face of a pending preference action.