UNITED STATES BANKRUPTCY COURT

NORTHERN DISTRICT OF CALIFORNIA

In re First Pacific Networks, Inc., Debtor(s).	Case No. 97-51077-ASW Chapter 11
First Pacific Networks, Inc., Plaintiff, vs. Act III Communications, Inc.; Hal Gaba; Robert Finkelstein; and Does 1-100, Defendants.	Adversary No. 00-5205

MEMORANDUM DECISION
FINDING DEFENDANTS LIABLE FOR BREACH OF CONTRACT

Before the Court is a complaint by First Pacific Networks, Inc., the Reorganized Debtor in this Chapter 11[1] case ("Debtor"),

[1] Unless otherwise noted, all statutory references are to Title 11, United States Code ("Bankruptcy Code"), as applicable to

against Act III Communications, Inc. ("Act III Communications, Inc."), Hal Gaba ("Gaba"), and Robert Finkelstein ("Finkelstein") (collectively, "Defendants"). The complaint seeks damages for breach of a contract under which Defendants allegedly agreed to pay certain legal expenses incurred by Debtor.

Debtor is represented by Paul A. Peters, Esq. of Kaufman & Logan LLP, and Peter Mallon, Esq. of Niesar & Diamond LLP. Defendants are represented by Abraham M. Rudy, Esq. of Weissmann, Wolff, Bergman, Coleman, Silverman & Holmes, LLP.

The following witnesses testified at trial:

Garrett Cecchini ("Cecchini") was one of Debtor's bankruptcy counsel -- he has eighteen years' experience as a bankruptcy attorney and is the co-author of a treatise on reorganization rights for business attorneys.

Gerald Niesar ("Niesar") was one of Debtor's corporate counsel -- he has practiced law since 1970 with a primary focus on corporate and securities law, including a "considerable" amount of work with the corporate aspects of bankruptcy law; he is co-author of the treatise referred to by Cecchini.

Jean Batman ("Batman") was another of Debtor's corporate counsel -- she has practiced law since 1991 and was an associate with Niesar's firm while representing Debtor.

Gaba is one of the defendants -- at time of trial, he was Chairman of the board of Concord Records ("Concord") and a

---

cases commenced on February 10, 1997.

co-owner of Act III Communications, Inc. -- his background is in the entertainment business and includes experience with mergers and acquisitions dating back to 1972.

Finkelstein is one of the defendants -- he is an attorney and has practiced law since 1972, including representation of companies owned by Gaba; he provided legal services to Gaba in connection with Gaba's dealings with Debtor.

Robert Valentine ("Valentine") was the "point man" assigned by Gaba to communicate with Debtor's counsel -- at that time, he was completing work on a masters degree in Business Administration at the University of California at Los Angeles; he became Vice President of strategic planning at Act III Communications, Inc. in June 1999, having worked for Gaba prior to that time in other capacities.

The matter has been tried and submitted for decision. This Memorandum Decision constitutes the Court's findings of fact and conclusions of law, pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure ("Bankruptcy Rules").

I.

FACTS

The contract ("Contract") that Debtor alleges was breached by Defendants states as follows, in its entirety:

AGREEMENT RE TRANSACTION COSTS

This Agreement is entered into between First Pacific Networks [Debtor], a California Corporation and

Hal Gaba and Robert A. Finkelstein and their assigns, who intend to act through Radio Net, an entity to be formed for the purposes of the transaction contemplated herein, (hereafter collectively referred to as RN). The parties hereto agree as follows:

WHEREAS: [Debtor] is a Debtor and Debtor in Possession in Chapter 11 no. 97-51077ASW filed in the Northern District of California, San Jose Division on February 1997, and with the approval of the Bankruptcy Court after a noticed hearing sold all its operating assets during March 1998; and;

WHEREAS: RN wishes to purchase or merge with the remaining [Debtor] entity through a Chapter 11 Plan of Reorganization when it is satisfied that (i) [Debtor] will have publicly tradable stock and will be current with SEC filings upon completion of the transaction, (ii) [Debtor] has a shareholder base of between 4,000 and 6,000 shareholders (iii) the merged entity will have a shareholder base consisting of existing [Debtor] creditors and shareholders of not less than 2,500 holding not more than 8% of the equity stock. The new entity will be free of all pre-confirmation liabilities of [Debtor] (The Transaction). RN wishes to commence the negotiation and due diligence required for the Transaction, and;

WHEREAS: In accomplishing the Transaction it will be necessary for the parties to negotiate and prepare a letter of intent and other agreements and documents and to seek the approval of the Bankruptcy Court and the creditors of [Debtor] for various aspects of the Transaction and for the Plan of Reorganization, and to perform other due diligence, and in accomplishing the Transaction [Debtor] will incur administrative expenses, including but not limited to the fees and costs of professionals, (Transaction Costs) and [Debtor] is not in a position to incur additional Trans- action Costs without assurances of its ability to pay them,

WHEREFORE, for good and valuable consideration recited herein, the Parties hereto agree as follows:

1. Transaction Fund: RN or its principals will pay or loan to [Debtor] all Transaction Costs incurred by [Debtor] up to a maximum of One Hundred and Ten Thousand Dollars ($110,000.00) (Transaction Fund). RN has placed

on deposit the sum of $75,000 in the Attorney-Client trust account of Robert A. Finkelstein. The Transaction Fund shall be used to pay or to reimburse [Debtor] for the Transaction Costs, up to a maximum of $110,000.

2. Disbursement: Unless it is necessary to pay a retainer to a professional retained by [Debtor], or to pre-pay for a necessary service subject to RN's prior approval, Transaction Funds will be disbursed only after confirmation of a [Debtor] Plan of Reorganization, approved by RN, that enables the Transaction. Transaction Funds will be disbursed to: 1) Professionals approved by the court after entry of an order of the Bankruptcy Court approving the requested fees and costs, and to: 2) [Debtor] 15 days after submission of an itemized bill. If there is a bona fide dispute by RN regarding the relationship of a particular expense to the Transaction only the amount in dispute will be withheld.

3. Termination: In the event [Debtor] is unable to obtain confirmation of a Plan of Reorganization or accomplish the Transaction by another method or cannot proceed with the Transaction for any reason except the withdrawal of RN, RN will be relieved of the obligation to fund the Transaction Costs. If the Transaction is terminated by RN for any reason, RN will give prompt written notice of such termination, and the reasons for such termination to [Debtor]. If termination of the Transaction by RN is voluntary and/or due to events within

the control of RN, and [Debtor] reasonably determines that the Transaction could have been effectuated but for the withdrawal, RN will be responsible for the Transaction Costs up to the Transaction Fund incurred by [Debtor], up to and through the date [Debtor] receives written notice of the termination of the Transaction. The prevailing party in an action to resolve a dispute regarding the liability of RN for Transaction Costs shall be entitled to its attorneys fees and costs.

4. Bankruptcy Court Jurisdiction and Approval: [Debtor] will use its best efforts to obtain the approval of the Bankruptcy Court for this Agreement concurrently with a request for approval of a letter of intent describing the Transaction. The Bankruptcy Court shall retain jurisdiction to enforce and interpret this Agreement. In the event the transaction is not concluded within six (6) months of the date from

Bankruptcy Court approval of the Letter of Intent (LOI) and RN has proceeded diligently RN shall be entitled to terminate and shall not be responsible for any costs.

5. Disputes: In the event RN disputes the relationship of any claimed costs or expense to the Transaction, RN may withhold payment of that portion of the claim only. If the parties are unable to resolve the dispute, the matter shall be brought before the Bankruptcy Court for resolution.

6. Entire Agreement: This Agreement contains the entire agreement of the parties hereto with respect to the subject matter hereof, and supersedes all prior verbal and written agreements relating thereto. Any modification of this Agreement must be in writing.

The Contract bears the signatures of Gaba in his individual capacity (dated June 1, 1999), Finkelstein in his individual capacity (undated), and Christopher Arenal as Chairman of Debtor's Board (dated June 11, 1999) -- it was signed in approval as to form and content by Cecchini as Debtor's attorney (dated June 16, 1999) and by Finkelstein as attorney for "RN" (undated). The Contract was approved by the Bankruptcy Court on August 3, 1999. Although Radio Net was never formed, the Contract was never modified or assigned in writing. Debtor and Defendants agree that the Contract is an integrated agreement, though they disagree as to whether Act III Communications, Inc. is a party to the Contract.

Debtor and Defendants first encountered each other in 1999, when Debtor had been in Chapter 11 for over two years. Cecchini testified that his friend Larry Gordon ("Gordon") had received inquiries from Finkelstein, who was counsel for an "entertainment group" interested in a reverse merger with a publicly traded company. Gordon asked Cecchini to speak with Finkelstein, and Cecchini did so in a brief telephone call. On March 4, 1999, Cecchini sent Finkelstein a "preliminary term sheet", which set forth that: Debtor was a publicly traded company that had been listed on NASDAQ; Debtor filed a Chapter 11 petition in February 1997 due to cash shortages; all operating assets were sold in March 1998; Debtor had 4,000 to 6,000 shareholders; there was no secured debt and unsecured debt totaled $11,500,000, but the largest creditor was willing to receive stock for its $8,000,000 claim; Debtor was accepting proposals for merger or acquisition through a Chapter 11 plan of reorganization; no cash investment would be required if at least 10% of the merged entity's shares were distributed to Debtor's creditors and shareholders; and up to $100,000 of Debtor's costs incurred by the transaction must be paid by the acquiring company.

On March 15, 1999, Finkelstein wrote to Cecchini, saying that he and Gaba had deposited $75,000 into Finkelstein's attorney client trust account, which "will be available to be utilized for acquisition of [Debtor] upon bankruptcy court confirmation and subject to our due diligence". On March 17, 1999, Cecchini wrote to Finkelstein, confirming "receipt of your letter escrowing the $75,000.00 as requested to cover the transaction costs of the deal" -- the letter also said that, of three proposals Debtor had received so far, Debtor's attorneys preferred that made by Gaba and Finkelstein, and a letter of intent should be created for approval by the Bankruptcy Court. On April 26, 1999 and May 13, 1999, Cecchini's firm sent Gaba and Finkelstein, respectively, drafts of a letter of intent and a proposed agreement concerning transaction costs, asking that they be signed and returned so that Court approval of both could be sought. Cecchini testified that no signed letter of intent was ever received from Defendants and the parties proceeded without one -- Finkelstein testified that he did not consider a letter of intent to be important so long as a contract was approved by the Court -- it is undisputed that no one ever asked Debtor or its counsel to provide a letter of intent and have it approved by the Court.

On May 17, 1999, a meeting was held at an office in Los Angeles; all agree that it was the office of some entity known as "Act III", but no one is certain which of several entities with that name held the lease. The participants included Niesar, Batman, Cecchini, Gordon, Finkelstein, and Gaba. There is conflicting testimony as to whether Valentine also attended: Batman, Gaba, and Valentine testified that he did; Finkelstein testified that he did not think Valentine was present; Cecchini testified that he thought Valentine may have been there briefly but left early; and Niesar testified that Valentine was present but did not contribute to the discussion and acted as a "note taker". As for Act III Communications, Inc., that entity had not yet been formed at the time of the meeting. Gaba testified that, at various times over the past twelve years, he and Norman Lear ("Lear") were "partners" in several "related entities" with similar names (e.g., Act III Communications, Act III Communications Holdings, Act III Communications Broadcasting, Act III Communications Theatres, Act III Communications Publishing, Act III Communications Productions), but Act III Communications, Inc. was not created until after the meeting.[2] Gaba said that he did not distinguish between the entities in his own mind because "I didn't think it was relevant" and "anytime you see Act III Communications it's Norman Lear and me", but "it wasn't a shell game to attempt to deceive anyone, in my mind we are Act III Communications".

The parties generally agree about what occurred at the meeting, with one important exception. Gaba wanted one of the entities that he owned with Lear to acquire a company with publicly traded stock, and "grow" the company so that its stock would become sufficiently valuable to be used in lieu of cash to purchase more companies. Debtor was a publicly traded company, so a private company could merge into Debtor and become a new entity with publicly traded stock, without having to meet the legal and practical requirements for a formal initial public offering (which Cecchini estimated typically cost $300,000 to complete). Since Debtor was in Chapter 11, the merger would have

---

[2] The record shows that the date of incorporation was July 8, 1999.

to be accomplished through a Chapter 11 reorganization plan that was confirmed by the Bankruptcy Court -- the plan would satisfy the claims of Debtor's creditors and shareholders by paying them with stock in the newly formed entity, so the new company would not be burdened with Debtor's liabilities. Debtor's attorneys explained at the meeting that confirmation of such a plan would require the new company's stock to be valued, in order to show voters and the Court that the plan complied with §1129(a)(7) by paying creditors and shareholders at least as much as they would receive if the Debtor's assets were liquidated under Chapter 7. Gaba made it clear that he did not want to "hype" the value by expressing an opinion and thereby having himself or Lear associated with something that might be misleading -- Debtor's attorneys explained that they usually retained an independent expert to evaluate stock in new companies and make a report to voters and the Court -- Gaba testified that he replied "fine". At the start of the meeting, the company being considered for merger into Debtor had not yet been formed and was merely a "concept" of Gaba's known as Radio Net, which would broadcast music over the Internet. It was not determined at the meeting what company would be merged into Debtor, but Debtor's representatives understood that many different kinds of assets were available for use in accomplishing a merger, including cash and management of the new entity by "luminaries" such as Lear and others who were well-known in the entertainment business (characterized by Cecchini and Niesar as a “dream team”). Gaba testified that, during the first quarter of 1999, he and Lear commenced arrangements to buy Concord from a bankruptcy estate, and that the “focus shifted” from Radio Net as the merger candidate to Concord at some point “shortly after” April 30, 1999 -- he could not recall who suggested the substitution and thought it might have been either Finkelstein or Cecchini, but said that he did approve it and would “take responsibility” for it.

The parties do not agree on the issue of requirements being imposed at the meeting concerning whether (and, if so, how) the merged entity’s stock must be listed on a public exchange. Finkelstein testified that no such requirements were stated. Gaba testified that he did not “qualify” the type of public company he wanted and did not care if it met the requirements for a NASDAQ smallcap listing or any other kind of listing because he believes that the public determines what the value is and even an unlisted company will eventually “seek the level it should be trading at”, so being listed was not important to him. Niesar testified that a “good deal of discussion” occurred about Gaba’s desire that the new company would not be “a penny stock” and that it meet the requirements for NASDAQ smallcap listing “if possible”, “at some time”, and the issue of timing was discussed. Cecchini testified that Gaba “stressed” that he “didn’t want to go anywhere near some fraudulent pump and dump boiler room type scheme that would hype a stock and, due to the people involved, he didn't want to get anywhere near some penny stock junk stock on some Denver exchange" -- Cecchini said that either Gaba or Finkelstein not only expressed a "preference" for NASDAQ smallcap listing but "that was the directive". Batman testified that Gaba and Finkelstein did not want "a penny stock company" but one that would qualify for a NASDAQ smallcap listing and she discussed the requirements for that at the meeting, but she did not consider that they stated an "ultimatum".

On July 6, 1999, Cecchini wrote to Gaba that Debtor's counsel had reviewed Concord's financial information and determined that a new entity consisting only of Concord would "generate a very tepid market response", such that it was necessary to include in the new company one or more "internet strategies" such as Radio Net. That letter enclosed a six page memo dated July 1, 1999 to Cecchini from Niesar and Batman, stating at the top of its second page: "With the reestablishment of an active trading market for shares of [Debtor] (soon to be New Concord) as one of the primary objectives of this transaction, it is important to keep in mind the minimum NASDAQ listing requirements while analyzing the proposed plan for the merger and reorganization". Those requirements were set out verbatim on the last three pages of the memo and summarized on the memo's second page as including net tangible assets of at least $4,000,000, a "public float" (shares not held by insiders) of at least 1,000,000 with a minimum market value of $5,000,000, and a minimum share price of $4. The memo explained that, in order for those requirements to be met by merging Concord into Debtor and distributing 8% of the new stock to Debtor's creditors and shareholders, the new entity's value would have to be $75,000,000 (which Niesar and Batman did not consider would be justified by Concord alone without the addition of something like Radio Net). Batman testified that the $75,000,000 figure in the memo was not intended to represent a determination of the new company's value, but was merely "a number arrived at by backing through the objective of reaching NASDAQ smallcap listing requirements to our current structure", and was an "illustration". That figure later changed to $120,000,000 when Defendants required that the percentage of new stock distributed to Debtor's creditors and shareholders be reduced from 8% to 5%, as discussed below, and the decrease in the public float resulted in an increased total value illustration for purposes of meeting the NASDAQ smallcap listing requirements.

Immediately after the meeting of May 17, 1999, Batman commenced drafting the disclosure statement that is required by §1125 for a Chapter 11 plan, and a proposed merger agreement to be effected through the confirmed plan. She said that she was "frustrated" by the process because a decision was never made as to what would be merged into Debtor (Concord, Radio Net, a combination of the two, or something else) and a final draft of the disclosure statement could never be completed due to lack of that and other necessary information from Defendants. Batman was frequently in communication with Valentine and testified that she sent him each draft as it was prepared; he testified that he received and reviewed four drafts.[3] The disclosure statement draft prepared on October 14, 1999 was sent to Valentine and annotated by him with changes that he wanted made -- that draft shows a "plan value" share price of $4 and 30,000,000 shares outstanding, which equates to a total value figure for the new entity of $120,000,000.[4] Cecchini testified that the $4 "plan value" share price was based on the NASDAQ requirement of a minimum share price in that amount, but it represented a value to be used for purposes of settling claims only, and not a prediction of what the shares might trade for on the market in the future. He said a claims settlement value of $4 per share was supported by a good faith basis because Concord had a history of successful operation for over twenty years, internet companies were doing very well in the marketplace at that time, and Defendants proposed "stellar" management for the new entity -- nevertheless, the settlement value was not a prediction or

[3] Gaba testified that he "may have skimmed" some of the drafts "along the way".

[4] That entry is not annotated with a written comment by Valentine, but he testified that he did state "informal" objections to Batman and Cecchini's associate Sandra Cross about values in drafts throughout the process, believing his objections would eventually be resolved. Batman testified that Valentine had not stated such objections to her, although "that doesn't mean we weren't having a discussion and we recognized that we had an issue".

guarantee that the stock would actually sell for a certain amount, and the draft disclosure statements made that clear with disclaimers and explanation of risk factors.

Valentine testified that he had "several" discussions with Batman, Niesar, and Cecchini after the meeting of May 17, 1999, about merging Concord into Debtor, NASDAQ smallcap listing requirements, and various capital structures for the new company with different share bases and prices. He said that he took issue with language in a draft disclosure statement dated October 21, 1999, showing 30,000,000 shares outstanding and stating that Debtor assigned a $4 share value for purposes of claims settlement, which represented "a substantial premium over Concord's net book value" but "Concord's management believes this valuation is justified and, perhaps even modest", in light of factors described thereafter. Valentine saw the $4 figure as representing the new company's present value (albeit while taking into account what the company intended to do in the future), and he wanted no value stated. Valentine then had a phone conversation with Cecchini and said he was told that the disclosure statement had to state a share value. On October 27, 1999, Valentine wrote to Cecchini, saying:

> I told Hal Gaba of your position that the minimum valuation for Concord Records at which the Plan of Reorganization could be approved by [Debtor's] creditors and shareholders is $4 per share or $120 Million, and I explained to him the rationale for that figure based on our conversation this morning. However, as I explained previously, this valua- tion is orders of magnitude higher than what the owners and management consider to

> be a reasonable current value for the Company. We would feel extremely uncomfortable with any business reference to such a value for Concord, re- gardless of your opinion that such a claim would be legal. [¶] This is the first we've heard that the Plan, as it is contemplated, could only be approved by the relevant parties with a valuation of $120 Million for Concord. Based on this position, it is clear that 5% of the equity of Concord Records, appropriately and realistically valued, will never meet the needs of [Debtor's] creditors and shareholders. [¶] We do not intend to waste any more time and effort on this transaction. Please call me if you would like to discuss this matter further.

In response to that letter, Niesar wrote to Valentine on October 28, 1999, saying (in part):

> I hope we are only dealing with a communications disconnect and, once your group understands how we intended to use the "valuation", we can get back on track. [¶] I am attaching a copy of some language we had drafted yesterday to be included in the disclosure statement. This would be just a working draft and is not intended to impose final language or position on anybody. However, what we are trying to do is explain the difference between current market value to a third party stock purchaser, i.e., somebody not already involved as a creditor of [Debtor], and those who are being offered something in place of nothing. [¶] I believe your colleagues are approaching this question from the stand- point of what they think they could legitimately suggest to the general John Doe investor as a "reasonable price" for a share of New Concord. In that regard we would certainly agree that it would take a leap of faith, based upon the information such person would have, to pay $4 per share for the stock immediately after the Plan is confirmed. [¶] However, given the combination of the existing business, the relationship with EMusic, <u>and the management team involved</u>, we believe it would be a piece of cake to find an underwriter to do a $20 to $30 Million secondary offering at $4. per share within a year after the merger. Actually, Garrett and I believe the price could approach $10 per share [based on very informal and general conversations that Cecchini recently had with a couple of investment bankers expressing serious interest]. (original emphasis)

Niesar's letter did not sway Valentine, who testified that he believed the "crux" of the matter to be whether a value should be stated at all. He did not consider Debtor's proposed value figures to be "theoretical future value" rather than present market value despite Niesar's proposed language attempting to clarify the future aspect, and he viewed the disclosure statement's explanation distinguishing share value for claims settlement purposes from actual future value as "standard boilerplate risk management" for investors in general that wasn't "specific to" Debtor or Concord. Valentine testified that his instructions from Gaba were that no value should be stated for the stock because Gaba did not want any such statement attributed to him -- he said that he and Gaba had not discussed whether a value could be stated by someone other than Gaba and that was a "grey area", but he believed that Gaba did not want his name in a document that stated a value because the representation could be associated with Gaba even if it were not made by him.[5]

Gaba's testimony differed from Valentine's with respect to

[5] No expert was ever retained to appraise the new entity. Debtor's counsel testified that they had no authorization from Defendants to do so, whereas Gaba and Finkelstein testified that the Contract permitted Debtor to spend up to $110,000 on whatever costs were deemed necessary and Debtor was free to include the cost of retaining an expert if Debtor considered that necessary. Debtor's counsel also testified that there was nothing for an expert to appraise until Defendants decided what the new entity would consist of, whether Concord alone, or Concord plus Radio Net, or Concord plus something else -- by the time of Gaba's November 8, 1999 letter of abandonment, the capital structure of the new entity had not been determined, nor had Debtor received a final business plan for Concord.

the issue of value. Gaba said that he saw the July 1, 1999 memo from Niesar and Batman stating that the merged entity would have to be valued at $75,000,000 in order to meet NASDAQ smallcap listing requirements, but it had no effect on him because he was not going to represent a value and "if [Debtor's] people wanted to represent it, they could" -- "I made it clear that I wasn't going to represent it as my opinion; if they thought they could get the plan approved with their opinion, that was OK". Gaba testified that he instructed Valentine to write the October 27, 1999 letter to Cecchini because he was "flabbergasted" that, "after all this time", Debtor would take the position that plan confirmation required Gaba to make a representation that he had said from the beginning he would not make. Niesar's letter to Valentine dated October 28, 1999 with an explanation and proposed language about future value did not make Gaba "comfortable" about the issue -- nor did a letter to Gaba from Niesar dated November 3, 1999 with a more detailed explanation, assuring Gaba that Debtor was not "trying to promote some flimflam scheme using your good names in the process", and offering to meet in Los Angeles "to put this opus back together" because "[w]e have all invested a lot of time, money and effort in taking the Plan to the eve of filing" and "it would be tragic to see that all go to waste if it is over a misunder-standing". In response to that letter, Gaba wrote to Niesar on November 8, 1999:[6]

> I received your letter dated November 3, 1999, detailing your summary of salient points regarding the reasons behind Act III's decision to abandon the proposed merger with [Debtor]. I would like to clarify my reasons, and put this matter behind us once and for all. [¶] As Bob Valentine's previous letter explained to you, it was never my understanding that a value for Concord Records would need to be anywhere close to the $120 million you and Garrett Cecchini told Bob would be required to get the Plan of Reorganization approved by the court. You affirmed that there was no misunderstanding on our part of this issue. Had you initially disclosed (at the time I first proposed to use Concord as the company with which to merge [Debtor], as opposed to RadioNet) that such a value would necessary, [sic] I never would have gone forward with the transaction. In fact, at our very first meeting, I told you that we would make no representations about the value or potential value of the assets we were contributing. [¶] I do not view your attempts to complete the merger between [Debtor] and Concord Records as some "flimflam scheme" to dupe the investors and creditors of [Debtor] or the bankruptcy court. However, I believe that in the end we were attempting to fit a square peg in a round hole. The amount of equity that I am willing to sacrifice in a merger with [Debtor], at a value that I view to be reasonable, would simply not match the requirements of the creditors of [Debtor] in such a way as to meet the goals of Act III and Concord Records. It is for this reason that I abandoned the proposed transaction. I trust that you will respect and understand this decision.

Gaba testified that, if Niesar had called him after the November 8, 1999 letter, he "probably" would have spoken to him, but he did not "voluntarily initiate" a call in response to Niesar's offer in the November 3, 1999 letter to meet in Los Angeles. He said that he believed Cecchini had "lied" to him

[6] The letter is undated but the evidence includes a copy of the envelope in which Niesar received it, bearing a postmark of November 8, 1999.

previously, which "made me cautious in terms of my perception of their integrity", though it did not change his behavior. The previous encounter with Cecchini occurred during the summer of 1999 when, according to Gaba, Valentine told Cecchini that the original proposal to pay 8% of the merged company's stock to Debtor's creditors and shareholders would have to be changed to give them only 5%, because Concord had just entered into a lucrative distribution agreement with EMusic and Gaba did not want to give up as much of the new entity now that it had become more valuable. Valentine reported to Gaba that Cecchini told Valentine that the Bankruptcy Court had already "ruled" on the 8% figure and it could not be changed. Gaba testified that he did not believe that he was "locked into" 8% but, if that were true, "we wouldn't go forward with the deal" -- he wrote to Cecchini on August 5, 1999, saying in part:

> I understand you spoke to Bob Valentine concerning the share distribution proposal for [Debtor's] claimants. During that discussion, you indicated that any change in the amount of equity offered to creditors was non-negotiable due to the fact that the Federal judge in charge of the case had "signed off on the deal", so that the percentage of equity offered to [Debtor] could not be changed from 8%. We both know this is nonsense. [¶] Maybe you're negotiating on behalf of your clients, but I now have serious reservations about the credibility of the representations that have been made to us regarding this transaction. I think it's in our mutual best interests to terminate discussions regarding a merger with [Debtor].[7]

---

[7] Cecchini testified that he did not take seriously Gaba's reference to termination, and he did ultimately agree to a 5% distribution as being "consistent" with the 8% referred to in the Contract that had been approved by the Court. He conceded that he

Niesar and Cecchini both testified that they believed Debtor could have received Bankruptcy Court confirmation of a plan providing for a merger had Defendants not abandoned the project and refused to reconsider that decision. They said that, by 1999, Debtor had sold all assets and had only $80,000 cash plus a right to receive royalties if its buyer was successful -- accordingly, liquidation of the estate was not likely to pay general unsecured creditors much (if anything) and shareholders would receive nothing. By contrast, the proposed plan would offer creditors and shareholders stock in a new entity consisting at least of Concord and possibly also including an internet enterprise such as Radio Net. The value of Concord alone might not be great, since its recent purchase price was only $7,500,000, its equity was only about half that amount, and its projected annual net income was only $150,000 -- however, it had been successful for over twenty years, had just acquired what were considered to be valuable EMusic distribution rights, Gaba had committed a $6,000,000 line of credit to it, and it had a "dream team" for management. Furthermore, it was common knowledge that internet companies were doing very well in the stock market at that time and, according to Cecchini, many of

---

was negotiating with Valentine, but said that he did not discuss the figure of 5% with him -- he did tell him that, if the figure were less or "substantially less" than 8%, "we'd have to go back to Court" and could have a "problem" there, and he believed that to be true.

them had far fewer attributes than the proposed new entity would have if it included both Concord and an internet enterprise -- Cecchini's general discussions with investment bankers suggested that a company combining Concord and an internet business would be attractive to the market. Debtor's counsel believed that Debtor's creditors and stockholders would vote to accept a plan offering them stock in a new entity (whether Concord alone or Concord plus an internet company), because that would be preferable to receiving the negligible or non-existent liquidation value of Debtor's sparse assets. Niesar believed that Debtor "definitely, absolutely" could have confirmed a plan proposing merger, and Cecchini said that "we thought we had a homerun".

After receiving Gaba's November 8, 1999 abandonment letter, Debtor's counsel stopped working on the project with Defendants -- Niesar testified that he understood the letter's final sentence ("I trust that you will respect and understand this decision") to be "saying politely 'get off my back we're not going forward'"; taken in the context of the recent communications, he believed that further salvage efforts would be "not only useless but maybe inflammatory". On March 27, 2000 Cecchini's office wrote to Gaba and Finkelstein, asking that $64,677.75 be paid under the Contract for fees and costs incurred by Cecchini's firm -- on April 3, 2000, Cecchini's office wrote to Gaba and Finkelstein, asking that $46,410.09 be paid under the Contract for fees and costs incurred

by Niesar's firm.[8] On April 6, 2000, Finkelstein wrote in response, saying in part:

> Garrett Cecchini insisted to Hal Gaba and Bob Valentine that in order to obtain confirmation of a Plan or to accomplish the Transaction, it was necessary for Hal Gaba to support a valuation to creditors and stockholders of [Debtor] inconsistent with sound business judgment, morality and fairness. [¶] Of course, Hal Gaba was unwilling to support any such valuation, no matter how cleverly couched by the [Debtor's] counsel, and accepted Mr. Cecchini's statement that the Transaction could not be accomplished. RN was thereupon relieved of any obligation to fund Transaction Costs.

Each firm then sought Court approval of those fees and costs by noticing applications for hearing on May 23, 2000 -- both applications stated that payment was not sought from Debtor's estate but would instead be sought from "Act III" under the Contract. In response, a "STATEMENT AS TO IMPROPRIETY AND NON-BINDING NATURE OF PROCEEDINGS ON FEE APPLICATIONS" was filed by "Act III Communications" through counsel Cynthia M. Cohen, Esq. ("Cohen") of Jeffer, Mangels, Butler & Marmaro LLP. The statement set forth that: the Bankruptcy Code, Bankruptcy Rules, and the Court's guidelines for compensation applications should not apply to or govern the applications because payment was not

---

[8] Finkelstein testified that he withdrew the $75,000 that had been on deposit in his attorney/client trust account at some point before receiving the demand letters. He said that he did not realize there was any dispute with Debtor before he received those letters, since there was no response to Gaba's letter of November 8, 1999 stating that the project was abandoned.

being sought from Debtor's estate but from "Act III"; the Bankruptcy Rules would require a complaint in an adversary proceeding if "Act III" were to be held liable for any of the compensation that was the subject of the applications; "Act III" should not be bound by approval of the applications; "the [Contract] gives Act III the contractual right to dispute the nature and amount of any fees and expenses for which recovery is sought" and principles of contract law would apply to any such dispute; the Bankruptcy Court would "in all likelihood" lack jurisdiction over "a plenary lawsuit" to determine the liability of "Act III" for the compensation that was the subject of the applications. Cohen appeared on behalf of the objector at the hearing of the applications. Orders were issued on June 8, 2000, approving both applications as obligations of Debtor's estate -- the orders further provided, inter alia, that the Bankruptcy Court had jurisdiction to enforce and interpret the Contract, which finding was binding upon "Act III"; and that "Act III" was bound by the Court's finding that the compensation approved was reasonable, appropriate, and necessary to the preservation of the estate. Cohen signed both orders in approval of form and content. At trial, Defendants did not contest the merits of either compensation application.

II.

ANALYSIS

A. Breach of Contract

The Contract states that the parties to it are Debtor and "Hal Gaba and Robert A. Finkelstein and their assigns, who intend to act through Radio Net, an entity to be formed for the purposes of the transaction contemplated herein, (hereafter collectively referred to as RN)". Gaba and Finkelstein made no formal written assignments, Radio Net was never formed, and Debtor's complaint for breach of the Contract names as Defendants Gaba, Finkelstein, and Act III Communications, Inc. (although Act III Communications, Inc. is not expressly identified by the Contract as a party to it). The issue of whether Act III Communications, Inc. should be treated as a party to the Contract is discussed in §II.B. below. For purposes of this section of the Memorandum Decision (i.e., §II.A.) concerning whether the Contract was breached, the parties to the Contract other than Debtor will be referred to as "Gaba, Finkelstein, et al."

(1) Duties

The Contract is not an agreement for a merger. Rather, the essence of the Contract is that, under certain circumstances, Gaba, Finkelstein, et al. will pay Debtor's expenses incurred to do certain work. The work to be done is defined as:

> In accomplishing the Transaction it will be necessary for the parties to negotiate and prepare a letter of intent and other agreements and documents and to seek the approval of the Bankruptcy Court and the creditors of [Debtor] for various aspects of the Transaction and for the Plan of Reorganization, and to perform other due

> diligence, and in accomplishing the Transaction [Debtor] will incur administrative expenses, including but not limited to the fees and costs of professionals, (Transaction Costs) ....

The work for which Gaba, Finkelstein, et al. will pay Debtor's expenses is work to accomplish "the Transaction" -- the Transaction is defined as:

> RN wishes to purchase or merge with the remaining [Debtor] entity through a Chapter 11 Plan of Reorganization when it is satisfied that (i) [Debtor] will have publicly tradable stock and will be current with SEC filings upon completion of the transaction, (ii) [Debtor] has a shareholder base of between 4,000 and 6,000 shareholders (iii) the merged entity will have a shareholder base consisting of existing [Debtor] creditors and shareholders of not less than 2,500 holding not more than 8% of the equity stock. The new entity will be free of all pre-confirmation liabilities of [Debtor] (The Transaction).

The circumstances under which Gaba, Finkelstein, et al. will pay Debtor's expenses are defined as:

> Unless it is necessary to pay a retainer to a professional retained by [Debtor], or to pre-pay for a necessary service subject to RN's prior approval, Transaction Funds will be disbursed only after confirmation of a [Debtor] Plan of Reorganization, approved by RN, that enables the Transaction. ... In the event [Debtor] is unable to obtain confirmation of a Plan of Reorganization or accomplish the Transaction by another method or cannot proceed with the Transaction for any reason except the withdrawal of RN, RN will be relieved of the obligation to fund the Transaction Costs. If the Transaction is terminated by RN for any reason, RN will give prompt written notice of such termination, and the reasons for such termination to [Debtor]. If termination of the Transaction by RN is voluntary and/or due to events within the control of RN, and [Debtor] reasonably determines that the Transaction could have been effectuated but for the withdrawal, RN will be responsible for the Transaction Costs up to the Transaction Fund incurred by [Debtor], up to and through the date [Debtor] receives written notice of the termination of the Transaction.

In order for Debtor to receive payment from Gaba, Finkelstein, et al., Debtor must have a Chapter 11 plan confirmed by the Court, which plan is "approved" by Gaba, Finkelstein, et al., and which "enables the Transaction". The Transaction to be effected by a confirmed plan is a merger with Debtor that meets certain criteria: Debtor must have publicly tradable stock, be current with SEC filings, and have a shareholder base of 4,000-6,000; the merged entity must have a shareholder base of Debtor's creditors and shareholders totalling at least 2,500 holding no more than 8% of equity stock; and the new entity must be free of all of Debtor's pre-confirmation liabilities. If Debtor cannot obtain confirmation of a plan providing for such a result, Gaba, Finkelstein, et al. need not pay Debtor's expenses incurred in attempting to do so, with one exception. The exception is termination of the Transaction by Gaba, Finkelstein, et al. (voluntarily or due to events within their control), if Debtor reasonably determines that the Transaction could have been completed but for the termination.

(2) Termination

Gaba, Finkelstein, et al., did terminate the Transaction. Gaba's letter of November 8, 1999 expressly referred to "Act III's decision to abandon the proposed merger" and went on to say "It is for this reason that I abandoned the proposed transaction". That letter was written after Valentine's letter of October 27, 1999, stating "We do not intend to waste any more time and effort on this transaction". Valentine's letter is not entirely unequivocal because it concludes "Please call me if you would like to discuss this matter further", but Gaba's letter leaves no doubt that there is nothing to talk about: "I would like to clarify my reasons, and put this matter behind us once and for all", and "I trust that you will respect and understand this decision". Niesar's impression of Gaba's letter was that he was "saying politely 'get off my back we're not going forward'", such that further approaches by Debtor would be "useless" or even "inflammatory" -- that interpretation was reasonable, and the fact is that no one on behalf of Gaba, Finkelstein, et al. accepted Niesar's November 3, 1999 offer to meet, or otherwise acted in any way that was inconsistent with final and complete termination.

Finkelstein's April 6, 2000 letter suggests that it was Debtor that terminated the project before Gaba's letter of November 8, 1999 was ever written:

> Garrett Cecchini insisted to Hal Gaba and Bob Valentine that in order to obtain confirmation of a Plan or to accomplish the Transaction, it was necessary for Hal Gaba to support a valuation to creditors and stockholders of [Debtor] inconsistent with sound business judgment, morality and fairness. [¶] Of course, Hal Gaba was unwilling to support any such valuation, no matter how cleverly couched by the [Debtor's] counsel, and accepted Mr. Cecchini's statement that the Transaction could not beaccomplished. RN was thereupon relieved of any obligation to fund Transaction Costs. [emphasis supplied]

Finkelstein's letter was written five months after Gaba's letter, and his reference to Gaba having accepted Cecchini's statement that the Transaction could not be accomplished is inconsistent with what Gaba himself wrote, referring to "Act III's decision to abandon", and saying that "I abandoned the proposed transaction", with no reference to accepting a conclusion by Debtor that the project could not be done. Gaba's own statements show that it was he who made the decision and took steps to halt the project, rather than merely accepting something already done by Debtor. Furthermore, the other evidence, including Niesar's letter of November 3, 1999 and counsel's conduct, does not support an inference that Debtor's attorneys thought or acted as if the transaction was over prior to receiving Gaba's letter of November 8, 1999.

(3) Voluntary

Gaba's November 8, 1999 letter shows that termination was voluntary, i.e., it was what Gaba chose to do when he came to believe that the project would not serve his purposes:

> I believe that in the end we were attempting to fit a square peg in a round hole. The amount of equity that I am willing to sacrifice in a merger with [Debtor], at a value that I view to be reasonable, would simply not match the requirements of the creditors of [Debtor] in such a way as to meet the goals of Act III and Concord Records.

Defendants argue that termination was caused by Debtor making improper demands -- e.g., Finkelstein's April 6, 2000 letter accuses Cecchini of having "insisted" that "in order to obtain confirmation of a Plan or to accomplish the Transaction, it was necessary for Hal Gaba to support a valuation to creditors and stockholders of [Debtor] inconsistent with sound business judgment, morality and fairness". This position suggests that the Contract goes further than it does -- as set forth above, the scope of the Contract is limited to providing for payment of Debtor's expenses incurred to obtain confirmation of a Chapter 11 plan providing for a merger, and the Contract does not address what will or will not have to be done by Gaba or anyone else in order to achieve confirmation. Moreover, to any extent that this argument may be relevant, it is flawed for the following reasons.

As the "point man" designated by Gaba, Valentine was, for the most part, the only one talking to Debtor's counsel. It is apparent that he misunderstood Gaba's position on whether the disclosure statement could state a value for the new entity's stock. Gaba testified that he was not willing to represent a value, but it would be "fine" with him if Debtor or an independent expert did so -- Valentine testified that he did not know whether Gaba would permit anyone else to represent a value, but believed that Gaba did not want a value stated by anyone in anything with Gaba's name on it because the statement might be associated with Gaba. Valentine's insistence that no value could be stated at all presented Debtor with an insurmountable obstacle because a value had to be ascribed to the stock, for two reasons. First, a disclosure statement must include a liquidation analysis showing voters how distributions under the plan compare to liquidation of the estate's assets without the plan -- when a plan proposes to distribute stock, the shares of stock must be given a value so that the value of what is to be distributed can be compared to the value of the assets that would be liquidated if no distribution occurred. Second, in order for stock to be distributed on account of creditors' claims and shareholders' interests, each share of stock must be given a value so that it can be known how many shares are to be distributed on account of each claim and interest. So it was necessary for a value to be stated by the disclosure statement, yet Valentine would not agree to having that done. As Finkelstein and Gaba pointed out, Debtor was free to retain an expert to represent a value, but that would have been futile in the face of Valentine's refusal to have any statement of value made by anyone (in addition to the fact that there was nothing to value until Defendants committed to a capital structure for the new entity). It was Gaba's decision to put Valentine in charge of communicating with Debtor's counsel, and it was his responsibility to see to it that Valentine accurately stated Gaba's views -- the fact that Valentine adhered to a position that was not in fact adopted by Gaba was no fault of Debtor's, and Debtor was not in the wrong by insisting that some statement of value was required for confirmation of a plan.

With respect to which value was needed, Debtor assumed from the outset that a NASDAQ smallcap listing was desired by Gaba, Finkelstein, et al. and based the $4 share value on the requirements for that listing; those requirements further dictated the calculations that produced the total values of $75,000,000 and $120,000,000. Gaba testified that he did not "qualify" the kind of public company he wanted and did not require it to be listed at all, but all of Debtor's counsel testified that the tenor of the discussions at the May 17, 1999 meeting was that the smallcap listing was important. Regardless of whether Debtor's counsel misunderstood Gaba, Finkelstein, et al. on that point at the meeting, the fact remains that no one ever corrected them about it. Valentine testified that he discussed the requirements for smallcap listing with Debtor's counsel, but he never told them that it was not necessary to meet those criteria. The memo by Niesar and Batman dated July 1, 1999 was sent to Gaba on July 6, 1999 and is devoted almost exclusively to the smallcap listing requirements and their effect on a reorganization plan, commencing at the top of the second page. Gaba testified that he saw that memo and considered its statement of a $75,000,000 value for the new entity to have no effect on him because that figure was being represented by Debtor rather than by him -- but the memo must have made him aware that Debtor was basing the plan and the value on the smallcap listing requirements. Yet, despite the awareness of Valentine and Gaba that all of the values stated were based on Debtor's efforts to comply with the smallcap listing requirements, and despite the fact that Valentine and

Gaba both thought that the new company could not support such value figures, no one ever told Debtor's counsel that the smallcap criteria could be ignored. Taking Gaba at his word that he did not require the new company to qualify for NASDAQ smallcap listing, and considering that he knew at least from the July 1, 1999 memo (not to mention Valentine's frequent discussions with Debtor's counsel) that Debtor was deriving values for its plan by applying those requirements, then it was up to him to point out to Debtor's counsel that they were proceeding under a false premise. Instead, Gaba's abandonment letter of November 8, 1999 complained about a value of $120,000,000 being necessary for confirmation, when he should have realized that such a value was based upon the effects of the smallcap listing requirements and would <u>not</u> be necessary if those requirements were not imposed (as he now says they need not have been).

<u>3. Reasonable Determination of Confirmability</u>

The voluntary termination by Gaba, Finkelstein, <u>et al.</u> gives rise to their duty to pay for Debtor's expenses only if Debtor reasonably determined that a plan could have been confirmed that provided for a merger meeting the criteria set forth in the Contract. Debtor's counsel testified that such a determination was made, and explained why.

The Contract refers to Debtor "reasonably" determining that such a result would have been achieved in the absence of termination, which suggests that the determination cannot be subjective. An objective analysis shows that Debtor's proposed plan could have been confirmed had Gaba, Finkelstein, et al. proceeded. Debtor's counsel testified without contradiction that the proposed plan would present Debtor's creditors and shareholders with a choice between something or nothing: vote to accept stock in a new company that may or may not prove to be valuable but which has a reasonable chance of succeeding, or vote against the plan and be left with virtually no assets available upon liquidation. The plan would not offer voters just anything rather than nothing, it would offer them a chance to participate in a new company that had legitimate prospects of being and remaining profitable. Defendants do not dispute Concord's track record of over twenty years' successful operation, or the "dream team" management available to it, or its credit line of $6,000,000 -- those factors alone would make the new company attractive, and the package would look even better if some kind of internet business were added so as to take advantage of the favorable market for such enterprises at that time. It does not require the considerable experience and expertise that Cecchini and Niesar both have in corporate bankruptcy reorganization to conclude that voters were more likely than not to elect Debtor's proposed plan over the alternative of liquidation.

B. Parties

The Contract does not name Act III Communications, Inc. as a party, though it does include as parties the "assigns" of Gaba and Finkelstein.[9] Debtor has named Act III Communications, Inc. as a defendant and contends that it became an assignee, albeit not by way of formal written assignment -- rather, Concord (which was owned by Act III Communications, Inc.) was proposed by Gaba as the business to be merged into Debtor, such that Act III Communications, Inc. participated with Gaba in attempting to accomplish the Transaction that was a subject of the Contract.

Debtor argues that an assignment does not have to be written, citing California Civil Code ("CC") §1052, which provides that "[a] transfer may be made without writing, in every case in which a writing is not expressly required by statute". Defendants argue that a writing is expressly required by the statue of frauds, CC §1624(2), concerning "[a] special promise to answer for the debt, default, or miscarriage of another" with exceptions not applicable here. Neither party cites any caselaw reconciling the two statutes, nor has the Court found any. On its face, CC §1052 makes exception for transfers that are

---

[9] The Contract is ambiguous on its face as to who the parties are, since it includes Radio Net as a party and that entity was never formed. To the extent of that ambiguity, the parol evidence rule of California Code of Civil Procedure §1856(a) does not preclude evidence of extrinsic matter that varies or contradicts the written Contract, even though the Contract is an integrated agreement in all other respects. The evidence includes previous drafts of the Contract that do name Act III Communications, Inc. as a party, which suggests that inclusion of that entity was considered and rejected.

statutorily required to be made in writing, and CC §1624(2) does require promises to answer for the debt of another to be made in writing. Debtor contends that an assignment occurred here, but all that Act III Communications, Inc. would have received had the Contract been assigned to it was the duty to pay Debtor's expenses -- as noted above, the Contract is not a contract for a merger under which Act III Communications, Inc. might have received some benefits in addition to duties. Since the essence of the Contract is to impose duties for payment of Debtor's debts, the California statute of frauds does apply and requires that any promise by Act III Communications, Inc. to assume the duties of Gaba, Finkelstein, et al. under the Contract must be in writing. It is undisputed that there is no such writing.

Debtor makes an alternative argument based on the doctrine of judicial estoppel, citing Jackson v. County of Los Angeles, 60 Cal.App.4th 171 (1997) and Schulze v. Schulze, 121 Cal.App.2d 75 (1953). That doctrine provides that a party who has elected to pursue one of two inconsistent courses of action is precluded from pursuing the other course at a later time. Here, an entity using the name "Act III" filed a pleading in this Court and appeared at a hearing through counsel, in response to compensation applications filed by Debtor's counsel. That response asserted rights under the Contract, including a right to make contractual defenses, a right to an adversary proceeding in the Bankruptcy Court, and a right to a plenary proceeding in some other court. At the time that response was filed in 2000, Act III Communications, Inc. had been incorporated for approximately one year, but the responding party did not specify whether it was Act III Communications, Inc. or some other entity known as "Act III". Act III Communications, Inc. has not even attempted to show that it is a different entity from the one that responded to the compensation applications and asserted rights under the Contract, as it clearly would be in a position to claim if that were the case. Accordingly, the doctrine of judicial estoppel applies to prevent Act III Communications, Inc. from denying now that it is a party to the Contract.

CONCLUSION

The Contract calls for Defendants to pay up to $110,000 of Debtor's expenses in having a Chapter 11 plan confirmed that would permit Defendants to merge a company of theirs with Debtor. The Contract also provides that, if Defendants voluntarily terminate the project before such confirmation and Debtor reasonably determines that such confirmation would have occurred but for the termination, Defendants are responsible for Debtor's expenses in attempting the confirmation. Defendants did voluntarily terminate the project and Debtor did reasonably determine that a plan permitting the proposed merger could have been confirmed but for the termination. Defendants are therefore liable for $110,000 of Debtor's expenses incurred to pursue the proposed merger and plan confirmation.

This Court has approved fees and costs charged by Debtor's counsel for such services as an expense of the estate totalling $111,087.84. Under the Contract, Defendants are liable for $110,000 of that amount and Debtor is entitled to judgment in that amount for Defendants' breach of the Contract, plus pre-judgment interest of 10% pursuant to CC §3289(b).

The Contract provides that the prevailing party in an action to resolve a dispute over Defendants' liability for Debtor's expenses is entitled to recover its attorneys' fees and costs from the other party. Debtor is the prevailing party in this action and is therefore entitled to recover from Defendants its reasonable expenses incurred in this litigation.

Counsel for Debtor shall submit a form of order so providing, after review by Defendants' counsel as to form.

Dated:

ARTHUR S. WEISSBRODT
UNITED STATES BANKRUPTCY JUDGE