

Bankruptcy
Deep Dive

US Courts Weigh Arbitration's Rising Role in Bankruptcy Disputes

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Summary by Bloomberg AI **AI Generated**



- Judges are weighing whether disputes with arbitration clauses in financial agreements can proceed before arbitrators or remain under the court's control in bankruptcy cases.
- The Federal Arbitration Act and the US bankruptcy code can be at odds, causing conflict, especially in the absence of explicit guidance on how to reconcile them.
- The issue may be taken up by the Supreme Court, with some observers concerned that the court could heavily lean on the Federal Arbitration Act without accounting for bankruptcy's collective nature.

As more distressed borrowers enter bankruptcy with arbitration clauses in their financial agreements, judges are weighing whether such disputes can proceed before arbitrators or remain under the court's control.

Arbitration and bankruptcy rules, the products of federal laws enacted decades apart, can be at odds. Allowing arbitration in a bankruptcy case could reshape the landscape and influence how quickly certain matters are resolved.

The Federal Arbitration Act establishes a national policy favoring arbitration when parties have agreed to it. The US bankruptcy code, by contrast, is designed to provide a collective, centralized resolution of a debtor's financial affairs.

Goldman Sachs recently lost a bid in the US Court of Appeals for the Fourth Circuit to compel arbitration in a suit alleging it violated bankruptcy law by continuing debt collection efforts despite the automatic stay, which bars most creditor actions against a debtor in bankruptcy.

The two statutory schemes can cause conflict, especially in the absence of explicit guidance on how to reconcile them. A common approach in bankruptcy has been the “core versus non-core” distinction, used to determine whether a dispute can be arbitrated.

“More people are taking advantage of dispute resolution as an option to resolve disputes,” said Leslie Berkoff, chair of Moritt Hock & Hamroff’s dispute resolution practice. “By the time a case hits bankruptcy, there may be pending arbitration matters, and since arbitration is on the rise, bankruptcy courts are seeing it more.”

Goldman Sachs’ Loss

In a dissent in the Goldman case, Judge Robert B. King said the statutes didn’t conflict and the outcome of arbitration wouldn’t alter distributions for creditors.

King cited a 2006 decision from the Second Circuit, which held that arbitrating a stay claim wouldn’t interfere with the US bankruptcy code.

He also cited the US Supreme Court’s 1987 decision in *Shearson/American Express, Inc. v. McMahon*, establishing that courts should analyze whether there’s an inherent conflict and Congress’ intent behind the competing statutes.

“You’ve got this interesting push and pull between two federal statutes that are trying to achieve different things,” said Kara Bruce, a professor at the University of North Carolina at Chapel Hill. “How do you figure out which one trumps?”

The Fourth Circuit decision, however, was a win for the consumer debtors as it preserved the possibility of a class action to address a pattern of alleged harm. If the court had held otherwise, they would be compelled to arbitrate their claims individually, she said.

Goldman plans to appeal to the Supreme Court.

Core Versus Non-Core

Bankruptcy judges generally assess whether arbitration would disrupt the centralized resolution of the case, while also considering the debtor’s limited resources, fair treatment of creditors, and the automatic litigation stay.

Issues considered core matters should remain before a judge, said Christopher S. Sontchi, former US Bankruptcy Court for the District of Delaware chief judge.

Core issues arise out of bankruptcy law and are central to a bankruptcy case itself—for instance, who has the authority to file a bankruptcy petition.

But parties could resolve bilateral, non-core disputes through arbitration, he added. Arbitration can work for bankruptcy disputes over claim amounts, interest rates, penalty provisions, and cure amounts tied to contracts and leases.

"These are often tail-wagging-the-dog issues at the end of a case that take up a lot of judicial time for no particular reason," Sontchi said.

Robert M. Lawless, a University of Illinois College of Law professor and author of a paper on arbitration and bankruptcy, has said that, unless amended or repealed, courts should follow both statutes.

The core versus non-core distinction, which can be tracked to a 1989 Third Circuit decision, is the wrong test for arbitrability, he argued.

"You've got to look and say, 'For this matter in this arbitration agreement, is this subject to arbitration, and does the arbitral demand conflict with a command in the bankruptcy code?'" Lawless said.

In a case involving claims against Aetna Health Management and CVS Health, an Illinois bankruptcy judge found in February that the debtor, a local pharmacy, wasn't bound by an arbitration agreement with the insurance giants. The claims alleged unauthorized post-bankruptcy transfers and constructively fraudulent pre-bankruptcy transfers.

The judge noted, however, that while the core-versus-non-core distinction can inform the conflict analysis, there has been criticism over that approach as "an oversimplification."

Arbitration Abroad

The risk of sending a matter to arbitration in bankruptcy arises when the arbitrator lacks an understanding of the timing of the case or the implications of the arbitrator's import, Berkoff said. But some cases may benefit from an arbitrator with specialized expertise in a particular area of law.

"Assuming you handle an arbitration case correctly, it's faster and more economical than traditional litigation," she said. "If people approach it like pure litigators, it's going to be litigation in an arbitration forum."

The US debate over arbitration doesn't occur in a vacuum. International insolvency practitioners have been examining how arbitration is shaping insolvency abroad, particularly in key jurisdictions such as England and Wales, Singapore, Hong Kong, and Canada.

The conversation is also relevant to the US because Chapter 15 of the bankruptcy code allows courts to recognize foreign insolvency proceedings.

"It's gathering some international traction, and I'm sure it's going to come up," Sontchi said. "How is that going to leak into the US, and how are bankruptcy judges going to react to it?"

In any case, the debate would have to translate into statutory reform in the US, Lawless said.

High Court

The tension between the bankruptcy code and the arbitration law hasn't been tested by the Supreme Court.

King's dissent said the Fourth Circuit majority in the Goldman Sachs decision "needlessly created a circuit split."

A concern among some bankruptcy observers is that if the Supreme Court takes up a case, it could heavily lean on the FAA without accounting for bankruptcy's collective nature.

"The hope is that if it gets to the Supreme Court, it's the right case," Berkoff said.

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