

American Home Mortgage A Different View of Servicing Rights

by Andrew D. Gottfried and Annie C. Wells



Purchasers in exchange for a transfer of funds. The Debtors would then repurchase the mortgage loans or interests from the Purchasers within 180 days (although the average time for repurchase was within 30 days) upon the Debtors' sale of the loans to a securitization trust or private investor. The repurchase price the Debtors paid to the Purchasers was equal to the original cash purchase price plus a factor that equated to interest.

The Contract also provided for the servicing of the mortgage loans, which entailed the collection of payments, administration of escrows, responses to borrower inquiries, and related services, for which the servicer is paid a fee. Mortgage loans can be bought and sold on a "servicing retained" (seller retains the right to designate the servicer) or "servicing released" (buyer has the right to designate the servicer) basis. Buyers will generally pay a higher price for a "servicing released" loan. The mortgage loans in the *AHM* case were sold to the Purchasers on a servicing retained basis.²

The recent downturn in the credit markets, especially in the mortgage industry, ultimately led to the Debtors' bankruptcy filings in August 2007. Shortly thereafter, Calyon sought (i) a declaratory judgment that the Contract was a "repurchase agreement" as defined in Section 101(47) of the Bankruptcy Code, and thus, its rights under the Contract were not limited by the automatic stay pursuant to Sections 362(b)(7), 555 and 559³ and (ii) to compel the Debtors

Introduction

In a case of first impression, a Delaware Bankruptcy Court recently considered the application of Sections 555 and 559 of the Bankruptcy Code to repurchase agreements of mortgage loans in *American Home Mortgage, Inc.*¹ While Bankruptcy Judge Christopher S. Sontchi correctly held that the contract for the sale and repurchase of mortgage loans constituted a repurchase agreement or securities contract within the purview of the Code's safe harbor provisions, we disagree with the Court's holding that the servicing portion of the contract was severable and not protected under Sections 555 or 559 as a securities contract or repurchase agreement. The bases for our contrary view are found in the plain text of the statute and the nature of loan servicing rights.

Case Background

In *AHM*, the Debtors and Calyon New York Branch ("Calyon"), as Agent for the Purchasers, entered into a Contract that provided for the transfer of mortgage loans or interests in mortgage loans from the Debtors to the

summer 2008

in this issue

- 1 American Home Mortgage
A Different View of Servicing Rights
- 4 Delaware Chancery Court Rules the
Automatic Stay Does Not Bar Shareholder Meeting

supplement

Recent Noteworthy Decisions

editors

Menachem O. Zelmanovitz
mzelmanovitz@morganlewis.com

Wendy S. Walker
wwalker@morganlewis.com

This communication is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered Attorney Advertising in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2008 Morgan, Lewis & Bockius LLP
1701 Market Street • Philadelphia, PA 19103-2921
Tel: 215.963.5000 • Fax: 215.963.5001

American Home Mortgage A Different View of Servicing Rights

continued from page 1

to transfer the servicing rights under the Contract to Calyon. The Debtors countered that the Contract was a form of secured financing and, alternatively, that the servicing portion of the Contract was not subject to the safe harbor provisions.⁴

The Safe Harbor Provisions

Sections 555 and 559 of the Bankruptcy Code were originally enacted in 1983 in

of the Contract. The Court found that the Contract for the sale and repurchase of mortgage loans was a “repurchase agreement” (as well as a securities agreement), and accordingly, Sections 555 and 559 applied to allow Calyon to enforce its rights thereunder.⁷

The Court then considered whether the portion of the Contract providing for loan servicing was also protected under the safe harbor provisions, and arrived at the opposite

and should not determine or change the nature of the transactions at issue. For example, the doctrine of recharacterization is often used by courts to recharacterize the true nature of a transaction. Parties may treat and document a transaction as a loan, but the court may recharacterize it, based upon the facts and circumstances, as an equity contribution.¹¹ Here, it may be true that the Debtors and Purchasers agreed to sell the servicing rights as a separate asset, but the parties could just as easily have agreed to sell the interest portion of the mortgage loans as a separate asset. Yet any right to interest payments would be considered part and parcel of the underlying mortgage loans and not a separate asset.

The preferable way to assess the severability of servicing rights is to ask whether such rights could exist apart from the mortgage loan. The answer is that they could not. If a mortgage loan ceased to exist (for example, where the loan was repaid), there would be no further “servicing” (i.e., escrowing insurance and tax amounts, collecting principal and interest payments, responding to borrower inquiries) needed as there would simply be no loan to service. Viewed in this context, servicing rights are part and parcel of the underlying mortgage loans and are equally subject to the protections of Sections 555 and 559.

The Court need not have worried about the Purchasers receiving a windfall from being able to designate new servicers without having paid a premium for such right. Section 559 of the Bankruptcy Code specifically provides that:

[i]n the event that a repo participant or financial participant liquidates one or more repurchase agreements with a debtor ... any excess of the market prices received on liquidation of such assets ... over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate, subject to the available rights of setoff.

Thus, any excess of the market prices the Purchasers might receive upon liquidation

The recent downturn in the credit markets, especially in the mortgage industry, ultimately led to the Debtors' bankruptcy filings in August 2007.

response to the increased use of repurchase and other derivative transactions as a means of fostering liquidity in the capital markets and conducting monetary policy. Fearing a domino effect of instability and illiquidity from a party's inability to “close out” its position with a debtor counterparty (due to the automatic stay and preference provisions), Congress added Sections 555 and 559 along with other “safe harbor” provisions, which protected a non-debtor party's rights to liquidate securities contracts and repurchase agreements.⁵ In 2005, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act (“BAPCPA”), further revisions were made that, among other things, expanded the definition of repurchase agreement to include “mortgage related securities, mortgage loans and interests in mortgage related securities or mortgage loans.”⁶

Legal Analysis

The Bankruptcy Court began its analysis in *AHM* by reviewing the legislative history of the safe harbor provisions (including the revisions under BAPCPA) and the “straightforward definition” of repurchase agreement in Bankruptcy Code Section 101, which explicitly includes mortgage loans. The Court also looked to the intent of the parties as evidenced by the language

conclusion – that the servicing rights were not subject to Section 555 or 559.⁸ First, the Court concluded that the servicing rights were severable from the sale and repurchase of the mortgage loans, primarily because of the manner in which the parties, as well as the mortgage industry, had treated the servicing rights as a separate asset.⁹

The Court also noted that “if the Court were to allow otherwise, the Purchasers would receive a windfall – the right to designate the servicer without paying the concomitant premium” since the mortgage loans were purchased on a servicing retained basis.¹⁰

Finally, the Court concluded, based on a three-part analysis of the “plain meaning” of the statute, that the servicing rights provision was neither a repurchase agreement nor a securities contract, but was property of the estate, and that the Debtors did not have to transfer such rights to Calyon.

While reasonable on its face, a closer examination demonstrates flaws in the Court's analysis. First, the Court relied on the parties' and industry's practice in evaluating the relationship between mortgage loans and servicing rights. Parties often treat and document transactions in order to achieve a certain purpose, but such conduct does not

of the Contract attributable to the servicing premium would have been property of the estate under Section 559 in any event.

Further, the Court's three-part interpretation of the text of Section 101(47) creates an unnecessarily narrow view of the definition of "repurchase agreement." First, the Court limited the meaning of "interest" to a proportional or fractional ownership concept.¹² However, "interest" may be more broadly defined as "an aggregation of rights, privileges, powers, and immunities."¹³ Under that definition, Calyon's right to service or designate the servicer of the mortgage loans would constitute an "interest" in the mortgage loans.

The Court concluded that "servicing" is not an "interest in a mortgage" because these terms are separately referenced in Section 541(d).¹⁴ However, this Section was enacted before the 1983 safe harbor provisions and the BAPCPA amendments, and nothing in the legislative history indicates that the drafters intended Section 541(d) to be used as a

reference point for the expanded definition of repurchase agreement. Moreover, the purpose of Section 541 was to address property of the estate issues relating to nominal title holders. Here, the Debtors and Calyon are not nominal holders of the mortgage loans and servicing rights, but actual legal and equitable owners, albeit, in the case of Calyon and the Purchasers, only for the short period in which they held the mortgage loans.

The Court also held that the servicing rights and the right to designate the servicer are not "related terms" to the repurchase agreement portion of the Contract based on the rather circular reasoning that servicing is a separate asset.¹⁵ The Court added that the phrase "related terms" existed prior to the BAPCPA amendments when the definition of repurchase agreements included only securities to which there are no servicing rights, such as certificates of deposits and eligible bankers' acceptances. However, such securities do require servicing, such as accounting for

interest and principal payments, although such servicing has not been historically treated as a separate asset in the industry.

Conclusion

The Bankruptcy Court based its holding that loan servicing rights are severable from the underlying repurchase agreement for mortgage loans, and hence are not subject to the protections of the safe harbor provisions of Sections 555 and 559 of the Bankruptcy Code on the premise that both the parties and industry practice treat servicing rights and the right to designate the servicer as a separate asset. While we disagree with this analysis, it may allow the parties control over the fate of their contractual rights and priorities in bankruptcy. Perhaps if the Purchasers had purchased the mortgage loans on a servicing released basis (and paid a concomitant premium for such right), the Court may have arrived at a different conclusion and required the Debtors to transfer such rights to the repo counterparty.

endnotes

¹ *Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.)* 379 B.R. 503 (Bankr. D. Del. 2008) (hereinafter "AHM").

² *Id.* at 509-10.

³ Section 101(47) defines "repurchase agreement" as "an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities [], mortgage loans, [or] interests in mortgage related securities or mortgage loans..." 11 U.S.C. § 101 (emphasis added).

Section 362(b)(7) excepts from the automatic stay "the setoff by a repo participant or financial participant of any mutual debt and claim under or in connection with repurchase agreements..." 11 U.S.C. § 362.

Section 555 provides for the contractual right to liquidate, terminate or accelerate a securities contract. 11 U.S.C. § 555. Section 559 provides the same for a repurchase agreement. 11 U.S.C. § 559.

⁴ *AHM*, 379 B.R. at 508.

⁵ See 5 King, *Collier on Bankruptcy* ¶ 559.LH (15th edition rev. 2007).

⁶ 11 U.S.C. Section 101(47).

⁷ *AHM*, 379 B.R. at 520.

⁸ *Id.*

⁹ In particular, the Court emphasized:

"Thus, as drafted by Calyon and agreed to by the parties, the Contract itself severs the owner of the mortgage loans (the Purchasers) from the party with the right to designate the servicer (the Debtors). This is, in and of itself, strong evidence of the parties' intent to sever the servicing or the right to designate the servicer from the sale and repurchase of the mortgage loans... [T]he testimony at trial established that mortgage servicing is viewed as an entirely separate asset and that asset is traded separately and accorded distinct accounting treatment. Moreover, Calyon acknowledged the distinct nature of the two agreements by issuing separate notices of default on the same day – one to the sellers of the mortgage loans and a separate notice to the servicer.

Id. at 521.

¹⁰ *Id.* at 522.

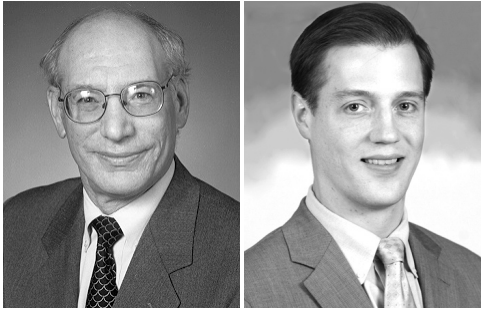
¹¹ See, e.g., *Bayer Corp. v. Mascotech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001); *Cohen v. KB Mezzanine Fund II, L.P. (In re SubMicron Sys. Corp.)*, 291 B.R. 314, 322 (Bankr. D. Del. 2003).

¹² Judge Sontchi states that "'interest' in this context means 'a financial share or state in something: the relation of being one of the owners or beneficiaries of an asset, company, etc.'" (quoting *1 Shorter Oxford English Dictionary* 1408 (6th ed. 2007)).

¹³ *Black's Law Dictionary* 828 (8th ed. 2004).

¹⁴ Section 541(d) of the Bankruptcy Code states: "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." 11 U.S.C. § 541(d).

¹⁵ *AHM*, 379 B.R. at 523.



Delaware Chancery Court Rules the Automatic Stay Does Not Bar Shareholder Meeting

by Richard S. Toder and Matt W. Olsen

Introduction

One of the fundamental principles of corporate law is the right of shareholders to participate in governance by voting during special or annual meetings to elect directors and to approve certain critical corporate decisions. Under certain conditions, shareholders are also empowered to compel the corporation and its directors to hold such meetings.¹ However, once a corporation enters bankruptcy reorganization, a shareholder's right to compel a meeting that threatens to replace the existing board of directors raises serious concerns as to whether the debtor-corporation's ability to rehabilitate its business and to maximize creditor recovery will be adversely affected. Nevertheless, federal and state courts alike have upheld the "the well-settled rule that the right to compel a shareholders' meeting for the purpose of electing a new board subsists during reorganization proceedings."²

proper forum to determine whether the automatic stay applied.⁴ While the notion that the automatic stay does not prevent an action to compel a shareholder meeting is implicit in prior case law, *U.S. Energy* appears to be the first court to directly address the issue. As such, *U.S. Energy* provides greater assurance to shareholders and equity committees that wish to proceed directly in state court to compel a shareholder meeting, without first seeking leave of the bankruptcy court.

Background

The dispute in *U.S. Energy* began more than five months before the company filed for bankruptcy when, during an impromptu board meeting, the company's three independent directors decided to fire Mr. Asher Fogel as Chief Executive Officer.⁵ Two days later, Mr. Fogel called for a special meeting of shareholders for the express purpose of replacing the independent directors, which call the board ignored. In response, Mr.

Court of the bankruptcy filing and argued that the automatic stay prevented the Court from scheduling the shareholder meeting. Mr. Fogel argued that in view of the Court's previous order, a further order merely scheduling the meeting was a ministerial act not barred by the stay. Alternatively, Mr. Fogel argued that matters of corporate governance, such as a shareholder meeting, continue notwithstanding the bankruptcy of a corporation.⁸

The Chancery Court determined that the act of scheduling a shareholder meeting involved some discretion and, therefore, could not be characterized as a ministerial act outside the scope of the automatic stay. Nevertheless, it held that "the automatic stay does not bar this Court from scheduling a shareholder meeting in this case."⁹ However, none of the cases cited in *U.S. Energy* directly addressed the application of the automatic stay, and the Chancery Court did not discuss the language of Section 362(a) (1) of the Bankruptcy Code, which prevents "the commencement or continuation ... of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the [bankruptcy] case" Nevertheless, the result in *U.S. Energy* finds indirect support in the cases cited in the decision (see note 9 *supra*) as well as several significant cases not referenced in the decision.¹⁰

Following the Chancery Court's decision, the debtor filed a motion in the Bankruptcy Court seeking enforcement of the automatic stay and declaring the Chancery Court's ruling void.¹¹ That motion is presently scheduled to be heard on September 3, 2008.

Shareholder Meetings During Bankruptcy and the Clear Abuse Standard

The principle that shareholder democracy continues notwithstanding the pendency of the corporation's bankruptcy finds its origins in cases from the 19th century.¹² In 1940, the

As deferential as federal courts have been to the continuation of corporate governance during reorganization, where the issue is decided in state court, the clear abuse exception may not even apply.

Consistent with that rule, the Delaware Chancery Court in *Fogel v. U.S. Energy Systems, Inc.*, recently ordered that a shareholder meeting take place notwithstanding the ongoing Chapter 11 case of U.S. Energy Systems, Inc. (U.S. Energy) in New York bankruptcy court.³ In *U.S. Energy*, the Chancery Court specifically held that the automatic stay that results from the commencement of a bankruptcy case did not bar the Court from scheduling the shareholder meeting and that the Chancery Court was the

Fogel commenced an action in the Chancery Court to compel the meeting. After deciding that Mr. Fogel's termination was not effective at the time he called for the shareholder meeting, the Chancery Court ordered U.S. Energy to hold such a meeting and directed the parties to submit an order implementing its decision.⁶ Before the Court entered an order scheduling the shareholder meeting, U.S. Energy filed for bankruptcy in the Southern District of New York.⁷ U.S. Energy promptly notified the Chancery

Second Circuit set forth a limited exception to the rule, in cases of “clear abuse.”¹³ In *Linahan*, a majority shareholder disputed the existing directors’ decision to file under Chapter X rather than Chapter XI of the former Bankruptcy Act, and sought permission to hold a meeting to elect new directors “who would safeguard the interests of stockholders.”¹⁴ The Second Circuit reversed the denial of the shareholder’s application, holding that while the bankruptcy court must be concerned that management is competent and will properly administer the property of the estate,

[t]he debtor has other parts to pay [sic], however, in a proceeding for reorganization or for arrangement, parts not directly concerned with management of the property during the period of court control, such as submission to involuntary proceeding and filing of plan, and over these the court ordinarily exercises no restraint. As to such matters the right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed *unless a clear case of abuse is made out*.¹⁵

In 1979, in *In re Potter Instrument Co.*, the Second Circuit applied the clear abuse test set forth in *Linahan* to affirm the denial of a shareholder’s right to hold a meeting for the purpose of electing new directors.¹⁶ The Second Circuit agreed that Potter was a disgruntled shareholder who wanted to “smash” the debtor “because he had been ousted from management and control.”¹⁷ The Court reasoned that an election of directors of Potter’s choosing “would probably jeopardize both [the debtor’s] rehabilitation and the rights of creditors and stockholders sounding the ‘death knell’ to the debtor as well as to [Potter] himself.”¹⁸ Thus, *Potter* is often cited as the prototypical example of a case of “clear abuse” on the part of a shareholder who is willing to sacrifice the debtor to advance his own selfish agenda.¹⁹

It was not until the Second Circuit’s decision in *In re Johns-Manville* that the Court more fully explained the “clear abuse” test.²⁰ In *Johns-Manville*, after four years of contentious negotiations among the debtor, the representative of asbestos personal injury plaintiffs and other creditors, and on the eve of their submission of a

Chapter 11 plan, the official equity security holders committee (the “Equity Committee”) commenced an action in Delaware state court to compel the debtor to hold a shareholder’s meeting for the purpose of replacing the debtor’s directors with new directors who would reconsider submission of the proposed plan.²¹ The Equity Committee was dissatisfied with the plan which, proposed to dilute their stock by more than 90%. The debtor commenced an adversary proceeding in the bankruptcy court to enjoin the Delaware action. On the debtor’s motion for summary judgment, the bankruptcy court issued the requested injunction based on the concern that the meeting and ensuing proxy fight had the potential to derail the entire reorganization or at least delay or halt negotiations.²² In affirming the bankruptcy court decision, the district court concluded that “the Equity Committee intended either to ‘torpedo’ the reorganization or to acquire a bargaining chip in aid of its negotiation power.”²³

Reversing both lower courts, the Second Circuit held that it was not clear abuse for the Equity Committee to leverage its right to call a shareholders’ meeting to obtain more bargaining power in plan negotiations, either by electing a new board or by obtaining concessions to avoid the meeting. The Second Circuit stated that “[u]nless the Equity Committee were to bargain in bad faith—e.g., to demonstrate a willingness to risk rehabilitation altogether in order to win a larger share for equity—its desire to negotiate for a larger share is protected.”²⁴ Further, the Equity Committee was not limited to asserting its concerns in the bankruptcy case by objecting to the proposed plan or seeking appointment of a trustee, as the Court held these options “provide only imperfect substitutes for a voice in the original formulation of a plan.”²⁵ Addressing the bankruptcy court’s concern for disruption to the plan negotiations, the Court stated that “the determination whether the Equity Committee is guilty of clear abuse turns on whether rehabilitation will be seriously threatened, rather than merely delayed, if Manville’s present plan is not submitted for confirmation now.”²⁶

Johns-Manville advances a rather narrow and pro-shareholder interpretation of the clear abuse test, requiring a finding either of bad faith on the part

of the shareholder or that the meeting and the attendant results will seriously threaten, and not merely delay, the debtor’s rehabilitation.²⁷ Also, implicit in the Second Circuit’s refusal to grant an injunction absent specific findings of clear abuse, *Johns-Manville* appears, consistent with *U.S. Energy*, to support the view that the automatic stay does not prevent the continuation of a state court shareholder action, although that issue was not litigated or addressed by the Court.²⁸

As deferential as federal courts have been to the continuation of corporate governance during reorganization, where the issue is decided in state court, the clear abuse exception may not even apply. In *NKFW Partners v. Saxon Industries*, the Delaware Chancery Court entered judgment in

Long-term commitment

The Restructuring Practice represents a diverse clientele ranging from financial institutions to media enterprises to retail companies.

Dedicated client relationship teams

We represent our clients in a wide variety of matters, from Chapter 11 proceedings and out-of-court restructurings to turnarounds and liquidations.

In-depth experience

The Restructuring Practice was recognized by *Chambers and Partners* in its annual compilation *Chambers Global: The World’s Leading Lawyers 2005–2006*, a ranking of the leading practices and practitioners in the global market.

Top-tier, effective legal advice

The Restructuring Practice consistently ranks in the top 10 in the *Daily Deal’s* review of 61 law firms with practices in the corporate bankruptcy area, based on active bankruptcy cases.

Delaware Chancery Court Rules the **Automatic Stay Does Not Bar Shareholder Meeting**

continued from page 5

morgan lewis fast facts

firmwide

One of the largest law firms in the world

More than 1,400 lawyers in 22 offices worldwide

Ranked among the top 10 law firms in *Corporate Counsel's* 2007 listing of "Who Represents America's Biggest Companies?"

business and finance practice

More than 350 lawyers in 18 offices throughout the world

Completed nearly 300 M&A transactions in the past two years, with a combined market value of more than \$120B

Ranked by *Dow Jones Private Equity Analyst* as the second most active law firm based on number of private equity or venture capital funds representing general and limited partners in closed transactions in 2007

Involved in more than 100 public offerings and in nearly 20 IPOs in the past two years

Completed more than 100 venture capital financing transactions in the past two years

Involved in more than 200 active bankruptcy cases at any one time

Completed more than 20 significant outsourcing transactions in the past two years

favor of a shareholder-plaintiff seeking to compel an annual meeting over the objections of the corporation. Saxon Industries had been a debtor in a Chapter 11 case pending in New York for about two years when a deal was struck to sell the debtor as a going concern that would provide \$5 million in preferred stock to existing shareholders, notwithstanding the debtor's \$200 million shareholder deficit.²⁹ Dissatisfied with the proposal, the plaintiff brought an action under Section 211(c) of the Delaware General Corporation Law to compel an annual meeting. The Chancery Court began its analysis by holding that "[i]t is well settled under Delaware law that a shareholder's right to compel an annual meeting pursuant to 8 Del. C. § 211 where more than 13 months have elapsed without such a meeting is virtually absolute."³⁰ Then, referring to the clear abuse test set forth in *Linahan and Potter*, the Court stated: "[A]ssuming, without deciding, that an annual meeting should not be ordered where a clear case of abuse is made out, the evidence here does not support such a finding."³¹

On appeal, the Supreme Court of Delaware affirmed the Chancery's decision.³² Although the Supreme Court stated that "a stockholder's prima facie case [under 8 Del. C. § 211] can be defeated by an adequate affirmative defense," it did not expressly adopt the Second Circuit's clear abuse standard. Instead, the Court balanced the concerns of Delaware General Corporation Law, which it viewed as favoring the free exercise of shareholder democracy, against the focus of the bankruptcy proceedings, which it left unstated, but apparently viewed as disfavoring shareholder meetings. Unconvinced that the shareholder meeting would cause the breakdown of the sale proposal or any actual harm to the debtor, the Court determined that the balance must tip in favor of Delaware law and allowing the shareholder meeting to proceed.³⁴

In the course of its analysis, the Delaware Supreme Court also held that neither the shareholder's motive in pursuing the meeting nor the debtor's insolvency would prevent the meeting from being held, plainly disagreeing with the Second Circuit's later dicta in *Johns-Manville*.³⁵ Thus, the *Saxon* decisions leave little doubt that a shareholder's request to compel

an annual meeting, if proper under Delaware law, will be granted by the Chancery Court absent demonstrable harm to the corporation's reorganization, even where the corporation is insolvent or where a shareholder pursues the meeting as a selfish gamble to extract some recovery.

The automatic stay was not an issue in the *Saxon* cases, however, because the plaintiff had first obtained approval to proceed with the state court action from the bankruptcy court.³⁶ Although it is doubtful that the lack of such approval would have altered the result, for this reason, *Saxon* does not provide direct support for the *U.S. Energy* decision.

Application of the Automatic Stay

What was implicit in prior cases – that the automatic stay does not prevent the exercise of shareholders' corporate governance rights – was made explicit in *In re Marvel Entertainment Group, Inc.*³⁷ There, bondholders of the debtor's parent held a security interest in 80% of the debtor's shares as collateral for the parent's obligations. After foreclosing on the shares, the Indenture Trustee notified the debtor of the bondholders' intent to vote the shares to replace the debtor's board of directors. Seeking injunctive relief from the bankruptcy court, the debtor argued that the bondholders' anticipated action was barred by Section 362(a)(3) of the Bankruptcy Code, which creates a stay against "any act to obtain possession of property of the estate or ... to exercise control over property of the estate."³⁸ After reviewing the Second Circuit's decision in *Johns-Manville* and other cases applying the clear abuse test, the Court stated:

It follows from these principles that the automatic stay provisions of the Bankruptcy Code are not implicated by the exercise of shareholders' corporate governance rights. Indeed, if it were otherwise, there would be no need to determine whether shareholders' actions evidenced clear abuse. For instance, because the directors of a debtor-in-possession control and manage the debtors' operations, any election of a new board would be considered an attempt to exercise control over the assets of the estate and would thus be barred by Section 362(a)(3).

In each of the cases cited above, however, courts considered only whether shareholders' attempts to elect a new board constituted clear abuse.³⁹

The *Marvel* court distinguished prior cases in which bankruptcy courts applied the automatic stay to bar creditors, who were also shareholders of the debtor, from exercising their voting rights to help ensure repayment of their claims against the debtor.⁴⁰ The Court observed that such courts applied the automatic stay "in order to prevent creditors of debtors from gaining control of the debtors' estates through the exercise of corporate governance rights."⁴¹ In contrast, the bondholders in *Marvel* were creditors of the debtor's parent, and the Court did not see any tangible risk that the bondholders would be able to exploit their right to elect a new board for the debtor to facilitate collection of their claims against the parent.⁴²

Thus, *Marvel* appears to provide greater support for the Chancery Court's decision in *U.S. Energy* than *Johns-Manville* or its predecessors. Surprisingly, however, although relied on by the plaintiff,⁴³ the *U.S. Energy* Court did not even cite *Marvel*. The reason may be found in one key distinction between the *Marvel* case and *U.S. Energy*. In *Marvel*, the debtor sought to enjoin the bondholders from voting their shares to elect a new board, an act which the debtor argued constituted an effort to exercise control over property of the estate that was barred by Section 362(a)(3) of the Bankruptcy Code. In *U.S. Energy*, Mr. Fogel commenced an action in Delaware Chancery Court to compel a shareholder meeting, which he continued to pursue after *U.S. Energy* filed for bankruptcy, and, unlike the shareholder in *Saxon*, without prior approval from the bankruptcy court. Accordingly, the debtor argued that the continuation of his state court action was barred by Section 362(a)(1) of the Bankruptcy Code, which was not at issue in *Marvel*.⁴⁴ Nonetheless, the reasoning of *Marvel*, which is based on an inference drawn from prior cases – that the clear abuse exception to shareholders' continuing rights to compel a meeting would be unnecessary if the automatic stay prevented the exercise of such rights in the first place – is sufficiently broad to support the outcome in *U.S. Energy* as well.

Following *Marvel*, the bankruptcy court in *American Media Distributors, LLC* held that the automatic stay did not bar an arbitration proceeding commenced by one member of the debtor against another demanding compliance with the debtor's operating agreement.⁴⁵ There, the Court adopted the reasoning of *Marvel*, and held that the determination of prior cases – that a shareholder meeting will not be enjoined absent a showing of clear abuse – demonstrates that

prohibition on the continuation of a "a judicial, administrative, or other action or proceeding against the debtor."⁴⁶ Indeed, in determining that its scheduling of a shareholder meeting did not fall within the ministerial act exception to the automatic stay, the Court implicitly held that its action constituted a continuation of a judicial "proceeding" within the meaning of Section 362(a).⁴⁹ Moreover, the automatic stay applies to all entities after the bankruptcy petition is filed,

Thus, *Marvel* appears to provide greater support for the Chancery Court's decision in *U.S. Energy* than *Johns-Manville* or its predecessors.

the automatic stay is not implicated in matters of corporate governance.⁴⁶ Note, however, that in *American Media*, the debtor was not a party to the operating agreement and, therefore, was not a party to the arbitration proceeding. As such, the Court's discussion of the clear abuse cases was not necessary for its determination.⁴⁷

U.S. Energy

Based on the precedent of the long history of cases upholding shareholders' rights to participate in governance during the course of the corporation's reorganization, and more recent cases holding, under varying facts, that the automatic stay is not implicated by the exercise of such rights, the *U.S. Energy* Court likely reached the correct result. Indeed, given that the matter came before the Chancery Court only days after *U.S. Energy* filed for bankruptcy, the oft-cited concern that the shareholder meeting and related litigation would impair the debtor's tenuous reorganization was not at issue. Also, the debtor and existing directors did not allege any bad faith on the part of Mr. Fogel. Thus, the clear abuse test was not satisfied.

Nevertheless, the Court's analysis of the automatic stay was inadequate. Mr. Fogel's prepetition action against *U.S. Energy* and the independent directors, which carried on postpetition, fell squarely within the scope of Bankruptcy Code Section 362(a)(1)'s

"[e]xcept as provided in subsection (b) of this section"⁵⁰ The *U.S. Energy* Court did not identify any exceptions listed within Section 362(b) that might apply to its case and, in fact, none of the numerous exceptions listed therein are applicable. Nor did the Court find that while the stay applied, grounds existed to lift the stay. Thus, in upholding the principle that shareholder governance continues during bankruptcy, the Court apparently concluded either that (i) Section 362(a)(1) was not implicated, or (ii) case authority has created a judicial exception to the automatic stay.

Conclusion

In ruling that the automatic stay does not prevent the continuance of a state court action to compel a shareholder meeting, *U.S. Energy* may encourage shareholders to commence litigation in the state courts in the first instance, rather than seek prior approval of the bankruptcy court. Such action would hardly be surprising given shareholders' usual concern for bankruptcy court bias in favor of the interests of creditors as well as the exigencies of the reorganization. A debtor's best countermeasure may be to seek an injunction in the bankruptcy court, though, even then, a showing of clear abuse will be required.

Delaware Chancery Court Rules the Automatic Stay Does Not Bar Shareholder Meeting

continued from page 7

- 1 See 8 Del. C. Section 211(c); NY BCL § 603(a).
- 2 *In re Johns-Manville Corp.*, 801 F.2d 60, 64 (2d Cir. 1986) (citing *In re Bush Terminal Co.*, 78 F.2d 662, 664 (2d Cir. 1935)); *In re Saxon Indus.*, 39 B.R. 49, 50 (Bankr. S.D.N.Y. 1984); *In re Lionel Corp.*, 30 B.R. 327, 330 (Bankr. S.D.N.Y. 1983); *NKFW Partners v. Saxon Indus., Inc.*, No. 7468, 1984 WL 8234, at *2 (Del. Ch. Aug. 8, 1984), *aff'd*, 488 A.2d 1298 (Del. 1985).
- 3 *Fogel v. U.S. Energy Systems, Inc.*, C.A. No. 3271-CC, 2008 WL 151857 (Del. Ch. Jan. 15, 2008).
- 4 *Id.* at *1. A majority of courts that have addressed the issue have held that federal and state courts have concurrent jurisdiction to determine the applicability of the automatic stay. See *In re Gruntz*, 202 F.3d 1074, 1087 (9th Cir. 2000); *Singleton v. Fifth Third Bank (In re Singleton)*, 230 B.R. 533, 539 (6th Cir. BAP 1999); *In re Ivani*, 308 B.R. 132, 135 (Bankr. E.D.N.Y. 2004); *Siskin v. Complete Aircraft Servs., Inc. (In re Siskin)*, 258 B.R. 554, 563 (Bankr. E.D.N.Y. 2001). *But see In re Rainwater*, 233 B.R. 126, 147 (Bankr. N.D. Ala. 1999) ("The state courts do not possess jurisdiction to entertain and decide upon questions and issues of federal bankruptcy law."); *In re Raboin*, 135 B.R. 682, 684 (Bankr. D. Kan. 1991) (bankruptcy court has exclusive jurisdiction to determine the applicability of the automatic stay); *In re Sermersheim*, 97 B.R. 885, 888 (Bankr. N.D. Ohio 1989) (same).
- 5 *Fogel v. U.S. Energy Systems, Inc.*, C.A. No. 3271-CC, 2007 WL 4438978, at *1 (Del. Ch. Dec. 13, 2007).
- 6 *Id.* at *5.
- 7 *In re U.S. Energy Systems, Inc.*, Chapter 11 Case No. 08-10054 (RDD) (Bankr. S.D.N.Y. 2008).
- 8 *Fogel v. U.S. Energy Systems, Inc.*, 2008 WL 151857, at * 1.
- 9 *Id.* at *1-2 (citing *NKFW Partners v. Saxon Indus., Inc.*, 1984 WL 8234, at *2; *Saxon Indus., Inc. v. NKFW Partners*, 488 A.2d at 1300; *In re Johns-Manville Corp.*, 801 F.2d at 64; *In re Lionel Corp.*, 30 B.R. at 329-30). It is not clear whether the U.S. Energy Court viewed these cases as supporting its specific holding that the automatic stay did not bar the scheduling of a shareholder meeting or the more general proposition that corporate governance does not cease when a company files for bankruptcy.
- 10 See discussion *infra* titled "Application of the Automatic Stay."
- 11 See *Emergency Motion of Debtor and Debtor-In-Possession U.S. Energy Systems, Inc. for Entry of an Order (I) Enforcing the Automatic Stay, etc.*, dated January 17, 2008 (Chapter 11 Case No. 08-10054 (RDD) (Bankr. S.D.N.Y. 2008).
- 12 In *Taylor v. Philadelphia & Reading R. Co.*, 7 F. 381 (Cir. Ct. E.D. Pa. 1881), for example, the court refused to postpone a shareholders' meeting for the election of officers, concluding that its

- jurisdiction extended only to actions necessary to preserve the property of the debtor for the benefit of creditors.
- 13 *In re J.P. Linahan, Inc.*, 111 F.2d 590 (2d Cir. 1940).
 - 14 *Id.* at 591.
 - 15 *Id.* at 592 (emphasis added).
 - 16 593 F.2d 470 (2d Cir. 1979).
 - 17 *Id.* at 474.
 - 18 *Id.* at 475.
 - 19 Sally S. Neely, *Bankruptcy Court Involvement in Corporate Governance: Interference with Shareholder Meetings*, American Law Institute - American Bar Association Continuing Legal Education, at 69 (July 26-28, 2001).
 - 20 801 F.2d 60.
 - 21 *Id.* at 63.
 - 22 *In re Johns-Manville Corp.*, 52 B.R. 879, 888 (Bankr. S.D.N.Y. 1985).
 - 23 *In re Johns-Manville Corp.*, 801 F.2d at 64 (citing *In re Johns-Manville Corp.*, 60 B.R. 842, 852 (S.D.N.Y. 1986)).
 - 24 *Id.* at 65. However, in an interesting footnote the Second Circuit retreated slightly, stating that "if Manville were determined to be insolvent, so that the shareholders lacked equity in the corporation, denial of the right to call a meeting would likely be proper, because the shareholders would no longer be real parties in interest." *Id.* at 65, n.6. Although dicta, the Second Circuit's concern over the solvency of the debtor suggests that federal courts presiding over bankruptcy cases may be more likely to enjoin a shareholder meeting than their state court counterparts.
 - 25 *Id.* at 66.
 - 26 *Id.*
 - 27 Finding a lack of evidence of either, the Second Circuit reversed the award of summary judgment and remanded the matter to the bankruptcy court. On remand and after a trial, the bankruptcy court held that the debtor was entitled to an injunction where the Equity Committee's state court action posed a serious threat to the reorganization given the fragile consensus achieved by the parties. *In re Johns-Manville Corp.*, 66 B.R. 517, 536-37 (Bankr. S.D.N.Y. 1986).
 - 28 See also *In re Lionel Corp.*, 30 B.R. 327 (denying debtor's motion for preliminary injunction of New York state court action to compel shareholder meeting absent a showing of irreparable harm to the debtor's reorganization); *In re Allegheny Int'l, Inc.*, No. 88-448, 1988 WL 212509 (W.D. Pa. May 31, 1988) (reversing bankruptcy court's order enjoining debtor's annual meeting of shareholders absent showing of clear abuse).
 - 29 1984 WL 8234, at *1.
 - 30 *Id.* at *2 (internal quotations omitted).
 - 31 *Id.* at *3 (emphasis added).

endnotes

- 32 *Saxon Indus., Inc. v. NKFW Partners*, 488 A.2d 1298.
- 33 *Id.* at 1302-03; see Mark E. Budnitz, *Chapter 11 Business Reorganizations and Shareholder Meetings: Will the Meeting Please Come to Order, or Should the Meeting be Cancelled Altogether?*, 58 Geo. Wash. L. Rev. 1214, 1253 (August 1990).
- 34 *Saxon Indus., Inc. v. NKFW Partners*, 488 A.2d at 1302-03.
- 35 *Id.* at 1302; see *supra* note 24.
- 36 *Id.* at 1300.
- 37 209 B.R. 832 (D. Del. 1997).
- 38 11 U.S.C. § 362(a)(3).
- 39 *In re Marvel Entm't Group, Inc.*, 209 B.R. at 838.
- 40 *Id.* at 839 (citing *Fairmont Commc'ns Corp.*, No. 92-B-44861 (Bankr. S.D.N.Y. Mar. 3, 1993) (oral decision); *In re Bicoastal Corp.*, No. 89-8191-8P1, 1989 WL 607352 (Bankr. M.D. Fla. Nov. 21, 1989)).
- 41 *Id.*
- 42 *Id.*
- 43 See Letter of Raymond J. DiCamillo, Esq. to Chancellor William B. Chandler, (Jan. 10, 2008) at 3 (*Fogel v. U.S. Energy Systems, Inc.*, C.A. No. 3271-CC).
- 44 See Letter of Michael Buskenell, Esq. to Chancellor William B. Chandler, (Jan. 14, 2008) at 1. U.S. Energy's argument has at least facial appeal. Section 362(a)(1) of the Bankruptcy Code provides that the filing of a bankruptcy petition operates as a stay against "the commencement or continuation... of [an] action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, **or** to recover a claim against the debtor that arose before the commencement of the case under this title." (emphasis added). Thus, an action against the debtor to compel a shareholder meeting, although having nothing to do with the recovery of a claim, would appear to be within Section 362(a)(1)'s scope.
- 45 216 B.R. 486 (Bankr. E.D.N.Y. 1986).
- 46 *Id.* at 489.
- 47 See *id.* ("Debtor [and other respondents] ... have offered little to no explanation as to why the automatic stay would apply in the first place to enjoin an arbitration of business governance issues between non-debtor entities.").
- 48 See *supra* note 44.
- 49 *Fogel v. U.S. Energy Systems, Inc.*, 2008 WL 151857, at *1.
- 50 11 U.S.C. § 362(a) (emphasis added).

- 1** *In re Bryan Road, LLC*, 382 B.R. 844 (Bankr. S.D. Fla. 2008)
Provision in prepetition forbearance agreement, negotiated by debtor with the assistance of experienced bankruptcy counsel, that waived the automatic stay protections if debtor later filed bankruptcy in return for rescheduling a foreclosure sale to provide debtor time to complete anticipated refinancing, was enforceable.
- 2** *In re Communication Dynamics, Inc.*, 382 B.R. 219 (Bankr. D. Del. 2008) Disagreeing with a New York case, the court held that a rejection of a damages claim was a prepetition claim not just for allowance or disallowance, but also for setoff purposes.
- 3** *In re Valley Health System*, 383 B.R. 156 (Bankr. C.D. Cal. 2008) Insolvent municipal healthcare district did not have to first negotiate with its many creditors in order to demonstrate that negotiation was "impracticable" as required for Chapter 9 relief under Section 109(c)(5) (C), in view of the district's "liquidity crisis, the number of its creditors, the risk of loss to its assets, and its resulting inability to construct a realistic plan of adjustment."
- 4** *In re Airadigm Communications, Inc.*, 519 F.3d 640 (7th Cir. 2008) Recognizing a split of authority in other circuits, the Seventh Circuit held that the bankruptcy court could confirm a plan of reorganization that provided a nonconsensual release to a third party financing the plan, from all liability in connection with the reorganization including from third party claims, except for willful misconduct.
- 5** *Maxwell v. KPMG LLP*, 520 F.3d 713 (7th Cir. 2008) Trustee could not recover from accounting firm on malpractice claim where firm's alleged negligence in overstating earnings of company that negotiated purchase of larger "dot.com" company was merely a "necessary condition" but not a "cause" of the harm to the debtor or its creditors when the "dot.com" market collapsed, forcing the debtor into bankruptcy.
- 6** *In re Tradex Swiss AG*, 384 B.R. 34 (Bankr. D. Mass. 2008) Given that Swiss corporation's trading platform was in Boston from where trade confirmations were faxed, the designated signatory authority was the manager of the Boston office, more employees were located in Boston, and assets and a significant number of creditors were in the United States, the corporation's "center of main interests" was in Boston, not Switzerland. Thus, foreign proceeding brought by the Swiss banking commission against the corporation was a "foreign non-main proceeding."
- 7** *In re Hedrick*, 524 F.3d 1175 (11th Cir. 2008) Agreeing with Eighth and Ninth Circuits, the Eleventh Circuit held that the "substantially contemporaneous" standard of Section 547(c)(1)(B) for the new value defense to an avoidance action is a flexible standard whose determination will be based on the facts and circumstances of each case. Disagreeing with the First and Sixth Circuits, the court held that this section "does not set out a bright line rule" and does not refer to the relation-back provision of Section 547(e)(2)(A) or any other provision's time standard. Thus, refinancing lender was protected against preference claim by new value defense, even though there was a lag between time loan closed and the perfection of the security interest because the two were intended to be and substantially were a contemporaneous exchange.
- 8** *In re Slatkin*, 525 F.3d 805 (9th Cir. 2008) Agreeing with the Seventh Circuit, the Ninth Circuit held that once the existence of debtor's Ponzi scheme is established, payments to investors as purported profits that exceeded the investors' initial investments were deemed fraudulent transfers as a matter of law.
- 9** *In re Reading Broadcasting, Inc.*, 386 B.R. 562 (Bankr. E.D. Pa. 2008) Reconsideration of confirmation order could be obtained by motion to alter or amend filed within 10 days of entry of order where motion is based on "clear error" or "newly discovered evidence," and need not be based on claim of fraud. Otherwise, a purpose of such motion, to provide an efficient mechanism for trial court to correct an erroneous judgment without involving the appellate process, would be undercut.
- 10** *In re Buffets Holdings, Inc.*, 387 B.R. 115 (Bankr. D. Del. 2008) Debtors had to assume or reject master leases covering multiple properties in their entirety and could not pick and choose specific properties, even though master lease provided for allocation of rent among the properties but the obligation to pay rent was joint and several.
- 11** *In re Mayco Plastics, Inc.*, 379 B.R. 691 (Bankr. E.D. Mich. 2008) Although under postpetition financing, lender was granted claim with priority over all administrative expenses, but it was not expressly granted and thus did not have status of an administrative expense claimant, and therefore, was not protected by Section 1129(a)(9)(A), which requires payment in full of administrative expense claims as of effective date of plan.
- 12** *In re Vita Corp.*, 380 B.R. 525 (Bankr. C.D. Ill. 2008) Noting split of authority, court held that Section 1126(c) requires creditors to affirmatively accept plan, and thus, failure to cast ballots either accepting or rejecting plan could not be deemed an acceptance of the plan.
- 13** *In re Dunmore Homes, Inc.*, 380 B.R. 663 (Bankr. S.D.N.Y. 2008) Where debtor's only contact with forum was its incorporation in state, case was transferred to Eastern District of California in interests of justice and convenience of parties since majority of debtor's assets, all but one of its top 30 creditors, all of its remaining employees and majority of its professionals, were located there. Further, New York court's familiarity with the case was not critical because objective was an orderly wind-down and sale of assets.
- 14** *In re Touch America Holdings, Inc.*, 381 B.R. 95 (Bankr. D. Del. 2008) Claims by debtors' former officers and directors for indemnification against liability and costs associated with ERISA action against them were subordinated under Section 510(b) as claims for damages arising from the purchase or sale of the debtor's securities because ERISA claims were based on the lost value of the stock that the plaintiffs received by their participation in the ERISA plan.