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

Alice D. Bonner
Superior Court of Fulton County

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IN THE SUPERIOR COURT OF FULTON COUNTY
STATE OF GEORGIA

FILED IN OFFICE
APR 22 2009
DEPUTY CLERK SUPERIOR COURT
FULTON COUNTY, GA

FIRST EMPIRE CORPORATION (directly and derivatively in its Capacity as a shareholder of LecStar Corporation), **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 Declaratory Judgment

This case is before the Court on the Southridge Defendants'[1] Motion for an Order Affirming the Procedures That Will Be Employed to Distribute Any Derivative Award

[1] The Southridge Defendants are Stephen Hicks, Southridge Capital Management, LLC ("Southridge") and McCormack Avenue, Ltd. ("McCormack") (hereinafter collectively referred to as "Southridge Defendants").

("Derivative Distribution Motion"). In support of their Motion for Summary Judgment, Defendants first raised the issue of derivative proceeds distribution. The Court declined to rule on that issue in conjunction with the motion for summary judgment finding that it was not properly before the Court. After this issue was again raised during a telephone conference with the parties on February 9, 2009, the Court invited a motion and briefing on the issue of derivative proceeds distribution. After reviewing the Derivative Distribution Motion, the record of the case and the briefs submitted by the parties, the Court finds as follows:

This case involves shareholder derivative claims alleging breached fiduciary duties, aiding and abetting breach of fiduciary duties, civil conspiracy, and unjust enrichment. LecStar was a publically traded company, organized in 1998 in Texas, that operated as a Competitive Local Exchange in the deregulated telecom environment. LecStar Corporation was involuntarily dissolved on February 13, 2003.

The Southridge Defendants do not themselves own stock in LecStar, but hold interests in companies that are shareholders of LecStar, and, thus, are impacted, albeit indirectly, by this Order. In addition, Defendants John C. Canouse, W. Dale Smith, Cache Capital (USA), L.P., and Atlantic Capital Fund, Ltd. are shareholders of LecStar and their rights will be affected by this Order. Therefore, pursuant to O.C.G.A. § 9-4-2 and this Court's finding that the issues raised in this Derivative Distribution Motion present an actual, justicable controversy involving the parties, this matter shall be treated as a motion for declaratory judgment. O.C.G.A. § 9-4-2 ("In cases of actual controversy, the respective superior courts of this state shall have power, upon petition

or other appropriate pleading, to declare rights and other legal relations of any interested party petitioning for such declaration...").[2]

Defendants petition the Court to affirm that any proceeds from the derivative claims are distributed pursuant to Texas Business Corporation Act Sections 6.04 and 7.12 where any recovery would be paid to LecStar, which would first pay any outstanding debts and liabilities before distributing any remaining recovery *pro rata* to all shareholders. V.A.T.S. Bus. Corp. Act, Art. 7.12 (2009). Plaintiffs, on the other hand, petition the Court to defer ruling on the distribution issue, or, in the alternative, to either distribute any recovery pursuant to the Court's equity powers, or, in the event of ordering a statutory distribution, to declare that LecStar has no outstanding debts.

The Court finds that LecStar is governed by Texas law. Diedrich v. Miller & Meier & Assoc., Architects and Planners, Inc., 254 Ga. 734, 735 (Ga. 1985). Article 7.12 of the Texas Business Corporation Act specifically allows for a dissolved corporation to continue its corporate existence for up to three years from the date of dissolution for "prosecuting or defending in its corporate name any action or proceeding by or against the dissolved corporation." V.A.T.S. Bus. Corp. Act, Art. 7.12. Article 7.12 further requires that any "assets....collected by the dissolved corporation" shall be distributed pursuant to Article 6.04 of the Act first to pay debts and liabilities and then as a *pro rata* shareholder distribution. Id.; § 6.04.

[2] Plaintiffs requested that the Court deny the Derivative Distribution Motion as being improperly before the Court because it seeks to declare the rights of parties not before the Court, because Defendants did not plead a counterclaim relating to distribution, and because it is improper for predetermination.

This derivative suit was brought within the three-year time limit for claims on behalf of a dissolved corporation. Therefore, the distribution process specifically outlined by the Texas Legislature shall not be disrupted by this Court.

Plaintiffs urge the Court to utilize its equitable powers to order that any recovery be paid into the registry of the Court whereupon a claims process for all "innocent" shareholders would be initiated. Plaintiffs urge the Court to disallow a *pro rata* distribution to Defendants who were also shareholders in LecStar and to LecStar shareholders invested in or managed by the Defendants. Additionally, under Plaintiffs' proposed distribution scheme, they ask the Court to strip distribution rights away from "innocent" shareholders who fail to make a claim upon the Court to share in the derivative proceeds distribution.

Plaintiffs cite to a few cases in foreign jurisdictions to support their petition, but those cases are distinguishable on the grounds that such relief was granted under common law and not in contradiction of a clear statute governing the distribution of such proceeds. See, e.g., Lynch v. Patterson, 701 P.2d 1126, 1131 (Wyo. 1985) (granting recovery directly to the minority shareholder upon a finding that the "Wyoming Business Corporation Act does not dictate a contrary result."); Backus v. Finkelstein, 23 F.2d 357, 366 (Minn. Dist. Ct. 1927) (granting direct recovery to injured shareholders under common law); Natoli v. Carriage House Motor Inn, Inc.,, No. 85-CV-1457, 1988 WL 53397, at *13 (N.D.N.Y. May 24, 1988) (declining to grant a direct award to the minority shareholder because "to deviate from the general rule" would increase the minority shareholder's interest in the corporation.); cf. Martin v. Texas Woman's Hosp., Inc., 930 S.W.2d 717, 720 (Tex. App.-Houston 1996) ("At common law, the legal existence of a

corporation was terminated upon dissolution. In order to alleviate the draconian effect of this principle, the courts developed the "trust fund theory," ...The legislature ultimately codified the trust fund theory in article 7.12....").

Plaintiffs raise a point—one that is not missed by the Court—that without a "direct" recovery to Plaintiffs, Defendants will be allowed to profit from their wrongdoings.[3] Such is the result with any derivative suit where the Defendants are also corporate shareholders. Years of case law and legislation regarding derivative suits have not yielded a rule that wrong-doing shareholders are excluded from sharing in a *pro rata* distribution. On the contrary, the Texas statute clearly states that distributions shall be made to **all** shareholders. Additionally, the distribution plan proposed by Plaintiffs places the Court in the untenable position of eliminating the claims of debtors and even those of shareholders in the event that they failed to respond to the Court's notice. Equity powers are broad, but must be exercised prudently.

Plaintiffs argue that LecStar is defunct, has no operating board of directors, and is incapable of receiving an award and distributing it to shareholders. The Court agrees and finds wisdom in Defendants' suggestion that the Court appoint a trustee or receiver to oversee the collection and distribution of any recovery. In the event of recovery on the derivative claims, the parties shall submit to the Court within ten days of the entry of Judgment, a list containing the names of three proposed and agreed upon individuals

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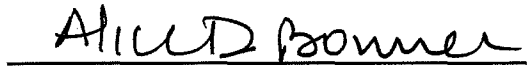
[3] The Court declines to exercise its cy pres power to direct that only innocent shareholders be awarded a recovery and that the remainder of any damages amount be paid to a charitable organization consistent with the practice established in some consumer class actions. See, e.g., *In re* Motorsports Merch. Anti-Trust-Litig., 160 F.Supp. 2d 1392, 1395 (N.D.Ga. 2001) (finding that neither plaintiffs nor defendants had a legal right to unclaimed settlement amounts and awarding it to various charitable organizations).

who, they agree, could serve in the capacity as trustee or receiver for any award. The Court will select one of these to serve as trustee.

Plaintiffs petition the Court to declare that there are no outstanding debts or liabilities existing against LecStar in the event that the Court found, as it has, that proceeds shall be distributed pursuant to the Texas Business Corporation Act. Plaintiffs highlight the three year time limit for all claims against dissolved corporations and argue that there are no claims against LecStar other than this lawsuit.[4] This issue, however, is not properly before the Court, and may require a more fully-developed record. Therefore, the Court declines to rule on this issue and shall leave the record open on this matter until closed by further action of this Court.

SO ORDERED this 22nd day of April, 2009.



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

[4] Only two cases have been brought within this time: this action and a Cobb County collection action filed by James Grenfell to collect on a 2002 arbitration award. Plaintiffs and Mr. Grenfell, however, have signed a subordination agreement.

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