1-16-2009

Order on Motion for Summary Judgment (ALAN B. THOMAS, JR.)

Alice D. Bonner
Superior Court of Fulton County

IN THE SUPERIOR COURT OF FULTON COUNTY
STATE OF GEORGIA

ALAN B. THOMAS, JR. (directly and derivatively in his capacity as a shareholder of LecStar Corporation) **and HEATHER McFARLAND** (directly and derivatively in her capacity as a shareholder of LecStar Corporation),

Plaintiffs,

v.

JOHN C. CANOUSE, STEPHEN M. HICKS, SOUTHRIDGE CAPITAL MANAGEMENT LLC, W. DALE SMITH, CACHE CAPITAL (USA), L.P., ATLANTIS CAPITAL FUND, LTD., and McCORMACK AVENUE, LTD.,

Defendants,

v.

LECSTAR CORPORATION,

as a Nominal Defendant.

CIVIL ACTION FILE
NO. 2004CV88793

Order on Motion for Summary Judgment

On December 4, 2008, Counsel appeared before this Court to present oral argument on the Motion for Summary Judgment filed on behalf of Directors W. Dale Smith and John C. Canouse as well as Southridge Defendants' Motion for Summary Judgment, or, in the alternative, Partial Summary Judgment.[1] After reviewing the

[1] Defendants Stephen M. Hicks, Southridge Capital Management LLC, and McCormack Avenue Ltd. (collectively, the "Southridge Defendants" filed their motion for summary judgment on August 29, 2003.

arguments made by counsel, the record of the case, and the briefs submitted on the motions, the Court finds as follows:

This case involves alleged securities fraud. The Plaintiffs are three (3) shareholders of the LecStar Corporation, a Texas corporation. LecStar was a publically traded company, organized in 1998, that operated as a Competitive Local Exchange ("CLEC") in the deregulated telecom environment. LecStar operated in eight states in the Southeast. LecStar Corporation is now dissolved.

LecStar Corporation had one subidiary, LecStar Communications Corporation, a Delaware corporation, which wholly owned two additional subsidiaries LecStar Telecom ("Telecom") and LecStar DataNet ("DataNet"), both Georgia corporations (collectively together with LecStar Corp. and LecStar Communications Corp. "LecStar"). Plaintiffs filed this action individually and derivatively on behalf of LecStar in 2004 against three (3) former LecStar managers, who allegedly fraudulently transferred all of LecStar's assets to Defendant McCormack Avenue Ltd., a British Virgin Islands corporation ("McCormack") for their own benefit. In addition, Plaintiffs allege that Defendant Cache Capital (USA), LP ("Cache"), owned in part by Defendant John Canouse and his brother Joseph Canouse, along with Defendants Southridge Capital Management LLC ("Southridge") and Atlantis Capital Fund. Ltd. ("Atlantis"), both entities controlled by Defendant Hicks, allegedly participated in the conspiracy to fraudulently transfer all of LecStar's assets to McCormack.

In April and May of 2002, LecStar entered into eight secured loans with Southridge and other institutional investors such as Maple Circle (an entity formed and controlled by Defendant Hicks), as well as with individual LecStar officers including Dale

Smith, President, William Woulfin, CEO, Jim Malcom, CFO, and Donald Santavicca, Controller. For each loan, LecStar entered into a promissory note with the lender. Some of those notes, such as the second Maple Circle note,[2] granted the holder a "first priority security interest in all of the assets" of LecStar including the stock of DataNet and Telecom. Plaintiffs contend that other notes, such as the Woulfin and Malcom notes, did not originally provide the holder with such security, although those notes were later amended to grant a first priority interest on all assets including the stock of DataNet and Telecom.[3] The total amount due on the notes was $769,000. Each note was required to be paid either at a maturity date prior to December, 2002, or upon demand.

In October, 2002, James Grenfell, former CEO of LecStar, obtained an arbitration award against LecStar for over $1 million. The award was affirmed by Cobb County Superior Court on November 4, 2002.

Around November 25, 2002, all eight promissory notes, and their attendant rights, were assigned to McCormack. At this time the law firm of Blank Rome Tenzer Greenblatt, LLP ("Blank Rome"), which had previously represented LecStar and which continued to remain in close contact with Defendant Hicks, began representing

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[2] Maple Circle entered into 3 promissory notes with LecStar: the first in the amount of $175,000.00 in July, 2002, the second in the amount of $175,000.00 in August, 2002, and the third in the amount of $90,000.00 in September, 2002.

[3] Plaintiffs assert that the original terms of the promissory notes with the William Woulfin, Jim Malcom, Southshore Capital Fund Ltd., a British Virgin Islands corporation created by Hicks, and the first Maple Circle Ltd., another British Virgin Islands corporation created by Hicks, were either unsecured or contained a security interest that excluded Telecom and DataNet. Copies of the promissory notes are included in the record at Plaintiffs' Exhibits 24 and 27. Those notes, however, all list the security interest as a "first priority security interst in all the assets of the Payor (the "Collateral") to secure the payment of this Note...." Citing William Woulfin's Affidavit, Plaintiffs allege that the security interest was later expanded to include all assets between August 30, 2002 and November 14, 2002. Plaintiffs Exhibit 50.

McCormack in the "asset acquisition" of LecStar.[4] On December 2, 2002, McCormack, through Blank Rome, made demand upon LecStar for immediate payment of all principal and interest due on the notes.[5] McCormack offered to accept all of the LecStar assets, including the stock of DataNet and Telecom (the collateral) for the notes in full satisfaction of the debt.

At the time of the McCormack demand, the LecStar Board of Directors was comprised of Messrs. Smith, Canouse, and Woulfin.[6] Because Directors Smith and Woulfin issued notes to LecStar, which they assigned to McCormack, they resigned their directorships and did not participate in decision to accept or reject McCormack's offer. Director John Canouse (a Defendant in this action), acting as the sole director of LecStar, accepted McCormack's offer and voluntarily surrendered to McCormack all of LecStar's assets including the stock of Telecom and DataNet. At this time, LecStar's stock was trading at 1¢. The following day, on December 6, 2002, LecStar Corp. and LecStar Communications Corp. entered into an Acceptance of Collateral Agreement with McCormack ("Acceptance Agreement") whereby the physical assets and the stock in DataNet and Telecom were transferred to McCormack. After the McCormack transaction there was no change in the telecommunications services provided through DataNet and Telecom, the operating divisions of LecStar.

In September 2003, McCormack transferred the former LecStar assets to LTEL Holding Corporation ("LTEL") in a stock exchange for approximately $28 million. LTEL is a Delaware company formed by Defendant Hicks on November 21, 2002.[7] At the

[4] See, e.g., Plaintiffs' Exhibits 22 and 30.
[5] Plaintiffs' Exhibit 77.
[6] See Plaintiffs' Exhibit 37.
[7] Plaintiffs' Exhibit 4

time of the transfer, Defendant Smith was the President and sole director of LTEL. Defendants Smith and Hicks, along with William Woulfson, all former LecStar officers, were re-elected as officers of LTEL and received stock in LTEL as a result of their "continued service" to the company and/or by signing a release of debt against LTEL. [8] Additional LTEL shareholders include McCormack, Cache, and Canouse, as well as Jim Malcom, and Donald Santavicca, who together with Defendants Smith and Hicks and William Woulfson comprised the majority of LTEL shareholders.

In the fall of 2003, LTEL and Fonix entered into a merger agreement which closed in April, 2004. Pursuant to the terms of the merger agreement, Fonix acquired LTEL, which continued as a Fonix subsidiary, for $33 million dollars. Fonix filed for bankruptcy in October 2006.

The heart of the debate in this case revolves around LecStar's valuation at the time of the McCormack transaction. Plaintiffs challenge the decision of the LecStar Board of Directors (*i.e.*, Defendant Canouse) to relinquish all LecStar assets to satisfy a debt of approximately $769,000. Plaintiffs allege that the transfer was a part of a fraudulent scheme to avoid the company's obligation to Grenfell and to eliminate the rights of certain minority shareholders. Defendants, on the other hand, assert that the McCormack transaction was fair and reasonable. Defendants assert that at the time of the sale, LecStar was operating at a deficit of approximately $200,000 per month and that the forced liquidation sale of the assets drastically drove down the value of the assets.

Determining the valuation of LecStar at the time of the McCormack transaction is difficult due to the conflicting valuation reports of the parties and contemporaneous

[8] See e.g., Plaintiffs' Exhibits 2 and 109.

statements made by Defendants. LecStar was an operating CLEC in the Southeast that had over 24,000 customers and a significant infrastructure developed. In the months immediately leading up to the McCormack transaction, Defendant Hicks issued press releases praising the company's customer and revenue growth as well as its debt consolidation. In addition, contemporaneous Securities and Exchange Commission ("SEC") filings reflected historical operating losses as well as current cash flow problems, but also documented a growing customer base, revenue stream, and debt consolidation.

Adding to the conflicting views of valuation are the different LecStar valuations generated around the time of the McCormack transaction. One estimate provided by Southeast Associates[9] valued the assets between $82,516 and $264,825. Another report prepared by a Southridge employee valued LecStar at $26.3 million. In addition, Mr. Francom, Plaintiffs' expert, valued the LecStar assets worth between $18 and $25.5 million on December 5, 2002. Within thirty days of the McCormack transaction, another third party appraiser, Ladenburg Thalmann & Co., Inc., estimated LecStar's assets to be worth between $8.27 and $10.57 million. Additionally, McCormack reported the value of its asset/stock exchange with LTEL as worth approximately $27 million in February 2003, only a few months after the McCormack transaction. Finally, the LTEL/Fonix transaction closed in 2004 for a total of $33 million. The table below outlines the different valuations, as well as their sources and dates.

[9] In October, 2002, LecStar retained and paid Southeast Associates a retainer to conduct an appraisal of the business. That retainer was eventually returned to LecStar and the valuation was ultimately paid for by Maple Circle, a creditor of LecStar, before the notes were assigned to McCormack. The record also contains various email correspondences between Defendant Hicks and Southeast Associates regarding the valuation of LecStar.

Date	Source	LecStar Valuation
December 10, 2002	Southeast Associates Fair Market Valuation of Orderly Liquidation Value	$264,825 FMV $82,516 forced liquidation value
Dec. 2002/ January 2003	LecStar Model Southridge employee valuation of LecStar	$26.3 million
December 5, 2008 (performed 2007)	Mr. Francom, Plaintiffs' expert	$ 18-25.5 million
December 30, 2002	Ladenburg Thalmann & Co., Inc. valuation	$8.27-10.57 million
September 5, 2003 (Date Sale Closed) [Merger signed February 2003]	McCormack report to the SEC when it transferred LecStar assets to LTEL	$20 million + $7.5 million option
February, 2004 (Date Merger Closed)	Stock transfer of LTEL to Fonix	$33 million

STATUTE OF LIMITATIONS

The Southridge Defendants, joined by Defendants Canouse and Smith, assert that the statute of limitations bars Plaintiff McFarland's claims because the transfer of assets occurred in 2002, but Plaintiff McFarland did not join the action until April 2007. Citing the applicable four year statute of limitations, V.T.C.A. § 16.004, Defendants assert that Plaintiff McFarland's claims are time barred and not subject to relation back to the original pleadings. See Crowley v. Coles, 760 S.W.23d 347.

Plaintiffs argue, however, that Georgia law controls this issue because relation back is a procedural matter. See Griffen v. Hunt Refining Co., 292 Ga. App. 451 (2008). Pursuant to O.C.G.A. § 9-11-15(c), relation back is allowed whenever there is an identity of interests between the old and new parties so that it will not create prejudice to the opposing party. If leave is sought to change or add plaintiffs after the expiration of the statute of limitation, provided "the claim ... asserted in the amended [complaint] arises out of the conduct, transaction, or occurrence set forth or attempted

to be set forth in the original [complaint], the amendment relates back to the date of the original [complaint]." Morris v. Chewning, 201 Ga. App. 658, 659, (1991) (citing OCGA § 9-11-15(c)). Plaintiffs assert that both Ms. McFarland and Mr. Thomas are shareholders and therefore share a unity of interests. Additionally, the claims brought by Ms. McFarland in Sixth Amended Complaint arise out of same conduct and same transaction (the McCormack transaction) complained of in the original Complaint.

The Court finds that Georgia law prevails on the issue of relation back. The Court also finds that Plaintiff McFarland shares a unity of interest with Plaintiff Thomas and alleges claims arising out of the same transaction so that Defendants are not prejudiced by Plaintiff McFarland's claim. Thus, the Court hereby **DENIES** Defendants' Motion for Summary Judgment on the statute of limitation claim as to Plaintiff McFarland.

STANDING

Defendants Smith and Canouse contend that Plaintiffs Thomas and McFarland lack standing to assert direct claims against them for breach of fiduciary duty because the claims are derivative in nature and must be pled as such. Whether a claim is direct or derivative in nature is determined by the law of the state of incorporation. Karmen v. Kemper Fin. Servs. Inc., 500 U.S. 90, 108-109 (1991).

The Texas code allowing the distinction between a direct and derivative action to be relaxed in the context of a shareholder derivative suit in a closely held corporation is inapplicable in this case because LecStar does not qualify under that statute. V.A.T.S. Bus.Corp.Act, Art. 5.14(L). Aside from the statutorily provided exception, Texas case law does not recognize a general relaxation of the direct/derivative distinction. Redmon

v. Griffith, 202 S.W.3d 225, 236 (Tex. App. 2006) ("The fiduciary duty an officer or director owes to the corporation is distinguishable from a fiduciary relationship that may exist between majority and minority shareholders or otherwise by contract or other special relationship between the individual parties."); cf. Haggett v. Brown, 971 S.W.2d 472, 487 n.13 (Tex. App. 1997) (recognizing "limited circumstances" where a majority shareholder owes a fiduciary duty to the minority shareholder); Norman v. Nash Johnson & Sons' Farms, Inc., 537 S.E.2d 248, 255 (N.C. Ct. App. 2000) (discussing North Carolina and other states' recognition of a minority shareholder's right to bring a direct action against a wrongdoing or oppressive majority shareholder). Because Plaintiffs have not demonstrated a unique or special injury or the existence of a fiduciary relationship separate from that created by Defendants' roles as directors of LecStar, the Court hereby **GRANTS** Defendants' Motion for Summary Judgment on Plaintiffs' direct claims of fiduciary duty for lack of standing.

Defendants Smith and Canouse also contend that Plaintiffs Thomas and McFarland fail the standing requirements for derivative suits articulated in Article 5.14 of the Texas Business Corporations Act, because they (a) fail to "adequately represent the interests of the corporation," and (b) Plaintiff McFarland failed to make a separate demand upon the corporation.

Whether a plaintiff shareholder adequately represents the interests of the corporation is a decision for the trial court, which shall not be disturbed absent abuse of discretion. Zeidman v. J. Ray McDermott & Co., Inc., 651 F.2d 1030, 1040 (5th Cir. 1981). A plaintiff in a shareholder derivative action owes the corporation his undivided loyalty. The plaintiff must not have ulterior motives and must not be pursuing an external

personal agenda. In deciding this question, the court may properly consider Plaintiffs' stake in the corporation as balanced against their interests and how the litigation may affect their external interests. Smith v. Ayres, 977 F.2d 946, 949 (5th Cir. 1992). "The trial court may properly consider the plaintiff's vindictiveness toward the defendant in determining whether the plaintiff is an adequate representative of the stockholders." Id. In Smith, the Fifth Circuit Court of Appeals affirmed the District Court's conclusion that the shareholder plaintiff was not an adequate representative where that plaintiff's company share was 1/10,000,000 of the authorized shares and where the plaintiff had a history of lawsuits and personal animosity against the director defendants.

In this case, Defendants assert that Plaintiffs have a personal agenda contrary to the interests of the corporation because (1) they are former executives or are related to former executives who were fired in 2001; and (2) they are advancing the interests of Mr. Grenfell, LecStar's former CEO and judgment creditor of LecStar. Additionally, Defendants contend that because Defendants held the majority of interests in LecStar Plaintiffs should not to be found to adequately represent the interests of the corporation.

The Court finds that Plaintiffs hold a sufficient ownership interest in LecStar in order to bring this action. Additionally, Plaintiffs have fully disclosed their relationship with Mr. Grenfell and the terms of the stipulation agreement entered into with him. The Court finds that Plaintiffs' relationship with Mr. Grenfell does not demonstrate "vindictiveness" towards either Defendants or the corporation sufficient to strip them of their rights to bring a derivative action.

With respect to Plaintiff McFarland's demand requirement, the Court finds that Plaintiff McFarland may join in the original demand brought by Plaintiff Thomas.[10] Previous demands and the subsequent decision by the board of directors should "bind similarly situated shareholders making identical claims. Judicial economy demands that identical claims, which in actuality belong to the corporation, be simultaneously disposed of by one demand." Pace v. Jordan, 999 S.W.2d 615, 621 (Tex. App.1999); see also Tex. Bus. Corp. Act Ann. Art. 5.14 (demand is required "unless the shareholder has earlier been notified that the demand has been rejected by the corporation....").

Accordingly, the Court hereby **DENIES** Defendants' Motion for Summary Judgment on the grounds that Plaintiffs lack standing to bring a derivative action.

BREACH OF FIDUCIARY DUTIES

Director Defendants seek summary judgment on the grounds that their actions are protected by the business judgment rule. Under Texas law, the business judgment rule is "a rule of substantive law under which a corporate director is entitled to a presumption of validity and good faith that cannot be overcome unless the plaintiff pleads and proves (1) that the directors' conduct was either ultra vires or fraudulent, or (2) that the directors had a personal interest in the transactions complained of." F.D.I.C. v. Schreiner, 892 F.Supp. 869, 880 -881 (W.D.Tex. 1995). In addition, a director's action that is grossly negligent may not be protected by the business judgment rule in Texas. TTT Hope, Inc. v. Hill, 2008 WL 4155465, *9 (S.D.Tex. 2008): see also, F.D.I.C. v. Benson, 867 F.Supp. 512, 523 (S.D.Tex. 1994) (concluding that Texas

[10] Plaintiff McFarland asserts that she made an independent demand upon LecStar on April 20, 2004. That demand is not in the record and is contested by Defendants.

business-judgment rule will protect a director as long as his acts are not grossly negligent or a complete abdication of duty).

Defendants assert that the McCormack transaction was approved by Defendant Canouse who, at the time, was not a creditor of LecStar, a shareholder/officer in McCormack, or a shareholder/officer in LTEL[11] and therefore was uninterested. Defendants argue that a transaction approved by uninterested directors, regardless of other potential conflicts, is protected by the business judgment rule. Roth v. Mims, 298 B.R. 272, 288 (N.D.Tex. 2003) ("An interested transaction may nevertheless be valid if (1) the material facts of the relationship or interest are disclosed and the transaction is approved by a majority of the disinterested directors...). Plaintiffs allege that Defendant Canouse was "interested" in the transaction, breached his duty of loyalty to the corporation, engaged in fraudulent conduct, acted with gross negligence, and was not provided with all material information regarding the McCormack transaction.

Officers and directors owe a duty of loyalty to their corporation to act only in the corporation's and its shareholders' best interest. In re Performance Nutrition, Inc., 239 B.R. 93, 110 (N.D.Tex. 1999). To fulfill the duty of loyalty, a director must exercise an "extreme measure of candor, unselfishness and good faith," particularly where there is an interested transaction. International Bankers Life Insurance Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963). Whether an officer or director is "interested" is a question of fact and encompasses transactions where the director derives a personal profit or which deprive the corporation of an opportunity to profit. Id.

[11] Defendant Canouse later obtained shares in McCormack and again in LTEL as a result of the McCormack/LTEL transaction. In addition, Cache, along with Atlantis and Sherman—entities in which both Defendant Canouse and his brother Joseph Canouse held interests and/or influence (advisors)—held shares in LecStar and later obtained shares in McCormack and LTEL.

Defendant Canouse testified in his deposition that at the time of the McCormack transaction he did not have an interest in McCormack nor did he expect to have an interest in the assets transferred. That testimony notwithstanding, within one year of the McCormack transaction, the LecStar assets were transferred from McCormack to LTEL where Defendant Canouse was made a director and a shareholder without providing consideration other than his "continued service".[12] Both McCormack and LTEL were created within the months preceding the McCormack transaction, and were both controlled by Hicks as an officer and director and through his affiliated entities (i.e., Southridge) as majority shareholders. In addition, Defendant Hicks sent emails in December 2002 discussing a future transfer of assets from McCormack to LTEL. Plaintiffs also allege that Hicks and Canouse had a long-standing and close personal and business relationship.

The McCormack transaction was a coordinated effort among LecStar's creditors--Hicks, Hicks-controlled entities (Southshore, Maple Circle) and LecStar officers and directors (Smith, Hicks, Woulfin, Malcom, Santivacca). LecStar executed secured notes to these creditors, who then transferred all of the notes to McCormack, an off-shore entity recently created by Hicks. McCormack then made a demand upon LecStar, which was approved by Canouse as the sole remaining director. Before the McCormack transaction was approved, LecStar was represented by Blank Rome, who, after a series of communications with Defendant Hicks and other LecStar officers and directors, began representing McCormack. In fact, Blank Rome served McCormack's demand letter on LecStar, its former client. These communications between Blank Rome, Defendant Hicks, and other LecStar officers and directors raise serious

[12] Plaintiffs' Exhibit 2.

questions regarding the McCormack transaction, especially in light of the fact that neither Blank Rome's alternating allegiance and communications with the LecStar officers and directors were not disclosed to the LecStar Board of Directors (i.e., Defendant Canouse) at the December 5, 2002 board meeting.

Defendants refer the Court to Board of Directors' due diligence actions in reviewing the McCormack transaction citing to financial reports prepared by the CFO, a report from bankruptcy counsel Arnall Golden & Gregory,[13] previous restructuring efforts, cost-cutting measures, and the independent appraisal report prepared by Southeast Appraisal Resource Association. Defendants highlight that pursuant to Texas law, a director may rely in good faith and with ordinary care on the opinion, reports, and information prepared by officers and employees of the corporation as well as professionals hired by the corporation such as attorneys and accountants. Tex. Bus. Corp. Act. Ann. Art. 2.41D.

LecStar CFO James Malcom, creditor of LecStar and future shareholder/director in LTEL, reported to the Board on December 5, 2003, that additional funding was necessary to continue the company and that he has substantial doubt regarding the company's future as a going concern. Mr. Malcom also reported to the LecStar Board that the company had exhausted all other remedies because it had restructured its liabilities and capital to attract investors, which failed, and had cut corporate overhead as much as possible but was unable to meet its cash needs. Malcom's financial interest as a creditor of LecStar (known by the Board) and his future interest in LTEL as a

[13] The LecStar Board of Directors received a report from bankruptcy counsel, Arnall, Golden and Gregory that bankruptcy was not a viable option. In addition, during the December 5, 2002 Board meeting, the Board concluded that LecStar had $20,000 in capital to cover $200,000 in ongoing operational costs. See Plaintiffs' Exhibit 37.

shareholder and director call into question whether or not a director could rely in good faith upon his report. Additionally, Plaintiffs assert that Malcom had knowledge of the Southridge report valuing LecStar at $26 million, but did not disclose that report to the Board of Directors.

In addition, Plaintiffs challenge the independence of the LecStar valuation prepared by Southeast. LecStar paid Southeast a retainer to conduct the valuation, but that money was ultimately returned to LecStar when Maple Circle, a creditor of LecStar and entity controlled by Defendant Hicks, funded the valuation report. In addition, the record contains several emails from Defendant Hicks communicating with Southeast regarding their valuation report to provide it with information or to comment on valuation estimates or techniques.[14] This information regarding the Southeast valuation was not disclosed to the LecStar Board of Directors prior to voting on the McCormack transaction. Finally, the Southeast valuation report was not finalized until December 10, 2002, five days after the Board of Directors' meeting.

Defendants also argue that there was no alternative to the McCormack transaction because the notes issued were valid and due. Because an officer or director has a contractual right to take a certain action, does not establish as a matter of law that he/she did not breach a fiduciary duty in exercising that right. Spethmann v. Anderson, 171 S.W. 3d 680, 696 (Tex. App. 2005). In Spethmann, director defendants entered into a buy sell agreement with the corporation. The company repurchased shares after two director/shareholders resigned over conflict. In buying back the stock, it depleted the company of over 80% of its assets. The Court held as a matter of law

[14] See, e.g., Plaintiffs' Exhibit 66 (November, 2002, email from Defendant Hicks to Southeast reviewing the LecStar Appraisal and suggesting changes, including the insertion of McCormack Avenue into the report); see also Plaintiffs' Exhibit 57.

that complying with the buy-sell agreement did not make the transaction fair to the corporation as a matter of law, and thus upheld a jury verdict for breach of fiduciary duty. Id. As in Spethmann, the Court in this action must determine whether the McCormack transaction was not only authorized by contractual rights, but was undertaken in compliance with fiduciary duties owed to the corporation.

Defendants argue that there is no evidence of Canouse's interest in the transaction, fraud, or negligence. The Court disagrees and finds that Plaintiffs have raised questions of fact regarding whether material information about the relationship and interest of the other directors was disclosed prior to Canouse's approval of the McCormack transaction. Additionally, the Court finds that Plaintiffs have raised questions of fact regarding whether or not Defendant Canouse was interested in the McCormack transaction and/or acted in good faith in approving it. See Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719-720 (5th Cir. 1984); Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 577 (Tex. 1963); General Dynamics v. Torres, 915 S.W.2d 45 (Tex. App. 1995). Ultimately, Canouse personally profited from the transaction which deprived LecStar and its remaining shareholders of the assets. That the directors inserted a shell entity (McCormack) to hold the assets in between the transfer from LecStar to LTEL does not necessarily insulate those directors from breach of fiduciary duty suits; otherwise, fiduciary duties of loyalty could be abrogated by simply inserting a middle man.

Finally, Plaintiffs raise questions of fact regarding whether or not Defendant Canouse participated in a "fraudulent" scheme. Defendants assert that Plaintiff's inability to demonstrate that Canouse knew about the scheme at the time of the transfer

merits summary judgment in their favor. Knowledge, however, is usually determined by circumstantial evidence, which has been sufficiently entered into the record here to raise irresolvable questions of fact (e.g., the transfer of the notes, the timing of McCormack/LTEL creation, the grant of stock in LTEL, the overlapping web of control by Hicks/Canouse/Joseph Canouse over the entities involved). Taylor Elec. Services, Inc. v. Armstrong Elec. Supply Co., 167 S.W.3d 522, 528 (Tex. App. 2005). The Court, however, agrees with Defendants that Plaintiffs have failed to rebut the business judgment rule on the grounds that Canouse acted with gross negligence.

A transaction that is not protected by the business judgment rule, may still be upheld if the transaction was fair as a matter of law. Roth v. Mims, 298 B.R. 272, 288 (N.D. Tex. 2003). To satisfy the entire fairness test, Texas courts review the "full adequacy of the consideration." Crook v. Williams Drug Co., Inc., 558 S.W.2d 500, 506 (Tex. Civ. App. 1977). Defendants contend that the Southeast appraisal of LecStar is evidence of a fair price, therefore satisfying the entire fairness test. For the reasons addressed above, the Court will not rely solely on the Southeast appraisal. In addition, alternative valuations provided by Southridge, Ladenburg, Francom, and the subsequent LTEL and FONIX transactions valued the assets substantially higher than in the report prepared by Southeast. Therefore, the Court rejects Defendants' argument that they are entitled to summary judgment under the entire fairness test even if the business judgment rule does not apply to the McCormack transaction.

Accordingly, the Court hereby **DENIES** Defendants' Motion for Summary Judgment on the Breach of Fiduciary Duty Claims.

AIDING AND ABETTING A BREACH OF FIDUCIARY DUTY

Defendants assert that Plaintiffs fail to establish all elements of "aiding and abetting" as provided in Insight technology Inc., v. FreightCheck, LLC, 280 Ga. App. 19, 25 (2006), because no fiduciary duties were breached and no actions were taken by the Southridge Defendants. In light of the Court's ruling on fiduciary duty claims above, Defendants' first argument fails. Citing to the Woulfin Affidavit, Plaintiffs assert that the Southridge Defendants participated in this scheme by "repapering" the notes that were transferred, in part by the Southridge Defendants, to McCormack which lead to the foreclosure. Plaintiffs assert that the original notes to Wolfson and Malcom were not secured and that the original Southshore and Maple Circle notes had a limited collateral description excluding the stock of Telecom and DataNet.[15] Finally, Plaintiffs point out that Hicks formed LTEL in November, 2002 as part of the alleged scheme to transfer the assets back onshore after they were foreclosed upon by McCormack. The record also contains email correspondences between the secured creditors and the Blank Rome attorney, with Hicks copied, discussing the plan for a subsequent transfer of the assets.[16]

The Court hereby finds that questions of fact remain regarding whether or not the Southridge Defendants acted to procure a breach of fiduciary duty; therefore, the Court

[15] Plaintiffs Exhibits 24-27 address the eight promissory notes. Those exhibits, however do not contain promissory notes with a restricted collateral description. Instead, the provided promissory notes specifically state that the creditor is given a first priority security interest in all assets. Plaintiffs point to Woulfin's Affidavit, Plaintiffs' Exhibit 50, as proof that the notes were repapered where he states that he participated, along with Defendant Smith, in repapering the notes. Additionally, Plaintiffs highlight Exhibits 25 and 26, the UCC financing statements filed by Maple Circle in August, 2002, which lists its security interest in LecStar's assets as accounts receivable, proceeds from loans, proceeds from the issuance of debt or equity, and proceeds from any legal settlement or judgment.

[16] See e.g., Plaintiffs Exhibits 31, 43, and 93.

hereby **DENIES** Defendants' Motion for Summary Judgment on the Aiding and Abetting Breach of Fiduciary Duty claims.

CIVIL CONSPIRACY

Plaintiffs have demonstrated triable issues of fact that Defendants may have participated in a civil conspiracy to commit torts. Insight Technology, Inc. v. FreightCheck, LLC, 280 Ga. App. 19 (2006) ("Turning to the issue of whether Insight has identified specific evidence giving rise to a triable issue, we conclude that Insight adduced evidence from which a jury could infer that Hull, acting as an agent of both GetLoaded and FreightCheck, tortuously procured Brewer's breach of his fiduciary duty, damaging Insight".); Strange v. Housing Authority of Summmerville, 268 Ga. App. 403, 410 (2004). The Court hereby **DENIES** Defendants' Motion for Summary Judgment on Plaintiffs' claims of civil conspiracy.

GEORGIA UNIFORM FRADULENT TRANSFERS ACT ("GUFTA")

Plaintiffs allege that Defendants violated O.C.G.A. §§ 18-2-74(a)(1) and 18-2-75(a) with the McCormack transaction. GUFTA protects valid creditors from sham asset transfers by debtors for the purposes of hiding assets from that creditor. Plaintiffs assert the GUFTA claims both directly and derivatively.

Pursuant to O.C.G.A. § 18-2-71(4) a creditor is "a person who has a claim." A claim is defined as "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." Id. (3). Because this Court has already granted summary judgment to Defendants on Plaintiffs direct claims, Plaintiffs cannot qualify as creditors under GUFTA to bring direct claims.

On their derivative claims, Plaintiffs contend that when the LecStar Board of Directors approved the McCormack transaction on December 5, 2002, Plaintiffs became creditors of a claim for breach of fiduciary duty. In this scenario, LecStar is the debtor and Defendants are beneficial transferees. See Qwest Comm'ns Corp. v. Weisz, 278 F. Supp. 2d 1188, 1191 (S.D. Cal. 2003) ("[J]udgment may be had against transferees or "the person *for whose benefit* the transfer was made."). This argument, however, ignores that derivative actions bring claims belonging to the corporation, but raised by the shareholders. This distinction is more than intellectual, and is evidenced by the requirement that any recovery in a derivative suit inures to the corporation, not to the shareholders individually. Ross v. Bernhard, 396 U.S. 531, 538-539 (1970) ("The proceeds of the [shareholder derivative suit] belong to the corporation and it is bound by the result of the suit.") Thus, in this scenario, Plaintiffs seek to bring a claim on behalf of LecStar as the creditor against LecStar as the debtor. While GUFTA is written with broad language to provide a flexible statute to facilitate the recovery of fraudulent transfers, the language of the statute cannot be stretched so that Plaintiffs can bring a suit alleging that LecStar is both the creditor and debtor in a single transaction. The Court hereby **GRANTS** Defendants' Motion for Summary Judgment on Plaintiffs' GUFTA claims.

UNJUST ENRICHMENT

The Southridge Defendants seek summary judgment on Plaintiffs' claim of unjust enrichment arguing that none of the LecStar assets were transferred to Mr. Hicks or Southridge. Plaintiffs, on the other hand, assert that the Defendants were enriched because they received stock in LTEL (because of past service and release of claims)

and subsequently in Fonix as a term of the merger with LTEL. "Where one unjustly obtains a pecuniary advantage of another to which he is not legally entitled and refuses to make restitution, an action for unjust enrichment lies.... it is not essential that the defendant come into possession of money or property, but simply that he be unjustly enriched by obtaining some financial advantage of the plaintiff." Trust Co. of Ga. v. S. & W. Cafeteria, 97 Ga. App. 268, 284 (1958).

The Court hereby **DENIES** Defendants' Motion for Summary Judgment on Plaintiffs' unjust enrichment claims because questions of fact remain.

DISTRIBUTION OF PROCEEDS

Defendants seek summary judgment on the alternative grounds that LecStar was insolvent at the time of the McCormack transaction so there were no damages, and that even if damages were recovered, eighty percent of any recovery would be distributed to Defendants as the majority shareholders. Tex. Bus. Corp. Act. Art. 6.04. The Court finds these questions of damages premature in light of the outstanding questions of liability and **DENIES** Defendants' Motion for Summary Judgment on these grounds.

SO ORDERED this 16 day of January, 2009.

Alice D. Bonner

ALICE D. BONNER, SENIOR JUDGE
Superior Court of Fulton County
Atlanta Judicial Circuit

Copies to:
Mark F. Dehler, Esq.
Mark F. Dehler, LLC
201 Swanton Way
Decatur, Georgia 30030

Richard L. Tate, Esq.
Tate & Associates
206 2nd Street
Richmond, Texas 77469

Scott L. Bonder, Esq.
Robert J. Flemming, Esq.
Fleming, Fried & Bonder, LLC
Promenade II, Suite 3750
1230 Peachtree Street, NE
Atlanta, Georgia 30309

Gary R. Kessler, Esq.
Irvin, Stanford & Kessler, LLP
One Buckhead Plaza, Suite 1050
3060 Peachtree Road, N.W.
Atlanta, Georgia 30305

John M. O'Quinn, Esq.
O'Quinn, Laminack & Pirtle
440 Louisiana, Suite 2300
Houston, Texas 77002

Denman Heard, Esq.
Sean Greenwood, Esq.
Heard, Robins, Cloud, Lubel & Greenwood, One Allen Center
500 Dallas, Suite 3100
Houston, Texas 77002

William B. Hill, Jr., Esq.
Joseph C. Sharp, Esq.
Deliannette Gaines, Esq.
Ashe, Rafuse & Hill, LLP
1355 Peachtree Street, NE
Suite 500, South Tower
Atlanta, Georgia 30309-3232

Jeff R. Joyce, Esq.
Joyce, Thrasher & Kaiser, LLC
150 South Terraces
115 Perimeter Center Place, NE
Atlanta, Georgia 30346-1284

Lonnie L. Simpson, Esq.
Perrie M. Weiner, Esq.
DLA Piper Rudnick Gray Cary US LLP
101 East Kennedy Boulevard, Suite 2000
Tampa, Florida 33602-5149

James W. Christian, Esq.
Christian Smith & Jewell, LLP
2302 Fannin, Suite 500
Houston, Texas 77002

LeeStar Corporation
c/o CT Corporation, Registered Agent
350 North St. Paul Street
Dallas, Texas 75201

Steve Hicks
Southridge Capital Management LLC
Sovereign Partners, L.P.
LTEL Holdings Ltd.
90 Grove Street
Ridgefield, Connecticut 06877

Roger A. Chalmers, Esq.
Arnall Golden & Gregory
1201 West Peachtree Street
2800 One Atlantic Center
Atlanta, Georgia 30309

Edwin J. Schklar, Esq.
Willian Brent Ney, Esq.
Schkar, Wright & Henderson, LLC
Resurgens Plaza, Suite 2250
945 East Paces Ferry Road, N.E.
Atlanta, Georgia 30326

David J. Hungeling, Esq.
Law Office of David J. Hungeling PC
Peachtree 25th, Suite 599
1718 Peachtree Street, N.W.
Atlanta, GA 30309