

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

IN RE:) In Proceedings
) Under Chapter 7
 ULY-PAK, INC.,)
) No. BK 89-40188
)
 Debtor(s))

 MUNNS MEDICAL SUPPLY COMPANY,)
 INC., and WILLIAM G. MUNNS,)
)
 Plaintiffs,)
)
 v.) ADVERSARY NO.
) 89-0249
 ULY-PAK, INC., H. KEITH)
 HOWARD, RETHA M. HOWARD,)
 and RONALD E. OSMAN,)
)
 Defendants.)

REPORT AND RECOMMENDATION

On February 13, 1989, Munns Medical Supply Company and William G. Munns (hereinafter referred to collectively as "Munns") filed a complaint in the state court of Shawnee County, Kansas, against Uly-Pak, Inc. ("Uly-Pak"), Keith and Retha Howard, and Ronald Osman. On February 24, 1989, Uly-Pak filed its Chapter 11 bankruptcy petition with this Court. A trustee was appointed to liquidate the assets of the debtor and to collect accounts receivable of the debtor, and the Chapter 11 case was converted to a case under Chapter 7. All that remains in the case is for the trustee to make distribution to unsecured creditors following a determination of claims against the estate.

On April 17, 1989, defendants Howards and Osman filed an application for removal of plaintiffs' action with the United

States Bankruptcy Court for the Southern District of Kansas and a motion to transfer venue to the Southern District of Illinois. See 28 U.S.C. §1452, Bankr. Rules 9027, 1014. In seeking removal, defendants asserted that this Court has subject matter jurisdiction of plaintiffs' action as a proceeding "related to" the debtor's bankruptcy case under 28 U.S.C. §§157(c)(1) and 1334(b). Munns filed a motion with the Kansas bankruptcy court for remand and abstention and for relief from the automatic stay, and that court transferred the proceedings to this Court for disposition of Munns' motion.

Plaintiffs' complaint consists of four counts. Count I, for breach of contract, is directed against the debtor Uly-Pak alone, while Count IV, alleging securities fraud, is directed against both the debtor and the individual defendants, the Howards and Osman, as officers and directors of Uly-Pak. Count II, alleging tortious interference with contract, and Count III, alleging breach of fiduciary duties, are directed against the individual defendants alone.

The complaint alleges that plaintiffs, who held shares of common stock of the debtor Uly-Pak, have been damaged by defendants' actions regarding a shareholder agreement for the purchase of the debtor's stock. The agreement, entitled "Redemption Buy-Sell Agreement, Stock Purchase Agreement," provides for the purchase of stock of a shareholder upon the shareholder's death and further provides that in the event of the insolvency of Munns, "its shares shall be subject to the agreement in the same manner as if a shareholder had deceased."

Count I of the complaint alleges that Uly-Pak, having received notice of Munns' insolvency on August 29, 1988, refused to purchase

Munns' shares and engaged in transactions to reduce the proportion of stock held by Munns in violation of the agreement. Count II, directed against the individual defendants, alleges that the Howards and Osman intentionally and tortiously interfered with the agreement as it related to Munns "by taking action to cause Uly-Pak to not honor its obligations under the agreement and to reduce the purchase price per share under the agreement."

Count III of the complaint alleges that the individual defendants, the Howards and Osman, breached their fiduciary duties as officers, directors, and controlling shareholders of Uly-Pak by issuing stock to themselves at reduced prices, thereby increasing their voting power and interests in Uly-Pak to the detriment of Munns and other shareholders. Count IV alleges further that the stock sales to the individual defendants violated Kansas securities laws in that the defendants provided inadequate information to shareholders and failed to register or otherwise qualify for exemption from registration under applicable securities laws.

In their motion for remand, plaintiffs argue that removal is improper because this Court lacks subject matter jurisdiction over the claims against defendants Howards and Osman asserted in Counts II, III, and IV. Plaintiffs assert that the liability of the individual officers and directors is separate and distinct from that of the debtor corporation and that the outcome of the litigation against the individuals will neither benefit nor harm the bankruptcy estate so as to make these claims "related to" the debtor's bankruptcy case. In the alternative, plaintiffs assert that

even if removal was proper, this Court should abstain from hearing the removed action under the provisions for either mandatory or permissive abstention. See 28 U.S.C. §1334(c)(2) and (1), respectively.

Defendants Howards and Osman oppose the motion for remand, arguing that they have properly invoked the subject matter jurisdiction of this Court by removal from the Kansas state court. Defendants assert that, while Count II is directed against them individually and not against the debtor corporation, determination of their liability or non-liability on this count will affect the bankruptcy estate because the individual defendants, as officers and directors of the debtor, may assert a claim for indemnification against the debtor for any judgment entered against them. Defendants note further that plaintiffs have each filed proofs of claim as unsecured creditors in the debtor's bankruptcy case and that any recovery against the individual defendants will affect the amount of these claims. Finally, defendants assert that to the extent Counts III and IV plead a cause of action for breach of fiduciary duties by them as directors of the corporation, they set forth derivative causes of action which are property of the bankruptcy estate and are, thus, an integral part of the debtor's bankruptcy proceeding.

Federal court jurisdiction over bankruptcy matters derives from 28 U.S.C. §1334, which grants the district courts original and exclusive jurisdiction of all cases under title 11 (section 1334(a)) and

original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.

28 U.S.C. §1334(b) (emphasis added). Upon referral by the district

court, the bankruptcy court is empowered to exercise such jurisdiction over cases and proceedings as specified in 28 U.S.C. §157. Under that section, the bankruptcy court may hear "core" proceedings described in section 157(b) and also noncore proceedings that are "otherwise related to" a bankruptcy case. 28 U.S.C. §157(c)).

The Seventh Circuit has determined that a proceeding is "related to" a bankruptcy case for purposes of section 157(c) when its resolution "affects the amount of property available for distribution or the allocation of property among creditors." Matter of Xonics, Inc., 813 F.2d 127, 131 (7th Cir. 1987); see Home Insurance Co. v. Cooper, 889 F.2d 746 (7th Cir. 1989). If the outcome of a dispute could affect only nondebtor parties and have no effect on the administration of the bankruptcy estate, no jurisdiction arises under section 157(c). Pacor, Inc. v. Higgins, 743 F.2d 984 (3rd Cir. 1984). Section 157(c) should be read narrowly not only out of respect for Article III but also to preserve the jurisdiction of state courts over questions of state law involving persons not party to the bankruptcy. Home Insurance Co. Thus, overlap between the bankrupt's affairs and another dispute is insufficient unless its resolution also affects the bankrupt's estate or the allocation of its assets among creditors. Id.

In the instant case, defendants contend that this Court has jurisdiction over Count II of the complaint directed against them individually because they may seek indemnification from the corporate debtor in the event of a finding of liability on the tortious interference with contract claim. Defendants allege no contractual right of indemnification but, rather, claim entitlement to

indemnification under Kansas statute.¹

Section 17-6305 of the Kansas statutes grants a corporation the power to indemnify an officer or director that becomes party to a lawsuit by virtue of his status as officer or director of the corporation.² The right to indemnification, however, is not automatic

¹The shareholder agreement at issue provided that it would be construed pursuant to Kansas law, and both parties acknowledge that Kansas law is applicable to this lawsuit.

²Section 17-6305 provides in pertinent part:

(a) A corporation shall have power to indemnify any person who was or is a party...to any...suit...by reason of the fact that he is or was a director [or] officer...of the corporation,...if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation....

(b) A corporation shall have power to indemnify any person who was or is a party...to any...suit by or in the right of the corporation...by reason of the fact that he is or was a director [or] officer...of the corporation, if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the corporation and except that no indemnification shall be made in respect of any claim, issue or matter as to which such Person shall have been adjudged to be liable for negligence or misconduct in the performance of his duty to the corporation unless and only to the extent that the court...upon application... [determines otherwise].

(c) To the extent that a director [or] officer...of a corporation has been successful on the merits...in defense of any...suit...referred to in subsections

but lies with the discretion of the corporation. Subsections (a) and (b) of the statute require that the corporation affirmatively agree to indemnify officers and directors,, and subsection (c), which incorporates these subsections, likewise requires that the corporation agree to indemnify an officer or director before he will be compensated for expenses incurred in litigation. Even if the corporation has so agreed, indemnification is only proper if the officer or director has acted in good faith or in the best interests of the corporation as determined by a vote of disinterested directors or stockholders (subsection (d)) and is not available in any event if the officer or director is adjudged to be liable for negligence or misconduct in his performance of corporate duties and is not found to be otherwise entitled to indemnification (subsection (b)).

While the Kansas statute allows for indemnification of officers and directors if the corporation so determines, the bylaws of the corporate debtor, Uly-Pak, contain no such provision. The defendants

(a) and (b)..., he shall be indemnified....

(d) Any indemnification under subsections (a) and (b)...shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the director [or] officer...is proper in the circumstances because he has met the applicable standard of conduct set forth in subsections (a) and (b). Such determination shall be made (1) by...a majority vote of [directors] who were not parties to such...suit..., or (2) ...by independent legal counsel..., or (3) by the stockholders.

Kan.Stat.Ann. §17-6305 (emphasis added).

Howards and Osman, therefore, would not be entitled to indemnification from the corporation unless the corporation were to affirmatively authorize such indemnification, which would be unlikely given its status as a debtor in bankruptcy. The individuals would not be entitled to indemnification in any event unless it were determined that they had acted in good faith or had otherwise met the standards of conduct specified in subsections (a) and (b). Since the corporation has made no provision for indemnification pursuant to statute, the individual defendants have, at best, only a possibility of indemnification if all the conditions of the statute are met.

An action against a nondebtor third party will not be found to have an effect on the administration of the debtor's estate so as to come within the subject matter jurisdiction of the bankruptcy court if the action raises a mere possibility of a third party claim for indemnification against the debtor. Pacor, Inc. v. Higgins, 743 F.2d 984. In Pacor, the court found that a state court action against a distributor of the debtor's products was not related to the debtor's bankruptcy proceeding even though the distributor might, in the event of a judgment against it, seek indemnification against the debtor as manufacturer of the product. The court stated:

The fact remains that any judgment received by the plaintiff [in the state court action] could not itself result in even a contingent claim against [the debtor], since [the distributor] would still be obligated to bring an entirely separate proceeding to receive indemnification.

743 F.2d at 995. The court distinguished the situation presented, in which the state court action was a "mere precursor to the potential

third party claim for indemnification [against the debtor]", from a situation in which a judgment against the nondebtor third party would automatically result in indemnification liability against the debtor because the debtor had "contractually agreed to indemnify [the third party] for any liability or judgments incurred...." Id.; see In re Brentano's, 27 B.R. 90 (Bankr. S.D. N.Y. 1983).

In the instant case, as in Pacor, a judgment against the individuals on Count II would not result in liability on the part of the debtor, as the corporation has not agreed to indemnify the individual defendants by contract and has not chosen to indemnify the defendants pursuant to statute. The individuals' potential claim for indemnification against the corporation is too tenuous and uncertain to render the plaintiffs' action against them "related to" the debtor's bankruptcy proceeding, and the Court rejects this argument as a basis of subject matter jurisdiction over Count II.

As an alternative basis of jurisdiction as to Count II, defendants argue that recovery on Count II of the complaint against the individual defendants would lessen plaintiffs' claims against the debtor's bankruptcy estate, thereby affecting the amount of property available for distribution to unsecured creditors. As stated previously, both Munns Medical Supply, Inc., and William G. Munns have filed proofs of claim in the debtor's bankruptcy case. One of the claims is for an unliquidated amount of damages arising from the debtor's breach of the shareholder agreement as alleged in Count I of the plaintiffs' complaint. Defendants assert that recovery against the individual defendants on the tortious interference with contract claim

of Count II would necessarily reduce the estate's exposure on the breach of contract claim of Count I so that this Court's jurisdiction over Count II would be properly invoked.

A breach of contract claim is closely related to an action for tortious interference with contract arising from the same transaction. Modern cases generally hold that the availability of a remedy against the party who breaks the contract is no defense to the one who induces the breach, since both are wrongdoers and are liable for the loss. W. Prosser, *Handbook of the Law of Torts*, §129, at 948 (4th ed. 1971) (hereinafter *Prosser on Torts*); see D. Dobbs, *Handbook on the Law of Remedies*, §6.4 (1973) (hereinafter *Dobbs on Remedies*). In many instances, the measure of damages will be the same against both the contract breaker and the tortfeasor who induced the breach, although the tortfeasor may be subjected to more extensive special damages if the requisite intent is found. *Dobbs on Remedies*, at 460-64; see *Hess v. Jarboe*, 201 Kan. 705, 443 P.2d 294 (1968).

The contract breaker and the tortfeasor are not joint and severally liable, and a second recovery is not barred on the technical ground that joint and several tortfeasors are involved. However, a double recovery is against legal policy, and to the extent that the plaintiff first recovers a judgment against the contract breaker and gets it satisfied, he would be barred from claiming those same damages from the tortfeasor. *Dobbs on Remedies*, at 464. Presumably, the converse is also true, so that recovery from the tortfeasor would reduce the contract breaker's liability for damages on the breach of contract claim, at least to the extent the measure of damages is the

same.

In the instant case, plaintiffs have sued both the alleged contract breaker (Uly-Pak) and the alleged tortfeasors (the Howards and Osman) in the same suit, and there has, as yet, been no determination of liability on either count.³ Given the close interrelation between these two causes of action, it is possible that plaintiffs may recover against the individual defendants on the tort claim, thereby reducing the debtor's exposure on the breach of contract claim. Since plaintiffs' claim against the estate would be correspondingly reduced, there would be more estate assets for payment to unsecured creditors. Because of the possible effect on the amount of property available for distribution in the debtor's bankruptcy case, the Court finds that it has subject matter jurisdiction over Count II of plaintiffs' complaint against the individual defendants.

The remaining counts as to which this Court's jurisdiction is challenged, Counts III and IV, likewise assert claims against the nondebtor defendants, and the Court must determine whether these counts are sufficiently "related to" the debtor's bankruptcy proceeding to come within its jurisdiction. Count III contains allegations that the individual defendants acted beyond the scope of their authority or breached their fiduciary duties as officers, directors, and controlling

³Liability on the breach of contract count (Count I) is not a condition precedent to a finding of a liability on the tortious interference count (Count II). A tortfeasor may be held liable for inducing breach of a contract which is not valid or not enforceable, since without his interference the contract may have been voluntarily performed by the parties to it. See Dobbs on Remedies, at 460; Prosser on Torts, at 932 (citing Jackson v. O'Neill, 181 Kan. 930, 317 P.2d 440 (1957)).

stockholders of the debtor corporation. As such, it constitutes a derivative action which, once the corporation has filed for bankruptcy, becomes property of the estate and is enforceable by the trustee on behalf of the corporation and its creditors. See Koch Refining v. Farmers Union Central Exchange, 831 F.2d 1339 (7th Cir. 1987); Delgado Oil Co. v. Torres, 785 F.2d 857 (10th Cir. 1986); 4 Collier on Bankruptcy, §541.10[8] (15th ed. 1989). Since the trustee has not abandoned this cause of action, plaintiffs Munns are stayed from pursuing the claim for themselves as individual creditors under section 362 of the Bankruptcy Code. 11 U.S.C. §362; see St. Paul Fire and Marine Insurance Co. v. Pepsico, Inc., 884 F.2d 688 (2nd Cir. 1989); Koch Refining.

At this point in the proceedings, Count III may be subject to dismissal based on plaintiffs' lack of standing. See Koch Refining. Because Count III represents property of the estate, however, it necessarily comes within this Court's subject matter jurisdiction. In the event the trustee chooses not to pursue this action and it is abandoned from the estate, the Court may be required to reconsider the issue of its jurisdiction presuming plaintiffs still wish to pursue this claim against the individual defendants.

Count IV, finally, is asserted against both the individual defendants and the debtor corporation. Plaintiffs contend that this claim is like those in Wayne Film Systems Corp. v. Film Recovery Systems Corp., 64 B.R. 45 (N.D. Ill. 1986), wherein no jurisdiction was found over an action brought against the corporate debtor and its officers, directors and shareholders. Plaintiffs assert that here, as

in Wayne Film Systems, the claims go to the liability of the individual defendants and, if successful, will not benefit the estate but will only cause detriment to the individual defendants.

In Wayne Film Systems, the court stated:

Stripping the complaint to its essence, Wayne, realizing that its debtor FRS has few assets, is attempting to extend liability to FRS' officers, directors and shareholders (the third-party defendants) under various theories While FRS and the trustee are named as defendants, Wayne has asserted that it is really after the other defendants, and that FRS and the trustee should actually be plaintiffs in this action.

64 B.R. at 48.

Unlike in Wayne Film Systems, the bankruptcy estate of the debtor Uly-Pak has substantial assets remaining for distribution to creditors, and there has been no indication that plaintiffs, by joining the debtor as a defendant, are not seeking recovery from the debtor as well as the individual officers and directors. Any recovery against the debtor under Count IV would obviously affect the amount of property available for distribution to creditors. Further, since Count IV seeks recovery from the debtor and the individual defendants "jointly and severally," a determination as to the liability of the individual defendants would affect the debtor's liability as well. Thus, administration of the debtor's estate would be affected by the outcome of the litigation on Count IV, and the Court has proper subject matter jurisdiction over this count.

Having found that it has jurisdiction over the matters alleged in plaintiffs' complaint, the Court must consider whether it should nevertheless abstain from hearing the action under the abstention

provisions of 11 U.S.C. §1334(c). Section 1334(c)(2) provides for mandatory abstention where (1) a proceeding is based on a state law cause of action, (2) it is a noncore or "related to" proceeding and not one arising under Title 11 or arising in a case under Title 11, (3) there is no independent basis for federal jurisdiction, (4) an action has been commenced in state court, and (5) it can be timely resolved there. 11 U.S.C. §1334(c)(2).

Mandatory abstention is not warranted in this case in which at least one of the counts of the complaint (Count III) represents property of the estate and so is not merely "related to" the debtor's bankruptcy case but is a core proceeding. See 11 U.S.C. §157(2)(0). Moreover, while a state court action had been commenced approximately 11 days prior to the debtor's bankruptcy filing, no rulings have been made in that action, and it is not evident that the action can be timely resolved there. Cf. In re Commercial Oil Service, 58 B.R. 311 (Bankr. N.D. Ohio 1986): mandatory abstention proper where trial date had been set in state court action and could be timely adjudicated there; In re Baumgartner, 57 B.R. 517 (Bankr. N.D. Ohio 1986): section 1334(c)(2) applicable where action in state court was in such procedural posture that only act which remained was journalization of entry by state court; In re Horace, 54 B.R. 671 (Bankr. D. N.J. 1985): abstention required under section 1334(c)(2) where state court action was so far advanced that it could be timely adjudicated there. Defendants Howards and Osman have indicated that, in the event of remand to the Kansas state court, they would strongly challenge that court's personal jurisdiction, and the action might have to be

dismissed and refiled in Illinois state court. The Court finds, therefore, that the elements for mandatory abstention are not present in this case and that abstention is not required under section 1334(c)(2).

Plaintiffs assert that, even if mandatory abstention is not applicable, the Court should abstain under the discretionary abstention provision of section 1334(c)(1) so that their related state law claims may be litigated in state court. Section 1334(c)(1) allows for abstention "in the interest of justice, or in the interest of comity with state courts or respect for state law." 11 U.S.C. §1334(c)(1).

One of the factors cited by courts in considering whether abstention should lie is the effect or lack thereof on the efficient administration of the bankruptcy estate if a court recommends abstention. See In re Republic Reader's Service, Inc., 81 B.R. 422 (Bankr. S.D. Tex. 1987). In the present case, the assets of the debtor have been sold and the accounts receivable substantially collected. Having liquidated the estate assets, the trustee is prepared to begin making distribution to creditors following determination of two groups of unliquidated claims. Munns' claims, as set forth in their complaint, represent one of these groups of claims. While the bankruptcy case in this Court is moving toward completion, no action has been taken in the state court toward resolution of plaintiffs' complaint. Remand to the state court at this point would undoubtedly delay determination of claims that will have a substantial impact on administration of the debtor's estate. The posture of this case, therefore, strongly favors resolution of plaintiffs' related claims in

this Court.

Another factor to be considered is the extent to which state law issues predominate over bankruptcy issues in the related proceeding and the difficulty or unsettled nature of the applicable state law. Id. There has been no showing that plaintiffs' complaint raises difficult or unsettled questions of state law that should be considered by the state court as a matter of comity or respect for state law. The contract law issues pertaining to the debtor's shareholder agreement and the corporate law issues based on the Kansas Uniform Business Corporation Act are matters well within this Court's competence, and, to the extent issues of the debtor's and Munns' insolvency are involved, the Court may be particularly suited to decide the issues in plaintiffs, complaint.

Having considered the factors relevant to discretionary abstention under section 1334(c)(1), the Court finds no reason to abstain from hearing the removed action at this point. The Court, however, would be inclined to abstain and remand the entire case if, at some later stage of the proceeding, it were to lose subject matter jurisdiction over one of the counts of plaintiffs' complaint. The Court must satisfy itself at every stage of a proceeding that its jurisdiction is proper. See Delgado Oil Co. v. Torres, 785 F.2d 857 (10th Cir. 1986). If, for example, the debtor corporation were found to have a valid defense on the breach of contract claim of Count I, the basis of the Court's jurisdiction over both Counts I and II would be eliminated, since the debtor would no longer be liable on the contract itself and there would be no relationship between the tortious interference with contract

claim of Count II and the debtor's liability on Count I.⁴ Rather than severing these counts and remanding the case piecemeal to the state court, the Court would find remand of the entire case to be appropriate to prevent waste of judicial resources in duplicitious litigation.⁵

For the reasons stated, this Court finds that it has subject matter jurisdiction over the counts alleged in plaintiffs' complaint and respectfully recommends to the District Court that it deny plaintiffs' motion seeking remand to the state court and further deny plaintiffs' motion seeking an order for abstention. See Bankr. Rules 5011, 9027.

_____/s/ Kenneth J. Meyers_
U.S. BANKRUPTCY JUDGE

ENTERED: March 12, 1990

⁴Plaintiffs' counsel has indicated that, if the corporation is legally prohibited from performing the contract, plaintiffs will join the other shareholders on the breach of contract claim of Count I.

⁵This presumes, of course, that Count III, which the Court has found is property of the estate, would have been dismissed based on plaintiffs' lack of standing or that the Court would have lost jurisdiction over Count III upon abandonment of this cause of action by the trustee.