Parties to International Commercial Arbitration Agreements Beware: Bankruptcy Trumps Supreme Court Precedent Favoring Arbitration of International Disputes

Lindsay Biesterfeld

Follow this and additional works at: https://scholarship.law.missouri.edu/jdr

Part of the Dispute Resolution and Arbitration Commons

Recommended Citation


Available at: https://scholarship.law.missouri.edu/jdr/vol2006/iss1/17

This Note is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Journal of Dispute Resolution by an authorized editor of University of Missouri School of Law Scholarship Repository. For more information, please contact bassettcw@missouri.edu.
NOTES

Parties to International Commercial Arbitration Agreements Beware: Bankruptcy Trumps Supreme Court Precedent Favoring Arbitration of International Disputes

Phillips v. Congelton (In re White Mountain Mining Co.)¹

I. INTRODUCTION

Traditionally, federal courts have refused to enforce arbitration agreements when the agreement called for arbitration of claims under four federal statutes—securities law, anti-trust law, Racketeer Influenced and Corrupt Organizations Act (RICO), and bankruptcy law.² Recently, the Supreme Court has reversed that inclination by enforcing agreements that require arbitration of claims arising under securities, anti-trust, and RICO law.³ However, the Supreme Court has not yet addressed enforcement of an arbitration agreement in the context of a bankruptcy proceeding. The lower federal courts have thus been left with the difficult task of reconciling the general federal policy favoring enforcement of arbitration agreements with the conflicting federal policy favoring the resolution of bankruptcy-related claims in the bankruptcy courts. Lower federal courts concentrate their analysis of whether to enforce an arbitration agreement involving a bankruptcy claim on (1) the type of claim that is involved, and (2) whether the agreement involves domestic or foreign entities.⁴ Bankruptcy courts have exclusive jurisdiction over certain types of proceedings, known as "core" proceedings, and they are particularly protective of their jurisdiction over such proceedings.⁵ The domestic/foreign distinction is important because Supreme Court precedent and federal policy dictate that the duty to enforce arbitration is even greater in the context of international arbitration.⁶ Phillips v. Congelton (In re White Mountain Mining Co.), presents a heightened version of the conflict between the general policy favoring enforcement of arbitration agreements and the policy favoring resolution

¹ 403 F.3d 164, 166 (4th Cir. 2005).
⁴ Neufold, supra note 2, at 541, 553.
⁶ See Mitsubishi, 473 U.S. at 614.
of bankruptcy-related claims in the bankruptcy court proceedings as the case involves a dispute over the enforcement of an international agreement to arbitrate a claim that is a "core" bankruptcy proceeding. In Phillips, the Fourth Circuit analyzed the underlying purposes of both the bankruptcy code and the federal arbitration statute, and resolved the conflicting purposes of the two by giving greater deference to the policy favoring resolution of bankruptcy-related claims in bankruptcy court proceedings.

II. FACTS AND HOLDING

Joseph C. Phillips (Phillips)\(^7\) and Arquebuse Trust\(^8\) owned White Mountain Mining Company, L.L.C. (White Mountain), a mining business located in southern West Virginia.\(^9\) In January 2001, Phillips and Arquebuse Trust sold a fifty percent interest in White Mountain to White Trust, a foreign investment trust.\(^10\) The parties executed two agreements during the sale: a Sales Agreement\(^11\) and an Operation Agreement.\(^12\) The Operation Agreement contained an arbitration clause requiring the parties to use arbitration in the event of any "claim, dispute or controversy of whatever nature arising out of, in connection with, or in relation to the interpretation, performance or breach of this Agreement (or any other agreement contemplated by or related to this Agreement)."\(^13\) The Operation Agreement further provided that the arbitration was to be conducted in London, England.\(^14\) The Sales Agreement incorporated by reference the arbitration clause contained in the Operation Agreement.\(^15\)

The parties also wrote a letter, signed by White Mountain and White Trust and executed on January 19, 2001 (the January 2001 Letter), which clarified certain matters prior to the closing.\(^16\) One such provision required Phillips to advance money to White Mountain in the event that White Mountain should need more money than that originally stated in the budgets and pro formas.\(^17\) This pro-

---

8. Arquebuse Trust is a private trust wholly owned by Phillips. Id.
9. Id.
10. Id.
11. The Sales Agreement called for any disputes to be resolved "in accordance with the Arbitration provisions of the Operating Agreement as if set out herein." Id.
12. Id. The Operating Agreement required that "each claim, dispute or controversy of whatever nature, arising out of, in connection with, or in relation to this interpretation, performance or breach of this Agreement (or any other agreement contemplated by or related to this agreement shall be settled, at the request of any party to this Agreement, by final and binding arbitration conducted in the City of London, United Kingdom . . . in accordance with the Commercial Arbitration Rules then in effect of the International Arbitration Agreement." Id.
13. Id.
14. Id.
15. Id.
16. Id.
17. Id. at 167. The January 2001 Letter provides: "If White Mountain requires additional advances over the amount that was originally stated in the budgets and proforma's [sic], Phillips will advance the company the money and will be repaid for these advances after the company begins operations." Id.
vision also stated that Phillips would be repaid for these advances after the company began operations.18

Following the sale, the ownership of White Mountain changed hands again. White Trust assigned its fifty percent interest in White Mountain to Congelton, L.L.C (Congelton)19 and Phillips and Arquebuse Trust assigned their one-half interest to Mowbray, L.L.C (Mowbray).20

White Mountain began operations at an underground mine in May 2001 under Phillips' supervision,21 but unfavorable geological conditions forced the mine to shut down in November 2001.22 The poor geological conditions resulted in financial difficulties for White Mountain.23 In an effort to keep White Mountain afloat, Phillips advanced over $10.6 million of his own money between January 2001 and June 2002 to help White Mountain meet expenses.24

A dispute arose between Congelton and Phillips over whether the $10.6 million Phillips advanced to White Mountain should be considered capital contributions or loans.25 Congelton argued that since Phillips was a shareholder, the $10.6 million should be considered either equity or capital contributions.26 Relying on the Sales Agreement, Congelton argued that Phillips was obligated to guarantee the sufficiency of White Mountain's capitalization.27 Phillips maintained, in contrast, that he was acting as a creditor, not a shareholder, and therefore the $10.6 million should properly be considered debt, not equity.28 Phillips based his assertion on a provision of the January 2001 Letter, which stated that Phillips must be refunded for any necessary advances he made to White Mountain.29 Phillips argued that the $10.6 million was simply one such advance and should therefore have been considered a loan.30

Invoking the binding arbitration provision contained in the parties' Sales Agreement,31 Congelton and White Trust served Phillips, Arquebuse Trust and Mowbray with a demand for arbitration in November 2001.32 Instead of submitting to the arbitration demand, Phillips filed an involuntary Chapter 11 bankruptcy petition against White Mountain in the United States Bankruptcy Court for the Southern District of West Virginia on June 26, 2002.33

Two weeks later, Phillips filed suit against White Mountain, Mowbray and Congelton in the United States Bankruptcy Court for the Southern District of West

18. Id.
19. Congelton is a West Virginia limited liability company. Id. at 166.
20. Id. Mowbray is a limited liability company wholly owned by Phillips. Id.
21. Id.
22. Id. at 167.
23. Id.
24. Id.
25. Id.
26. Id.
27. Id.
28. Id.
29. Id.
30. Id.
31. One of the remedies sought by Congelton and White Trust was a declaration that "advances made by Phillips to White Mountain should be treated as contributions to capital rather than as loans." Id. (citing Congelton and White Trust's August 13, 2002 statement of claim in the arbitration proceeding).
32. Id.
33. Id.
Virginia in July 2002. Phillips asked the bankruptcy court for a determination that, under the January 2001 Letter, White Mountain must repay the $10.6 million and that "he was not obligated to advance additional money to White Mountain." Congelton answered Phillips' complaint by demanding that the bankruptcy court stay or dismiss the proceeding and compel Phillips to submit his claims to arbitration.

The bankruptcy court found that because Phillips' complaint asked the court to decide whether White Mountain (the debtor) owed Phillips money and whether Phillips was a creditor or a shareholder, the complaint involved a core bankruptcy proceeding. The bankruptcy court concluded that "the core proceeding trumped the arbitration" proceeding because arbitration would disturb White Mountain's ability to reorganize. After refusing to compel arbitration, the bankruptcy court held an adversary proceeding and determined that Phillips was acting as a creditor not a shareholder, that Phillips' $10.6 million advance to White Mountain was a loan pursuant to the January 2001 Letter, and that Phillips was not required to advance any more funds.

Congelton appealed the bankruptcy court's order denying arbitration to the district court, and both courts denied motions for a stay pending appeal. The district court additionally affirmed the bankruptcy court's finding in favor of Phillips. Congelton appealed both the bankruptcy court's denial of the motion to compel arbitration and the district court's affirmation of that denial to the Fourth Circuit Court of Appeals. In affirming the district court's order, the Fourth Circuit held that when a bankruptcy court is faced with an agreement to arbitrate that would, if enforced, conflict with the underlying purpose of bankruptcy laws to centralize disputes, the court can refuse to enforce even international arbitration agreements.

III. LEGAL BACKGROUND

A. The Jurisdiction and Purposes of the Bankruptcy Court

Congress established the broad jurisdiction of bankruptcy courts in the Bankruptcy Reform Act of 1978 (the 1978 Act). The goal of the 1978 Act was to consolidate all controversies involving the property of a debtor in the bankruptcy
courts in order to eliminate the division, delay, and cost associated with separate bankruptcy proceedings.\textsuperscript{45} The 1978 Act granted to bankruptcy courts original, but not exclusive, jurisdiction over all proceedings related to a bankruptcy case.\textsuperscript{46} In order to do this, the statute conferred to the bankruptcy courts all of the jurisdictional powers granted to the Article III district courts.\textsuperscript{47}

This jurisdictional framework, which gave bankruptcy courts the same authority as district courts, created constitutional problems because the district courts' jurisdiction is defined by Article III of the Constitution and Article III imposes certain conditions on the judges who exercise such jurisdiction.\textsuperscript{48} Article III requires district court judges to be appointed for life and bankruptcy judges are not appointed for life.\textsuperscript{49} The 1978 Act violated Article III of the Constitution, therefore, by giving the non life tenure bankruptcy court judges jurisdiction that is constitutionally reserved for judges who are appointed for life.\textsuperscript{50} In 1982, the Supreme Court held in \textit{Northern Pipeline Construction Co. v. Marathon Pipe Line Co.}\textsuperscript{51} that the jurisdictional framework was unconstitutional because the 1978 Act's broad jurisdictional grant to the bankruptcy courts took away from the Article III district courts the "essential attributes of the judicial power."\textsuperscript{52}

Two years later, Congress amended the 1978 Act with the Bankruptcy Amendments and Federal Judgeship Act of 1984 amendments (the Amended Bankruptcy Code).\textsuperscript{53} The Amended Bankruptcy Code grants original jurisdiction over bankruptcy cases to the Article III district courts.\textsuperscript{54} Although the district courts are vested with original jurisdiction, the Amended Bankruptcy Code permits each district court to delegate part of its jurisdiction to a bankruptcy court.\textsuperscript{55} While the Amended Bankruptcy Code authorizes district courts to commit proceedings to bankruptcy courts, the Amended Bankruptcy Code limits the bankruptcy courts' jurisdiction over certain types of proceedings.\textsuperscript{56} Bankruptcy courts have full jurisdiction over claims arising in or arising under title 11—these types of proceedings are known as "core" bankruptcy proceedings and include claims involving the administration of the estate and the allowance of claims for or against the estate.\textsuperscript{57} The Amended Bankruptcy Code grants the bankruptcy courts limited jurisdiction over other types of proceedings—"non-core" bankruptcy pro-

\textsuperscript{45} See Neufold \textit{supra} note 2, at 530.  
\textsuperscript{46} See B.R.A. of 1978, \textit{supra} note 44.  
\textsuperscript{47} \textit{COLLIER ON BANKRUPTCY} \textsection{2(b), 3.01 (15th ed. 2005).}  
\textsuperscript{49} See \textit{COLLIER ON BANKRUPTCY} \textit{supra} note 47.  
\textsuperscript{50} Id.  
\textsuperscript{51} 458 U.S. 50, 87 (1982).  
\textsuperscript{52} \textit{Northern Pipeline Constr. Co.}, 458 U.S. at 87.  
\textsuperscript{54} "[T]he district courts shall have original and exclusive jurisdiction of all cases under title 11." 28 U.S.C. \textsection{1334(a) (2000).}  
\textsuperscript{55} "Each district court may provide that any or all cases under title 11 and any or all proceedings arising under title 11 or arising in or related to a case under title 11 shall be referred to the bankruptcy judges for the district." 28 U.S.C. \textsection{157(a) (2000).}  
\textsuperscript{56} 28 U.S.C. \textsection{157(b-c).}  
\textsuperscript{57} \textit{Supra} note 5 at 1009-10; 28 U.S.C. \textsection{157(b-1).} "Bankruptcy judges may hear and determine all cases under title 11 and all core proceedings arising under title 11." 28 U.S.C. \textsection{157(b-1).} "Core proceedings include, but are not limited to—matters concerning the administration of the estate; allowance or disallowance of claims against the estate." 28 U.S.C. \textsection{157 (b-2)(A-B).}
ceedings, or proceedings that are not considered 'core' but may still effect the bankruptcy estate. The bankruptcy courts cannot enter orders in non-core proceedings absent consent of the parties. The jurisdiction of bankruptcy courts over non-core matters is limited to submitting proposed findings of facts and conclusions of law to the district courts. The implication of the core/non-core distinction is that it is not unusual for a tribunal other than the bankruptcy courts, i.e. the district court, to decide a non-core proceeding. Core proceedings, on the other hand, can always be decided by the bankruptcy courts.

While a bankruptcy court's jurisdiction depends upon whether the issue is classified as a "core" proceeding or a "non-core" proceeding, Congress has not specifically defined what constitutes a core proceeding. Congress outlined some, but not all, examples of core proceedings in 28 U.S.C. § 157(b)(2). The fifteen examples of core proceedings illustrated by Congress in 28 U.S.C. § 157(b)(2) can be generally categorized as falling into four categories: (1) matters of administration, (2) avoidance actions, (3) matters concerning property of the estate and (4) others.

The list of examples of core proceedings laid out in the Amended Bankruptcy Code is not all-inclusive. The struggle to define what constitutes a core proceeding has been largely left to the courts. The Fourth Circuit has created guidelines both by articulating how the Amended Bankruptcy Code should be interpreted and by identifying requisite features of core proceedings. The Fourth Circuit has characterized a core proceeding as one that is uniquely affected by bankruptcy rights or that could only arise in the context of a bankruptcy court. The Fourth

---

59. 28 U.S.C. § 157(c)(1)(2). "A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected. The district court, with the consent of all the parties to the proceeding, may refer a proceeding related to a case under title 11 to a bankruptcy judge to hear and determine and to enter appropriate orders and judgments." 28 U.S.C. § 157(c)(1)(2).
60. 28 U.S.C. § 157(c)(1).
62. Id.
63. Id.
65. Id.; COLLIER ON BANKRUPTCY, supra note 47. "The reach of the last, or omnibus, category has been and will continue to be controversial. This category includes the matters set out in section 157(b)(2)(C)—"counterclaims by the estate against persons filing claims against the estate"—and section 157(b)(2)(O), "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims." Id.
66. 28 U.S.C. § 157(b)(2). "Core proceedings include, but are not limited to . . . ." Id.
67. "In re American Energy, Inc., 50 Bankr. 175 (Bankr. D.N.D. 1985) (cited with approval in In re Landbank, 77 Bankr. at 47-48), the court explained: Although Section 157(b)(2) was meant by Congress to be a non-exclusive list of what might be included in the term "core" proceedings, this court does not believe the sections or categories should be interpreted or expanded so as to in effect emasculate the jurisdiction proscriptions of the Marathon case...The decisions In re American Energy, Inc. and In re Landbank are persuasive..." Helmer v. Murray, 149 B.R. 383, 386 (D. Va. 1993).
68. "Core proceedings either 1) invoke a substantive right provided by the Code or 2) by their nature, could arise only in the context of a bankruptcy case. Bankruptcy courts may enter appropriate
Circuit has also recognized certain factors as useful in analyzing whether a proceeding is "core" or "non-core", such as whether the claim is outlined in the Amended Bankruptcy Code, whether the claim arose before or after the filing of the bankruptcy petition, and the effect of the bankruptcy proceeding on the rights of the parties.69

The jurisdictional framework of the Amended Bankruptcy Code satisfies the constitutional concerns addressed in Northern Pipeline70 by treating bankruptcy courts as units of the Article III district courts (rather than as equals) and by limiting bankruptcy courts' jurisdiction over non-core matters.71 The distinction between core and non-core proceeding also allows a bankruptcy court to maintain its principal feature under the 1978 Act—centralization of bankruptcy proceedings.72

B. The Growth of International Arbitration Agreements

The Federal Arbitration Act (FAA)73 was enacted in 1925 to "reverse the longstanding judicial hostility to arbitration agreements."74 The FAA mandates that written agreements to arbitrate any existing or future disputes arising out of a commercial contract or transaction are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."75 The general rule that arbitration agreements are enforceable expanded to include arbitration agreements in international commercial contracts when the United States acceded to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the Convention) in 1970.76 Congress incorporated the Convention into the United States Arbitration Act.77 The United States Arbitration Act requires the courts to recognize and enforce arbitration agreements be-

69. Hudgins v. Shah (In re Systems Eng'g & Energy Mgmt. Assocs.), 252 B.R. 635, 642 (Bankr. D. Va. 2000). "This Court previously has set forth a number of factors to review in this core/non-core determination. In Seven Springs, Inc. v. Abramson (In re Seven Springs, Inc.), 148 B.R. 815 (Bankr. E.D. Va. 1992), the Court, in concluding that the claim in question was not core, but was an otherwise related proceeding, examined the following factors: (1) [The claim] is not specifically identified as a core proceeding under [28 U.S.C.] § 157(b)(2)(B). (2) [The claim] existed prior to the filing of the bankruptcy case. (3) [The claim] would continue to exist independent of the provisions of Title 11, and (4) The parties' rights, obligations or both are not significantly affected as a result of the filing of the bankruptcy case." Id.
70. 458 U.S. 50 (1982).
72. Kurth, supra note 5, at 1009.
76. 9 U.S.C. § 201 (2000). "Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration." Recognition and Enforcement of Foreign Arbitral Awards, art. II, December 29, 1970, 21 U.S.T. 2517.
77. 9 U.S.C. § 201. "The Convention on the Recognition and Enforcement of Foreign Arbitral Awards of June 10, 1958, shall be enforced in United States courts in accordance with this chapter." Id.
between parties to an international commercial contract. After the United States acceded to the Convention, the Supreme Court explained that special treatment of international arbitration agreements is necessary because refusal to enforce international arbitration agreements "would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international agreements." The combination of the FAA, the Convention, and subsequent Supreme Court decisions have resulted in such a strong federal policy in favor of arbitration agreements that arbitration agreements are now characterized as "super contracts" and "an unstoppable force in modern contract law."

C. The Courts Attempt to Reconcile Arbitration of Federal Statutory Claims

At least until 1985, federal appellate courts had not applied the FAA to four statutory areas: securities law, antitrust law, Racketeer Influenced and Corrupt Organizations Act (RICO), and bankruptcy law. One of the Supreme Court's major tasks in establishing a strong federal policy in favor of arbitration agreements was to reverse this trend and to enforce arbitration agreements of federal statutory claims.

The Supreme Court's decision in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, is significant for three reasons. First, the Supreme Court extended the FAA to one of the previously excluded federal statutory claims—antitrust law. Second, the Court emphasized the particular importance of enforcing arbitration agreements that arise in the international commercial context. Third, the Court created a framework for future courts to use in deciding if a federal statutory claim was exempt from the FAA.

Prior to *Mitsubishi*, the federal courts had consistently refused to enforce agreements to arbitrate antitrust claims due to the "fundamental importance to American democratic capitalism of the regime of antitrust laws." The Supreme Court agreed that the purposes of the antitrust laws were to promote "the national interest in competitive economy" and to "protect the public's interest." Despite

81. Id.
82. Neufold, supra note 2, at 535.
85. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 639 (1985). The *Mitsubishi* decision also rejected the argument that an arbitration clause of an international commerce clause would only apply to claims arising out of federal statutes if the arbitration clause specifically included those rights. Id. at 625.
86. Id. at 629.
87. See id. at 634.
88. Id. at 635.
these strong policies in favor of having antitrust claims decided in a domestic forum, the Supreme Court relied on the "concerns of international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes" in enforcing the arbitration agreement.\(^9\) The court in Mitsubishi declared that international arbitration agreements would be enforced even when a different result would be reached in a domestic tribunal.\(^9^0\) The court also recognized that, while the FAA embodies a strong federal policy in support of arbitration, the FAA is still a statute. As a statute, the FAA can be limited by proof that Congress, in a subsequent act, intended to preclude enforcement of arbitration agreements of certain categories of claims.\(^9^1\)

Two years after the Mitsubishi decision, the Supreme Court clarified how congressional intent can be used to avoid arbitration, and decided that both RICO and Securities Act claims are arbitrable.\(^9^2\) In Shearson/American Express, Inc. v. McMahon,\(^9^3\) the Court set out a three-part test (the "McMahon test") for determining whether an agreement to arbitrate a claim arising out of a federal statute is enforceable.\(^9^4\) Under the McMahon test, a party claiming that an agreement to arbitrate a statutory claim is not enforceable must prove Congressional intent to make an exception to the FAA from either 1) the text of the statute, 2) the legislative history of the statute, or 3) an inherent conflict between arbitration and the purposes of the statute.\(^9^5\) The Supreme Court has expressly applied the FAA to three out of the four federal statutes that were previously considered exceptions to the FAA.\(^9^6\) The arbitrability of the fourth federal statute previously excluded from the FAA, bankruptcy, the Court left to be decided by the federal lower courts.

In Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., the Third Circuit dealt with an agreement to arbitrate a bankruptcy proceeding for the first time under the Supreme Court’s new framework.\(^9^7\) The Hays court overruled Zimmerman v. Continental Airlines, Inc.,\(^9^8\) a 1983 Third Circuit case that interpreted the 1978 Act “to impliedly modify” the FAA so that the decision to enforce an arbitration agreement was within the “sound discretion” of the bankruptcy courts.\(^9^9\) In Hays, the court faced an agreement to arbitrate a non-core bankruptcy proceed-

---

\(^9^0\) See id. at 627-28, 639 n.21. The Convention "contemplates exceptions to arbitrability grounded in domestic law." Id. at 639 n.21.

\(^9^1\) See id. at 627-28, 639 n.21. The Convention "contemplates exceptions to arbitrability grounded in domestic law." Id. at 639 n.21.


\(^9^4\) Id. at 227.

\(^9^5\) Id.

\(^9^6\) See Mitsubishi, 473 U.S. at 628-29; McMahon, 482 U.S. at 238, 242.

\(^9^7\) 885 F.2d 1149 (3d Cir. 1989).

\(^9^8\) 712 F.2d 55 (3d Cir. 1983).

\(^9^9\) Id. at 59-60.
The Amended Bankruptcy Code authorizes non-core matters to be heard by the district court itself, to be referred to the bankruptcy courts only upon agreement by all parties to the dispute. If the non-core proceeding is referred to a bankruptcy court, the bankruptcy court's proposed findings are subject to de novo review upon any party's objection. The *Hays* court reasoned that these amendments to the 1978 Act (the Amended Bankruptcy Code) demonstrated that Congress no longer intended for the Bankruptcy Code to modify the FAA. The Third Circuit then reversed the district court's decision refusing to enforce the arbitration agreement, holding that the case should have been decided under the third part of the McMahon test. The Third Circuit held that because non-core proceedings were not exclusively heard in the bankruptcy courts—and because those that were heard in the bankruptcy courts were subject to the time consuming possibility of review—no irreconcilable conflict existed between the FAA and the Bankruptcy Act for non-core claims, and so the lower court should not have denied enforcement of the arbitration agreement.

The Third Circuit and the Eleventh Circuit stand alone in expressly rejecting *Zimmerman*, yet virtually every circuit agrees with the underlying premise of *Hays* that once a proceeding is classified as non-core, the likelihood of avoiding enforcement of an arbitration agreement under the McMahon test significantly decreases. After *Hays*, courts have continued to emphasize the importance of

100. See *Hays*, 885 F.2d at 1150.
102. Id. § 157(c)(1), (2).
103. Id. § 157(c)(1).

A bankruptcy judge may hear a proceeding that is not a core proceeding but that is otherwise related to a case under title 11. In such proceeding, the bankruptcy judge shall submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge's proposed findings and conclusions and after reviewing de novo those matters to which any party has timely and specifically objected.

Id.

104. *Hays*, 885 F.2d at 1161. The Third Circuit's rejection of *Zimmerman* is still the minority view; it is the only court to expressly overrule *Zimmerman*. See Neufold, *supra* note 2, at 545-52.
105. *Hays*, 885 F.2d at 1156-57.
106. Id. at 1158.
108. While the circuits vary in the degree of importance placed on the core/non-core distinction, virtually all courts agree that the distinction is instructive. *See* Larocque v. CitiFinancial Mortg. Company-TX (*In re* Larocque), 283 B.R. 640, 642 (Bankr. D.R.I. 2002) (First Circuit: "I also conclude that this adversary proceeding is a core matter, which strongly favors it staying in the Bankruptcy Court."); U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n (*In re* U.S. Lines, Inc.), 197 F.3d 631, 640 (2nd Cir. 1999) ("Such a conflict is lessened in non-core proceedings which are unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration."); Videsh Sanchar Nigam, Ltd. v. Startec Global Commc'n's Corp. (*In re* Startec Global Commc'n's Corp.), 300 B.R. 244, 254 (Bankr. D. Md. 2003) (Fourth Circuit: "Finding that a claim is core is often a factor in finding that a court has discretion to refuse to compel arbitration."); Gandy v. Gandy (*In re* Gandy), 299 F.3d 489, 494 (5th Cir. 2002) ("It is generally accepted that a bankruptcy court has no discretion to refuse to compel the matters not involving 'core' bankruptcy proceeding under 28 U.S.C. § 157(b."); Cooker Restaurant Corp. v. Seelbinder (*In re* Cooker Restaurant Corp.), 292 B.R. 308, 311 (D. Ohio 2003) (Sixth Circuit: "A number of circuits have reached the conclusion that bankruptcy courts, in virtually all instances, must compel arbitration regarding non-core proceedings."); *In re*
the distinction between core and non-core proceedings in determining the outcome of the third part of the McMahon test. 109

District courts in the Fourth Circuit agree that the likelihood of an inherent conflict between the purposes of the Amended Bankruptcy Code and the FAA are greater when the dispute involves an agreement to arbitrate a core proceeding. 110 The Fourth Circuit has not adopted a bright line rule allowing bankruptcy courts’ discretion to stay arbitration whenever the agreement to arbitrate involves a core proceeding. In the Fourth Circuit, a court’s determination that a proceeding is core increases the likelihood that a bankruptcy court may refuse to compel arbitration, but the core/non-core distinction is not dispositive. 111

IV. INSTANT DECISION

In Phillips v. Congelton (In re White Mountain Mining Co.), 112 the Fourth Circuit Court of Appeals was faced with deciding whether to enforce an international commercial agreement to arbitrate a core bankruptcy proceeding. 113 The court reviewed the district and bankruptcy courts’ conclusions of law de novo, and the bankruptcy court’s findings of fact for clear error. 114

The court began its analysis by recognizing federal courts’ duty to enforce valid arbitration agreements under the FAA. 115 The court identified the added weight this duty has carried in the international commercial setting ever since the United States joined the Convention on the Recognition and Enforcement of Foreign Aribtral Awards in 1970. 116 The court acknowledged, however, that the duty to enforce international arbitration agreements was rooted in statute, i.e., the FAA,


109. See supra note 108.
110. See, e.g., Videsh Sanchar Nigam Ltd. v. Startec Global Commc’ns Corp. (In re Startec Global Commc’ns Corp.), 300 B.R. 244, 252 (D. Md. 2003). “In a core proceeding, the bankruptcy court’s interest is greater, as is the risk of a conflict between the Bankruptcy Code and the Arbitration Act.” Id.
111. Id. at 254.
112. 403 F.3d 164, (4th Cir. 2005).
113. See id. at 168.
114. Id. As for the bankruptcy court’s findings of fact, the appellate court found nothing to be clearly erroneous and took the facts as they were presented by the lower courts. Id. at 170.
115. Id.
116. Id.; see supra notes 75-76.
and therefore later, congressionally-created exceptions could modify the duty.\textsuperscript{117} The court then summarized the McMahon test, finding it to be the appropriate method to determine whether a congressionally created exception to the general duty to enforce arbitration agreements existed in this case.\textsuperscript{118}

After discussing arbitration generally, the court then moved to a brief explanation of the bankruptcy court’s jurisdiction under the Amended Bankruptcy Code. The court stated the general rule that bankruptcy courts have jurisdiction over core proceedings.\textsuperscript{119} In an attempt to give some meaning to the term “core proceeding,” the court limited its definition by citing the first two examples of core proceedings listed in the Amended Bankruptcy Code: “core proceedings include, for example, ‘matters concerning the administration of the estate’ and the ‘allowance or disallowance of claims against the estate.’”\textsuperscript{120} The court then concluded that, since Phillips sought a determination that White Mountain (the debtor) owed him money, this case involved a core proceeding.\textsuperscript{121}

Satisfied that the Phillips-Congelton dispute involved a core proceeding, the court introduced the McMahon test. The court briefly addressed the first part of the McMahon test—whether congressional intent to prohibit arbitration of core issues is deducible from the statutory text—and noted that this issue could be argued both ways.\textsuperscript{122} The court recognized that some circuits, like the First Circuit, have held that the text of the Amended Bankruptcy Code requires bankruptcy courts to serve as the exclusive forum for adjudication of core proceedings.\textsuperscript{123} The First Circuit has adopted a bright-line rule preventing bankruptcy courts from enforcing arbitration agreements that involve core proceedings.\textsuperscript{124} The court also recognized that other circuits, like the Second Circuit, have held that courts should not automatically refuse to enforce arbitration of all core proceedings.\textsuperscript{125} Although the court acknowledged both arguments, the court did not decide whether or not the First Circuit’s bright-line approach, and the court did not even mention the second part of the McMahon test, because the court found that the case would be best resolved under the third prong of the McMahon test.\textsuperscript{126}

In applying the third part of the test, the court asked whether a conflict existed between the underlying purposes of the FAA and the bankruptcy laws as applied to international arbitration agreements and core bankruptcy proceedings.\textsuperscript{127} It

\textsuperscript{117} Phillips, 403 F.3d at 168.

\textsuperscript{118} Id.

\textsuperscript{119} Id. at 168-69.

\textsuperscript{120} Id. at 169 (citing 28 U.S.C. §§ 157(b)(2)(A), (B) (2005)).

\textsuperscript{121} Id.

\textsuperscript{122} Id.

\textsuperscript{123} Id. “[T]he statutory text giving bankruptcy courts core-issue jurisdiction reveals a congressional intent to choose those courts in exclusive preference to all other adjudicative bodies, including boards of arbitration, to decide core claims.” Id. (citing Sisters of Providence Health Sys., Inc. v. Summerfield Elm Manor (\textit{In Re Summerfield Pine Manor}), 219 B.R. 637, 638 (B.A.P. 1st Cir. 1998)).

\textsuperscript{124} See id.

\textsuperscript{125} Id. “A determination that a proceeding is core will not automatically give the bankruptcy court discretion to stay arbitration.” Id. (citing U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass’n, Inc. (\textit{In re U.S. Lines, Inc.}), 197 F.3d 631, 640 (2d Cir. 1999)).

\textsuperscript{126} Id. The second part of the McMahon test asks whether a congressional exception to the arbitration agreement can be implied from the legislative history of the Amended Bankruptcy Code. Shearson/American Express Inc. v. McMahon, 482 U.S. 220, 227 (1987).

\textsuperscript{127} Id.
found that allowing debtor-creditor rights to be determined by an arbitrator was inconsistent with the purpose of the bankruptcy laws to centralize bankruptcy disputes. After affirming the bankruptcy court’s finding that the arbitration would have significantly undermined White Mountain’s ability to reorganize, the court concluded that the conflict of purposes between the statutes was particularly apparent in this type of core proceeding, and the bankruptcy court’s refusal to order arbitration between Congelton and Phillips was affirmed.  

V. COMMENT

A. How the Court Should Have Used the McMahon Test

In Phillips, the Fourth Circuit failed to properly apply Supreme Court precedent. The court did not weigh the purposes of the Amended Bankruptcy Code against the purposes of the FAA as required by the McMahon test. Instead, the court adapted the outer framework of the McMahon test to fit its own version of federal policy—centralization of bankruptcy proceedings above all other interests. While the court stated that its decision was based on the third part of the McMahon test, a comparison between the Supreme Court’s and the instant court’s analyses of the same test reveals that the purposes of the Amended Bankruptcy Code were not so important as to warrant a finding that the FAA was inapplicable.

The McMahon test was adapted from the 1985 Supreme Court case, Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc. Mitsubishi is particularly instructive in Phillips because in Mitsubishi, the Supreme Court, like the instant court, essentially used the third part of the McMahon test to decide whether an international commercial agreement to arbitrate a federal statutory claim should be enforced. The premise of the third part of the McMahon test is clearly explained by the Supreme Court in Mitsubishi—the concerns of the federal statute must be weighed against “a strong belief in the efficacy of arbitral procedures for the resolution of international commercial disputes,” and “any doubts concern-

128. Id.
129. Id. at 170. The Court of Appeals also affirmed the bankruptcy court’s findings that: “an ongoing arbitration proceeding in London would (1) make it very difficult for the debtor to attract additional funding because of the uncertainty as to whether Phillip’s claim was debt or equity, (2) undermine creditor confidence in the debtor’s ability to reorganize, (3) undermine the confidence of other parties doing business with the debtor, and (4) impose additional costs on the estate and divert the attention and time of the debtor’s management.” Id. Congelton also raised two additional arguments on appeal: that its notice of appeal to the district court divested the bankruptcy court of jurisdiction over the adversary proceeding, and that the bankruptcy court’s injunction against the London arbitration was overly broad. Id. at 170-71. The court briefly answered both arguments, dismissing the first as moot, and holding on the second issue that “because Congelton does not request alternative relief, we decline to modify the injunction.” Id. at 171.
131. In McMahon, the Supreme Court cites to Mitsubishi as the source of the three-part test: “If Congress did intend to limit or prohibit waiver of a judicial forum for a particular claim, such an intent ‘will be deductible from’ . . . an inherent conflict between arbitration and the statute’s underlying purposes.” Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226-27 (1987) (citing Mitsubishi, 473 U.S. at 632-37).
132. Mitsubishi, 473 U.S. at 616.
133. Id. at 631.
ing the scope of arbitrable issues should be resolved in favor of arbitration.”¹³⁴ In setting the foundation for the McMahon test, the Mitsubishi opinion was largely devoted to emphasizing the seriousness of the purposes underlying the FAA. The Supreme Court observed that one underlying purpose of the FAA was to protect party autonomy and principles of contract interpretation.¹³⁵ In order to give meaning to this purpose, the Supreme Court recognized that all courts were necessarily required to “rigorously enforce agreements to arbitrate.”¹³⁶ The Mitsubishi court also recognized an even greater purpose underlying the FAA in the international commercial context, explaining that the success of the American economy depended upon international businessmen’s willingness to enter into, and ability to rely upon, arbitration contracts made with Americans.¹³⁷ The Supreme Court concluded by stating that national courts must “subordinate domestic notions of arbitrability to the international policy favoring commercial arbitration.”¹³⁸

Notwithstanding the striking similarities between Mitsubishi and Phillips—both cases involved international commercial agreements to arbitrate federal statutory claims, and both cases were apparently applying the same test—the instant court’s opinion stands in stark contrast to the Mitsubishi opinion. The Fourth Circuit not only neglected to weigh the purposes of the Amended Bankruptcy Code against the strong presumption in favor of enforcing international commercial arbitration agreements, but the court completely omitted the purposes underlying the FAA from its analysis of conflicting purposes. The Fourth Circuit’s analysis under the McMahon test failed to mention a single purpose underlying the FAA, even though the court purported to be using a test adapted from a case which clearly outlines several.

Although Mitsubishi involved a federal antitrust claim that was previously considered non-arbitrable, and although the Court conceded that the antitrust laws held “fundamental importance to the American democratic capitalism,” the Court maintained its emphasis on the importance of enforcing international arbitration agreements, and enforced the arbitration agreement.¹³⁹ There is no explanation in Phillips as to why the purposes underlying the Amended Bankruptcy Code deserved such greater deference than the purposes underlying anti trust law so as to result in such an insulated McMahon analysis that the purposes of the FAA, even when applied to an international commercial setting, were completely abandoned.

B. How the Court Actually Used the McMahon Test

Instead of weighing the purposes of the Amended Bankruptcy Code against the purposes underlying the FAA as required by the McMahon test, the Fourth Circuit used the McMahon test to detail how arbitration of Phillips’s claim would

¹³⁴ Id. at 626.
¹³⁵ Id. at 625-26.
¹³⁶ Id. "'The preeminent concern of Congress in passing the [FAA] was to enforce private agreements into which parties had entered,' a concern which 'requires that we rigorously enforce agreements to arbitrate.'" Id. [quoting Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221 (1985)].
¹³⁷ Id. at 629-30. The Supreme Court emphasized that "the expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we [the courts] insist on a parochial concept that all disputes must be resolved under our laws and in our courts." Id. at 629.
¹³⁸ Id. at 638-39.
¹³⁹ See id. at 634.
conflict with the purposes underlying bankruptcy. While the Fourth Circuit addressed the strong federal policy and duty to enforce associated with international commercial arbitration agreements at the beginning of its opinion, such consideration was not a part of its McMahon analysis. Once the court decided that Phillips's claim involved a core bankruptcy proceeding, the court began its McMahon analysis and there was no further discussion of the purposes of the FAA.

Like most circuits, the outcome in the Fourth Circuit under the McMahon test varies depending upon whether the bankruptcy proceeding is considered "core" or "non-core."140 Again following suit with the other circuits, the Fourth Circuit has made clear that core proceedings are more likely to conflict with arbitration than non core proceedings.141 One explanation for the courts' pattern of finding core proceedings more likely to conflict with arbitration than non-core proceedings is that bankruptcy courts are particularly protective of their jurisdiction over core bankruptcy claims.142 The Amended Bankruptcy code prohibits the bankruptcy courts from automatically exercising full jurisdiction over any type of claim other than core bankruptcy proceedings, and so relinquishing this jurisdiction and allowing an arbitrator to decide a core claim is more troublesome for the courts than it is for an arbitrator to decide a claim over which the bankruptcy courts do not automatically have full jurisdiction.143

A second reason why bankruptcy courts are reluctant to forgo their jurisdiction over core bankruptcy proceedings has to do with one of the purposes underlying bankruptcy law--centralization of bankruptcy proceedings.144 The goal of centralizing bankruptcy disputes into one forum has caused the lower courts difficulty in reconciling arbitration with bankruptcy. In the instant case, the court focused on this purpose of bankruptcy in deciding whether or not to enforce the arbitration agreement under the third part of the McMahon test.145 On one level, arbitration of bankruptcy proceedings clearly conflicts with the goal of centralization because it allows core proceedings to be decided in forums other than the bankruptcy courts. However, the court's exclusive focus on the goal of centralization and failure to examine the purposes of the FAA caused the court to ignore the underlying purposes shared by both the bankruptcy and the arbitration statutes.146 Due to the limited financial resources available in the bankruptcy context, one of

140. See supra note 110.
141. See supra note 110.
142. See Kurth, supra note 5, at 1021-22.
143. See id.
144. See Phillips v. Congelton (In re White Mountain Mining Co.), 403 F.3d 164, 169-70 (4th Cir. 2005).
145. Id. "Congress intended to centralize disputes about a debtor's assets and legal obligations in the bankruptcy courts." Id. at 169. "Arbitration is inconsistent with centralized decision-making." Id. "Centralization of disputes concerning a debtor's legal obligations is especially critical in chapter 11 cases, like White Mountain's." Id. at 170. "To protect reorganizing debtors and their creditors from piecemeal litigation, the bankruptcy laws 'centralize all disputes.'" Id. (quoting Shugrue v. Air Line Pilots Ass'n, Int'l (In re Ionosphere Clubs, Inc.) 922 F.2d 984, 989 (2d Cir. 1990)). "Finally [the bankruptcy] court found that allowing the adversary proceeding to go forward would allow all creditors, owners and parties in interest to participate in a centralized proceeding." Id. "[The bankruptcy court's] findings confirm that the London arbitration was inconsistent with the purpose of the bankruptcy laws to centralize disputes... accordingly, the bankruptcy court did not err in refusing to order arbitration." Id.
146. See Lisa A. Lomax, Alternative Dispute Resolution in Bankruptcy: Rule 9019 and Bankruptcy Mediation Programs, 68 AM. BANKR. L.J. 55, 63 (1994).
the primary purposes of bankruptcy courts is to reduce the delay and expense associated with litigation.\textsuperscript{147} Arbitration was also designed to decrease the cost and length associated with traditional litigation.\textsuperscript{148}

Once the proceeding is classified as core, most courts move to the third part of the McMahon test to determine if arbitration will be enforced.\textsuperscript{149} The circuits have latched onto the third "irreconcilable conflict" part of the McMahon test in order to protect the centralization purpose of bankruptcy.\textsuperscript{150} The lower courts’ pattern of finding that core proceedings are more likely to conflict with bankruptcy than non-core proceedings is particularly significant under the third part of the McMahon test, which is essentially a conflict of purposes test. Instead of using the conflict of purposes test to weigh the purposes of bankruptcy against the purposes of arbitration, the instant opinion reveals how a court can misuse the test by focusing on how arbitration would conflict with the purposes of bankruptcy instead of weighing those purposes against the purposes of arbitration, as the Supreme Court intended. The Fourth Circuit used the irreconcilable conflict test to ignore the purposes underlying the FAA and to elevate the goal of centralization of bankruptcy disputes.\textsuperscript{151}

In the instant case, after deciding that Phillips brought a core proceeding, the rest of the court’s opinion focused exclusively on protecting the purposes underlying bankruptcy. The court’s opinion exposes the impact of a court’s decision that a proceeding is core—the likelihood that arbitration will be refused increases and the scope of the ensuing analysis will be limited to the underlying purposes of bankruptcy.\textsuperscript{152} The court’s failure to address a single purpose underlying international arbitration under the McMahon test reveals the outcome-determinative nature of the court’s decision that Phillips’s claim involved a core bankruptcy proceeding. In the context of core proceedings, the Fourth Circuit has used the McMahon test to let bankruptcy trump "emphatic federal policy" and Supreme Court precedent in favor of international commercial arbitration through exclusive reliance on the purposes underlying the Amended Bankruptcy Code.

The lower federal courts have previously demonstrated how the desire to centralize bankruptcy claims can get out of hand. In 1978, the bankruptcy courts were given so much power to centralize bankruptcy proceedings that the Supreme Court declared the jurisdiction of bankruptcy courts unconstitutional.\textsuperscript{153} While the bankruptcy courts' jurisdiction is now constitutionally safeguarded by the core/non-core distinction,\textsuperscript{154} the goal of centralizing bankruptcy disputes is begin-

\textsuperscript{147} Id.
\textsuperscript{148} Id.
\textsuperscript{149} See Phillips, 403 F.3d at 169.
\textsuperscript{150} See id.
\textsuperscript{151} See id. at 169-70.
\textsuperscript{152} See Videsh Sanchar Nigam Ltd. v. Startec Global Commc’ns Corp. (\textit{In re} Startec Global Commc’ns Corp.), 300 B.R. 244, 252 (D. Md. 2003) "In a core proceeding, the bankruptcy court’s interest is greater, as is the risk of a conflict between the Bankruptcy Code and the Arbitration Act." \textit{Id.} See also Phillips, 403 F.3d at 169-70.
ning to create new problems by over-riding the strong federal policy in favor of international commercial arbitration.

C. Misusing the McMahon Test Hurts International Commerce

When courts refuse to enforce valid arbitration contracts, international commerce suffers. The Supreme Court has recognized that American courts must be sensitive to “the need of the international commercial system for predictability in the resolution of disputes.”\textsuperscript{155} In order to maintain healthy international commerce, parties must be able to rely upon international commercial contracts. When valid international commercial arbitration contracts are not enforced because arbitration would conflict with the purposes of bankruptcy, courts replace predictability with uncertainty and damage international commerce. If courts want to support economic growth, they must allow disputes to be resolved under different laws and in foreign tribunals.\textsuperscript{156}

The Supreme Court has taken this duty seriously, by enforcing international arbitration of federal statutory claims, even when the private cause of action provides an important “policing function” in our nation.\textsuperscript{157} and even when “a contrary result would be forthcoming in a domestic context.”\textsuperscript{158} Despite the Supreme Court’s endorsement, the lower federal courts continue to not enforce agreements to arbitrate core bankruptcy proceedings, thus upsetting the Supreme Court’s support of international economic growth.\textsuperscript{159}

VI. CONCLUSION

The Fourth Circuit’s opinion reveals the lingering judicial hostility of the lower federal courts toward arbitration. Although the court may have appeared to follow Supreme Court case law by adopting the basic framework of McMahon, the court’s reasoning deviated sharply from the intended analysis as demonstrated in \textit{Mitsubishi}. This court’s opinion suggests that instead of resolving the conflicting statutes by weighing the underlying purposes as established in \textit{Mitsubishi}, the court will stubbornly preserve the bankruptcy courts’ exclusive jurisdiction of core proceedings even when the parties have contracted to the contrary. By failing to consider the international character of the arbitration agreement under the McMahon test, the court implicitly rejected the unique obligations the Supreme Court has imposed upon the lower federal courts in the context of international commerce. The Fourth Circuit not only failed to take account of the particular duty to enforce arbitration in the international commercial context as set forth by the Supreme Court, but the court’s holding also harms international commerce by suggesting that parties cannot confidently rely on international commercial arbitrations agreements whenever there is a chance that a core bankruptcy disputes may result. Despite the strong steps the Supreme Court has taken to support in-

\textsuperscript{156} See id. at 629-30, 638-39.
\textsuperscript{158} See Mitsubishi, 473 U.S. at 629.
\textsuperscript{159} See supra note 110.
International commerce, parties’ reliance on international commercial arbitration agreements will continue to be misplaced in the event of a dispute involving a core bankruptcy proceeding unless and until the Supreme Court enforces an agreement to arbitrate a core bankruptcy proceeding.

LINDSAY BIESTERFELD