Dealing With Rejection: Are Arbitration Clauses Enforceable After the Underlying Contract is Rejected in Bankruptcy?

*By: Gianfranco Finizio, Esq. and Kelly E. Moynihan, Esq., Kilpatrick Townsend & Stockton LLP**

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Abstract

Arbitration provisions are material portions of a contract or purchase order that were bargained for by the parties and allow for a potentially cheaper and quicker resolution to contractual disputes as compared to protracted litigation in state or federal courts. However, what happens to an arbitration provision contained in a contract that was rejected by a contract counterparty that filed for bankruptcy? That is precisely the question that was addressed in a recent opinion from the United States Bankruptcy Court for the Northern District of Texas (the "Bankruptcy Court") in the Highland Capital Chapter 11 case.[1] This article will summarize the Bankruptcy Court's opinion in Highland Capital and discuss the import of whether an arbitration clause contained in a contract that was rejected by a debtor is enforceable.

**The views expressed herein are solely the view of the authors, Gianfranco Finizio, Esq. and Kelly E. Moynihan, Esq. and not necessarily the views of Kilpatrick Townsend & Stockton LLP. This article is provided for educational purposes and does not constitute legal advice.*

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[1] *Highland Cap. Mgmt., L.P. v. Dondero (In re Highland Cap. Mgmt., L.P.)*, No. 19-34054-sgj11, 2021 WL 5769320 (Bankr. N.D. Tex. Dec. 3, 2021).

I. Enforceability of Arbitration Clauses Generally

The enforceability of arbitration clauses is supported by a long history of federal policy. Indeed, there is a wealth of case law articulating the strong federal policy behind the Federal Arbitration Act ("FAA") in enforcing arbitration clauses in contracts. Section 4 of the FAA specifically directs a court to order parties to arbitrate upon a request by a party that is entitled to demand arbitration in a written contract.[2] Various bankruptcy courts (including in Delaware and Pennsylvania, to name a few) have held that arbitration clauses survive a debtor's rejection of a contract in a bankruptcy case.[3] These holdings suggest an almost immutable approach in enforcing arbitration clauses, notwithstanding the rejection of the underlying contract that contains the subject arbitration clause. In the *Highland Capital* case, however, a very different outcome was reached: an arbitration clause was described as a "classic" form of executory contract subject to rejection, after which no party can be compelled to arbitrate a contractual dispute. As a result, and because the underlying agreement was rejected by the debtor during the course of Highland Capital's Chapter 11 case, the Bankruptcy Court denied a request by a party to compel the debtor to participate in arbitration. In so holding, the Bankruptcy Court conceded that treating an arbitration clause as an executory contract that is subject to rejection is a minority position not previously adopted by most courts. It remains to be seen whether other bankruptcy courts will find the *Highland Capital* court's treatment of arbitration clauses as persuasive.[4]

II. *Highland Capital*

In *Highland Capital*, the debtor commenced adversary proceedings in the bankruptcy case to recover amounts owed under certain promissory notes.[5] The debtor subsequently amended its complaint to add certain defendants and assert alternative theories of liability.[6] The added defendants filed motions seeking to (i) compel arbitration with respect to certain of the claims asserted in the complaint based upon a mandatory arbitration provision[7] contained in the debtor's

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[2] 9 U.S.C. § 4.

[3] *In re Fleming Cos., Inc*., 325 B.R. 687 (Bankr. D. Del. 2005); *Se. Pa. Transp. Auth. v. AWS Remediation, Inc*., No. Civ.A. 03-695, 2003 WL 21994811, at *3 (E.D. Pa. Aug. 18, 2003) (holding that arbitration clause survived debtor's rejection of contract); *Societe Nationale Algerienne Pour La Recherche v. Distrigas Corp*., 80 B.R. 606, 609 (D. Mass. 1987) (holding that arbitration provision is a separate undertaking which survives debtor's rejection of the underlying agreement); *In re Monge Oil Corp.*, 83 B.R. 305, 308 (Bankr. E.D. Pa. 1988) ("Rejection [of an executory contract] does not make the contract null and void ab initio; it simply protects the estate from assuming contractual obligations on a priority, administrative basis. Thus, it may not follow from § 365(g)(1) that rejection of a contract voids a compulsory arbitration clause." (internal citation omitted)).

[4] Although not decided in the context of a bankruptcy case, the Supreme Court recently held, in a unanimous opinion, that "a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation." *Morgan v. Sundance, Inc.*, No. 21-328, 2022 WL 1611788, at *4 (Sup. Ct. May 23, 2022). The Supreme Court further stated that the federal policy favoring arbitration "is about treating arbitration contracts like all others, not about fostering arbitration." *Id.*

[5] *Highland Cap*., 2021 WL 5769320, at *1-2.

[6] *Id.*

[7] "In the event there is an unresolved legal dispute between the parties and/or any of their respective officers, directors, partners, employees, agents, affiliates or other representatives that involves legal rights or remedies arising from this Agreement, the parties agree to submit their dispute to binding arbitration under the authority of the Federal Arbitration Act . . . ." *Id.* at *2 (alteration in original).

Limited Partnership Agreement (the "LPA");[8] and (ii) stay the adversary proceedings altogether during the pendency of the requested arbitration. During the Chapter 11 case, however, the debtor rejected the LPA pursuant to section 365 of the Bankruptcy Code.[9]

As noted above, there is a "liberal federal policy favoring arbitration" that is codified in the FAA.[10] Where a contract contains a provision in which parties agreed to submit future disputes thereunder to arbitration, these provisions should be enforced according to their terms.[11] The FAA requires arbitration agreements to be rigorously enforced according to their terms.[12]

Some courts have grappled with whether a bankruptcy court needs to treat an arbitration provision as any less mandatory than other courts given that bankruptcy cases involve multiple parties, are fast-moving, and are designed to centralize disputes over a debtors assets and liabilities in one court.[13] There is no *per se* bankruptcy exception to enforcement of an arbitration agreement.[14] Some courts have suggested that a bankruptcy court generally must abstain from adjudication and direct parties to arbitration in a non-core dispute (i.e., dispute that is merely related to a bankruptcy case and would have been litigated elsewhere but for the bankruptcy filing).[15] Under law from the Fifth Circuit Court of Appeals, a bankruptcy court can refuse to enforce arbitration clauses and may adjudicate a dispute itself when (i) a matter is "core" (i.e., one which derives from provisions of the Bankruptcy Code (Title 11 of the United States Code)); and (ii) enforcement of the arbitration provision would irreconcilably conflict with the purposes or goals of the Bankruptcy Code.[16]

The debtor in *Highland Capital* argued that, since the LPA had been rejected, the debtor was no longer bound by its provisions requiring specific performance (such as the arbitration clause) because a counterparty to a rejected contract can only seek monetary damages and cannot force a debtor to perform under the contract.[17] The Bankruptcy Court agreed with the debtor, citing

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[8] *Id.*
[9] The parties agreed that the LPA, as an executory contract, was rejected under 11 U.S.C § 365 in connection with the court's order confirming Highland's plan of reorganization in February 2021. *Id.* at *3. If a debtor rejects an executory contract, the rejection constitutes a breach of the contract as if it occurred immediately before the filing of the bankruptcy petition and the contract counterparty is generally entitled to a claim for money damages against the debtor's bankruptcy estate as a result of the breach.
[10] *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339 (2011) (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983)).
[11] *Id.*
[12] *Id.*
[13] *Id.* at *4.
[14] *Id.*
[15] *MBNA Am. Bank, N.A. v. Hill*, 436 F.3d 104, 108 (2d Cir. 2006) (suggesting that there is a "presumption in favor of arbitration [that] usually trumps the lesser interest of bankruptcy courts in adjudicating non-core proceedings"); *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 885 F.2d 1149 (3d Cir. 1989) (determining that there is no discretion to deny arbitration in non-core matters); *Gandy v. Gandy (In re Gandy)*, 299 F.3d 489, 495-96 (5th Cir. 2002) ("[I]t is generally accepted that a bankruptcy court has no discretion to refuse to compel the arbitration of matters not involving 'core' bankruptcy proceedings under 28 U.S.C. § 157(b) . . . .").
[16] *See Gandy*, 299 F.3d at 491; *Ins. Co. of N. Am. v. NGC Settlement Tr. & Asbestos Claims Mgmt. Corp. (In re Nat'l Gypsum Co.)*, 118 F.3d 1056, 1064 (5th Cir. 1997).
[17] *Highland Cap.*, 2021 WL 5769320, at *5.

primarily to a decision involving federal receiverships, but relying heavily on bankruptcy law.[18] The Bankruptcy Court held that the LPA and the arbitration clause contained therein were separate executory contracts, both of which had been rejected by the debtor, and, accordingly, the debtor could not be forced to specifically perform under the arbitration clause.[19] The Bankruptcy Court determined that although arbitration clauses survive a contract as a matter of contract law, such obligations may be avoided by a debtor through rejection of such contract.[20] Since a debtor cannot be required to specifically perform under a rejected contract as a matter of bankruptcy law, the debtor could not be required to perform under the arbitration clause contained in the LPA.

While not set forth as the primary factors for the decision, the Bankruptcy Court did provide additional commentary regarding the specific facts of *Highland Capital* that may have impacted the outcome of this decision. When declining to follow an opinion from the Bankruptcy Court for the District of Delaware in *In re Fleming Cos., Inc.*, 325 B.R. 687 (Bankr. D. Del. 2005), for the proposition that rejection of an executory contract does not prevent a party from invoking an arbitration clause in that contract, the *Highland Capital* court explained that it was the debtor in *Fleming* that sought to invoke the arbitration clause in a rejected contract, not the contract's counterparty, and described this distinction as one "not without significance."[21] The Bankruptcy Court further found that requiring arbitration would impose "undue and unwarranted burdens and expenses on the parties to the detriment of [the debtor's] creditors."[22] On that point, it is worth highlighting that the defendants in *Highland Capital* sought arbitration for only certain of the theories of liabilities (i.e., those that were governed by the LPA such as claims for breach of fiduciary duties), but requested a stay of the entirety of the adversary proceedings pending the arbitration. Lastly, the Bankruptcy Court also determined that the defendants had waived any right to invoke the arbitration provision in the LPA due to months' long delay in raising the arbitration issue.[23]

Despite the holding in the *Highland Capital* decision, other courts have found that an arbitration clause is still enforceable following the debtor's rejection of an executory contract. In *Fleming,* the court noted that arbitration is only sought when there is a breach of an agreement by one of the parties, and the rejection of a contract, or even breach of it, would not void an arbitration clause because to hold otherwise would permit a party to avoid arbitration by simply breaching a contract.[24] In *Paragon Offshore*, the court similarly found that because rejection was only a breach of a contract and the terms of a contract still controlled the relationship of the parties, the court could not "erase" the contractual obligations the parties had previously agreed to as it related to an arbitration provision.[25]

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[18] *Id.*; *Janvey v. Alguire*, No. 3:09-CV-0724-N, 2014 WL 12654910 (N.D. Tex. July 30, 2014).
[19] *Janvey*, 2014 WL 12654910, at *7.
[20] *Id.* The Court further acknowledged that an arbitration clause is a classic executory contract, "since neither side has substantially performed the arbitration agreement at the time enforcement is sought." *Id.* at *9 (citation omitted).
[21] *Highland Cap*., 2021 WL 5769320, at *7.
[22] *Id.*
[23] *Id.* at *9.
[24] *In re Fleming Cos., Inc*., 325 B.R. 687, 693-94 (Bankr. D. Del. 2005).
[25] *In re Paragon Offshore PLC*, 588 B.R. 735, 749 (Bankr. D. Del. 2018).

III. Key Takeaways

Depending on the circumstances, arbitration may be an attractive option for parties in a dispute with a debtor. Among other things, arbitration takes away any perceived "home court advantage" of the debtor in the bankruptcy court and is often a less expensive proceeding. Alternatively, a contract counterparty may resist a debtor's desire to arbitrate as arbitration could limit discovery, damages, or other useful litigation tactics. In either scenario, however, it is important to be aware of the implications that contract rejection in a bankruptcy case may have on the enforceability of arbitration clauses, including the minority position recently adopted by the Bankruptcy Court in *Highland Capital*.

Although a majority of courts have ruled in favor of the enforceability of arbitration clauses in a rejected contract, debtors may attempt to use the *Highland Capital* opinion to support arguments to the contrary. As such, it is important for contract counterparties to be aware that, following a debtor's rejection of an executory contract containing an arbitration provision, and depending upon the jurisdiction in which a bankruptcy case is pending, the bankruptcy court may not enforce the arbitration provision against a debtor, regardless of whether a dispute is "core" or "non-core." Such a finding leaves a non-debtor contract counterparty with limited ability to have any disputes resolved outside of the bankruptcy court.

Parties seeking to enforce an arbitration clause contained in a previously rejected contract should also be aware that in *Janvey*, the federal receivership case that was heavily relied upon in the *Highland Capital* decision, the court found that arbitration agreements must be analyzed "as separate executory contracts, based on the nature of the agreement as well as arbitration caselaw regarding severability."[26] Accordingly, parties should familiarize themselves with applicable state law regarding whether an arbitration provision is treated as an independent contractual obligation of the parties to help determine whether an arbitration provision may be treated by the bankruptcy court as executory and, as a result, ripe for rejection.

About the authors

Gianfranco Finizio is a bankruptcy and financial restructuring partner in the New York office of Kilpatrick Townsend & Stockton LLP. He represents creditors' committees, indenture trustees, debtors, unsecured creditors, and other significant parties-in-interest in complex Chapter 11 reorganizations and other distressed situations.

Kelly E. Moynihan is a bankruptcy and financial restructuring associate in the New York office of Kilpatrick Townsend & Stockton LLP. She specializes in the representation of debtors, creditors' committees, indenture trustees, and other significant parties-in-interest in complex Chapter 11 reorganizations and other distressed situations.

[26] *Janvey*, 2014 WL 12654910, at *9 (citing Jay Lawrence Westbrook, *The Coming Encounter: International Arbitration and Bankruptcy*, 67 MINN. L. REV. 595, 623, 623 n.112 (1983)).