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20 Counsel for the Ad Hoc Committee of Equityholders

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22  
23 **UNITED STATES BANKRUPTCY COURT**  
24  
25 **SOUTHERN DISTRICT OF CALIFORNIA**

26 In re )  
27 )  
28 )

**CASE NO. 06-00510-LA11**

SERACARE LIFE SCIENCES, INC., )  
A California Corporation )

Chapter 11 Proceedings

Debtor and Debtor-in- )  
Possession )

**OBJECTION OF AD HOC EQUITY  
COMMITTEE TO DEBTOR'S MOTION FOR  
ORDER (1) APPROVING BREAKUP FEE, (2)  
PAYMENT OF LEGAL FEES AND DUE  
DILIGENCE EXPENSES, AND (3) SETTING  
HEARING ON MOTION FOR APPROVAL OF  
SECURED FINANCING PURSUANT TO  
SECTION 364**

**Date: August 31, 2006  
Time: 3:00 p.m.  
Dept: 2  
Judge: Hon. Louise DeCarl Adler**



1 "Tranche A Notes") in respect of the Initial Loan that may, at the election of the Investor  
2 Group, be exchanged at confirmation for "Tranche B" senior secured convertible notes  
3 (the "Tranche B Notes"). The Tranche B Notes are convertible at the option of the  
4 Investor Group at any time prior to maturity (60 months from the closing of Tranche A) at  
5 an initial conversion price of \$5.50 per share. The conversion right is intended to survive  
6 confirmation of a plan of reorganization. *Cresci Tr.* pp. 107-08. The Tranche B Notes  
7 will be non-callable for the first three years after issuance and thereafter are callable  
8 provided that a to-be-agreed-upon "make-whole premium" is paid to the Investor Group.  
9 *Id.* at 108.

11 3. The LOI further contemplates a break up fee in the amount of \$1.25 million,  
12 which amount, according to the Debtor, constitutes "5% of the \$25 million potential  
13 financing". *Breakup Fee Motion*, p. 3. In light of the anticipated financing amount of \$15  
14 million, the \$1.25 million breakup fee constitutes approximately 8.3% of the actual  
15 anticipated financing amount. After bankruptcy court approval – and prior to any funding  
16 of the Initial Loan -- the Debtor will be bound to pay the breakup fee in accordance with  
17 the terms of the LOI. In addition to the breakup fee, the Debtor will be bound to pay an  
18 additional \$100,000 of the Investor Group's due diligence fees and \$35,000 of the Investor  
19 Group's out-of-pocket due diligence expenses. *See SeraCare Life Sciences, Inc. Term*  
20 *Sheet*, filed as Exhibit 1 to *Breakup Fee Motion*, (the "Term Sheet") p. 35 – 36.

23 4. But the fees still continue to mount. After the closing of the issuance of the  
24 Tranche A Notes, the Debtor becomes obligated to pay the Investor Group's legal fees and  
25 diligence expenses, as well as a \$200,000 facility fee, all, of course, in addition to the 9%  
26 interest on the loans. *See Term Sheet*, p. 31, 35. The proposed transaction would also  
27 impose the following potential -- and substantial -- costs on the Debtor:  
28

- 1           ▪ if an alternate transaction is consummated after the Initial Loan has been advanced  
2 and before the confirmation of a plan of reorganization, the Investor Group will  
3 receive a multi-million dollar cash payment as a "return on sale." The LOI offers  
4 the following sample calculation of the Investor Group's "return on sale" in such a  
5 situation: "[I]f a sale of the Borrower occurs at an effective price per common  
6 share of \$7, and at the time of sale Borrower has \$16m of Tranche A Notes  
7 outstanding, then concurrently with the closing of the sale transaction, [the Debtor]  
8 would make an aggregate cash payment to the Investors of approximately \$4.4  
9 million." See Term Sheet, p. 33. See also Cresci Tr. at 108-109.
- 10           ▪ as troubling as a \$4.4 million payout to the Investor Group would be, the sample  
11 calculation provided in the LOI actually understates the potential windfall to the  
12 Investor Group. Varying the numbers in the example results in substantial  
13 increases in the total windfall. For example, if \$25 million in Tranche A Notes are  
14 outstanding at the time of such an alternate transaction, the cash payment to the  
15 Investor Group would be \$6.8 million if the per share price of the Debtor's  
16 common stock at the time is \$7 and **\$15.9 million** if the per share price is \$9.  
17 Cresci Tr. at 109-110;
- 18           ▪ if the Tranche B Notes are redeemed, the Debtor is required to pay a "make whole  
19 premium" in an amount that the Debtor and the Investor Group have yet to  
20 negotiate. *Id.* at 108;
- 21           ▪ the interest rate on the loans can increase to 15% if a required registration  
22 statement is not declared effective by the earlier of: (i) ninety days following  
23 confirmation of the Debtor's plan of reorganization; and (ii) February 28, 2007.  
24 See Term Sheet, p. 35. Cresci Tr. at 111-12. To date, the Debtor has made no  
25 showing of its likelihood to file a registration statement in the near future.

26           5. The Tranche B Notes are convertible into common stock of the Borrower at  
27 any time prior to maturity at an initial price of \$5.50 per share, which on conversion  
28 would equal approximately 23% of the equity of the Debtor. *Id.* at 124. The maturity date  
will not occur, however, until 60 months after the closing of the Initial Loan and thus the  
Investor Group is being offered a secured loan at 9%, with the right to capture years into  
the future 23% of all upside of the company. The Debtor's chairman acknowledges that  
the Debtor could be worth significantly more two years from now when the Debtor  
emerges from bankruptcy. *Id.* at 84. Indeed, it is for this very reason that Mr. Cresci  
opined that it is not currently the right time to sell the Debtor. *Id.* at 83. The Debtor,  
nonetheless, proposes to give away 23% of the future upside of the Debtor and makes this

1 proposal prior to confirmation of a plan of reorganization, over the objection of the Ad  
2 Hoc Committee and notwithstanding the existence of better alternative financing strategies  
3 that have the support of the stockholders of the Debtor.

4           6. After learning that there is broad interest among shareholders in the stock of  
5 the Debtor, starting on or about July 27, 2006, the Ad Hoc Committee asserted that the  
6 Debtor should alter its financing approach to adopt a rights offering in which each current  
7 shareholder of the Debtor would be given an equal right, as part of a plan of  
8 reorganization, to invest additional funds into the Debtor, on a pro rata basis. To ensure  
9 the success of such a rights offering, members of the Ad Hoc Committee have offered to  
10 provide a backstop by agreeing to purchase any offered shares in the rights offering that  
11 other existing shareholders decline to purchase. Under such a scenario, the Ad Hoc  
12 Committee would ensure the success of the rights offering and provide the Debtor with  
13 financing, without imposing a debt liability (likely accruing at 15%) on the balance sheet,  
14 without giving away 23% of the company to the Investor Group and without imposing on  
15 the estate an outrageous breakup fee and other liabilities that the Investor Group's proposal  
16 would entail.

17           7. If, for some reason, the Court concludes that a rights offering is not  
18 favorable, the breakup fee should nevertheless be denied since the members of the Ad Hoc  
19 Committee are prepared to commit immediately to the identical proposal as that offered by  
20 the Investor Group, except that the Ad Hoc Committee members would not require the  
21 breakup fee that the Debtor is seeking to have this Court approve.

22           8. The Ad Hoc Committee has performed a preliminary analysis of the value  
23 of comparable companies in the Debtor's industry, and applied such analysis to the third  
24 party proposal being pursued by the Debtor. Using the low end of comparable valuations,  
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28

1 the proposed Investor Group financing would likely result in a substantial windfall to the  
2 outside investors. By contrast, should a rights offering to current shareholders be pursued  
3 instead, all current shareholders would have an equal opportunity to participate in the  
4 rights offering and retain their respective equity value.

### 5 ARGUMENT

6  
7 9. Courts have articulated that the justifications for the granting of a breakup  
8 fee are: (1) to attract or retain a potentially successful initial bidder, (2) to establish a floor  
9 for other bidders, or (3) to attract additional bidders. *See, e.g., Official Comm. Of*  
10 *Subordinated Bondholders v. Integrated Resources, Inc. (In re Integrated Resources,*  
11 *Inc.)*, 147 B.R. 650, 662 (S.D.N.Y. 1992). By contrast, if the primary impact of a breakup  
12 fee is to give a favored purchaser an advantage over other bidders by increasing the cost of  
13 the transaction to those bidders, the breakup fee is plainly illegitimate and should not be  
14 approved. *Calpine Corp. v. O'Brien Env. Energy, Inc. (In re O'Brien Env. Energy, Inc.)*,  
15 181 F.3d 527, 535 (3d Cir. 1999). If a debtor requests a breakup fee for legitimate  
16 purposes, but such alleged purposes are not, in fact, promoted by the introduction of a  
17 breakup fee, the court should deny the request. *See O'Brien*, 181 F.3d at 535. Based upon  
18 the facts before this Court, the proposed breakup fee serves no legitimate purpose and  
19 should not be approved.

### 20 The Breakup Fee Should Not Be Approved Because The LOI Is 21 Not A Binding Commitment By The Investor Group

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23 10. The LOI cannot reasonably be argued to allow the Debtor to "retain" the  
24 Investor Group's bid or create a "floor" for future bidders that guarantees a minimum bid  
25 to the Debtor. First, the Investor Group proposal simply does not bind the Investor Group  
26 to any minimum bid, or to provide any financing at all, for that matter. By its very terms,  
27 the LOI is non-binding. The LOI is also missing essential terms, such as the amount of  
28

1 the "make-whole premium" referenced above, and the terms of a plan of reorganization  
2 that would be acceptable to the Investor Group. Even after definitive documentation is  
3 executed, the LOI contemplates that the definitive documentation will continue to have a  
4 due diligence contingency that the Investor Group can exercise right up to the initial  
5 closing. Thus, the Debtor is seeking to grant to the Investor Group an option, exercisable  
6 by the Investor Group in its sole discretion, and the LOI is nothing but a non-binding term  
7 sheet for the grant by the Debtor of an option to the Investor Group. Nonetheless, the  
8 Debtor requests that a breakup fee be approved!

9  
10 **The Breakup Fee Should Not Be Approved Because The Ad Hoc Committee**  
11 **Has Proposed To Provide Financing To The Debtor On Better Terms**

12 11. The granting of a break-up fee to the Investor Group is also unnecessary to  
13 attract other bidders. The Ad Hoc Committee is already interested and has been involved  
14 in discussions with the Debtor since May.<sup>2</sup> The Ad Hoc Committee opposes the Investor  
15 Group's proposal because it offers expensive financing which, as a component thereof,  
16 gives away the upside of 23% of the equity value of the Company. The proposed  
17 \$1,250,000 break-up fee makes the Investor Group's proposal even more expensive, and  
18 chills rather than promotes bidding.

19  
20 12. As noted above, the Ad Hoc Committee believes that a rights offering,  
21 available to all shareholders, is the appropriate approach for the Debtor to raise any  
22 financing. If notwithstanding the Ad Hoc Committee's objections this Court is inclined to  
23 approve the Investor Group's proposal, the breakup fee component of that proposal should  
24 not in any event be approved because the members of the Ad Hoc Committee (all of  
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28 <sup>2</sup> Indeed, another potential investor (Gateway Capital Management LLC) has recently served notice that it intends to submit a competing bid.

1 whom are substantial financial institutions) will enter into the identical proposal without  
2 the requirement of a break-up fee.

3 **The Breakup Fee Should Not Be Approved Because There Is No Necessity**  
4 **To Enter Into The Proposed Transaction With The Investor Group**

5 13. The Debtor asserts that if the Investor Group enters into definitive  
6 documentation with the Debtor, and if the Investor Group subsequently closes the  
7 Tranche A, the Debtor will be in a position to propose a plan of reorganization. In fact,  
8 however, the Debtor has made no progress in proffering a plan. The chairman of the  
9 Debtor's board, Robert J. Cresci, testified on Tuesday, August 22, that the Debtor's plan is  
10 not yet in shape even for consideration by the Debtor's directors, Cresci Tr. 46, that the  
11 Debtor has had no plan negotiations with any of the securities class action plaintiffs, the  
12 D&O insurer or the subordinated secured lenders. *Id.* at 114-115. Indeed, when asked  
13 with whom, if anyone, plan-related discussions had taken place, Mr. Cresci had to admit  
14 that he did not know of any. *Id.* at 115.

15  
16 14. Second, there is no need for interim financing. Mr. Cresci testified at his  
17 deposition that (i) the senior secured bank debt is secured by cash in excess of the amount  
18 of that indebtedness, *id.* at 117 (ii) the company has a substantial net worth, *see id.*(portion  
19 filed under seal), and (iii) the Debtor has submitted 8 or 9 requests for proposals to  
20 traditional asset based lenders for financing in the range of 10-15 million dollars to which  
21 the Debtor expects to receive responses soon. *Id.* at 41-44.

22  
23 15. Furthermore, even if there were an arguable benefit to the estate from  
24 having the Investor Group's proposal as a minimum bid or "floor" (even one as illusory as  
25 the Investor Group's), as noted above, the Ad Hoc Committee has proposed to provide  
26 financing to the Debtor pursuant to a rights offering and to provide a backstop by agreeing  
27 to purchase any shares that are not purchased by other shareholders in the offering. A  
28

1 rights offering with such a backstop will give the Debtor the best of both worlds, by  
2 guaranteeing the Debtor its requested financing while protecting its shareholders from  
3 dilution.

4 16. Moreover, as noted above, if a rights offering is not viable or preferable,  
5 the members of the Ad Hoc Committee will enter into a letter of intent on terms identical  
6 to those in the LOI, but *without any breakup fee*. The Debtor, therefore, can obtain from  
7 the Ad Hoc Committee the identical financing being proposed by the Investor Group, but  
8 without foisting upon creditors and shareholders the risk of a \$1.25 million breakup fee  
9 payable to the Investor Group. Under these circumstances, *any* breakup fee in favor of the  
10 Investor Group is unnecessary and does not in any way benefit the estate under section  
11 503(b).  
12

13  
14 **The Breakup Fee Should Not Be Approved Because It Is**  
15 **Part Of An Impermissible *Sub Rosa* Plan**

16 17. The proposed breakup fee is part of an impermissible *sub rosa* plan that  
17 should only be approved in the context of a plan of reorganization, with all attendant  
18 notice and disclosure obligations. *See, e.g., In re Braniff Airways, Inc.*, 700 F.2d 935, 940  
19 (5th Cir. 1983) (denying approval of sale transaction that, if consummated, would dictate  
20 terms of subsequent plan of reorganization). The proposed financing arrangement seeks to  
21 accomplish through section 364 what can only properly be accomplished through a  
22 confirmed plan of reorganization. As noted above, the LOI purports to dictate the future  
23 conversion price of the Tranche B Notes as well as the capital structure of the Debtor for  
24 the next 5 years. Yet, the Debtor proposes to make the Initial Loan upon the entry by the  
25 Bankruptcy Court by a financing order and not pursuant to an confirmed plan of  
26 reorganization, which, the evidence shows, has not even been discussed with other major  
27 constituencies in the case. In contrast to the Investor Group's proposal, the rights offering  
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1 proposed by the Ad Hoc Committee would be conducted pursuant to a plan of  
2 reorganization to ensure adequate notice and opportunity to be heard for all parties in  
3 interest.

4           18. A debtor may not circumvent the requirements of confirmation by entering  
5 into an overreaching financing arrangement. *See e.g., In re Defender Drug Stores, Inc.*,  
6 145 B.R. 312, 317 (9th Cir. B.A.P. 1992) ("The bankruptcy court cannot, under the guise  
7 of section 364, approve financing arrangements that amount to a plan of reorganization  
8 but evade confirmation requirements.") (citing *In re Chevy Devco*, 78 B.R. 585, 589-90  
9 (Bankr.C.D.Cal.1987)); *In re Mid-State Raceway, Inc.*, 323 B.R. 40, 62 ( Bankr.  
10 N.D.N.Y. 2005) (holding that proposed financing arrangement that included, among other  
11 elements, a post-confirmation loan and equity investment, exceeded the scope of section  
12 364, and noting that the debtor was free to propose the same financing arrangement as part  
13 of a proposed plan of reorganization).

14           19. The proposed financing arrangement goes far beyond the debtor-in-  
15 possession financing that is typically approved by a financing order pursuant to section  
16 364 of the Bankruptcy Code. Although the LOI relies on section 364 to attempt to  
17 circumvent the plan confirmation process, the proposed financing does not even comply  
18 with Section 364. The proposed financing is to be a priming DIP financing, senior in  
19 rights to both the existing unsecured creditors, and junior secured creditors, of the Debtor.  
20 Yet, Section 364 requires that the Debtor may only obtain such financing if, *inter alia*,  
21 there is no such other financing available. *See* 11 U.S.C. § 364(d)(1)(A). In fact, such  
22 financing is available in the form of the rights offering proposed by the Ad Hoc  
23 Committee, and such financing would be subordinate to the payment of both junior  
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1 secured creditors and trade creditors. There is no conceivable justification for a breakup  
2 fee under such circumstances.

3 **The Breakup Fee Fails Each Of The Three Tests Applied By Courts**  
4 **To Evaluate Breakup Fees In The Bankruptcy Context**

5 20. In addition to the infirmities noted above, the breakup fee also fails to pass  
6 muster under any of the three tests courts have applied to evaluate breakup fees. These  
7 three tests, in order of significance, are as follows:

8 (1) an administrative expense analysis under section 503(b) of the  
9 Bankruptcy Code, which has been applied by the Third Circuit and  
10 by the Eighth Circuit Bankruptcy Appellate Panel;

11 (2) a multi-factor inquiry that focuses on the benefit of the breakup fee  
12 to the estate, its creditors, and its shareholders; and

13 (3) a business judgment test (used in the Southern District of New York  
14 prior to the emergence of the section 503(b) approach in the Third Circuit)  
15 that considers whether the negotiation of the breakup fee was tainted by  
16 self-dealing, whether the fee chills rather than encourages bidding and  
17 whether the amount of the fee is reasonable relative to the proposed  
18 purchase price.

17 **The Breakup Fee Is Not Actually Necessary To Preserve The Value Of The Debtor's**  
18 **Estate And Should Not Be Allowed Pursuant To Bankruptcy Code Section 503(b)**

19 21. In *O'Brien*, the Third Circuit held that, in a bankruptcy case, expenses and  
20 breakup fees are to be evaluated under Bankruptcy Code §503(b) and are allowable as an  
21 administrative expense only if the requirements of general administrative expense  
22 jurisprudence are satisfied. *See O'Brien*, 181 F.3d at 535; 11 U.S.C. § 503(b)(1)(A); *see*  
23 *also In re Tama Beef Packing, Inc.*, 290 B.R. 90, 97-98 (8th Cir. BAP 2003). Thus, “the  
24 allowability of break-up fees. . . depends upon the requesting party’s ability to show that  
25 the fees were actually necessary to preserve the value of the estate.” *O'Brien*, at 535.

26 22. A party seeking to recover break-up fees and expenses must prove that its  
27 participation in the bidding process was necessary to accord the estate an actual benefit.  
28

1 *O'Brien*, 181 F.3d at 533 (citations omitted). Under this approach, the business judgment  
2 rule is inapplicable to a debtor's decision to award an initial bidder expense reimbursement  
3 fees or break-up fees in connection with a bankruptcy auction sale. *See O'Brien*, 181 F.3d  
4 at 535.

5  
6 23. The Third Circuit in *O'Brien* identified three possible ways in which break-  
7 up fees and expenses could benefit the estate. First, a break-up fee may benefit the estate  
8 where the promise of such a fee would “promot[e] more competitive bidding, such as by  
9 inducing a bid that otherwise would not have been made and without which bidding would  
10 have been limited.” *Id.* at 537. Second, an initial bidder protected by a break-up fee could  
11 serve as a “stalking horse” to encourage other bidders. *Id.* Third, a break-up fee could,  
12 theoretically, be justified if an initial bidder has conducted diligence with respect to the  
13 debtor and submitted a bid (on which other bidders can rely) that reflects the information  
14 gained from that diligence, thereby “increasing the likelihood that the price at which the  
15 debtor is sold will reflect its true worth.” *Id.* The *O'Brien* court, however, affirmed  
16 bankruptcy court denial of a break-up fee where no showing was made that the claimants'  
17 initial bid was the catalyst for higher bids, even where the auction resulted in competitive  
18 bidding.  
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20  
21 24. In this case, the Debtor can make no showing that payment of the breakup  
22 fee will provide an actual benefit to the estate for purposes of Section 503(b). First, the  
23 Investor Group's "bid" is so contingent as to be illusory. By its terms, the LOI is non-  
24 binding and subject to a due diligence contingency. It is unfathomable that such an offer  
25 could merit a \$1.25 million break up fee or that such a breakup fee could possibly benefit  
26 the estate. Second, it is undisputed that the Ad Hoc Committee's initial financing proposal  
27 preceded the offer by the Investor Group. To the extent that any "stalking horse" or  
28

1 "competitive bidding" benefit to the estate exists, it has been provided by the Ad Hoc  
2 Committee, not by the Investor Group. Third, because of the LOI's due diligence  
3 contingency, which suggests that any diligence conducted by the Investor Group to date is,  
4 at best, incomplete, it would be absurd to suggest that the Investor Group has generated  
5 information about the Debtor that would help increase the likelihood that the ultimate  
6 price of any proposed financing will reflect its true worth.

8 25. Furthermore, as stated above, if the Debtor insists on pursuing the  
9 transaction structure described in the LOI, the Ad Hoc Committee would be willing to  
10 agree to a letter of intent with terms identical to the LOI, but *without any breakup fee*.

11 **The Breakup Fee Is Not In The Best Interests Of The**  
12 **Debtor, Its Creditors Or Its Shareholders**

13 26. Other courts, including the only court in the Ninth Circuit to have given  
14 detailed consideration to breakup fees in a reported case, have analyzed whether a  
15 proposed breakup fee will "further the diverse interests of the debtor, creditors and equity  
16 holders, alike." *See In re America West Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz.  
17 1994) (quoting *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983)). The court in  
18 *America West* rejected a proposed \$8 million breakup fee because it was not in the best  
19 interest of the various constituencies in the case. In reaching that conclusion, the court  
20 observed that a breakup fee would chill bidding and deplete estate assets that could  
21 otherwise be used to fund a plan of reorganization and pay administrative expenses. *Id.* at  
22 913. That result was particularly problematic where, as here, the successful bidder stood  
23 to gain a substantial profit. As the court explained: "No funds of the estate should be used  
24 to pay break-up fees in a transaction that on this record would appear to yield a large profit  
25 to the top bidder. Instead, the estate should be preserved because as much money as  
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1 possible should be available to the creditors, bondholders, and shareholders under a  
2 consensual plan of reorganization." *Id.*

3           27. Other courts, in applying a "best interests" test, have expressed similar  
4 concern over the propriety of paying a break-up fee to a bidder at the expense of the  
5 constituencies in a bankruptcy case. As the court in *S.N.A. Nut Co.* framed the issue  
6 before determining that payment of a breakup fee was not in the best interests of the  
7 estate:  
8

9           The ultimate question becomes, who pays the costs of investigating the  
10 potential subject of an auction? If Debtor agrees to reimburse a bidder  
11 or to pay the opportunity cost of bidding, then the creditors are paying  
12 those costs. The goal of a bankruptcy auction, however, is to maximize the  
13 return to the estate. The costs of bidding should be borne by those who  
14 are best able to bear them – the bidders who have voluntarily entered the  
15 bidding process, and who are bidding for a company with title free and  
16 clear of liens and with all the advantages provided by the Bankruptcy Code.

17 *In re S.N.A. Nut Co.*, 186 B.R. 98, 106 (Bankr. N.D. Ill. 1995).

18           28. As an initial matter, both the Ad Hoc Committee and the Creditors  
19 Committee have voiced their concerns with the breakup fee, which alone raises serious  
20 doubts that the fee could possibly be in the best interests of the Debtor's estate, creditors  
21 and shareholders. Moreover, a breakup fee in this case would necessarily either chill  
22 bidding, because other bidders would be subjected to an artificial \$1.25 million overbid, or  
23 deplete the assets available for creditors and shareholders if the Debtor were to pursue a  
24 superior proposal. Also, as previously noted, based on the Ad Hoc Committee's  
25 calculations, the transaction contemplated by the LOI would result in a significant  
26 windfall to the Investor Group. In sum, there is a "perfect storm" of elements that  
27 underscores the inappropriateness of a breakup fee under the approach followed in  
28 *America West*. Therefore, the Investor Group itself, and not the Debtor's estate, should  
absorb the breakup fee and bear the costs of its own diligence.

1                    **The Breakup Fee Is Not Within The Business Judgment Of The Debtor**

2  
3                    29.    The leading case on the application of the business judgment test to  
4 proposed breakup fees is a district court case outside of the Ninth Circuit that predates  
5 *O'Brien* and is therefore of questionable utility. *See Integrated Resources, Inc.*, 147 B.R.  
6 650 (S.D.N.Y. 1992). Nevertheless, the proposed breakup fee fails to satisfy even this  
7 test, the most deferential of the tests courts have applied to breakup fees in the bankruptcy  
8 context.

9  
10                  30.    As applied in the bankruptcy setting, the business judgment test considers:  
11 (i) whether the relationship of the parties who negotiated the break-up fee is marked by  
12 self-dealing or manipulation; (ii) whether the fee chills rather than encourages bidding;  
13 and (iii) whether the amount of the fee is reasonable in relation to the proposed purchase  
14 price. *Id.*, 657, 659, 662 . As noted above, the proposed breakup fee chills, rather than  
15 promotes, bidding. Beyond that, however, the breakup fee is part of a proposed deal that  
16 appears to be tainted by ulterior motives on the part of the Debtor's Board of Directors  
17 and, in any event, is completely disproportionate to the level of financing contemplated by  
18 the Debtor.

19  
20                  31.    The Debtor's current directors appear to have significant motivations that  
21 are unrelated to the best interests of the creditors and shareholders of the Debtor. The  
22 remaining directors of the Debtor are currently defendants in eight federal class actions,  
23 one federal derivative suit and four state derivative suits for *inter alia*, alleged violations  
24 of the Securities laws. Mr. Cresci, the directors and Pecks are in the now consolidated  
25 federal class actions accused of having violated Sections 10(b) and 20 of the Exchange  
26 Act, Rule 10(b)(5), and Sections 11 and 15 of the Securities Act. The Debtor (and  
27 presumably its officers and directors) are also the subject of the ongoing investigations by  
28

1 the Department of Justice and the Securities and Exchange Commission. Cresci Tr. 89-  
2 99.

3           32. The proposed breakup fee also fails the business judgment test because it is  
4 excessive. Courts that apply this test have found that break-up fees that are less than  
5 approximately 3.5% are typical. *See, e.g., In re Bidermann Industries, USA Inc.*, 203 B.R.  
6 547 (Bankr. S.D.N.Y. 1997 (4.4 – 6% breakup fee and expense reimbursement rejected  
7 where the court found self-dealing); *In re Twenver, Inc.*, 149 B.R. 954, 957 (Bankr. D.  
8 Colo. 1992) (requested 10% breakup fee "greatly exceeds the 1% to 2% fees found to be  
9 reasonable in the majority of cases approving such fees."). *See also Integrated Resources*,  
10 147 B.R. at 662 (the court heard expert testimony that the industry standard on average is  
11 3.3. percent, and ultimately approved a breakup fee that was 1.6 percent of the purchase  
12 price).  
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14

15           33. The Debtor suggests that the breakup fee is 5% of the \$25 million  
16 financing proposal. This is disingenuous. The LOI contemplates only that the Investor  
17 Group will provide \$15 million of financing, with "up to" \$10 million to be provided  
18 apparently either by the Investor Group or by a third party, presumably on terms different  
19 from those set forth in the LOI. Indeed, Robert Cresci confirmed in his deposition that the  
20 investment of the Investor Group is expected to be limited to the \$15 million investment  
21 under Tranche A. Cresci Tr. at 124:15. Viewed in this context, the break-up fee is really  
22 \$1.25 million against a \$15 million financing (approximately 8.3%) -- well in excess of  
23 the typical range approved by bankruptcy courts applying the business judgment test and  
24 in excess of all but one unreported case cited by the Debtor in the Breakup Fee Motion.  
25 Accordingly, even if this Court were to apply the business judgment test instead of the  
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28

1 more appropriate administrative expense or "best interests" test, the proposed breakup fee  
2 would fail on all counts.

3 **CONCLUSION**

4 There is no support in fact or in law for the Breakup Fee Motion and the Ad Hoc  
5 Committee respectfully requests that this Court deny the Breakup Fee Motion and grant  
6 such other and further relief as may be appropriate under the circumstances.  
7

8  
9 AD HOC COMMITTEE OF EQUITYHOLDERS

10 By its attorneys

11  
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