UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS OF PHD, INC., ON BEHALF OF THE ESTATE OF PHD, INC., *et al.*,	)	Case No.: 1:03CV2466
Plaintiffs,	)	Judge Ann Aldrich
v.	)	
BANK ONE, NA, BANC ONE CAPITAL PARTNERS, LLC, STONEHENGE FINANCIAL HOLDINGS, INC., DANIEL D. PHLEGAR, GRACE M. KEYS and RICHARD HENRY,	)	
Defendants.	)	
	)	MEMORANDUM AND ORDER

PHD, Inc. ("PHD") was a manufacturer of household appliances. In January 2003 PHD and several of its subsidiaries ("the Subsidiary Debtors") sought protection under Chapter 7 of the United States Bankruptcy Code, and the Bankruptcy Court appointed an official committee of PHD's unsecured creditors ("the Committee"). Eighteen of the Committee's twenty-three claims in this court are solely against Bank One, NA ("Bank One") and/or Banc One Capital Partners, LLC ("BOCP"), collectively "the banks." Most of the claims against the banks implicate "core" bankruptcy matters. The banks move to refer all the Committee's claims against them back to the Bankruptcy Court. Defendant Daniel Phlegar, a Director of bankrupt PHD, moves to dismiss claim 18 (breach of fiduciary duty) as to him. There are three other defendants – Stonehenge Financial Holdings ("SFH") and PHD Directors Grace Keys and Richard Henry -- who have not filed motions.

For the reasons that follow, the court grants the banks' motion to re-refer the Committee's claims against them to Bankruptcy Court, and grants Phlegar's motion to dismiss Claim 18 (breach of fiduciary duty) as to him. For the same reasons given for holding that Phlegar had no fiduciary duty to PHD's creditors, the court holds that the other directors (Grace and Keys) had no such duty; therefore the fiduciary duty claims against them (Claims 17, 18 and 23) will be dismissed as well.

Lastly, the dismissal of the sole claim against Phlegar requires the dismissal of three other claims which rest on the premise that Phlegar is liable: Claim 19 (alleging SFH's liability for acts by its "agent" Phlegar), Claim 20 (alleging BOCP's liability for conduct by its "agents" Phlegar and SFH), and Claim 21 (alleging that BOCP aided and abetted Phlegar).

I. BACKGROUND

A. The Parties, and the Committee's Claims

The Committee starts with the premise that Bank One and BOCP were "insiders"as defined by the Code and so owed a fiduciary duty to the PHD entities and their creditors. Where, as here, the debtor is a corporation (PHD), the term "insider" includes any individual who (or entity which) is a director or officer of the debtor, a person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, or a relative of a general partner, officer, director, or person in control of the debtor. *See* 11 U.S.C. § 101(31)(B)(i)-(vi).

> The Committee alleges that Bank One wronged PHD's unsecured general creditors by:
> making fraudulent or negligent representations to PHD vendors and the Subsidiary Debtors;
> receiving preferential transfers from PHD and the Subsidiary Debtors within 90 days before PHD petitioned for bankruptcy protection, thereby improving Bank One's position and leaving less for the repayment of PHD's general unsecured creditors;

attempting to obtain a security interest in the assets of a recently created subsidiary, PHD East, Inc., without exchanging anything of "reasonably equivalent value."

As a consequence, the Committee seeks to equitably subordinate Bank One's claims to the claims of PHD's general unsecured creditors. Title 11 U.S.C. § 510(c) permits a court to impose equitable subordination after notice and a hearing. Under the doctrine, the court is permitted, but not required, to equitably subordinate a creditor's claim when three criteria are met: the claimant must have engaged in some kind of inequitable conduct; the injury must have resulted in injury to the bankrupt's other creditors or conferred some unfair advantage on the claimant; and equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code. *See In re Autostyle Plastics, Inc.*, 269 F.3d 726, 744 (6th Cir. 2001) (citations omitted).

The Committee also seeks to void the preferential transfers and compel Bank One and BOCP to disgorge the value of the transfers for the benefit of PHD's unsecured creditors. *See In re Tri-City Turf Club*, 323 F.3d 439, 443 (6th Cir. 2003) (reviewing elements needed to justify setting aside a transaction as an avoidable preference under 11 U.S.C. § 547(b)); *Matter of Randall Const., Inc.*, 20 B.R. 179, 183 (N.D. Ohio 1981) (applying former 11 U.S.C. § 60(a)).

Defendants Grace Keys and Richard Henry were Directors of PHD beginning in or before June 2001. Defendant Daniel Phlegar was an employee of BOCP and/or SFH at all relevant times, and in that capacity he was appointed to the Board of Directors in June 2001. *See* Comp. ¶ 186. The Committee alleges that Keys, Henry and Phlegar breached fiduciary duties to PHD and to PHD'S creditors by failing to monitor PHD's business conduct and financial condition; preserve PHD's assets and see that PHD operated in a manner that was beneficial, or at least not detrimental to PHD and its shareholders; and

prevent, correct, or mitigate the effect of actions taken by PHD's officers that the directors knew or should have known could be detrimental to PHD. *See* Comp. ¶¶ 185-198.

Lastly, the Committee asserts a claim against SFH entitled "liability for acts of authorized agent." During the period relevant to this controversy, Phlegar was employed either by BOCP or by SFH, which served as the portfolio manager of BOCP's interest in some or all of the PHD Debtors. Phlegar was appointed to PHD's Board, the Committee says, as a direct result of BOCP's interest in PHD. The Committee contends SFH is responsible for Phlegar's conduct while he was acting within the course and scope of his employment with SFH. *See* Comp. ¶¶ 199-203 (Claim 19).

In all, the Committee's complaint asserts twenty-three claims:

Count 1	Equitable Subordination	11 U.S.C. § 510(c)	(Bank One)
Counts 2, 4	Improvement in Position	11 U.S.C. § 547(b)	(Bank One)
Count 3	Improvement in Position	11 U.S.C. § 547	(BOCP)
Count 5	Avoidable Preference	11 U.S.C. § 547(b)	(BOCP)
Count 6	Avoidable Preference	11 U.S.C. § 547(b)	(Bank One)
Count 7	Fraudulent Transfer	11 U.S.C. § 548(a)	(Bank One)
Count 8	Fraudulent Conveyance	11 U.S.C. § 544(b)	(Bank One)
Count 9	Recover Preferential Transfer	11 U.S.C. § 550	(Bank One & BOCP)
Counts 10, 11	Fraudulent Inducement	Common Law	(Bank One)
Count 12, 13	Negligent Misrepresentation	Common Law	(Bank One)
Count 14	Declaratory Judgment	28 U.S.C. § 2201	(Bank One & BOCP)
Count 15	Declaratory Judgment	UCC § 9-203	(Bank One & BOCP)
Count 16	Declaratory Judgment	UCC § 9-502, 9-506	(Bank One & BOCP)
Cts 17, 18, 23	Breach of Fiduciary Duty	Common Law	(PHD Directors: Phlegar, Keys & Henry)
Count 19	Liability for Acts of Agent	Common Law	(Stonehenge FH**)**
Count 20	Liability for Acts of Agent	Common Law	(BOCP)
Count 21	Aiding & Abetting Phlegar	Common Law	(BOCP)
Count 22	Equitable Subordination	11 U.S.C. § 510(c)	(BOCP)[1]

[1] The Committee asserted the foregoing claims in its complaint filed September 4, 2003. Apparently the Committee filed an amended complaint in bankruptcy court on December 1, 2003, but no one has made the amended complaint part of the record in this adversary proceeding in this court. It appears that the amended complaint leaves intact the claims

B. Agreements Between PHD Entities (Borrowers) & Bank One Entities (Lenders)

In June 1996 PHD and two of its subsidiaries (PHD West, Inc. and PHD Southwest, Inc.) entered into a Credit Facility and Security Agreement ("Credit Facility") with Bank One. In return for a revolving loan, the PHD borrowers granted Bank One a security interest in substantially all of their assets. In September 1998 PHD issued a $2 million senior subordinated note to Capital Partners ("the Purchase Agreement"), secured by certain PHD assets and guaranteed by subsidiaries PHD West & PHD Southwest. BOCP agreed to subordinate its claims under the Purchase Agreement to Bank One's claims under the Credit Facility.

In July 2002 PHD created another subsidiary, PHD East. In September 2002, PHD Director Henry advised Bank One that an inventory misstatement was causing financial difficulties for PHD and its subsidiaries. In October 2002, Bank One filed a UCC-1 financing statement with the Delaware Secretary of State, purporting to encumber all PHD East's assets.

C. 2002: Bank One and BOCP Declare PHD and Subsidiaries in Default

PHD customarily released its financial statement at the end of July. In August 2002, however, PHD told vendors and auditors that its FY01 statement was not ready. On September 13, 2002, a field examination revealed significant discrepancies in PHD's books, including a $6 million inventory overstatement. PHD Director Henry retained a firm to provide workout and turn-around services, including a study of restructuring or liquidating the debtors. From September 13-18, 2002, PHD told a

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against Bank One, BOCP, Stonehenge FH, and former PHD directors Phlegar, Henry and Keys. The Committee explains that "The Amended Complaint added Stonehenge Partners, Inc. ('SPI'), Stonehenge Services, Inc. ('SSI') and Bluestone Investors, LP ('Bluestone' ....)." Committee's Opp'n to the Banks' Mot. to Re-Refer Claims against the Banks to Bankr. Court, at 3 n.6.

creditor (Remington) that it was on track to earn a $100,000 profit during FY02, and had good "plans" for FY03. Relying on these representations, Remington continued to ship inventory to PHD, e.g., $750,000 in October 2002. PHD also told Committee member Applica and vendors that Bank One had extended the maturity on its $26 million revolving loan through July 2004.

On September 27, 2002, PHD told Bank One it had overstated its assets by $6 million and no longer had collateral to cover its loan obligations. Bank One terminated the Credit Facility and demanded repayment by the end of 2002. On October 8 and November 5, 2002, Bank One and BOCP issued notices of PHD's default on the Credit Facility and Purchase Agreement, respectively.

D. Bank One Officials Assure PHD's Creditors of PHD's Health

On November 19, 2002 Bank One official Radik told PHD vendors that: (1) the reason Rutt now handled the PHD account instead of him was merely a restructuring of the bank's offices (not because Bank One had declared PHD in default of the Credit Facility); (2) "he was comfortable that Bank One's collateral base was intact relative to the PHD account," PHD's Credit Facility had been renewed through July 2004, and PH's borrowing base was about $1.5 million. Three days later, PHD and its subsidiaries placed a moratorium on payments to vendors, including the Committee.

E. PHD and Its Subsidiaries Seek Chapter 11 Bankruptcy Protection

In January 2003 the Committee filed an involuntary petition for relief against PHD under Chapter 7; as a matter of right, PHD converted the case to Chapter 11. The PHD Subsidiary Debtors also sought Chapter 11 relief, and the Bankruptcy Court ordered their cases jointly administered with PHD's. By a series of Agreed Orders, the court afforded the Committee until August 31, 2003 to investigate the validity of the defendant banks' claims against the debtors' estates.

II. DISCUSSION

A. The Committee's Claim Against Daniel Phlegar is Without Merit

In Claim 18 of the original complaint, the Committee alleges that Daniel Phlegar breached a fiduciary duty that he owed to PHD's creditors while he served on PHD's board of directors:

> Beginning in June 2001, Mr. Phlegar was a director of PHD. While Phlegar was a director, PHD became insolvent. In October 2002, Phlegar learned that PHD had misstated its inventory and therefore knew or should have known that PHD was insolvent.
>
> Upon PHD's insolvency, Mr. Phlegar owed a duty of care to PHD's unsecured creditors. He breached that duty of care to PHD's unsecured creditors by not fulfilling any responsibilities as a director, but not preventing others from making misrepresentations to certain of PHD's creditors, and by not acting "to mitigate the effect" of others' misrepresentations to certain of PHD's creditors. As a result, PHD's unsecured creditors were harmed and seek damages from him.

Comp. ¶¶ 16, 196, 192-98. Phlegar moves to dismiss this claim on the ground that an Ohio statute provides that corporate directors do not owe a fiduciary duty to the corporation's creditors.

Ohio Revised Code section 1701.59(B) generally describes the standard of care to which a corporation's directors are held in Ohio:

> A director shall perform the director's duties as director, including the duties as a member of any committee of the directors upon which the director may serve, in good faith, in a manner the director reasonably believes to be in or not opposed to the best interest of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances.

Subsection (D) of the same section delineates the circumstances under which a director may be held liable for a breach of his duties to the corporation:

> A director shall be liable in damages for any action that the director takes or fails to take as a director only if it is proved by clear and convincing evidence in a court of competent jurisdiction that the director's action or failure to act involved an act or omission undertaken with deliberate intent to cause injury to the corporation or undertaken with reckless disregard for the best interests of the corporation.

Ohio Rev. Code § 1701.59(D). Most important here, the statute expressly provides that directors are permitted, *but not required*, to consider the interests of the corporation's creditors:

> For purposes of this section, a director, in determining what the director reasonably believes to be in the best interests of the corporation's shareholders and, *in the director's discretion, may* consider any of the following:
>
> (1) *The interests of the corporation's* employees, suppliers, *creditors*, and customers;
>
> (2) The economy of the state and nation;
>
> (3) Community and societal consideration;
>
> (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

Ohio Rev. Code § 1701.59(E) (emphasis added).

This court follows the Ohio rule that "the word 'may' shall be construed as permissive and the word 'shall' shall be construed as mandatory unless there appears a clear and unequivocal legislative intent that they receive a construction other than their ordinary usage." *In re Darling*, 2003 WL 23094930, at *4 (Ohio App. 9th Dist. Dec. 31, 2003) (quoting *Dep't of Liquor Control v. Sons of Italy Lodge 0917*, 605 N.E.2d 368, 370 (Ohio 1992) (citations omitted)).

More specifically, only three available Ohio decisions cite section 1701.59(E), and they all draw this distinction between its mandatory and permissive directives: "In considering the best interests of the corporation, a director *must* consider the best interests of the corporation's shareholders, R.C. 1701.59(E), and *may* consider the interests of the corporation's creditors." *Thompson v. Central Ohio Cellular*, 1996 WL 492263, at *5 (Ohio App. 8th Dist. Aug. 29, 1996) (emphasis added), *app. not allowed*, 674 N.E.2d 376 (Ohio 1997); *accord Thompson v. Central Ohio Cellular*, 639 N.E.2d 462, 469 (Ohio App. 8th Dist.), *app. not allowed*, 637 N.E.2d 12 (Ohio 1994); *Abrahamson v. Waddell*, 624 N.E.2d 1118, 1120 (Ohio Com. Pl. 1992).

The Committee does not provide any evidence that the legislature intended "may" to have a meaning other than the usual one. On the contrary, the committee report for the 1984 act enacting subsection (E) confirms the permissive nature of the director's consideration of creditor interests. The report states, "The Committee believes that Ohio law presently *permits* a director to take into account interests other than those of shareholders; however, the Committee believes that it is desirable to specify and clarify the breadth of the interests which a director *may* consider." The Committee does not identify any decision interpreting subsection (E) in a contrary fashion, and this court finds none.

In short, Ohio Rev. Code § 1701.59(E) forecloses the Committee's claims that PHD's directors had a legal duty to consider the interests of creditors in carrying out their duties for the corporation. Although only Phlegar raised this issue, this court must also dismiss the Committee's fiduciary duty claims against the other PHD directors, Henry and Keys, on the same ground.

B. Some of the Committee's Claims Fail Without a Finding of Liability Against Phlegar

Some of the Committee's claims against other defendants are wholly derivative of Phlegar's liability, i.e. they cannot succeed without a finding of liability against Phlegar. Because the court is dismissing the sole claim against Phlegar, those claims necessarily fail as well. Namely, claim 19 seeks to hold SFH liable

for Phlegar's conduct while Phlegar was employed by SFH and served on PHD's Board. In turn, claim 20, entitled "Liability for Acts of Agent," seeks to hold BOCP liable for the acts of SFH and/or Phlegar. Similarly, claim 21 alleges BOCP aided and abetted Phlegar.

Since Phlegar is not liable (claim 18), claims 19, 20 and 21 also must be dismissed.

C. The Committee's Claims Against the Banks Are Properly Before the Bankruptcy Court

In October 2003 defendant Daniel Phlegar filed a motion, pursuant to 28 U.S.C. § 157(d), asking this court to withdraw the reference to the Bankruptcy Court of all claims the Committee asserted against him. In November 2003 defendant SFH likewise filed a motion asking this court to withdraw the reference to the Bankruptcy Court of all claims the Committee asserted against it. Neither Bank One nor BOCP ever moved to withdraw the reference of the claims against them.

The basis for Phlegar's motion and SFH's motion was that the Committee's claims against them did not arise under the Bankruptcy Code and were not unique to bankruptcy proceedings. As such, those claims were so-called "noncore" proceedings. The bankruptcy court has no authority to conduct a jury trial on noncore proceedings, nor may it issue binding final orders in such proceedings. In noncore proceedings, the bankruptcy court can only submit proposed findings of fact and conclusions of law to this court for *de novo* review. *See* 28 U.S.C. § 157(c)(1) and (2).

On December 3, 2003, this court issued an order stating, "Upon motion of the defendant, Daniel D. Phlegar, this Court hereby withdraws the reference of the above-captioned adversary proceeding pursuant to 28 U.S.C. § 157(d). The matter will proceed as a civil case in this Court." This court's December 3 order failed to note that Phlegar's motion asked this court only to withdraw the reference of *the claims against him*, not the claims against any other party. This court's December 3 order also failed

to mention SFH's motion to withdraw, which asked this court only to withdraw the reference of *the claims against it*, not the claims of any other party. This court intended only to grant the limited motions to withdraw filed by defendants Phlegar and SFH.

As noted above, neither Bank One nor BOCP ever filed a motion to withdraw the reference of the Committee's claims against them; nor did the Committee ever file such a motion. While this court has the authority to withdraw the reference of the claims against the banks *sua sponte*, it sees no persuasive reason to do so. The Committee contend that the Committee's "Officer and Director Claims, Vicarious Liability Claims, and Aiding and Abetting Claims" against the banks "are arguably non-core proceedings which, even if adjudicated by the Bankruptcy Court, will remain subject to this Court's *de novo* review. Consequently, the Banks' request to bifurcate the Litigation defies judicial economy because the issues determined by the Bankruptcy Court will come before this Court in any event." Committee's Opp'n to Banks' Mot. to Re-Refer Claims, at 9-10.

Following today's opinion and order, the Committee's argument is far less persuasive. This court today dismisses many of the Committee's "arguably noncore" common law claims. Specifically, this court has dismissed the Committee's claims for breach of fiduciary duty against the PHD Directors Phlegar, Henry and Keys (Claims 17, 18 and 23). This court has also dismissed the vicarious liability / *respondeat superior* claim against SFH (Claim 19), the vicarious liability claim against BOCP (Claim 20), and the aiding and abetting claim against BOCP (Claim 21).

Accordingly, this court did not intend to withdraw, and should not have withdrawn the reference of the Committee's claims against Bank One and BOCP. Claims 1 through 9, claims 14 through 16, and claim 22, are clearly core bankruptcy claims within the purview and expertise of the Bankruptcy Court and should be adjudicated by that court. *Contrast Security Farms v. IBT*, 124 F.3d 999, 1008-1009 (9th Cir. 1997) ("In this case efficiency was enhanced by withdrawing the reference because non-core issues predominate."). Judicial economy warrants having claims 10-13, the only remaining claims which are arguably non-core, in the Bankruptcy Court as well.

III. CONCLUSION

The motion of defendants Bank One and Banc One Capital Partners LLC ("BOCP") to refer the Committee's claims against them to the Bankruptcy Court [doc. # 11] is granted.

Defendant Daniel Phlegar's motion to dismiss Claim 18, Breach of Fiduciary Duty, as to him [doc. # 6] is granted. For the same reasons, the Committee's breach of fiduciary duty claims against defendants Henry and Keys (Claims 17, 18 and 23) are dismissed.

These seventeen claims against Bank One and BOCP are re-referred to Bankruptcy Court:

– Claims 1 through 16, and Claim 22

These six claims are dismissed with prejudice on the merits:

-- Claim 17, against defendants Henry and Keys
-- Claim 18, against defendants Phlegar, Henry and Keys
-- Claim 19, seeking to hold SFH liable for Phlegar's conduct
-- Claim 20, seeking to hold BOCP liable for Phlegar's and/or SFH's conduct
-- Claim 21, seeking to hold BOCP liable for Phlegar's conduct
-- Claim 23, against defendants Henry and Keys

The case management conference previously scheduled for today is vacated. This case is closed, subject to reopening, if necessary, for *de novo* review of any noncore claims that the Bankruptcy Court may address. This is a not a final and appealable order.

IT IS SO ORDERED.

sAnn Aldrich
ANN ALDRICH
UNITED STATES DISTRICT JUDGE

Dated: April 23, 2004