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# Featured Article

## Small Players Can Make Big Differences in Large Bankruptcy Cases

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There is a prevailing perception that the outcome in corporate bankruptcy cases is dictated by the decisions and conduct of the debtor, its secured creditors, and the official committee of unsecured creditors - which are sometimes dominated by bondholders. The conventional wisdom is that an individual unsecured creditor's voice will be drowned out by the din generated by the major constituencies in any given case, so the individual creditor should not waste its time and energy attempting to participate actively, but should instead sit back, let the process play itself out, and wait to collect any distribution that may be available to general unsecured creditors once a plan is confirmed or the debtor's assets are liquidated.

However, claims purchasers have proven that this perception should not deter creditors, even small ones, from speaking up and raising important, even unpopular, questions in significant bankruptcy cases. Claims purchasers typically study very carefully the strengths and weakness of the positions of various parties in chapter 11 cases before deciding whether to purchase claims from trade or other creditors. Even claims purchasers of relatively modest means are able to step into the shoes of the individual selling creditor, play the role of independent watchdog, and make dramatic contributions that change the complexion of chapter 11 cases. There is no reason why any diligent party-in-interest cannot do the same thing. Recent events in the long-running bankruptcy case of SONICblue Incorporated illustrate this point. *See In re SONICblue, Inc.*, No. 03-51775 (Bankr. N.D. Cal. filed Mar. 21, 2003).

*SONICblue's Joint Venture with VIA*

In 2001, SONICblue formed a joint venture with VIA Technologies ("VIA") to operate SONICblue's graphics chip business, to which SONICblue contributed a patent cross-license with Intel Corporation ("Joint Venture"). From the inception of the Joint Venture, there were serious disputes between SONICblue and VIA. In 2002, the parties negotiated a settlement under which VIA would extend a $15 million loan to SONICblue, but neither the loan nor the settlement was consummated before SONICblue's March 2003 bankruptcy filing.

*The Senior Debentures*

Before filing for bankruptcy, SONICblue raised $75 million by issuing senior secured subordinated debentures. Significantly, the relevant indenture provided that the debentures would be subordinated to all of SONICblue's indebtedness to VIA in an amount up to $15 million. SONICblue's counsel, Pillsbury Winthrop Shaw Pittman LLC ("Pillsbury"), issued an opinion letter to the senior debenture holders stating that the debentures constituted valid and binding obligations of SONICblue that were enforceable according to their terms. Due to an apparent scrivener's error, the opinion letter did *not* state that the opinion was subject to the effect of bankruptcy or similar laws.

*Non-Disclosure of the Opinion Letter*

Within a year of issuing the bonds, SONICblue and its three operating subsidiaries ("SONICblue" or "Debtors") were unable to meet their maturing financial obligations and were forced to file chapter 11 petitions with the United States Bankruptcy Court for the Northern District of California. SONICblue retained Pillsbury as its bankruptcy counsel. The Federal Rules of Bankruptcy Procedure require a professional seeking to be retained by a debtor to disclose its connections to the debtor, creditors and any interested parties. *See* Fed. R. Bankr. P. 2014. Pillsbury did not disclose to the bankruptcy court, in its initial disclosures or in any of seven supplemental disclosures that it filed with the court over the next three years, the fact that it had issued the opinion letter to the senior debenture holders only one year earlier.

*The Bondholders Control the Creditors' Committee*

Three institutional bondholders who had purchased the debentures at a discount were named to the official committee of unsecured creditors in SONICblue's chapter 11 case. As other members of the creditors' committee did not remain active in the case, these three bondholders became the majority voice and effectively controlled the committee. These bondholders also retained their own counsel, Bruce Bennett, who functioned separate and apart from the law firm retained by the committee.

*SONICblue's Litigation with VIA Stalls the Bankruptcy Case*

Shortly after the bankruptcy filings, Debtors sold the assets of their three operating businesses, and their cases became liquidating chapter 11 cases. The sales produced sufficient proceeds to pay off secured claims in full, and it was anticipated that Debtors would be able to pay unsecured creditors 33 cents on the dollar. At the time, Debtors did not have a functioning board of directors.

After the asset sales were completed, the cases stalled, as creditors waited for counsel for the Debtors to resolve their disputes with VIA and the Joint Venture. VIA and the Joint Venture filed duplicate proofs of claim for $70 million in July 2003, and SONICblue objected to those claims. In December 2004, SONICblue filed an adversary proceeding asserting various claims against VIA and the Joint Venture. Pillsbury represented SONICblue in that litigation as well.

*Negotiation of the Settlement with VIA*

After settlement discussions between the Debtors, VIA and the Joint Venture began in earnest, in August 2005, Pillsbury consulted on settlement terms not only with the committee's counsel but also with Mr. Bennett. The Debtors believed that consent of the bondholders to the terms of any settlement with VIA and the Joint Venture would be essential to obtaining court approval. During the negotiations, Mr. Bennett stated that the bondholders would consent to a settlement that provided VIA a claim of $12.5 million, as long as VIA's claim would *not* be senior or junior to other general unsecured claims. VIA agreed to waive its right to assert that its claim should have priority over the senior secured debentures pursuant to the indenture.

*The Bondholders Demand Indemnification from Pillsbury*

Next, Pillsbury examined the claims of the bondholders and determined that they may be subject to partial disallowance. In August 2006, after an attorney with Pillsbury shared his claims analysis with him, Mr. Bennett and one of his partners separately contacted Pillsbury attorneys, including the firm's managing attorney, asserting that the bondholders had relied on Pillsbury's opinion letter, which they interpreted as assuring that their claims would be allowed in a bankruptcy case of SONICblue. The bondholders' lawyers demanded that Pillsbury defend and indemnify the bondholders from any losses resulting from any challenge by SONICblue to the bondholder's claims. In response, Pillsbury immediately notified counsel for the creditors' committee of the indemnification demand, and turned over to the committee responsibility for prosecuting the objection to the bondholders' claims. But the law firm did not file a supplemental disclosure, revealing the claim threatened by the bondholders, with the court.

*VIA's Potential Priority Over the Bonds is Not Disclosed to the Court*

In October 2006, the Debtors filed their motion for approval of the settlement with VIA under seal. Counsel for the creditors' committee, who had not seen prior drafts of the settlement agreement, requested and received an oral explanation of the terms of the settlement from the Debtors' special counsel. According to committee counsel, he had no discussion with Debtors' counsel regarding VIA's waiver of priority status for its claim. The bankruptcy court approved the VIA settlement in late October 2006, without knowing that VIA had waived the right to claim priority over the bondholders.

*The Claims Purchasers Intervene, Prompting a Motion by the United States Trustee*

The Debtors and the creditors' committee filed a proposed joint plan of reorganization and disclosure statement in December 2006. A claims purchaser objected to the disclosure statement, asserting that the document did not adequately explain why Pillsbury had a conflict of interest, according to the bondholders. The disclosure statement was therefore amended to state that the role of analyzing the bondholders' claims was transferred to the committee after the bondholders asserted that Debtors' counsel had issued an unqualified opinion letter stating that the senior secured subordinated debentures were enforceable according to their terms. But neither version of the disclosure statement disclosed that the bondholders were members of the committee, which was charged with objecting to their claims.

Two claims purchasers objected to the amended disclosure statement, notifying the bankruptcy court for the first time of VIA's waiver of the priority status to which its claim was arguably entitled under the indenture. The claims purchasers asserted that the VIA settlement effectively reduced the distribution that would be made to unsecured creditors because if VIA had retained the right to priority of payment over the bondholders, it likely would have settled for a lower amount. In other words, the claims purchasers argued that the bondholders, using their influence on the committee, protected their own claims at the expense of the general unsecured creditor body for whom they functioned as fiduciaries, by conditioning their consent to the settlement upon VIA's waiver of the right to priority.

Committee counsel responded to the objection by asserting that it had not previously been aware of the issue of VIA's priority under the indenture, and that it had only a limited role regarding the VIA settlement, not having been party to any confidential settlement discussions. That characterization, the bankruptcy court later observed, "appears markedly at odds" with the statement by committee counsel in a fee application that it "played a material role in negotiating and documenting the [VIA] settlement." *See* Memorandum Decision and Order on Motion to Appoint a Chapter 11 Trustee, Motion to Covert Case, and Motion to Disqualify Pillsbury Winthrop Shaw Pittman LLP and for Disgorgement of Attorney's Fees ("Memorandum Decision") at 13, *In re SONICblue, Inc.*, No. 03-51775 (Bankr. N.D. Cal. Mar. 26, 2007).

Upon learning the facts regarding Pillsbury's opinion letter and the bondholders' indemnification demand, the United States Trustee - an arm of the United States Department of Justice charged with oversight of several aspects of bankruptcy cases - moved for an order disqualifying Pillsbury from serving any further as counsel for the Debtors, requiring the firm to disgorge the millions of dollars of attorneys fees it had collected in the case, and appointing a chapter 11 trustee.

*The Bankruptcy Court Rules that Debtors' Counsel Was Disqualified After Serving for Four Years*

In the Memorandum Decision, bankruptcy judge Marilyn Morgan observed that, to serve as debtor's counsel, a law firm must be free of all conflicting interests that might impair the impartiality and neutral judgment that it is expected to exercise. Professionals representing a debtor's estate must make full, candid and complete disclosure of all facts affecting their eligibility for employment. Judge Morgan held that Pillsbury had a continuing duty to apprise the court of any previously undisclosed connections and conflicts, but the firm had failed to disclose the disabling conflict of interest with respect to the bondholders and its opinion letter. Accordingly, she ruled, regardless of whether its failure to disclose was intentional or inadvertent, Pillsbury had to be immediately disqualified from continuing to represent the Debtors, even though the law firm had been serving as Debtors' counsel for four years.

The court further held that the appointment of a chapter 11 trustee was necessary to restore creditor confidence in the bankruptcy system and to assure that there would be no lingering taint from Pillsbury's representation of the Debtors. The court reserved for a later date, after review by the new trustee, the question of whether the law firm would be required to disgorge fees.

*The Bondholders and Creditors' Committee Counsel Are Also Criticized*

Bankruptcy Judge Morgan also found, in the Memorandum Decision, that the facts indicate an appearance of impropriety by the creditors' committee and its counsel. As members of the committee, the bondholders were fiduciaries bearing a duty of loyalty to act impartially on behalf of all unsecured creditors. But the court found that the bondholders appeared to have used their position on the committee to insert themselves into the settlement negotiations with VIA without revealing a hidden agenda. The court also stated that it appeared that counsel for the committee had failed to independently review the settlement between the Debtors and VIA. Judge Morgan further observed that the facts presented "certainly raise questions" regarding the suitability of committee counsel to pursue objections to the bondholders' claims on behalf of the Debtors' estates. *Id.* at 18.

*The Court Calls for a Nationwide Search for an Independent Chapter 11 Trustee*

Conversion of the case to one under Chapter 7 of the Bankruptcy Code would have removed the influence of the creditors' committee in the case. Nevertheless, Judge Morgan expressed concerns about selection of a trustee who practices "in the protective atmosphere surrounding the close-knit referral circle [that] is reminiscent of the 'opprobrious' bankruptcy ring and the cronyism that Congress decried in the legislative history of the Bankruptcy Reform Act of 1978." *Id.* Accordingly, the bankruptcy court decided to appoint a chapter 11 trustee, rather than convert the case, so that the United States Trustee could tap into a large pool of possible trustees by conducting a nationwide search for a strong and disinterested trustee without connections to the case and the legal community in which the case was pending. The court noted that the Federal Rules of Bankruptcy Procedure require, as a safeguard, that the United States Trustee's application for an order approving appointment of a trustee include a disclosure of all of the proposed trustee's connections to the debtor, creditors and parties in interest, but there is no similar disclosure requirement in a chapter 7 case.

*Conclusion*

But for the diligence of the claims purchasers in the SONICblue case, the disabling conflict of interest of Debtors' counsel probably would have remained unknown to the bankruptcy court, the United States Trustee, the creditors in the case, and the general public. In addition, the creditors committee dominated by the bondholders would have been "entrusted" with prosecuting objections to the bondholders' claims. But the claims purchasers asked hard questions and raised important issues that caught the attention of the bankruptcy court and the United States Trustee's office. The integrity of the bankruptcy system was thus preserved.

There is no reason why any party-in-interest in a bankruptcy case cannot ask tough questions of the professionals upon whom the debtor and creditors rely. Such questions may include not only the existence of conflicts, but also, for example, the basis for decisions to pursue or settle litigation, or procedures used to sell significant assets.

To be sure, in order to be in a position to ask a discerning question and evaluate the answer received, a party must devote time and effort to develop relevant information, and may incur attorneys' fees in connection therewith. Fortunately, to encourage active and meaningful participation in bankruptcy cases, the Bankruptcy Code provides that the court may require a debtor to reimburse a creditor for fees and expenses they incur while making an actual and demonstrable "substantial contribution" in a bankruptcy case. *See* 11 U.S.C. §503. While a full discussion of entitlement to such reimbursement is beyond the scope of this article, it is important for individual creditors to understand that they can make an important difference in a bankruptcy case, and efforts that produce tangible results beneficial to other creditors as a whole are encouraged.

In other words, sometimes the conventional wisdom is wrong.

# Federal Bankruptcy Law

## Discharge

### Debt from Copyright Infringement Judgment Nondischargeable under 11 U.S.C. §523

*Yash Raj Films (USA), Inc. v. Naseem Akhtar (In re Akhtar)*, No. 04-21354-ess, 2007 BL 20702 (Bankr. E.D.N.Y. May 17, 2007)

By order dated May 17, 2007, the United States Bankruptcy Court for the Eastern District of New York held that debt incurred from a copyright infringement judgment was nondischargeable under 11 U.S.C. §523(a)(6) and no genuine issue of material fact existed.

*Debtor Found In Contempt for Copyright Infringement*

Yash Raj Films (USA), Inc. ("Plaintiff" or "Yashi Raj"), manufactured, reproduced, imported, marketed, and sold Indian films. The Plaintiff owned the copyrights and exclusive distribution rights to its motion pictures in the United States and Canada. Naseem Akhtar, was the sole owner of Bobby Music Co. & Sporting Goods Inc. ("Debtor"), a company that sold VHS tapes and DVDs.

After accusing the Debtor of the illegal copying and distribution of the Plaintiff's films, the Plaintiff brought a copyright infringement action against the Debtor in the district court on December 17, 2001. The district court issued an order authorizing the seizure of any unauthorized copies of the Plaintiff's films. Two days later, unauthorized copies of the Plaintiff's films were recovered from Debtor. Significantly, around the very same time, a preliminary injunction had been entered against Debtor in a copyright infringement action brought by another film company.

The Debtor failed to attend a January 2002 hearing to show cause as to why the court should not have entered a preliminary injunction enjoining distribution of unauthorized copies of the Plaintiff's films. In response, the court issued a preliminary injunction barring the Debtor from making or selling unauthorized copies of the Plaintiff's copyrighted material ("Preliminary Injunction"). Notwithstanding the Preliminary Injunction, a police raid in November 2002 uncovered eleven unauthorized Yash Raj titles on Debtor's property ("November 2002 Raid"). Accordingly, in March 2004, the Plaintiff filed a motion seeking entry of an order of contempt. The Plaintiff also sought damages for the violation of the Copyright Act, including attorneys fees ("Copyright Action"). Shortly thereafter, in August 2004, the Debtor filed for Chapter 7 bankruptcy relief.

On July 8, 2005 the bankruptcy court granted Plaintiff's motion to lift the automatic stay, thereby allowing the Copyright Action to proceed. After a hearing and testimony from the parties, the magistrate judge issued a report and recommendation advising the district court to grant the contempt motion. In his findings, the magistrate judge stated that the Debtor had clearly violated the unambiguous Preliminary Injunction and had been fully aware of and willfully violated the proscribed activities set forth therein. The magistrate judge recommended that the Plaintiff be awarded $330,000, the maximum available statutory damages under the Copyright Act, comprised of $30,000 for each of the Plaintiff's eleven unauthorized titles seized at the November 2002 Raid. Additionally, the magistrate found that the Plaintiff should be awarded reasonable attorneys' fees and costs. Hence, the district court entered an order declaring the Debtor's objections to the contempt motion to be without merit and adopted the magistrate judge's recommendations in full ("Contempt Order").