

Hostess Case — Bankruptcy Court Refuses to Send Cash Collateral Dispute to Arbitration

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U.S. Bankruptcy Court Judge Robert Drain's decision in the Hostess case demonstrates that even if a dispute between a debtor and a third party is arguably subject to a pre-petition arbitration clause, that dispute may not be subject to arbitration if it is considered a "substantially" core aspect of the bankruptcy process.



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On January 7, 2013, the Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York held that a dispute concerning the debtors' use of cash collateral was not subject to arbitration, notwithstanding a broad arbitration clause in the parties' underlying agreement, because the decision to allow a debtor to use cash collateral constituted a "core" issue and was a fundamental aspect of the bankruptcy process. *In re Hostess Brands, Inc.*, No. 12-22052 (RDD), 2013 WL 82914 (Bankr. S.D.N.Y. Jan. 7, 2013).

Background

On November 5, 2012, the debtors, Hostess Brands, Inc. and certain affiliates, filed a motion for authority to use the cash collateral of ACE American Insurance Company (ACE), pursuant to §363, §361 and §105 of the Bankruptcy Code. Previously, the debtors had assumed certain insurance agreements with ACE and agreed to provide ACE with cash collateral to secure the debtors' obligations to ACE pursuant to a collateral agreement. While the debtors' cash collateral motion was pending, ACE filed a motion to compel arbitration of what it termed a contract dispute underlying the cash collateral motion. In its motion to compel, ACE alleged that the debtors' request to use ACE's cash collateral contemplates a breach of the collateral agreement, and that the

dispute over this breach must be arbitrated pursuant to the collateral agreement's arbitration clause. The arbitration clause in question is very broad, providing that any dispute relating to the collateral agreement, including any breach of the agreement, is exclusively subject to arbitration. In addition, the clause provides that the selected arbitrators "may abstain from the strict rule of law" and will consider the "custom and usage of insurance business" when adjudicating the dispute. While ACE contended that arbitration is required to resolve this alleged breach of contract issue, the debtors argued that the dispute concerned the non-arbitrable issue of whether the debtors had the right to use the cash collateral pursuant to §363(c)(2) of the Bankruptcy Code.

Analysis

When considering whether to compel arbitration in bankruptcy cases, bankruptcy courts in the Second Circuit consider four factors: 1.) whether the parties agreed to arbitrate; 2.) the scope of the arbitration agreement; 3.) whether, if federal statutory claims are at issue, Congress intended those claims to be non-arbitrable; and 4.) whether the entire proceeding should be stayed pending arbitration if only some of the claims at issue are arbitrable. Courts applying this analysis, and particularly when considering the first and third factors, are swayed by whether the matter in question is "substantially core," or, in other words, a central function of the multi-party bankruptcy process. Further, even if a core matter is arbitrable under this analysis, bankruptcy courts may exercise their discretion to deny an arbitration demand if the matter is unique to bankruptcy cases, and the proceedings are a core bankruptcy function invoking substantial rights under the Bankruptcy Code and conflict with resolution by arbitration.

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Judge Drain first found that the question of whether a debtor may use cash collateral is a “clearly substantially core” matter that “is central to the bankruptcy process that Congress contemplated as substantially altering otherwise existing and enforceable rights under applicable non-bankruptcy law. . .” *Id.* at *3. As a substantially core matter, Judge Drain also concluded that a debtor’s rights to use cash collateral under the Bankruptcy Code are not derivative of the pre-petition debtor’s rights. There is a distinction between the pre-petition debtor and the post-petition trustee or debtor in possession and, therefore, the parties here did not, despite the arbitration provision’s breadth, necessarily agree to arbitrate the use of cash collateral.

Next, Judge Drain determined that Congress likely intended a request to use cash collateral to be non-arbitrable. Although Congress did not explicitly state in the Bankruptcy Code that a dispute over the use of cash collateral is not subject to arbitration, Congress did provide that “the court” will adjudicate the use of cash collateral under §363(e) of the Bankruptcy Code, which Judge Drain also noted applies to a trustee or debtor-in-possession, as opposed to the pre-petition debtor. Furthermore, since the use of cash collateral is a “substantially” core matter, Judge Drain found it “hard to see how Congress would have meant to turn over this particular type of determination, in which, . . . other parties in interest would have the right to intervene if they wanted to an arbitration panel in a two party dispute, which may abstain from following with rules of law and ‘shall make their decision with regard to the custom and usage in the insurance business.’” *Id.* at *4 (citation omitted).

Finally, because of the fundamentally core nature of the cash collateral dispute, Judge Drain held that he had the authority to exercise his discretion and deny ACE’s arbitration demand. In so holding, Judge Drain also found that even assuming arguendo that Congress intended cash collateral disputes to be arbitrable and that the parties agreed to arbitrate the cash collateral issue at hand, the entire dispute was not something that should be sent to arbitration, as doing so “would seriously jeopardize the objectives of the Bankruptcy Code as expressed in §363(c) and (e) and conflict with the integrity of the bankruptcy process in this case.” *Id.* at *6.

Conclusion

Judge Drain’s decision in *Hostess* demonstrates that even if a dispute between a debtor and a third party is arguably subject to a pre-petition arbitration clause, that dispute may not be subject to arbitration if it is considered “substantially” core — i.e., a matter “central to the bankruptcy process.” While the *Hostess* decision concerned only the use of cash collateral, Judge Drain explicitly cited a law review article listing several bankruptcy matters that “are arguably inconsistent with resolution through arbitration,” because they require the bankruptcy court to make particular findings (i.e., plan confirmation, the sale of assets outside of the ordinary course of business and the assumption and rejection of executory contracts). *Id.* at *4 (quoting Randall G. Block, “Bound in Bankruptcy,” 29 *Los Angeles Lawyer*

(2007)). Thus, in the aftermath of *Hostess*, a bankruptcy court in the Southern District of New York may not submit a matter to arbitration if it involves a central

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The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances. Specific questions relating to this article should be addressed directly to the authors. abfj

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