Robinson & Wood - News

Wednesday, 31 May 2006

Defense Verdict in JTS Bankruptcy Litigation

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Related Practice Areas: Commercial Litigation

Chris Nielsen, a senior shareholder at the firm and Chairman of the Commercial Litigation Practice Group recently obtained a defense verdict in favor of Jack Tramiel the founder of Commodore Computer and former CEO of Atari Computer. In a long running fraudulent conveyance and breach of fiduciary duty case that was eventually the subject of a trial before the Hon. Marilyn Morgan the court decided in Mr. Tramiel's favor after his co-defendants (other directors and JTS' lawyers) settled around him. The plaintiff was the trustee of JTS Corporation which had merged with Atari in 1996 and went into bankruptcy in 1999.

Jack Tramiel was the founder of Commodore International and CEO of Atari Corporation. Commodore was the first company to manufacture computers for home use on a large scale. Atari manufactured computers and home gaming systems. JTS Corporation designed, manufactured, and marketed hard disk drives for personal computers. Through merger, JTS acquired the assets of Atari Corporation in 1996, which consisted of $15 million in cash, $55 million attributable to intellectual property, and eight real properties with a book value of $10 million. Following the merger, shares of JTS stock were publicly traded on the American Stock Exchange.

David Mitchell, Roger Johnson, Sirjang Lal Tandon, Jean Delage, Lip Bu Tran and Jack Tramiel were directors and officers of JTS. Cooley Godward, served as counsel to the corporation.

In 1997, the disk drive industry suddenly declined and sales plummeted. To survive, JTS' board of directors decided to pursue a business model based on a low-cost, higher-performance disk drive. Despite management's efforts, the company was unable to recover. On November 17, 1998, the company was forced into bankruptcy through an involuntary petition. JTS scheduled assets of $4.2 million and liabilities of $136 million.
Upon merging with Atari, JTS became the owner of eight parcels of real property which it decided to sell for operating funds. Defendant Tramiel, who had been the chairman of Atari's board of directors and, after the merger, became one of JTS' directors, offered to purchase the properties. Under the terms of the sale, JTS received $10 million, the properties' book value, plus it retained the right to repurchase the properties for one year following the sale. According to the trustee's expert, the fair market value of the eight properties was nearly $16 million at the time it was sold to Tramiel. The defendants insist that the property was worth no more than JTS received, namely $10 million plus a repurchase option.

In late 1997, one of JTS' major shareholders, Amber Arbitrage, agreed to participate in a plan to infuse cash into JTS. Amber, along with Mitchell, Tandon and Tramiel, collectively the Amber Group, placed $25 million in an escrow account. Pursuant to the plan, JTS established a second escrow account that contained $25 million of JTS Series D convertible stock. Additional funding was necessary in 1997 as the price of JTS common stock continued to fall to a level where it could be purchased for less than the conversion price of the Series D stock.

As a result, when JTS requested permission to use additional funds from the cash escrow, Amber refused, necessitating a search for funding from other sources. In February 1998, NationsBanc agreed to provide a $10 million line of credit to JTS if the Amber Group provided collateral for the loan. The Amber Group purchased $10 million in certificates of deposit with funds from the cash escrow account. NationsBanc also received a security interest in all of JTS' assets, and the Amber Group received a junior lien on JTS' assets to the extent that the certificates of deposit were drawn down.

The Series D stock became worthless. This last ditch effort to receive additional funding resulted in a situation known as "Death Spiral Financing." However, the Series E stock was subject to a lock-up period that prevented exercise of the conversion rights prior to August 5, 1998. By the end of the lock-up period, the price of JTS' common stock had again dropped below the conversion price of the Series E shares.

Trustee claimed that defendants breached their fiduciary duties in regard to the real estate transaction, the stock repurchase and funding transactions, and certain loan forgiveness transactions with various directors. Trustee asserted the lawyers were negligent in regard to their advice on all these transactions and advice regarding corporate governance. All defendants denied liability.

Result: The court found that Tramiel acted in good faith in regard to all causes of action. The court held that while Tramiel acted in good faith in regard to the real estate transaction JTS did not receive full value as the effect of the payment one year's rent on the option decreased the value of the option. The court awarded trustee $1,350,000 on this claim, plus interest for a total of $1,830,000 and denied Tramiel an offset for the previous settlements. As a result of post-trial motions the Court reversed itself and gave Tramiel an offset for the previous settlements and entered judgment in his favor as to all causes of action.

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