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The Rejectability of Arbitration Clauses

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In a piece titled "Enforcement of Arbitration Provisions in Bankruptcy,"¹ Jaime Byrnes discusses the possibility of an arbitration clause being considered an executory contract and either assumed or rejected in bankruptcy, separate from the underlying "main" contract of which it is a part. This article examines that concept more closely.

"Selective" Assumption and Rejection

Typically, an executory contract or unexpired lease must be assumed or rejected under §365 of the Bankruptcy Code *cum onere*, meaning that it must be assumed or rejected in its entirety.² A debtor-in-possession (DIP) or trustee³ generally cannot "cherry-pick" and



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assume only the beneficial parts of an executory contract while rejecting the burdensome parts. However, when a contract contains provisions that are severable from the remaining portions

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of the contract, it is possible to engage in "selective assumption."

The Fifth Circuit Court of Appeals has held in *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.* that a lease comprised of two distinct contracts was severable, such that the fulfilled portion of the lease would remain enforceable while the remainder of the lease could be rejected.⁴ This holding has been followed by many courts and is the seminal case on the

pursuant to §365 of the Code, but later conducted an auction to sell the reproduction rights as a "potential asset" of the estate. Stewart Title was the successful bidder.



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When Stewart Title attempted to exercise the reproduction rights, however, Old Republic National Title Insurance Co. (formerly Southwest Title Insurance Co. of Minnesota/Land Title Co. of Dallas/Southwest Land Title Co.—collectively, "Southwest"), the successor and assignee of the lessor, refused to honor the reproduction rights. Stewart Title sued Southwest for

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severability of contracts for purposes of §365 of the Code.⁵

In *Stewart Title*, the parties had entered into a lease (the lease) for the personal property in a plant that contained abstracts, records, files and other property necessary to the title insurance and abstract business. The lease also contained a provision that allowed the lessee to copy, for its own use, any of the records pertaining to matters filed in Dallas County, Texas, after Nov. 30, 1961 (the reproduction rights) in the event the lease was terminated for any reason. The lessee filed for chapter 11 in June 1990. The case was subsequently converted to a chapter 7 liquidation, and a trustee was appointed. The trustee rejected the lease

breach of the lease and specific performance. The district court held that the rejection of the lease by the trustee excused Southwest from its obligations and that the reproduction rights were unenforceable. Stewart Title appealed and argued that the lease consisted of two severable agreements: (1) an executory agreement regarding the use of the personal property in the abstract plant (the use rights) and (2) an executed agreement regarding the reproduction rights.

Under Texas law, "a contract is divisible, or severable, when one party's performance consists of more than one 'distinct and separate item...and the price paid by the other party is apportioned to each item.'"⁶ In determining that the reproduction rights were a separate divisible agreement, the Fifth Circuit considered three factors: (1) intent of the parties, (2) subject

¹ See Byrnes, Jaime D., "Enforcement of Arbitration Provisions in Bankruptcy," p. 21-16 through 21-18 (hereafter, "Enforcement"). Ms. Byrnes presented the concepts underlying her article as a panelist at, and her article was published as part of the compendium of materials distributed in connection with, the 80th Annual Meeting of the National Conference of Bankruptcy Judges in November 2006.

² See, e.g., *Thompkins v. Lil' Joe Records Inc.*, 2007 WL 316302 (11th Cir. 2007) ("debtor must either assume an executory contract in its entirety or completely reject it"); *In re Exide Techs.*, 340 B.R. 222, 228 (Bankr. D. Del. 2006 (contract must be assumed or rejected in its entirety and "a party may not pick and choose among elements of a contract to assume or reject"); *Official Committee of Unsecured Creditors v. Aust (In re Network Access Sol'ns, Corp.)*, 330 B.R. 67 (Bankr. D. Del. 2005) (citing *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 734, 741 (5th Cir. 1996)).

³ See 11 U.S.C. §1107(a) (providing that, with certain exceptions, a DIP has all the rights and powers of a trustee).

⁴ *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 742 (5th Cir. 1996).

⁵ See, e.g., *Fidelity and Deposit Co of Maryland v. Rotec Indus. Inc.*, 392 F.3d 944, 945 (7th Cir. 2004); *In re Mirant Corp.*, 318 B.R. 100, 104 (N.D. Tex. 2004); *In re Wolfen Oil LLC*, 318 B.R. 392, 397 (Bankr. N.D. Tex. 2004); *In re Prakope*, 317 B.R. 593, 598 (Bankr. E.D.N.Y. 2004); *In re Lijeborg Enterprises Inc.*, 304 F.3d 410, 436 (5th Cir. 2002); *In re Rickel Home Centers Inc.*, 209 F.3d 291, 298 (3rd Cir. 2000).

⁶ *Stewart Title*, 83 F.3d at 739 (citing *In re Ferguson*, 183 B.R. 122, 124 (Bankr. N.D. Tex. 1995) (quoting *Johnson v. Walker*, 824 S.W.2d. 184, 187 (Tex. App.—Fort Worth 1991, no writ)).

matter of the agreement and (3) the conduct of the parties.⁷

The Fifth Circuit considered the intent of the parties as the principal determinant of separability,⁸ and found that the terms of the lease evidenced the parties' intent that the reproduction rights be separate and distinct from the use rights. Specifically, the use rights permitted the lessee to use the property and the plant, but did not allow the lessee to duplicate or copy the materials. The reproduction rights, however, provided the lessee with the privilege to make copies after termination of the lease, thus complimenting the use rights.⁹ "[B]y the terms of the lease, the parties intended to protect the rights of the lessee to reproduce materials... The parties expressly manifested their intention that the lessee's reproduction rights survive breach and termination."¹⁰ The Fifth Circuit further held that the subject matter of the lease weighed in favor of severability,¹¹ as the "subject matter" of the lease was not "uniform and undifferentiated," but rather two "distinct and clearly defined" agreements.¹² Finally, the Fifth Circuit held that the conduct of the parties also favored a finding of severability based on the fact that the lease provided for two distinct types of consideration, "each kind appropriate to one of the two types of rights granted: monetary payments for the use rights [and] day-by-day updating for the reproduction rights."¹³

Once it was determined that the lease was a severable contract, the court considered whether rejection of the lease pursuant to §365 rendered the reproduction rights unenforceable. The court stated that where one document contains several distinct agreements, some of which are executory and some of which are performed, only the executory portions of the document are subject to rejection. Thus, where a trustee rejects a severable contract containing both an executory and an executed agreement, rejection does not

constitute a breach of the executed agreement. Instead, the executed portions of the agreement remain intact.¹⁴ The reproduction rights were executed because the lessee had substantially performed its obligation at the time of bankruptcy and there was no dispute that the use rights were executory.¹⁵ As a consequence, the lease was rejected only to the extent it was executory (*i.e.*, with respect to the use rights), and the executed reproduction rights remained intact and thus enforceable by Stewart Title.¹⁶

Arbitration Clauses

So how should arbitration clauses be viewed when contained within a document otherwise subject to assumption or rejection under §365?

There are volumes of materials regarding arbitration clauses and how and when they should be enforced in bankruptcy.¹⁷ But regardless of whether an arbitration clause should be enforced and what test governs that determination, arbitration clauses are freely negotiated dispute resolution "super contracts" that are in effect a specialized kind of forum-selection clause agreed to in advance by the parties.¹⁸ In order for an arbitration clause to have any weight, the parties agree to be bound by the arbitrator's award.¹⁹

Fundamental to the law of arbitration is that arbitration clauses are severable from the principal contract.²⁰ In *Prima Paint*, the Supreme Court held that "except where the parties otherwise intend, arbitration clauses as a matter of federal law are 'separable' from the contracts in which they are embedded."²¹ Arbitration clauses are considered to be freely negotiated clauses that are "not thoughtlessly incorporated into complex...contracts as

a mere ballast or as a meaningless nod."²² The *Distrigas* court further noted that arbitration clauses are "separable" from the principal contract, otherwise arbitration clauses would be invalidated when the principal contract is breached. Allowing invalidation of the arbitration clause would be "akin to destroying precisely what the parties had sought to create as a dispute resolution device."²³ It is thus clear that an arbitration clause is considered "a separable contract between the parties which survives as an obligation of the promisor even if the underlying contract is voidable."²⁴

Typically, in the nonbankruptcy context, for the reasons stated above, one party to the agreement would not be able to terminate or invalidate the arbitration clause while keeping the principal contract in place.²⁵ In bankruptcy, however, a different result is possible. When the separability concept of arbitration clauses is combined with the assumption and rejection powers under §365 of the Code, it appears that a DIP should be able to reject an arbitration clause while assuming (or at least not rejecting) the principal contract.

Given that the Code, at its core, is a forum-selection statute that allows debtors to bring their conflicts to one forum,²⁶ this result seems appropriate. Generally speaking, the bankruptcy jurisdictional provision of 28 U.S.C. §1334 is extremely broad.²⁷ In fact, one law review article posits that the ability to reject arbitration agreements in bankruptcy should be considered an implied repeal of the Federal Arbitration Act.²⁸ Furthermore, the separability of arbitration clauses is well-established and fundamental to the law of arbitration.²⁹ Therefore, a DIP's

²² See *Distrigas*, 80 B.R. at 609.

²³ *Id.* (citing *Lummus Co. v. Commonwealth Oil Refining Co. Inc.*, 280 F.2d 915, 924 (1st Cir. 1960), cert. denied, 364 U.S. 911 (1960)). See, also, 9 U.S.C. §2 (providing that arbitration clauses "shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract").

²⁴ *Id.* (citing Westbrook, Jay L., "The Coming Encounter: International Arbitration and Bankruptcy," 67 Minn. L. Rev. 595, 623 (1983)).

²⁵ The Federal Arbitration Act (FAA) does, however, provide that any arbitration clause is invalid if "grounds...exist at law or in equity for the revocation of any contract." 9 U.S.C. §2.

²⁶ *Celotex Corp. v. Edwards*, 514 U.S. 300, 307-308 (1995) ("Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate, and that the 'related to' language of §1334(b) must be read to give district courts (and bankruptcy courts under §157(a)) jurisdiction over more than the simple proceedings involving the property of the debtor or the estate.") (internal citations omitted).

²⁷ See 28 U.S.C. §1334(b); *Celotex*, 514 U.S. at 308.

²⁸ "Implied Repeal," 117 Harv. L. Rev. at 2316 (arguing, *inter alia*, that because §365 modifies that normal rules of contract, the FAA's exception to revocability is triggered and §365 thus impliedly displaces the FAA).

²⁹ *Prima Paint*, 388 U.S. at 403.

⁷ *Id.* (citing *Johnson*, 824 S.W.2d at 187). Texas law applied because the subject matter of the lease, the place of performance, and the residence and place of business of the parties were all in Texas. *Id.* at 738.

⁸ *Stewart Title*, 83 F.3d at 739 (citing *Lake LBJ Mun. Util. Dist. v. Coulson*, 771 S.W.2d 145, 153 (Tex. App.—Austin 1988), *rev'd on other grounds*, 781 S.W.2d 594 (Tex. 1989) (internal citations omitted)).

⁹ *Id.*

¹⁰ *Id.* at 740.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 741-42.

¹⁵ *Id.* at 741-42.

¹⁶ *Id.* at 742.

¹⁷ See, e.g., "Enforcement," *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 885 F.2d 1149 (3d Cir. 1989); *In re Nat'l Gypsum Co.*, 118 F.3d 1056 (5th Cir. 1997); *Gandy Ltd. P'Ship v. Sarma Gandy (In re Gandy)*, 299 F.3d 489 (5th Cir. 2002); Kurth, Mette H., "An Unstoppable Mandate and an Immoveable Policy: The Arbitration Act and the Bankruptcy Code Collide," 43 UCLA L. Rev. 999 (1996); Note, "Jurisdiction in Bankruptcy Proceedings: A Test Case for Implied Repeal of the Federal Arbitration Act," 117 Harv. L. Rev. 2296 (2004) (hereafter, "Implied Repeal").

¹⁸ See *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477, 482-483 (1989); *Societe Nationale Algerienne v. Distrigas Corp.*, 80 B.R. 606, 609 (D. Mass. 1987); Carbonneau, Tom, "A Comment upon Professor Park's Analysis of the *Dicta* in *First Options v. Kaplan*," *Mealy's Int'l. Arb. Rep.*, Nov. 1996, at 18.

¹⁹ See *Prima Paint Corp. v. Flood & Conklin Mfg.*, 388 U.S. 395, 404 n. 12 (1967).

²⁰ See "Enforcement" at 21-7 (citing *Prima Paint*, 388 U.S. at 402-04 (adopting the separability doctrine under the Federal Arbitration Act)).

²¹ See *Prima Paint*, 388 U.S. at 402.

ability to reject an arbitration clause hinges on whether arbitration clauses are considered executory contracts.

In general, a contract is considered executory if “the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”³⁰ An arbitration clause provides for reciprocal obligations to resolve any future dispute through arbitration.³¹ Thus, at the time the bankruptcy case is filed, each party still has a future obligation to arbitrate any disputes that arise under the principal contract. This reciprocal future obligation would appear to make the arbitration clause executory³² and would thus subject the arbitration clause to independent assumption or rejection.

Conclusion

Allowing arbitration clauses to be rejected appears to be in line with the policies behind the Code and the Arbitration Act: The Act requires that arbitration contracts be given the same deference as other contracts,³³ and the Code permits DIPs to retain contracts that are valuable to the estate and reject those that are not. To the extent an arbitration clause is not of value or benefit to the estate, it should be treated the same as other executory contracts and should be subject to rejection by the DIP or the trustee. ■

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³⁰ See “Implied Repeal,” 117 Harv. L. Rev. at 2313 (citing Countryman, Vern, “Executory Contracts in Bankruptcy” (pt. 1), 57 Minn. L. Rev. 439, 460 (1973) (internal citations omitted)). The above-quoted “Countryman definition” has been adopted as the governing definition of “executory contract” by a majority of courts. See, e.g., *Kimmelman v. Port Authority (In re Kiwi Int'l Air Lines Inc.)*, 344 F.3d 311, 318 (3d Cir. 2003); *Kaler v. Craig (In re Craig)*, 144 F.3d 593, 596 (8th Cir. 1998); *Unsecured Creditors' Comm. of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp.*, 139 F.3d 702, 705 (9th Cir. 1998).

³¹ See “Implied Repeal,” 117 Harv. L. Rev. at 2315.

³² See *Id.* at 2314-15 (arguing that arbitration clauses are executory).

³³ See *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220, 228 (1987), and *Enforcement* at 21-11.