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Shareholder Derivative Suit Dismissed for Lack of Jurisdiction Following Cancellation of Debtor's Stock in Bankruptcy Case

As part of a plan of reorganization under Chapter 11 of the Bankruptcy Code, a debtor will often seek to release its officers and directors of claims that the debtor or its estate would have been entitled to assert against them. Such a release seems particularly appropriate where the officers and directors will continue working for the reorganized debtor and where the debtor, as part of the plan of reorganization, agrees to indemnify the officers and directors.

There exists a dispute among courts, however, as to whether such releases are permissible under the Bankruptcy Code. Some courts hold that 11 U.S.C. §524(e) does not permit a debtor to release non-debtor officers and directors. See, e.g., *In re Lowenschuss*, 67 F.3d 1394, 1401 (9th Cir. 1995), cert. denied, 517 U.S. 1243 (1996); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601 (10th Cir. 1990). Other courts do not read section 524(e) so restrictively and, pursuant to 11 U.S.C. §§105(a) and/or 1123(b)(3)(A), have found that such releases are permissible under a narrow set of circumstances if they are necessary or appropriate to effectuate a reorganization. See, e.g., *In re Continental Airlines*, 203 F.3d 203, 214 (3rd Cir. 2000); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293 (2d Cir. 1999); *In re A.H. Robins Co.*, 880 F.2d 694, 702 (4th Cir. 1989).

For releases of shareholder derivative claims, however, the debate regarding non-debtor releases may be much ado about nothing. A recent decision by the United States Court of Appeals for the Federal Circuit has held that shareholder derivative suits will be dismissed for lack of standing if a debtor's stock is canceled pursuant to a Chapter 11 plan of reorganization. See *Johnson v. United States*, 2002 U.S. App. LEXIS 24463 at *6-7 (Fed. Cir. Dec. 3, 2002).

Michael M. Johnson was the sole shareholder and vice-president of Johnson Properties, Inc. (JPI), which owned and operated sewage and water treatment plants in Louisiana and several other states. The EPA and state of Louisiana sued JPI, claiming violations of the Clean Water Act and state law violations. The U.S. District Court for the Western District of Louisiana (the District Court) entered a consent decree negotiated by JPI and the respective state and federal governments, requiring JPI to take immediate remediation steps. When the EPA discovered 661 violations of the consent decree, the EPA and the state of Louisiana petitioned the District Court for the appointment of a receiver to ensure JPI's compliance with the consent decree.

While the petition for the appointment of a receiver was pending, JPI filed for bankruptcy in the Bankruptcy Court for the Middle District of Louisiana (the Bankruptcy Court). The Bankruptcy Court found that the automatic stay did not apply to the enforcement action pending in the District Court and eventually appointed a trustee to oversee the reorganization. The District Court then granted the petition of the EPA and the state of Louisiana

> Shareholder plaintiff in derivative suit must hold stock when claim is filed and throughout the suit.

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and appointed the bankruptcy trustee as the receiver to ensure compliance with the consent decree. The District Court granted the receiver expansive discretionary powers to do whatever was necessary to effect compliance with the consent decree, including authority to sell corporate property and to "manage, control, convey, liquidate, and deal with all items, assets, properties, contracts and other matters incident to the Receiver's responsibilities." The order also prohibited Johnson from interfering with the receiver in the discharge of his duties. Meanwhile, in JPI's bankruptcy proceeding, the Bankruptcy Court confirmed a reorganization plan that provided for the cancellation of all equity interests in JPI.

After the appointment of the receiver, Johnson filed a complaint, as a shareholder on behalf of JPI, in the Court of Federal Claims, alleging that the appointment of a receiver with such broad powers constituted a taking under the Fifth Amendment of the U.S. Constitution. The Court of Federal Claims found that in the context of JPI's bankruptcy, Johnson could not bring a shareholder action unless the bankruptcy trustee abandoned the claim. Since the trustee had not abandoned the claim, Johnson could not maintain the takings claim.

On appeal, relying on Fed. R. Civ. P. 23.1 and case law interpreting the rule, the Federal Circuit Court found that a plaintiff bringing a derivative action in the Court of Federal Claims must be a shareholder at the time the suit is brought and maintain such shareholder status throughout the course of litigation. Although Fed. R. Civ. P. 23.1 does not explicitly require that a derivative plaintiff retain ownership for the duration of the lawsuit, the Federal Circuit Court found that courts have inferred the requirement from its language. See *Johnson*, 2002 U.S. App. LEXIS 24463 at *6 (citing *Schilling v. Belcher*, 582 F.2d 995, 996 (5th Cir. 1978); *Lewis v. Chiles*, 719 F.2d 1044, 1047 (9th Cir. 1983); cf., *Furst v. Fenberg*, 2002 U.S. App. LEXIS 26174 (3rd Cir. Dec. 18, 2002) (noting that "shareholders who sell their shares always forfeit the right to sue in derivative claims"). According to the Federal Circuit Court, because Johnson's shares were canceled under a plan of reorganization in bankruptcy, Johnson did not maintain his shareholder status and had no standing to bring the takings claim.

This result seemingly obviates the debate over whether releases of potential shareholder derivative claims may be included in Chapter 11 plans that cancel equity interests in a debtor. Under the *Johnson* decision, upon the cancellation of the equity interests in the debtor, only the debtor's estate could maintain standing to pursue the claims that shareholders might have otherwise pursued derivatively. Since section 1123(b)(3) of the Bankruptcy Code explicitly provides for the settlement or adjustment of any claim or interest belonging to the debtor or the estate as part of a plan of reorganization, a debtor's release of shareholder derivative claims under a plan of reorganization should not implicate section 524(e) of the Bankruptcy Code.

–Dennis Jenkins
–George Shuster

Termination Damages under Swap Agreement Are Not Unmatured Interest under 11 U.S.C. §502(b)(2)

In *Thrifty Oil Co. v. Bank of America National Trust and Savings Association*, No. 00-56159 (9th Cir. Nov. 19, 2002), the United States Court of Appeals for the Ninth Circuit held that a claim for "termination damages" under an interest rate swap agreement does not constitute unmatured interest disallowed by 11 U.S.C. §502(b)(2). Interestingly, the court found that the resolution of the issue turned not on economic theories of interest but on equitable principles and bankruptcy policy. According to the court, the policies underlying section 502(b)(2) of the Bankruptcy Code, are not frustrated where a lender provides a standard interest rate swap to a sophisticated borrower for a legitimate non-bankruptcy purpose.

Allowing a lender's claim for swap agreement termination damages "offends none of the principles and policies of Section 502(b)(2)."

In *Thrifty*, Golden West Refining Company (GWR) entered into a secured, floating interest rate, term loan agreement with Bank of America (BofA). Contemporaneously, GWR and BofA entered into three separate swap agreements. The swaps were in the same notional amount as the term loan, for the same term, and followed approximately the same amortization schedule. In effect, the transaction provided GWR with fixed-rate financing for the term loan. When GWR and its parent, Thrifty Oil Co. (Thrifty) filed for bankruptcy protection, BofA filed a claim, seeking to collect the termination damages under the three swaps.

Thrifty, as a guarantor, objected to the claim, arguing that the termination fee constituted unmatured interest because the swaps and term loan, viewed together, formed an integrated transaction designed to provide GWR with fixed rate financing. The Court of Appeals, adopting the decision of the district court, disagreed.

The court found that strong bankruptcy policy and several provisions in the Bankruptcy Code, including 11 U.S.C. §§ 362(b)(17), 546(g), and 548(d), favored protecting interest rate swaps, termination damages and the swap market from the effects of bankruptcy. According to the court, a claim for swap termination damages filed by a non-lending swap dealer could not implicate section 502(b)(2). By analogy, the court found that "where the lender provides a standard interest rate swap to a sophisticated borrower and the swap serves a legitimate non-bankruptcy purpose, the lender's claim for termination damages is, for all purposes, indistinguishable from a claim filed by a non-lending swap dealer. Allowing the lender to collect termination damages in such a case offends none of the principles and policies of section 502(b)(2)." Finding that the GWR swap agreements met these requirements, the court concluded that Thrifty's section 502(b)(2) objection was properly rejected.

As an alternative claim, Thrifty argued that the interest rate swaps violated California's Bucket Shop Law, and, therefore, the court should have found the interest rate swaps unenforceable and should have disallowed the swap claim. The term "bucket shop" refers to illegitimate gambling operations common at the end of the nineteenth century that permitted investors to place bets based on fluctuations in the market prices of stocks and commodities. Many states, including California, responded to these abuses by enacting laws to eradicate bucket shops. The court rejected Thrifty's arguments, finding that California's Bucket Shop Law was preempted by the Futures Trading Practices Act of 1992.

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