

Fiduciary Duty Claims Held Non-core and Subject to Jury Trial

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Are claims for breach of fiduciary duty and aiding and abetting breach of fiduciary duty against an officer and director of a debtor core proceedings under 28 U.S.C. Section 157(b)? Are such claims subject to trial by jury? In [*The Official Committee of Unsecured Creditors of Allied Systems Holdings v. Black Diamond Opportunity Fund II LP \(In re Allied Systems Holdings\)*](#), Adv. Pro. No. 13-50530 (CSS) (Bankr. D. Del. Jan. 28, 2015), a recent decision by U.S. Bankruptcy Judge Christopher Sontchi of the District of Delaware, the court held that such claims were not core proceedings and were legal in nature, rather than equitable, such that they were amenable to a jury demand.

The bankruptcy proceedings in question began as an involuntary proceeding against Allied Systems Holdings Inc. and its subsidiary, but thereafter the alleged debtors consented to the involuntary petitions. The U.S. trustee appointed an official committee of unsecured creditors, which commenced an adversary proceeding against Mark Gendregske, the chief executive officer and a director of Allied, for breach of fiduciary duty and aiding and abetting breach of fiduciary duty. The gravamen of the committee's claims was that Gendregske acted at the behest of and in concert with several investment funds (Yucaipa) that held a majority of Allied's equity and were responsible for appointing him as CEO and a director of Allied, in furtherance of a scheme to take control of the debtors. The committee alleged that Gendregske failed to take steps to protect Allied's interests. Specifically, as a member of the board and a special committee of independent directors, he failed to exercise appropriate control over Yucaipa's actions, failed to educate himself in reviewing proposed transactions, and failed to seek independent advice when reviewing transactions involving Yucaipa. Along with other directors, he failed to consider alternative transactions to save Allied that would potentially adversely affect Yucaipa's interests.

Gendregske filed a motion for a determination that the claims against him constituted non-core proceedings and a demand for jury trial. The committee opposed the core/non-core motion and moved to strike the jury demand.

Sontchi began his analysis with a review of basic principles involving the questions of jurisdiction and judicial power. With respect to jurisdiction, he noted that the district courts have original jurisdiction but not exclusive jurisdiction over proceedings in cases under Title 11, which can be further divided into proceedings that (1) arise under Title 11, (2) arise in a Title 11 case, or (3) are related to a case under Title 11. As to judicial power, district courts may refer any or all such proceedings to the bankruptcy judges in their district.

Section 157 of Title 28 provides that bankruptcy judges may hear and enter final judgments in all core proceedings under Title 11, or arising in a case under Title 11. Core proceedings include, but are not limited to, certain types of matters enumerated in 28 U.S.C. Section 157(b)(2). The bankruptcy judges' power over non-core proceedings is limited to issuing proposed findings of fact and conclusions of law that are subject to de novo review by the district court.

Sontchi noted that the U.S. Court of Appeals for the Third Circuit applies a two-step process to determine whether a claim is a core proceeding. First, the court must consult Section 157(b) to determine if the claim falls within one of the enumerated proceedings in the list of proceedings that may be considered core. Second, even if a matter is not on the enumerated list of proceedings denominated as core, a proceeding may be core if (1) it involves a substantive right provided by Title 11, or (2) it is a proceeding that by its nature could arise only in the context of a bankruptcy case.

The committee argued that the claims against Gendregske for breach of fiduciary duty and aiding and abetting breach of fiduciary duty should be treated as core proceedings because they were "inextricably intertwined" with the equitable subordination claim against Yucaipa. Gendregske argued that the committee failed to take into account the Third Circuit's two-part test for determining whether a proceeding is core or non-core.

Sontchi concluded that the claims against Gendregske were non-core. First, he noted that the claims for breach of fiduciary duty and aiding and abetting breach of fiduciary duty are not on the list of core proceedings in Section 157(b). Second, the claims are not core, because they do not invoke a substantive right provided by Chapter 11, nor do the claims arise only in the context of a bankruptcy case. Sontchi observed that the overwhelming majority of courts in the District of Delaware and other districts have concluded that breach of fiduciary duty claims do not involve the application of bankruptcy law, are ordinary state-law causes of action, and could proceed outside the bankruptcy court.

Sontchi found the committee's argument that the claims should be treated as core because they are intertwined with the equitable subordination claim against Yucaipa was not persuasive. According to Sontchi, the Third Circuit in *In re Exide Technologies*, 544 F.3d 196 (3d Cir. 2008), overruled the intertwinement argument finding that it was "legally unsound" and reasoned that "non-core claims do not become core simply by virtue of being pursued in the same litigation as core claims." Each claim within the same cause of action must be analyzed individually and each must satisfy the two-part test in order to be considered a core proceeding.

Even though the claims are non-core, the court has "related to" jurisdiction over them if their resolution could conceivably have an effect on the estate. The committee argued, and the court

agreed, that the claims against Gendregske were related to the debtors' cases because if the claims were successful, they could conceivably increase the size of the estate.

The second issue faced by the court was whether Gendregske had a right to a trial by jury of issues for which a jury trial was demanded. Sontchi looked to the test enunciated by the U.S. Supreme Court in *Granfinanciera S.A. v. Nordberg*, 492 U.S. 33, 40-41 (1989). Sontchi first considered whether the claims against Gendregske for breach of fiduciary duty and aiding and abetting breach of fiduciary duty would have been considered legal or equitable in 18th-century English courts. Relying on established case law, Sontchi found that historically speaking, actions for breach of fiduciary duty are almost uniformly actions "in equity" carrying with them no right to a trial by jury and would have been considered equitable in 18th-century English courts. Neither party appears to have contended otherwise.

Sontchi next examined the remedy sought to determine whether it was legal or equitable in nature. Here the parties sharply disagreed. The committee argued that its complaint did not limit itself to legal remedies for damages, but also sought "other and further relief as is just, proper and equitable." Gendregske argued that the relief sought was legal in nature, because it was for compensatory damages allegedly incurred by Allied. The complaint did not seek restitution nor did it allege that he was in possession of any particular funds that belonged to Allied.

Sontchi found that the relief sought by the committee was similar to that in other circumstances in which courts have concluded that the relief for breach of fiduciary duty constitutes money damages and was not equitable relief. The committee's allegations seek to impose personal liability on Gendregske, rather than to restore to Allied particular funds or property in his possession. The committee's complaint does not allege or seek a remedy that is equitable in nature, for example, restitution in the form of a constructive trust or an equitable lien. The claims seek compensatory damages, which are legal in nature. Under *Granfinanciera*, the characterization of the remedy sought as legal rather than equitable is more important and outweighs the historical analysis of the claims as legal or equitable. Accordingly, Sontchi denied the committee's motion to strike the jury demand.

The bankruptcy courts are still working out the distinction between core and non-core proceedings, a distinction made more acute by the U.S. Supreme Court's decision in *Stern v. Marshall*, 131 S.Ct. 2594, 2604 (2011). This case illustrates the application of the core/non-core distinction to claims for breach of fiduciary duty against a debtor's director and officer. Looking at the claims presented here, Sontchi held that they were non-core. More interesting, he concluded that those claims were subject to a demand for a jury trial. Those same claims, if brought in the state courts in Delaware, would be considered equitable in nature and not subject to trial by jury. However, whether a suit in federal court is legal or equitable is a question of federal law, and in this case the characterization of the requested relief as primarily legal in nature outweighed the historical treatment of such claims as equitable in the courts of England prior to the merger of law and equity.

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