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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re Case No. 01-54143-JRG
KOMAG, INCORPORATED, f/a/k/a Chapter 11
HMT TECHNOLOGY CORPORATION, a
Delaware corporation.
Debtor.

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OPINION

I. INTRODUCTION

On August 24, 2001, Komag, Incorporated ("Komag") filed an Application for Order Authorizing Retention of Ernst & Young Capital Advisors LLC as Special Restructuring and Financial Advisor for the Debtor and Debtor In Possession.¹ The proposed order submitted by the Debtor authorizes Ernst & Young Capital Advisors' LLC ("Ernst & Young") employment as the debtor's "restructuring and financial advisors, on substantially the terms and conditions set forth in the

¹ Due to an internal reorganization within Ernst & Young, the entity now the subject of the application is Ernst & Young Corporate Finance LLC. The change in the particular Ernst & Young entity involved does not effect the questions raised as the proposed retention is on the exactly the same terms and conditions as originally proposed.

1 Application and Retention Agreement." The Retention Agreement or
2 Letter of Understanding ("Agreement") includes provisions which
3 attempt to limit jurisdiction, and the means of resolution, of any
4 controversy or claim that may arise from Ernst & Young's employment.
5 Specifically, the Agreement provides that:

- 6 1) Any claim or controversy with Ernst & Young
7 arising out of the Agreement, or in any way
related to it, must be brought in federal court;
- 8 2) The parties to the Agreement, and any and all
9 successors and assigns, waive their right to a
10 trial by jury in any proceeding that is
11 commenced.
- 12 3) If the federal court does not have or retain
13 jurisdiction over the claim or controversy, it
must first be submitted to non-binding mediation
and, if not resolved, then to binding
arbitration. There is no right to a trial of any
type in a state court.

14 Finally, the Agreement attempts to bind any future trustee appointed
15 in the case.

16 The United States Trustee filed an objection to the appointment
17 of Ernst & Young based on these provisions.

18 **II. BACKGROUND**

19 The provisions sought by Ernst & Young appear to be an effort to
20 limit the company's potential exposure for malpractice claims. This
21 effort may have resulted from a \$185 million settlement in a case
22 brought by a Chapter 7 Trustee against Ernst & Young in Maryland
23 several years ago. See In re Merry Go Round, 244 B.R. 327 (D.Md.
24 2000).

25 Merry Go Round Enterprises ("MGRE") filed a Chapter 11 petition
26 in 1994 and the bankruptcy court approved the debtor's application to
27 hire Ernst & Young as its turnaround specialist. In its application,
28 MGRE stated that Ernst & Young would (i) prepare financial information

1 for MGRE, (ii) assist in developing a plan of reorganization, (iii)
2 assist in negotiating approval of a plan, (iv) render expert testimony
3 as to the feasibility of a proposed plan, and (v) assist with other
4 matters as requested by MGRE. Subsequently, MGRE's reorganization
5 effort failed and the Court appointed a Chapter 7 Trustee.

6 After some investigation, the Trustee filed a fraud and
7 malpractice action against Ernst & Young in the Circuit Court for
8 Baltimore City. Ernst & Young removed the action to the bankruptcy
9 court and the Trustee moved for remand. The Court granted the remand
10 motion. In re Merry Go Round, 222 B.R. 254 (D.Md. 1998). Ernst &
11 Young made a last minute attempt to postpone the trial. When that
12 failed the company agreed to a \$185 million settlement on the eve of
13 trial.

14 Since that time Ernst & Young has explored various ways to limit
15 its exposure. It sought to include indemnification provisions in its
16 agreements that would require a debtor to indemnify Ernst & Young for
17 any claims brought against it, presumably including claims for fraud
18 and willful misconduct. There is no indication that this provision
19 has ever been judicially approved. In re United Companies Financial
20 Corporation, 241 B.R. 521 (D. Del. 1999). Ernst & Young has also
21 sought to avoid any type of trial by requiring binding arbitration of
22 all claims, to prohibit the "assessment of consequential, incidental,
23 indirect, punitive or special damages" and finally to limit damages
24 by capping damages at the amount of fees charged. These efforts
25 appear to have been similarly unsuccessful. Id. This brings one to
26 the more limited prophylactic provisions that are now before the
27 Court.

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1 **III. DISCUSSION**

2 The United States Trustee does not object to the retention of
3 Ernst & Young. Rather, its objection is limited to the "forum
4 shopping, jury trial waiver, and binding arbitration provisions" that
5 are included in the Agreement. The U.S. Trustee argues that the
6 provisions were not put in the Agreement to benefit the estate and its
7 creditors but simply to insulate Ernst & Young's malpractice exposure
8 to the extent possible.² Simply put, the U.S. Trustee argues that
9 other professionals do not receive such protections and there is no
10 basis to give Ernst & Young "special treatment."

11 The rights that Komag has agreed to waive are substantial. The
12 right to trial by jury is viewed as being so fundamental to our system
13 of jurisprudence that it is part of the Bill of Rights, the Seventh
14 Amendment to the United States Constitution. Binding arbitration not
15 only eliminates a trial by jury but any trial at all. The venue
16 provisions, while not as obviously detrimental, certainly limit the
17 right of a potential plaintiff to choose its forum from those legally
18 available.

19 Ernst & Young's response to the Trustee's objection raises two
20 points. First, Ernst & Young argues that the provisions should be
21 approved because they have been approved in various other bankruptcy
22 courts. That argument, standing alone, is simply not persuasive. The
23 only reported decision on the subject appears to be United Companies

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² These provisions are certainly not included because Ernst & Young is concerned about the thoroughness or quality of its work. Ernst & Young received \$441,211.91 from Komag in the 90 days preceding the filing and is providing Komag with a team of professionals billing as high as \$650 per hour.

1 Financial Corporation³ supra. That Court seemed relieved that Ernst
2 & Young had deleted the "draconian" provisions it had previously
3 promoted and was persuaded that the alternative dispute resolution
4 provisions were appropriate and "laudable in relieving the court
5 system of some of its burden."

6 In its response, Ernst & Young ignores the impact of the waiver
7 of a jury trial and the limitation of jurisdiction to the federal
8 court. Rather, it focuses on the desirability of alternative dispute
9 resolution. Ernst & Young argues that federal policy encourages the
10 use of ADR procedures and attaches as exhibits to its response the
11 Justice Department's Voluntary Civil Dispute Resolution Policy and a
12 memorandum from then Attorney General Janet Reno, Promoting The
13 Broader Appropriate Use Of Alternate Dispute Resolution Techniques.
14 Certainly, most judges and attorneys agree that ADR is a tremendously
15 helpful tool. ADR proceedings may provide a better result for the
16 parties as mediation often provides a greater array of possible
17 solutions than the underlying court proceeding. Not all, however,
18 agree that ADR should mandatorily replace a plaintiff's right to trial
19 by jury.

20 An argument can be made that Komag should have negotiated these
21 provisions out of the Agreement. As the Trustee pointed out, the
22 provisions are not for the benefit of the estate and its creditors.
23 However, the playing field is not always level. A Chapter 11 debtor
24 with 8,000 creditors is not usually in a strong bargaining position.
25 Nevertheless, Komag appears to have a sophisticated management team

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27 ³ With respect to other courts that have approved some form of the provisions, there
28 is no indication of whether objections were raised and argued or whether the provisions even
came to the court's attention. Such provisions are usually not highlighted. In this case,
for example, the subject provisions are found on the third page of Exhibit B to the
application.

1 and competent legal representation. A reasonable argument can be made
2 that Komag's agreement should be honored as to Komag.

3 That the Court could honor Komag's agreement as to itself does
4 not decide the question. The issue for Komag is the survival of its
5 business. In the event something should go terribly wrong in its
6 reorganization effort, Komag's executives and counsel will likely be
7 gone and the pursuit of remedies will be left to others. That was the
8 situation in Merry Go Round and in almost all reorganizations that
9 fail.

10 The real problem is with Ernst & Young's attempt to bind all
11 "successors and assigns," most notably any trustee that might be
12 appointed. Ernst & Young contends that a trustee and others will be
13 bound by the agreement. There is authority to support this
14 proposition. In re Trout, 964 F.2d 797, 801 (8th Cir. 1992); In re
15 Southland Supply, Inc., 657 F.2d 1076, 1080 (9th Cir. 1981); In re
16 Tandem Group, Inc., 61 B.R. 738, 743 (Bankr.C.D.Cal. 1986).

17 The Agreement provides: "The parties to this Agreement, and any
18 and all successors and assigns thereof, hereby waive trial by jury,
19 such waiver being informed and freely made." The waiver is certainly
20 not informed and freely given by a trustee that has not yet been
21 appointed or by Komag's 8,000 creditors. Their fundamental rights
22 should not be eliminated in such cursory fashion. If the rights of
23 unidentified parties in interest are to be waived without notice and
24 their consent, that is a decision more properly made by Congress.
25 Stated another way, if bankruptcy practice is to provide a greater
26 insulation from malpractice claims than that which exists under state
27 law, that should be a legislative not judicial determination.
28 Finally, if Ernst & Young is entitled to the requested protections,

1 is it not axiomatic that all other bankruptcy professionals should be
2 similarly protected?

3 There is an additional provision of the agreement that causes
4 concern to the Court. Ernst & Young is engaged to, among other
5 things, prepare financial information for creditors and other
6 stakeholders and to meet with and present information to parties such
7 as Komag's senior lenders. Komag states that it intends to use Ernst
8 & Young's liquidation analysis in its disclosure statement. Despite
9 the anticipated use of Ernst & Young's work product, the Agreement
10 states that it is performed for Komag "and should not be relied upon
11 by any other party for any purpose." On what basis can Komag provide
12 Ernst & Young's work product to creditors without telling them they
13 should not rely on it?

14 Ernst & Young attempts to justify the provision by saying that
15 it is using information from Komag without independent verification
16 and relying on that information. If the disclaimer were tailored to
17 address this concern, it would not be a problem. Ernst & Young next
18 argues that it should have protection similar to that provided by §
19 1125(e) of the Bankruptcy Code, which provides a safe haven for those
20 who solicit votes on a plan in good faith based on an approved
21 disclosure statement. Again, similar protection for Ernst & Young
22 would not be a problem. However, the broad wording of the present
23 provision seems designed to limit the standing of those who might have
24 reason to question Ernst & Young's work in the future.

25 **IV. CONCLUSION**

26 Based on the foregoing, the application must be denied in its
27 present form.

28 This ruling was initially issued as a Tentative Ruling prior to

1 a continued hearing on the Ernst & Young retention application. At
2 the hearing Ernst & Young declined to offer any modification to the
3 Agreement and, on the basis of the tentative ruling, asked that the
4 application be withdrawn.

5 DATED: _____
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10 JAMES R. GRUBE
11 UNITED STATES BANKRUPTCY JUDGE
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