VIEWPOINT

U.S. Energy Ruling Could Invite Further Shareholder Litigation

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One of a series of opinion columns by bankruptcy professionals.

It is hard to conceive of an event more distracting and potentially damaging to a chapter 11 debtor than scheduling and conducting a shareholder meeting that threatens to unseat the company's board and management. Such an event could alter not only the corporate structure and governance of a debtor, but could undermine the confidence of employees, vendors and customers at an especially tenuous time in the company's corporate life.

In light of these facts, is the scheduling of a shareholder meeting a "process…against the debtor that was or could have been commenced before the commencement of the case" or an "act … to exercise control over property of the estate," either of which would represent violations of the automatic stay? Probably not, at least according to a recent decision by the Court of Chancery of the State of Delaware.

In Asher E. Fogel v. U.S. Energy Systems, Inc. et al., the Chancery Court conducted a trial to address whether U.S. Energy had terminated the plaintiff, the former CEO, pursuant to a valid board meeting. In determining that U.S. Energy's purported termination was ineffective, the Chancery Court issued an order directing U.S. Energy to schedule a shareholder meeting. Subsequent to the ruling, the plaintiff sought to modify the ruling and moved for reconsideration. However, U.S. Energy filed a voluntary petition in the United States Bankruptcy Court for the Southern District of New York before the Court could rule on the motion.

After commencement of the chapter 11 case, the Chancery Court held a hearing to determine whether it would schedule the previously ordered shareholder meeting. The plaintiff argued that the shareholder meeting should be scheduled and conducted in accordance with the Chancery Court's prior order, notwithstanding the intervening chapter 11 case, because it involved a ministerial act that was not barred by the automatic stay. The debtor, on the other hand, countered that the automatic stay barred the very meeting that the Chancery Court had already found was necessary. In the alternative, the debtor suggested that if the Chancery Court had misgivings about determining the applicability of the automatic stay, it should allow the bankruptcy court to resolve that issue.

In a decision rendered on January 15, 2008, the Chancery Court determined that the automatic stay was not applicable and that it could and would schedule the shareholder meeting. In rejecting the debtor's arguments, however, the Court initially disagreed with the plaintiff's argument that the scheduling of a shareholder meeting was a mere ministerial act that was excepted from the breadth of the automatic stay. Noting that a "ministerial act" was more akin to a clerical act or similar responsibility of the Court, the Chancellor determined that choosing a date required the "exercise [of] some discretion and is probably more than merely clerical."

Having made such determination, the Court then moved on to the substance of the decision - whether the scheduling of the meeting rose to a level that was barred by the mandate of section 362(a) of the Bankruptcy Code. The Court looked first to the decision of the Chancery Court in NKFW Partners v. Saxon Industries, Inc., C.A. No. 7468 1984 WL 8234 (Del. Ch. Aug. 8, 1984), in which then-Vice-Chancellor Berger found that the authority of shareholders to exercise their rights to control a company "will not be disturbed unless a clear case of abuse is made out." Then, citing to the decision of the Delaware Supreme Court in Saxon, which affirmed the Chancery Court ruling, Chancellor Chandler recognized that "absent other compelling legal or equitable factors, insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporate of their right to exercise the powers for corporate democracy."

The Chancery Court traced the rationale for Saxon to the decision of the Second Circuit Court of Appeals' in In re J.P. Linahan, Inc., 111 F. 2d 590 (2d Cir. 1940), which was

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re-affirmed by the Second Circuit in In re Johns-Mansville Corp., 801 F.2d 60 (2d Cir. 1986) (reversing the district court's attempt to supplant the Saxon rule). In Johns-Manville, the Second Circuit went further and supplemented the rulings in Saxon to hold that a finding of clear abuse turned on "whether rehabilitation [of the debtor] will be seriously threatened, rather than merely delayed." Having traversed the legal landscape regarding the issue and the possible conflict between shareholder corporate governance rights and the Bankruptcy Code, the Chancery Court in U.S. Energy concluded that scheduling a shareholder meeting was not barred by Title 11 and did not "impair the rehabilitative process," especially since there was "no showing whatsoever" of abuse by the movant. As such, the Court saw no reason to abstain from determining the issue in favor of the bankruptcy court, and ordered the parties to schedule a shareholder meeting.

At first glance, the decision in U.S. Energy would appear to be an unadorned ruling on a narrow issue that had not been adjudicated in more than 20 years - whether the Chancery Court can direct the scheduling of a meeting that was already ordered prior to commencement of the chapter 11 case. But the Court engaged in a much broader discussion of the intersection of chapter 11 and corporate governance. What might have been resolved with a brief unambiguous order evolved into a discussion of the disenfranchisement of shareholders in chapter 11 and a more far- reaching ruling that (i) the Chancery Court is the proper forum to address corporate governance issues as they may be impacted by the automatic stay, (ii) the filing of a chapter 11 case does not, in and of itself, divest shareholders of their right to "exercise their rights of corporate democracy," and (iii) absent some clear showing of abuse, which need likely rise to such a level as to "seriously threaten the rehabilitation of the debtor," the rights of shareholders in respect of shareholder meetings will not be disturbed.

The ruling has potentially wider implications, raising perhaps more questions than answers provided. The most important of these unanswered questions is the extent to which other corporate governance matters are outside the ambit of chapter 11 and the automatic stay. Many company charters and by-laws have complex shareholder (and preferred shareholder) rights designed to permit investors to acquire greater control of companies under certain circumstances.

While ultimately the applicability of the automatic stay to corporate governance matters must await a case-by-case determination (particularly as to the purpose of the action sought to be taken and its relation to potential abuse), it appears that the Chancery Court was upholding as paramount the principle of shareholder democracy and the concomitant actions that shareholders might take at duly convened shareholder meetings, and not holding more generally that any rights of corporate governance (such as non-meeting-related rights embedded in charters and by-laws) could be exercised notwithstanding the automatic stay.

What is clear is that the U.S. Energy ruling will invite further litigation of these issues and in some cases, if shareholder meetings are able to affect the makeup of company boards, could well threaten the viability of otherwise lawfully-commenced chapter 11 cases. In fact, as of the date hereof, U.S. Energy has filed a motion seeking a declaration from the Bankruptcy Court that the shareholder meeting is effectively enjoined by the automatic stay and that the mandate of the Chancery Court is void, which motion is scheduled for hearing on February 4th.

(Opinions expressed are those of the authors, not of Dow Jones Newsletters.)

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