UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

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In re: Chapter 11

HOSTESS BRANDS, INC., 12-22052-rdd

Debtors.

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MODIFIED BENCH RULING ON MOTION OF THE ACE COMPANIES TO COMPEL ARBITRATION RELATED TO DEBTORS' CASH COLLATERAL MOTION

APPEARANCES:

JONES DAY

Attorneys for Debtors

222 East 41st Street

New York, NY 10017

BY: ROBERT HAMILTON, ESQ.

HEATHER LENNOX, ESQ.

MICHAEL SILBERFARB, ESQ.

DUANE MORRIS LLP

Attorneys for ACE Companies

1540 Broadway

New York, NY 10036

BY: LEWIS OLSHIN, ESQ.

WENDY M. SIMKULAK, ESQ.

HON. ROBERT D. DRAIN, UNITED STATES BANKRUPTCY JUDGE:

The debtors in this case filed a motion, dated November 5, 2012, for authority to use cash collateral of ACE American Insurance Company pursuant to section 363(c) of the Bankruptcy Code, and, as applicable, sections 361 (dealing with adequate protection) and 105.

The motion was adjourned on consent to January 2013. However, in the meantime ACE has moved to compel arbitration of what it terms a contract dispute underlying the debtors' cash collateral motion. And it is that motion to compel arbitration that is presently before me.

The reply brief submitted by ACE succinctly summarizes the facts. Pursuant to prior agreements, which have been, by order of the Court, assumed (and I'm compressing a lot into that phrase, because the orders themselves are important and affect the interpretation of the agreements), the debtors have agreed to provide the cash collateral to the ACE Companies for purposes of securing their obligations under the agreements, including the agreement to pay deductibles, that the debtors owe to the ACE companies under their insurance program.

Those obligations continue to accrue, although the policies have now been replaced or expired, because, obviously, there's a continuing expectation that injuries covered by the policies will manifest themselves.

ACE asserts, simply, the collateral was provided pursuant to the collateral agreement, the collateral secures their obligations under the collateral agreement, the collateral agreement, in Article 4, expressly requires the debtors to continue to provide collateral until ACE determines that there is no longer any need for such security, before the calculation of the insurance obligation, as defined in the collateral agreement, and that calculation may only be determined by interpreting the collateral agreement. Therefore, ACE contends, the motion contemplates a breach of the collateral agreement, and, therefore, ACE contends, that breach, or that dispute, must be arbitrated under the arbitration clause in the agreement.

That arbitration clause states, "Any controversy, dispute, claim, or question arising out of or relating to this agreement, including, without limitation, interpretation, performance, or non-performance by any party, or any breach thereof, (hereinafter collectively “controversy”) shall be referred to and resolved exclusively by three arbitrators through private confidential arbitration conducted in Philadelphia, Pennsylvania."

There's a mechanism for selecting the arbitration panel: "One arbitrator shall be chosen by each party, and a third by the two so chosen. If either party refuses or neglects to appoint an arbitrator within 30 days after

receipt of written notice from the other party requesting it to do so, the requesting party may choose a total of two arbitrators who shall choose a third. If those arbitrators fail to select a third arbitrator within ten days, after both have been named, the party plaintiff shall notify the American Arbitration Association, which shall appoint the third arbitrator," who shall be disinterested and neutral.

Further, "The arbitrators may abstain from following the strict rules of law and shall make their decision with regard to the custom and usage of insurance business as of the effective date of this agreement."

The ACE insurers contend in their motion that under applicable law the foregoing provision requires arbitration of the dispute regarding the debtors proposed breach of the applicable insurance program, and, as laid out on the record today by counsel for ACE, at least part of the issue relating to the cash collateral motion, which is what is the exact amount of the debtors' obligations that are secured under the applicable agreement.

The debtors contend, to the contrary, that the issue before the Court is not a breach of contract issue, but, rather, their right, whether or not the contract is breached by exercising such right, to use cash collateral pursuant to section 363(c)(2) of the Bankruptcy Code, which states that "The trustee" (and, for these purposes, a debtor

in possession is the equivalent of a trustee) "may not use, sell, or lease cash collateral under paragraph 1 of this subsection, unless (a) each entity that has an interest in such cash collateral consents, or (b) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section."

The standard for such determination is set forth in Section 363(e) of the Bankruptcy Code, which states, "Notwithstanding any other provision of this section, at any time on request of an entity that has an interest in property sold, used, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest."

“Adequate protection” is also referred to and defined, although, in a fairly open-ended way, in section 361 of the Bankruptcy Code, which states that "when adequate protection is required under Section 363, it may be provided by," and then it lists several factors in the alternative, which have been supplemented by the case law.

At this point, following the leading decisions of In re United States Lines, Inc., 197 F.3d 631 (2d Cir. 1999), and MBNA America Bank v. Hill, 436 F.3d 104 (2d Cir. 2006), the law regarding when and under what circumstances

arbitration is required in a bankruptcy case, and when, if it is not required, the Court should exercise its discretion to stay it, is fairly well defined in the Second Circuit.

The law is well summarized by Bankruptcy Judge Glenn in In re Bethlehem Steel Corp, 390 B.R. 784 (Bankr. S.D.N.Y 2008). He states, at 789, "When determining whether to compel arbitration and stay proceedings pending arbitration, a court must " (that is, the bankruptcy court in particular) "undertake a multi-step process: first, it must determine whether the parties agreed to arbitrate; second, it must determine the scope of that agreement; third, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be non-arbitrable; and, fourth, if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to stay the balance of the proceedings pending arbitration." (quoting Oldroyd v. Elmira Bank, 134 F.3d 72, 75-76 (2d Cir. 1998).

When reading the case law, it is clear that in applying that analysis the courts are motivated or swayed in part by not just a simple determination of whether a matter is non-core or core pursuant to 28 U.S.C. section 157(b), although that is an important factor, but whether, even if it is core under that section of the Judicial Code, it is, in fact, “substantially” core or truly a function of the

bankruptcy process. They do so, I believe, in part because they are interpreting whether, in fact, the first factor is met, which is whether the parties agreed to arbitrate, and, also, whether the third factor is met, which is whether Congress intended the claims at issue to be non-arbitrable.

Bankruptcy is a multi-party process that is rooted in the past but that in many cases drastically alters the parties' prebankruptcy rights. It appears clear to me that using Judge Glenn's phrase “substantially core” from the Bethlehem Steel case, whether a debtor has authority to use cash collateral is clearly substantially core. That is, it is central to the bankruptcy process that Congress contemplated as substantially altering otherwise existing and enforceable rights under applicable non-bankruptcy law, and that Congress did so in light of the fact that it is a multi-party process, and not just a simple two-party dispute.

Many courts apply that analysis in the context of determining whether the parties actually agreed to arbitrate the dispute, making the distinction between the prepetition debtor and the postpetition trustee or debtor in possession. See, for example, Bethlehem Steel, 390 B.R. at 790 and 793, in which the court, citing many other authorities, holds that bankruptcy law-created claims that are not derivative of the prepetition debtor's rights are not subject to

arbitration. See also -- I appreciate it's the same judge, but the logic is the same, and equally telling -- In re S.W. Bach & Company, 425 B.R. 78 (Bankr. S.D.N.Y 2010), at 91 through 92, as well as In re Salander-O'Reilly Galleries, LLC, 475 B.R. 9 (S.D.N.Y 2012), in which District Judge Seibel states, "There is no justification for binding creditors to an arbitration clause with respect to claims that are not derivative of one who is a party to it."

I recognize that Judge Lane in In re Cardali, 2010 Bankr. LEXIS 4113 (Bankr. S.D.N.Y 2010), took the view that a fraudulent transfer lawsuit could be subject to arbitration, notwithstanding that the party in the shoes of the debtor in that case was asserting rights under the Bankruptcy Code created by Congress. He did so because, however, those rights specifically derived from state law causes of action, and his view regarding Granfinanciera, S.A. v. Nordberg, 492 U.S. 33 (1989). That view, frankly, conflicts with numerous other cases. I don't need to decide my own position on that issue, but it appears clear to me that congressional authority to use cash collateral under the requirements set forth in sections 363(e) and 361 of the Bankruptcy Code is not at all rooted in a right that exists pre-bankruptcy. Indeed, the whole purpose of the sections is to alter those rights, as created by Congress.

Therefore, it appears to me that with regard to

this particular dispute, the parties, in fact, did not agree to arbitrate the use of cash collateral. I say that notwithstanding my belief that it is a broad arbitration agreement, as phrased, and, therefore, would satisfy in favor of ACE (and certainly the debtors would not carry their burden to show otherwise) that the agreement is broad. But, to me, it does not deal with the unique bankruptcy context of the cash collateral motion.

One can also approach the problem presented by the motion from the perspective of whether Congress intended this particular type of dispute to be non-arbitrable. Obviously, Congress did not so state expressly in the relevant provisions of the Bankruptcy Code. On the other hand, Congress did expressly provide for the Court to make the relevant determination under section 363(e), and applied it to a trustee or debtor in possession, not the prepetition debtor.

And, further, it is, as such, a core matter going beyond the basic statutory definition of “core,” 28 U.S.C. section 157(b), to be a fundamental aspect of the bankruptcy process. It is hard to see how Congress would have meant to turn over this particular type of determination, in which, as the Second Circuit has recognized, other parties in interest would have the right to intervene if they wanted to (see In re The Caldor Corp., 303 F.3d 161 (2d Cir. 2002); 11

U.S.C. section 1109(b)) to an arbitration panel in a two party dispute, which may abstain from following the strict rules of law and “shall make their decision with regard to the custom and usage of the insurance business.” See generally Randall G. Block, “Bound in Bankruptcy,” 29 Los Angeles Lawyer (2007), in which the author states, "Other provisions of the Bankruptcy Code” (other than lift-stay motions) “that require the bankruptcy court to make findings or approve certain actions are arguably inconsistent with resolution through arbitration. For example, the confirmation of a plan, sale of property outside the ordinary course, use of cash collateral, or assumption or rejection of executory contracts all require express authorization by the court. Arguably this authorization requirement does not comport with allowing disputes over these matters to be handled through arbitration.”

Again, all of those issues involve both multi-party notice and determination, recognizing the multi-party nature of bankruptcy issues in bankruptcy cases, and, finally, in a summary proceeding manner, the exercise, as a final call, of the bankruptcy judge's judgment as to the propriety of the action to be taken. See In re Orion Pictures Corp., 4 F.3d 1095 (2d Cir. 1993).

It also appears to me that even if the arbitration provision does, in fact, apply to this dispute, the Court

should exercise its discretion and deny the arbitration demand. The Court clearly has that authority, given that this is a core proceeding. The cases stemming from the MBNA v Hill decision make that clear, as does the United States Lines decision, although MBNA also made it clear that to exercise the court's discretion on a core matter, that is, core under 28 U.S.C. section 157, the type of matter must be unique to or uniquely affected by bankruptcy proceedings, and the proceedings are a core bankruptcy function that invokes substantial substantive rights that are created by the Code and in severe conflict with arbitration under the Federal Arbitration Act.

As I noted earlier, this is clearly that type of proceeding. Therefore, I see no contradiction in the logic employed by Bankruptcy Judge Walsh in Delaware in the NEC Holdings' case, which involved a similar request for cash collateral (the transcript of which has been attached as Exhibit B to the objection of the motion, which is Case No. 10-1890, Docket No. 1360, Bankruptcy D. Delaware, June 30, 2011), and Judge Walsh's written decision in In re Olympus Healthcare Group, 352 B.R. 603 (Bankr. D. Del. 2006), which involved not use of cash collateral, but a contract dispute, a true contract dispute, which certainly would be subject to arbitration.

If I were to exercise any discretion here, I

believe it would not be over whether I should hear the section 363(e) matter, because clearly I need to hear it, I have a duty to hear it, but, rather, whether I should parcel out a piece of that litigation to an arbitration panel. But, as I stated during oral argument, it would seem to me that that piece would only be a piece to fix a specific fact that might be at issue, as opposed to underlying rights of the parties.

It would be analogous to compelling a piece of a lift stay motion to go to arbitration, and then have that fact come back to me. I suppose under certain circumstances, applying the Second Circuit's factors laid out in In re Sonnax, a court might do that, particularly if the non-bankruptcy tribunal or arbitrable panel was about to rule on that key issue. See In re Sonnax Industries, Inc., 907 F.2d 1280, 1286 (2d Cir. 1990), laying out the twelve factors that the Circuit believes relevant to whether to lift the stay for another decision-making body to determine an issue.

But it would be in that context, as opposed to requiring arbitration, and it is the approach that has been taken by countless courts in the analogous situation where there was a lift-stay motion and parts of the issue were involved in arbitration and where the courts applied the Sonnax factors as opposed to saying that pieces of the lift

stay issue were to be sent to the arbitrators. See, for example, Salander-O'Reilly Galleries, 479 B.R. at 25; In re St. Vincent's Catholic Medical Centers of New York, 2012 U.S. Dist. LEXIS 139584 (S.D.N.Y September 27, 2012), at 8 through 10; and In re Quigley Company, Inc., 361 B.R. 723, 743 through 44 (Bankr. S.D.N.Y 2007). See also In re Spectrum Information Technologies, Inc., 183 B.R. 360 (Bankr. E.D.N.Y 1995), although I recognize that that case predates MBNA v Hill.

I conclude, in exercising my discretion with respect to this core matter under 28 U.S.C. section 157(a)(2) (and it is "substantially" core under the arbitration/bankruptcy court analysis), that the issues, which substantially affect both bankruptcy policy as well as the conduct of this case, are such that even if the parties did, in fact, agree to arbitrate the cash collateral issue, and, further, that Congress did not intend to preclude the arbitration of this issue, having considered the nature of the claim and the facts of this case, clearly the whole dispute (and even the portion of dispute which would not result in anything more than providing a data point for the Court in deciding the dispute), should not be determined by an arbitration panel.

To do so would seriously jeopardize the objectives of the Bankruptcy Code as expressed in section 363(c) and

(e) and conflict with the integrity of the bankruptcy process in this case. So I'll deny the motion. The debtors can submit an order, and they should e-mail a copy of it to counsel for ACE before they submit it, to make sure it's consistent with my ruling.

Dated: White Plains, New York
January 7, 2013

/s/Robert D. Drain_____ __
UNITED STATES BANKRUPTCY JUDGE