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The Rejectability of Arbitration Clauses: Part II

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In *The Rejectability of Arbitration Clauses*,¹ we postulated that, in light of the history and nature of arbitration clauses and §365 of the Bankruptcy Code, an arbitration clause should be subject to assumption or rejection separate from the underlying executory contract.² After “Rejection I” was submitted, but before it was published in the April 2007 edition of the *ABI Journal*, the U.S. District Court for the District of Delaware issued *Selby's Market Inc. v. PCT (In re Fleming Companies, Inc.)*,³ holding that an arbitration clause survived rejection of the underlying contract, and should be enforced. As an opinion of first impression in the Third Circuit,⁴ and the most recent pronouncement on the issue, it is worthy of review and analysis.

Facts and Decision



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In March 1996, the debtor, Fleming Companies, entered into a long term supply agreement with Selby's Market for the provision of food, groceries and related products and merchandise.⁵ Embedded within the supply agreement was an arbitration clause, pursuant to which the parties agreed to have “all disputes between them relating to [the supply agreement]...

¹ Brookner, Jason S. and Blacker, Monica S., “The Rejectability of Arbitration Clauses,” *Am. Bankr. Inst. J.* at 1 (April 2007) (hereinafter, “Rejection I”).

² See “Rejection I” at 77.

³ 2007 WL 788921 (D. Del. March 16, 2007).

⁴ *Fleming*, 2007 WL 788921 at *3.

⁵ *Id.* at *1.

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resolved by arbitration.”⁶ Fleming filed for bankruptcy in April 2003, and sought to reject (among others) the supply agreement with Selby's. A stipulation deeming the agreement rejected as of March 10, 2004, was approved by the bankruptcy court.⁷

Following rejection of the supply agreement, Fleming filed for arbitration before the American Arbitration Association to collect on a claim of approximately \$1.1 million against Selby's. The Fleming post-confirmation

District Court Appeal

On appeal, the parties disputed the effects of rejection. Selby's contended that rejection (like assumption) is “all or nothing,” and that upon rejection the entire contract is rejected; therefore, Fleming could not reject the supply agreement yet simultaneously seek to enforce the arbitration clause.¹⁰ Fleming, on the other hand (via the post-confirmation trust), argued that a contract is rejected only to the extent it is executory—that is, “for purposes [only] of all executory performance obligations remaining under the terms of the contract”



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trust, which assumed all collection efforts after Fleming's chapter 11 plan was confirmed, filed a motion with the bankruptcy court in late December 2004 to compel arbitration of the claims relating to the supply agreement and to stay certain state court proceedings that had been initiated by Selby's to stay the arbitration.⁸

The bankruptcy court ruled that rejection of the supply agreement was not a termination of the supply agreement, but was instead a mere breach of the agreement. As a result, the arbitration clause was enforceable notwithstanding rejection.⁹ Selby's appealed that ruling to the district court.

i.e., those obligations which “are intended to be the bargained-for benefit of the contract.”¹¹ As a consequence, argued Fleming, because the arbitration clause governs only the means by which disputes are to be resolved, and Fleming was not seeking to compel payment or compel (or bar) any substantive performance under the contract, the arbitration clause should be enforced.¹²

The district court began its analysis by first determining the effect of rejection. After reviewing applicable Third Circuit law, the court held that rejection under §365 does not constitute a termination of the contract, but is instead a breach of the agreement.¹³

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.* See, also, *In re Mirant Corp.*, 316 B.R. 234, 238 n.5 (Bankr. N.D. Tex. 2004), wherein the court ruled that the rejection of the main contract simply means that it has been breached and that “rejection does not alone prevent applicability of the arbitration clause.” The court exercised its discretion to deny the request for arbitration to resolve a claim based on the rejection of the executory contract.

¹⁰ *Id.* at *2. See also *In re CellNet Data Sys. Inc.*, 327 F.3d 242, 249 (3d Cir. 2003) (cited in *Fleming*); “Rejection I” at 1 and n.2 (citing cases).

¹¹ *Fleming*, 2007 WL 788921 at *2.

¹² *Id.* To support its position, *Fleming* cited to *Societe Nationale Algerienne Pour La Recherche v. Distrigas Corp.*, 80 B.R. 606 (D. Mass. 1987) (cited in “Rejection I” at 76-77 and accompanying notes), where the court held that an arbitration clause was separable from the main contract. *Distrigas*, 80 B.R. at 609.

¹³ *Fleming*, 2007 WL 788921 at *3.

Therefore, because a rejected contract is not “cancelled, repudiated, rescinded or in any other fashion terminated...it stands to reason that an arbitration clause survives rejection as well.”¹⁴ The court then went on to hold that the arbitration clause was enforceable, and that the claims generated as a result of rejection should be resolved in arbitration.¹⁵

Analysis

The *Fleming* opinion is short—just 2-1/2 printed pages—and contains almost no analysis regarding why the arbitration clause should be enforced. The court reviewed the arguments of the parties, determined that under Third Circuit law rejection equates to breach rather than termination, and then summarily concluded that the arbitration clause survived rejection. Presumably, the district court in *Fleming* relied principally on the *Distrigas* case, as that was the case the court cited as being relied upon by *Fleming*.¹⁶ However, merely because rejection constitutes a breach rather than a termination and “cuts off any right of the contracting creditor to require the estate to perform the remaining executory portions of the contract”¹⁷ does not *per se* mean that an arbitration clause survives rejection. There must be an independent legal basis for the arbitration clause to remain enforceable.¹⁸

Under the Bankruptcy Code and the case law, a contract is either (1) a single executory agreement that may be assumed or rejected, (2) already executed (*i.e.*, performance is complete) and therefore enforceable and not subject to assumption or rejection, or (3) comprised of multiple distinct agreements that are severable from the main contract and may themselves either be executory and separately subject to assumption or rejection, or fully performed and enforceable. If an arbitration clause itself is not considered a separate distinct executory agreement, then either it is executed (performance has already occurred and is enforceable notwithstanding rejection of the main agreement)¹⁹ or it is simply just part of the main agreement. Typically, unless arbitration has already commenced or has been completed, an arbitration clause will not be

executed. By implication, unless an arbitration clause is a separate agreement capable of being assumed or rejected in its own right, then the clause is merely an executory portion of the main agreement and would thus have to be rejected with the rest of the contract.

As a result, in order for the arbitration clause to have “survived” rejection, the *Fleming* court would appear to have made the *de facto* holding that the arbitration clause was, in fact, executory, severable and therefore subject to separate assumption or rejection.

Conclusion

The *Fleming* decision does not shed any direct light on the issue of whether an arbitration clause is itself a severable executory contract that may be separately assumed or rejected. The question therefore remains open. *Fleming* does, however, appear to implicitly support the proposition that separate authorization to assume or reject an arbitration clause should theoretically be required, over and above the necessary authorization to assume or reject the main agreement.²⁰ ■

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¹⁴ *Id.*

¹⁵ *Id.* at *3-*4.

¹⁶ *Id.* at *2.

¹⁷ *Id.* at *3 (quoting *University Med. Ctr. v. Sullivan (In re University Med. Ctr.)*, 973 F.2d 1065, 1075 (3d Cir. 1992)).

¹⁸ See, e.g., *Stewart Title Guar. Co. v. Old Republic Nat'l Title Ins. Co.*, 83 F.3d 735, 741-42 (5th Cir. 1996) (holding that where a contract contains distinct and severable agreements, one of which is executory and one of which is performed, only the executory agreement is rejected, and the executed agreement remains intact and enforceable).

¹⁹ *Id.*

²⁰ See 11 U.S.C. §365(a) (“the trustee, *subject to the court's approval*, may assume or reject...”) (emphasis added); *In re University Med. Ctr.*, 973 F.2d at 1077; 3 *Collier on Bankruptcy* ¶365.03 at p. 365-24 (15th ed. revised 2006) (collecting cases).