UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF SOUTH CAROLINA

IN RE: ChanneLinx, Inc., Debtor.	C/A No. 03-01262-W Adv. Pro. No. 03-80475
Harold Miller, Robert Thomas, and Gary Hyman, Plaintiffs, v. ChanneLinx, Inc., James D. Zielinski, Daniel Schmidt, DGS Management, LLC, Halong Investments, Hanley-Wood, Herwald Financial Consulting, LLC, iHousing, and Kurt Herwald, Defendants.	**JUDGMENT** Chapter 11

Based upon the Findings of Fact and Conclusions of Law as recited in the attached Order of the Court, the Court dismisses Plaintiffs' Negligent Misrepresentation Action. Plaintiffs' Equitable Subordination Action, and Breach of Fiduciary Duty Action, to the extent set forth in the attached Order, remain.

John E. Waites
UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina,
February 18, 2004.

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Harold Miller, Robert Thomas, and Gary Hyman, Plaintiffs, v. ChanneLinx, Inc., James D. Zielinski, Daniel Schmidt, DGS Management, LLC, Halong Investments, Hanley-Wood, Herwald Financial Consulting, LLC, iHousing, and Kurt Herwald, Defendants.	**ORDER** Chapter 11

THIS MATTER comes before the Court upon the Motion to Dismiss of James D. Zielinski ("Zielinski"), Hanley-Wood and iHousing (collectively, the "Group One Defendants"), and the Motion to Dismiss (together, the "Motion") of Daniel Schmidt, DGS Management, LLC, Herwald Financial Consulting, LLC, Kurt Herwald, and Halong Investments (collectively, the "Group Two Defendants") and the opposition of Harold Miller, Robert Thomas and Gary Hyman (collectively, the "Plaintiffs") thereto.

FINDINGS OF FACT

1. On February 3, 2003, ChanneLinx, Inc. (the "Debtor" or "ChanneLinx") filed its petition for relief under Chapter 11 of the United States Bankruptcy Code[1]. Debtor has operated as the debtor-in-possession throughout this case.

2. The Plaintiffs are former officers and employees of Debtor. They are also shareholders and non-priority unsecured creditors of Debtor.

3. Debtor's Plan of Reorganization, as amended, was confirmed by this Court's Order entered on August 31, 2003.

4. Plaintiffs filed a complaint on September 15, 2003, and subsequently an amended complaint on September 24, 2003 (the "Complaint") alleging four causes of action against certain Defendants: the First Cause of Action is one for breach of fiduciary duty ("Breach of Fiduciary Duty Action"); the Second Cause of Action is one for equitable subordination under 11 U.S.C. § 510(c)(1) ("Equitable Subordination Action"); the Third Cause of Action is one for breach of contract accompanied by a fraudulent act ("Breach of Contract Accompanied by a Fraudulent Act Action"); and the Fourth Cause of Action is one for negligent misrepresentation ("Negligent Misrepresentation Action").

5. Defendants Schmidt and Herwald are Directors of Debtor, and Defendant Zielinski served as Chairman of the Board of Directors (the "Board") during 2001 and 2002.

6. The Complaint alleges that Defendant Schmidt is the sole owner of Defendant DGS Management, LLC and that Defendant Herwald is the sole owner of Herwald Financial Consulting, LLC.

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[1] Further references to the United States Bankruptcy Code shall be by section number only.

7. The parties agree that Defendant Halong Investments controlled two positions on the Board during 2001 and 2002 and held a substantial investment position in ChanneLinx during 2001 and 2002.

8. The parties agree that Defendant Hanley-Wood controlled three positions on the Board of Directors of ChanneLinx during 2001 and 2002 and held a substantial investment position in ChanneLinx during 2001 and 2002.

9. The Complaint alleges that Defendant iHousing is a business controlled by Defendant Hanley-Wood.

10. Plaintiffs loaned funds to ChanneLinx through instruments that are titled ChanneLinx, Inc. 13% Senior Subordinated Debentures (the "Debentures"). As a result of the loans, the Debentures were issued to Miller in the amount of $100,000, to Thomas in the amount of $77,000, and to Hyman in the amount of $75,000. Plaintiffs placed their funds with ChanneLinx through periodic payments from October 2001 through February 2002, in the form of cash contributions and deferred compensation (the "Loans").

11. The Debentures were amended in November 2001 with respect to redemption by certain holders of the Debentures upon termination without cause on or before October 31, 2002 (the "Amendment").

12. At some time after the issuance of the Debentures, "C Notes" were issued to Defendants Schmidt, Herwald, Halong Investments, Hanley-Wood, iHousing, and Herwald Financial Consulting, LLC. The Complaint alleges that the C Notes granted the holders a blanket first lien on all of ChanneLinx's assets.

13. Certain Defendants participated in the C Note subscription by making investments in ChanneLinx.

14. The parties agree that Defendant DGS Management, LLC is controlled by Defendant Schmidt, and that DGS Management, LLC deferred compensation in consideration of ChanneLinx's modifying the C note subscription. DGS Management, LLC received a C Note for the deferred compensation of Defendant Schmidt.

15. The parties agree that Defendant Herwald Financial, LLC is controlled by Defendant Herwald and that Herwald Financial, LLC deferred compensation in consideration of ChanneLinx's modifying the C Note subscription. Herwald Financial, LLC received a C Note for the deferred compensation of Defendant Herwald.

16. Plaintiffs allege that each Plaintiff was terminated without cause before the expiration of the one-year period referenced in the Amendment.

17. Plaintiffs allege that as an inducement for Plaintiffs make the Loans to ChanneLinx, Defendant Zielinski represented to Plaintiff that Hanley-Wood would place additional funds with ChanneLinx under the same terms and conditions as Plaintiffs.

18. Plaintiffs allege that Debtor has defaulted on Plaintiffs' Loans.

19. Plaintiffs allege that throughout ChanneLinx's corporate existence, it failed to realize a profit and operated for several years as an insolvent business.

20. Defendants filed their Motion to Dismiss Plaintiffs' causes of action or about October 29, 2003.

CONCLUSIONS OF LAW

A motion to dismiss for failure to state a claim pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure ("Rule 12(b)(6)"), made applicable in these proceedings by Rule 7012 of the Federal Rules of Bankruptcy Procedure, may be granted where no set of facts could be proven at trial that would entitle the plaintiff to relief. Conley v. Gibson, 355 U.S. 41, 45-46

(1957); Mylan Labs, Inc. v. Matkari, 7 F.3d 1130, 1134 (4th Cir. 1993). On a motion to dismiss, a court must accept as true all the plaintiff's allegations and view the complaint in the light most favorable to the plaintiff. In re Doe 2 v. Associated Press, 331 F.3d 417, 420 (4th Cir. 2003).

However, the Court is not to accept sweeping and unwarranted averments of fact. In re Dunes Hotel Assocs., 194 B.R. 967, 975 (Bankr. D.S.C. 1995) (citing cases). In addition, the Court shall disregard legal conclusions, deductions or opinions couched as factual allegations. Id. (citing 5A Charles A. Wright & Arthur R. Miller, *Federal Practice and Procedure* § 1357, at 311-18 (2d Ed.1990); 2A James Wm. Moore *et al., Moore's Federal Practice* ¶ 12.07[2-5] at 12-84 to 12-85 (2d Ed.1995)).

Defendants move to dismiss all causes of action in that the Complaint fails to state a claim upon which relief can be granted. The three remaining causes of action subject to the Motion are Breach of Fiduciary Duty, Equitable Subordination, and Negligent Misrepresentation.[2] Plaintiffs' Negligent Misrepresentation Action is based upon allegations made by Plaintiffs that Zielinski induced Plaintiffs to loan money to Debtor by representing that Hanley-Wood would place additional funds with Debtor under the same terms and conditions as Plaintiffs. Plaintiffs' Breach of Fiduciary Duty Action alleges that the issuance of C Notes to certain Defendants granted certain insiders preferred status and placed them in a better position than that provided to Plaintiffs. The Breach of Fiduciary Duty Cause of Action also refers to the allegation by Plaintiffs regarding Zielinski's representation that Hanley-Wood would place funds with Debtor upon the same terms and conditions as Plaintiffs. Finally, Plaintiffs' Equitable

[2] Plaintiffs clarified on the record of the hearing held on the Motion that the Third Cause of Action, breach of contract accompanied by a fraudulent act, was only against Debtor. The Court dismissed this cause of action by separate order on February 9, 2004. The only remaining cause of action against Debtor is one for equitable subordination.

Subordination Action is based generally upon Defendants' alleged breach of fiduciary duty to Plaintiffs.

The crux of Defendants' Motion is that Plaintiffs' causes of action are barred by the South Carolina statute of frauds relating to failure to perform an alleged promise regarding a loan of money. S.C. Code Ann. § 37-10-107 (Law. Co-op. 2002 rev.). Defendants allege that to the extent the causes of action are predicated on the representations made by Zielinski as an inducement for Plaintiffs to make the Loans, they are barred by S.C. Code § 37-10-107. Defendants' other arguments in support of their Motion will also be addressed herein.

Negligent Misrepresentation

Plaintiffs allege that Debtor and the Directors,[3] through Zielinski, made false representations to the Plaintiffs as an inducement to have them enter into the Debentures. The Complaint further alleges that the Directors had a pecuniary or financial interest in making the representations, that they owed a duty of care to Plaintiffs, that the Directors breached this duty, and that Plaintiffs justifiably relied on the representations. Plaintiffs further allege damages as a result.

Defendants argue that the Negligent Misrepresentation Action is barred by the statute of frauds, S.C. Code § 37-10-107, enacted in 1991. S.C. Code Ann. § 37-10-107 (Law. Co-op. 2002 rev.).[4] This code section provides as follows:

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[3] The Complaint does not specifically define "Directors," but Zielinski, Schmidt and Herwald are the only Defendants referred to individually as Directors. Accordingly, it appears that the Complaint only alleges Negligent Misrepresentation with respect to Debtor, Zielinski, Schmidt and Herwald. As previously noted, the Negligent Misrepresentation Action was dismissed against Debtor by separate Order. Inasmuch as the Court will dismiss this cause of action, for reasons that would apply with respect to all Defendants, the actual Defendants named in the Negligent Misrepresentation cause of action is not pertinent.

[4] Inasmuch as the Group One Defendants joined in the Group Two Defendants' Motion to Dismiss, and separately submitted their own Memorandum in Support, the Court will refer to the arguments made by the Defendants interchangeably.

(1) No person may maintain an action for legal or equitable relief or a defense based upon a failure to perform an alleged promise, undertaking, accepted offer, commitment, or agreement:

(a) to lend or borrow money;
(b) to defer or forbear in the repayment of money; or
(c) to renew, modify, amend, or cancel a loan of money or any provision with respect to a loan of money, involving in any such case a principal amount in excess of fifty thousand dollars, unless the party seeking to maintain the action or defense has received a writing from the party to be charged containing the material terms and conditions of the promise, undertaking, accepted offer, commitment, or agreement and the party to be charged, or its duly authorized agent, has signed the writing.

(2) Failure to comply with subsection (1) precludes an action or defense based on any of the following legal or equitable theories:

(a) an implied agreement based on course of dealing or performance or on a fiduciary relationship;
(b) promissory or equitable estoppel;
(c) part performance, except to the extent that the part performance may be explained only by reference to the alleged promise, undertaking, accepted offer, commitment, or agreement; or
(d) negligent misrepresentation.

(3) Subsections (1) and (2) do not apply to:

(a) a loan of money used primarily for personal, family, or household purposes;
(b) an agreement or change in the terms of an agreement relating to a line of consumer credit, lender credit card, or similar arrangement;
(c) an overdraft on a demand deposit or other bank account; or
(d) promissory notes, real estate mortgages, security agreements, guaranty and surety agreements, and letters of credit.

(4) In the event of a conflict between this section and any other provision of law of this State relating to the requirement of a signed writing, the provisions of the other provision of law shall control.

S.C. Code Ann. § 37-10-107 (Law. Co-op. 2002 rev.). Defendants allege, and the Court agrees, that Plaintiffs' Negligent Misrepresentation Action directly refers to representations made by Zielinski as an inducement for Plaintiffs to make the Loans. The issue for the Court is whether this statute is applicable based on the facts of this case.

The Court's analysis of any statute begins with the language of the statute and its plain meaning. If the language is plain and unambiguous, there is no need go any further. Stiltner v. Beretta U.S.A. Corp., 74 F.3d 1473, 1482 (4th Cir. 1996) (citing United States v. Ron Pair Enters., Inc., 489 U.S. 235 (1991)). An examination of legislative history is only necessary where the statue is ambiguous or in rare instances where literal application would "thwart its obvious purpose" or "in which a literal application of the statute would produce an absurd result." Holland v. Big River Minerals Corp., 181 F.3d 597, 603 n.2 (4th Cir. 1999) (citing cases).

The parties did not present, and the Court did not find, any case law interpreting or developing S.C. Code § 37-10-107. Nevertheless, the Court sees no reason to depart from a literal application of the language of the statute, and the parties raised no issues as to any ambiguities presented. Rather, Plaintiffs argue that the focus of their claims are for damages arising out of an alleged fiduciary duty to Plaintiffs relating to the issuance of the C Notes to Defendants preferring the "insider" C Note holders. Further, Plaintiffs contend that S.C. Code § 37-10-107 is inapplicable because damages are not sought for Defendants' failure to loan money to Debtor inasmuch as loans were in fact made. Plaintiffs did not argue that any of the enumerated exceptions to S.C. Code § 37-10-107 were applicable. See S.C. Code Ann. § 37-10-107(3) (Law. Co-op. 2002 rev.)

The plain terms of S.C. Code § 37-10-107 bar any action for, *inter alia*, negligent misrepresentation by *any person* based upon a failure to perform an alleged promise, undertaking, accepted offer, commitment, or agreement to lend or borrow money that is not in writing and signed by the party to be charged, containing material terms and conditions. S.C.

Code Ann. § 37-10-107 (1) and (2)(d) (Law. Co-op. 2002 rev.) (emphasis added).[5] Plaintiffs' Negligent Misrepresentation Action directly refers to Zielinski's alleged representation that Hanley-Wood would place funds with Debtor under the same terms and conditions as Plaintiffs as an inducement for Plaintiffs to make the Loans. Plaintiffs' argument that § 37-10-107 is inapplicable because loans were eventually made to Debtor by Defendants, including Hanley-Wood, is illogical. Plaintiffs' Negligent Representation Action is based upon Hanley-Wood's alleged failure to perform what Zielinski promised it would – loan money to Debtor on the same terms and conditions. It is paradoxical that Plaintiffs can complain that Defendants did not perform as represented but also argue, when it comes to application of S.C. Code § 37-10-107, that the performance was in fact done.[6] Finally, it appears undisputed that this representation was not in writing. Zielinski's alleged false representation is the basis for the Negligent Misrepresentation Action and appears to fall directly within the terms of S.C. Code § 37-10-107.[7]

To the extent Plaintiffs argue that the statute is inapplicable because Defendants never promised to loan money *directly* to Plaintiffs, that contention is belied by the plain terms of the statute. S.C. Code Ann. § 37-10-107 (Law. Co-op. 2002 rev.). See also Schoen v. Morris, 15 P.3d 1094 (Colo. 2000) (statute of frauds barred action even where there was no direct borrower-lender relationship).

Even taking the allegations of the Complaint in the light most favorable to Plaintiffs, the Complaint fails to state a claim upon which relief can be granted for Negligent

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[5] South Carolina adopted the arguably broad model statute prepared by the Joint Task Force of the Committees on Consumer and Commercial Financial Services. By its terms, there is no express language that would render certain parties outside the scope of the legislation, as opposed to legislation that has limited the scope of similar statutes of frauds to financial institution lenders or only those engaged in the business of lending. See, e.g., Colo. Rev. Stat. Ann. § 38-10-124 (West, WESTLAW through 2003 First Regular Session); Cal. Civ. Code § 1624(a)(7) (West, WESTLAW through portion of 2004 Legis. Sess.).

[6] To the extent Plaintiffs' argument is based upon a "part performance" defense to the statute of frauds, the Court notes that such defense appears to be barred by the express terms of S.C. Code § 37-10-107(2)(c).

[7] The parties do not argue that the S.C. Code § 37-10-107 is inapplicable in this case by virtue of the dollar

Misrepresentation. Accordingly, the Court will dismiss Plaintiffs' Negligent Misrepresentation Action.[8]

Breach of Fiduciary Duty

Plaintiffs allege that by virtue of Debtor's insolvency, each of the Defendants owed a fiduciary duty to Plaintiffs due to their status as creditors of Debtor. The acts and omissions alleged include:

a. participating in and supporting and/or allowing the issuance of C Notes by [Debtor] to insiders, and granting said insiders and entities secured preferred status, to the detriment of creditors of [Debtor];

b. causing subsequent investments in [Debtor] to be made as disguised "secured loans," for the purpose of placing subsequent investments in a better position than that provided to Plaintiffs under the [Debentures].

c. by failing to fulfill fiduciary obligations to creditors of [Debtor] through the creation of a preferred class of creditors.

d. inducing Plaintiffs to forego compensation and make loans in [Debtor] through assurances that [Debtor's] principal shareholders would make similar investments on similar terms, and failing to so act.

Plaintiffs allege damages as a result.

Initially, Defendants again seek dismissal of this cause of action pursuant to S.C. Code § 37-10-107, that also bars an action as outlined above based upon a fiduciary relationship. Therefore, to the extent Plaintiffs rely upon any of the Defendants' failure to loan money within

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threshold contained therein.

[8] Defendants further allege that Plaintiffs' Negligent Misrepresentation Action should be dismissed because it does not comply with the requirements of Fed. R. Civ. P. (9)(b) to plead fraud with particularity. Inasmuch as the Court finds that Plaintiffs' Negligent Misrepresentation Action is barred by the statute of frauds, the Court need not

the meaning of S.C. Code § 37-10-107, those acts or omissions cannot be a basis for a breach of fiduciary duty claim. Based upon a review of the four acts and omissions outlined by Plaintiffs in their Complaint (items a-d above), these allegations can be separated into two categories: (1) claims that relate to Zielinski's alleged representation, regarding a loan, to Plaintiffs as former employees of Debtor; and (2) claims that relate to the issuance of alleged preferential C Notes to certain insiders that affects all creditors as well as Plaintiffs' status as creditors of Debtor.

The Court notes that two of the four acts and omissions alleged by Plaintiffs in their Breach of Fiduciary Duty Action (items a. and c. above) center upon the issuance of the C Notes to certain Defendants as alleged insiders, a cause of action that arguably affects all creditors, rather than being based upon an oral promise directly to Plaintiffs regarding a loan from Hanley-Wood. Accordingly, taking the allegations in a light most favorable to Plaintiffs, the acts and omissions outlined in items a. and c. above do not fall within the terms of S.C. Code § 37-10-107 and are thus not barred by that statute.

With respect to the remaining two acts or omissions alleged by Plaintiffs (items b. and d. above), these acts and omissions appear to rely upon the Defendants' failure to loan money on the same terms and conditions as an inducement for Plaintiffs' Loans, and therefore would be barred by S.C. Code § 37-10-107 for the reasons set forth previously and should be dismissed.

Secondly, as to the acts and omissions set forth in items a. and c. above, Defendants further contend that they owed no fiduciary duty to Plaintiffs as a matter of law, and that balance sheet insolvency alone cannot trigger the exception to the general rule that directors and officers do not owe a fiduciary duty to creditors. See FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982) (when corporation is insolvent, fiduciary duty of officers and directors shifts from the stockholders to the creditors); Whitley v. Carolina Clinic, 118 N.C. App. 523, 528-29, 455

address Defendants' Fed. R. Civ. P. (9)(b) argument at this time.

S.E.2d 896, 900 (N.C. Ct. App. 1995) (analyzing North Carolina law and recognizing that many balance sheet insolvent corporations are solvent on a cash flow basis).

The Group One and Two Defendants admitted in their Answers certain allegations with respect to Debtor's insolvency. The Group Two Defendants admitted that throughout Debtor's corporate existence, it failed to realize a profit and operated for several years as an insolvent business, and the Group One Defendants admitted that Debtor failed to realize a profit throughout its corporate existence, but aver that Debtor operated as a solvent entity for a considerable period of time before it became insolvent and sought protection under Chapter 11 of the bankruptcy laws. Not only did Plaintiffs allege the insolvency of Debtor, but Defendants do not wholly deny Plaintiffs' assertion of insolvency. In any event, the existence of insolvency as it related to certain Defendants' duties to creditors is best addressed following discovery. Accordingly, Plaintiffs' allegations with respect to its Breach of Fiduciary Duty Action (items a. and c.) are sufficient for that cause of action to survive a motion to dismiss.[9]

Equitable Subordination

Plaintiffs allege that Defendants are insiders of Debtor and have breached their fiduciary duty to Plaintiffs for the reasons set forth above. Defendants do not raise any new arguments in their Motion with respect to dismissal of Plaintiffs' Equitable Subordination action that have not been addressed previously. Inasmuch as a determination as to whether conduct gives rise to equitable subordination is a particularly fact intensive analysis, because the equitable subordination action is generally based upon an alleged breach of fiduciary duty, and because the existence of a breach of fiduciary duty is a factor in considering whether equitable subordination

[9] Defendants did not raise any argument that a fiduciary duty did not exist by virtue of a particular Defendant's relationship with Debtor, such as a position or status other than that of an officer or director. Accordingly, at this stage of the litigation, the Court will not address legal arguments not raised by Defendants in support of their Motion.

is warranted, dismissal of Plaintiffs' Equitable Subordination Action is not proper at this time. See McGuffin v. Barman (In re BHB Enters., LLC), C/A No. 97-01975, Adv. Pro. No. 97-80227, 1998 WL 2016846, at *14 (Bankr. D.S.C. Sept. 30, 1998) (to warrant equitable subordination, Court considers, *inter alia*, whether claimant has engaged in inequitable conduct such as a breach of fiduciary duty).

CONCLUSION

Pursuant to the foregoing Findings of Fact and Conclusions of Law, the Court will dismiss Plaintiffs' Negligent Misrepresentation Action. Plaintiffs' Equitable Subordination Action, and Breach of Fiduciary Duty Action, to the extent set forth herein, will remain.[10]

AND IT IS SO ORDERED.

John E. Waites
UNITED STATES BANKRUPTCY JUDGE

Columbia, South Carolina,
February 18, 2004.

[10] The Court notes that all of Plaintiffs' causes of action, with the exception of Equitable Subordination, have been dismissed by separate Order of this Court against Debtor.