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IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF UTAH, CENTRAL DIVISION

In re:	Case No. 17-29073
VIDANGEL, INC.,	Chapter 11
Debtor.	Judge Kevin R. Anderson

DEBTOR'S OBJECTION TO THE STUDIOS' MOTION TO CONVERT CASE TO CHAPTER 7

VidAngel, Inc. (the "Debtor" or "VidAngel"), by and through its undersigned counsel, respectfully submits its objection to the Studios' Motion to Convert Case to Chapter 7 (dkt. #317) (the "Studios' Conversion Motion").

PRELIMINARY STATEMENT

On November 2, 2018, the following colloquy occurred in connection with the Studios' renewed motion to lift the automatic stay:

> THE COURT: I want to make sure that their [the studios] motivations are to seek repayment rather than termination of the debtor's existence.
>
> MS. EHLER: And [VidAngel] also said that the fact that the studios were trying to conclude the California litigation now was somehow

> evidence that my clients wanted to drive VidAngel out of business completely.
>
> And I just want to --
>
> THE COURT: Do they?
>
> MS. EHLER: I want to be very clear on the record, that is not our goal. We have no desire for VidAngel to go out of business.

Transcript, dkt. #255, page 72, lines 16-18. The Studios made this representation in support of their lift stay motion. *See* Memorandum Decision, dkt. #252, p. 18 ("The Court expressed its concern at the hearing that if relief from stay is granted, the Studios might attempt to bury VidAngel in litigation.")

Now, by their pending motion, the Studios seek to put VidAngel out of business. Cause exists, they say, because of "substantial or continuing loss to or diminution of the estate ***and*** the absence of a reasonable likelihood of rehabilitation." 11 U.S.C. § 1112(b)(4)(A) (emphasis added).

Both parts of their argument are incorrect. In fact, the Debtor has substantially *increased* the value of its estate during this case. And, while the California jury's $62.4 million verdict is certainly breathtaking, it remains just a verdict. It is not a judgment. The jury's verdict did not determine the Studios' allowed claim in this case. Without an allowed claim, the Studios cannot demonstrate that VidAngel is unlikely to be rehabilitated.

Moreover, their contrivances are inconsistent with their stated motivation—to increase recoveries on their allowed claims. Those recoveries will increase only if VidAngel remains a growing going concern; they will decrease if VidAngel's assets are sold in a post-shutdown liquidation. On the other hand, if this case is converted, VidAngel would be put out of business, which is the Studios' real motivation. Collectively, the Studios have over $350 billion in market value. Their monetary recoveries from this Debtor are clearly less material to them than putting VidAngel (and with it, family-friendly filtering) out of business.

OBJECTION

A. Legal Authority.

The test for "cause" under Section 1112(b)(4)(A) is two-pronged: First, after the commencement of the case, is there a continuing loss to or diminution of the estate? Does the debtor continue to experience a negative cash flow? Or, does the debtor continue to experience declining asset values? Second, is there any reasonably likelihood that the debtor or some other party will be able to make the business profitable within a reasonable amount of time? *In re Hyatt*, 479 B.R. 880, 887 (Bankr. D.N.M. 2012); *In re Bartmann*, BAP no. 03–078, 2004 Bankr. LEXIS 620 (10th Cir. BAP, May 10, 2004); *see Morreale v. 2011-SIP-1 CRE/CADC Venture, LLC*, 533 B.R. 320, 324 (D. Colo. 2015).

The Studios have the burden of establishing "cause" to convert or dismiss. *In re Hyatt*, 479 B.R. at 886 (holding that, unless the movant demonstrates cause, the directive to convert the case is inoperative). "The movant bears the burden of establishing cause by a preponderance of the evidence." *Id.*; *In re Vaughan Co.*, No. 11-10-10759, 2013 WL 2244285, *5 (Bankr. D.N.M. May 21, 2013) (citing *Matter of Woodbrook Associates*, 19 F.3d 312, 317 (7th Cir. 1994); *In re Brooks*, 488 B.R. 483, 489 (Bankr. N.D. Ga. 2013) (stating that the moving party "must first establish cause [under § 1112(b)] by a preponderance of the evidence.")); 5 Collier on Bankruptcy ¶ 1112.03[2][a].

In re Vaughan Co., Realtors explains the determination of losses to or diminution of the estate:

> In evaluating whether the Debtor has suffered continuing losses or diminution of the estate under 11 U.S.C. § 1112(b), the Court considers *all relevant information*, including the bankruptcy estate's financial history and financial prospects and the financial records on file in the case. *See In re Gateway Access Solutions, Inc.*, 374 B.R. 556, 564 (Bankr. M.D. Pa. 2007) ("the Court looks to both the financial prospects of the Debtor and the financial records filed with the Court" to determine whether there has been a continuing loss or

> diminution to the estate). *See also, In re The AdBrite Corp.*, 290 B.R. 209, 215 (Bankr. S.D.N.Y. 2003) (stating that "*a court must make a full evaluation of the present condition of the estate, not merely look at the debtor's financial statements*.")

In re Vaughan Co., Realtors, 2013 WL 2244285, at *6 (emphasis added).

The failure of either prong of the test will defeat a motion brought under 11 U.S.C. §1112(b)(4)(A). For example, in *Vaughan*, the chapter 11 trustee conceded that she did not intend to rehabilitate the business. But, the court held that there was no loss or diminution of the estate because the liquid assets had increased since the petition, the funds exceeded the payables, the trustee was recovering money in litigation, and she had taken steps to minimize litigation costs. Therefore, the court held there was no "cause" to convert under section 1112(b)(4)(A). *Id.*

B. "Likelihood of Rehabilitation."

Because the Studios do not yet have a judgment, their Conversion Motion should simply be denied. Without an allowed claim, the Studios simply cannot make any showing with respect to the likelihood of rehabilitation. As that is a required element of 11 U.S.C. § 1112(b)(4)(A), their motion must fail.

C. "Substantial or Continuing Loss to or Diminution of the Estate."

The Studios allege that the Debtor is "squandering the estate's assets." Studios' Conversion Motion, p. 3. They conclude that "the Debtor has lost the ability to operate as a viable, ongoing business…." *Id.*, p. 15. They accuse the Debtor's CEO, Neal Harmon, of breaches of fiduciary duty, *id.*, p. 16-17, and worse. *See generally* Studios' Motion for Chapter 11 Trustee, dkt. #310.

The Studios' inuendoes are tactical, baseless, and incorrect. If necessary, in an evidentiary hearing at the appropriate time, the following facts will show that the opposite of those inuendoes is true:

1. When the Studios sued VidAngel in June 2016, VidAngel had $1,480,525 in cash and $2,551,804 in total assets. Its revenue depended entirely on its "disc-based" content filtering technology. Since inception, it had earned revenues of $2.8 million from this technology. July 12, 2019 Declaration of Patrick Reilly, attached hereto as Exhibit "A" ("Reilly Decl."), ¶ 2.

2. After the California District Court preliminarily enjoined it from using its disc-based technology in December 2016, VidAngel totally abandoned that technology. Its revenues entirely dried up. Lightning had struck. July 12, 2019 Declaration of Neal S. Harmon, attached hereto as Exhibit "B" ("Harmon Decl."), ¶ 2.

3. When VidAngel filed its petition in October 2017, it had $3,582,361 in cash and $5,996,507 in total assets. It had improved its cash and total asset positions since the preliminary injunction with a capital raise of nearly $10 million, $2.65 million of which was its estimate of the cost of its legal defense in California. Reilly Decl., ¶ 3.

4. Post-petition, the Debtor's first priority was to win a declaratory judgment in Utah (where it resides) that its new "stream-based" content filtering technology complied with copyright law. With that judgment, the Debtor believed it could reorganize its business around its new technology. The Debtor has been criticized for not prosecuting this lawsuit in California (where the Studios reside, but where the Debtor has no other contacts), but it was very wary of its possible treatment in Hollywood. Harmon Decl. ¶ 3.

5. Post-petition, the Debtor's stream-based business has earned $9.2 million in revenues. Those revenues would be much higher, but the Debtor does not offer that technology for titles that are owned by the Studios. Nevertheless, the Debtor fully expects the Studios to make every effort to have the permanent injunction aspect of a judgment (if and when one is entered on

the California docket) cover and enjoin VidAngel's stream-based technology in addition to the disc-based technology that it abandoned long ago. Harmon Decl., ¶ 4.

6. After the dismissal of its declaratory judgment action in Utah, the Debtor focused its reorganization efforts on developing original content (including Dry Bar Comedy and The Chosen) and its consulting and services businesses in the family-friendly entertainment crowdfunding space. Harmon Decl., ¶ 5.

7. When this Court lifted the automatic stay on November 9, 2018, the Debtor had $2,314,907 in cash and $4,481,610 in total assets. MOR, dkt. #258. The Debtor had asked this Court to further delay lifting the stay until it had improved its wherewithal to defend itself against the Studios. Dkt. #217. The Studios resisted, claiming that the Debtor was substantially overstating the expense of the California action; they downplayed its complexity:

> THE COURT: Would that involve witnesses or just documentary evidence?
>
> Mr. KLAUS: It would probably be almost entirely documentary, almost entirely VidAngel's documents. And I think, most likely, we would, again, be -- always been a very pleasant experience because he's a very, very, very nice witness and person, but it would probably be mostly Mr. Harmon's testimony, maybe one other person, which would mean that we would probably be coming here to depose him.

Transcript, dkt. #255, page 40, lines 2-11.

> THE COURT: Give me your best estimate... How soon do you estimate this matter could be concluded as to … a jury trial?
>
> MS. EHLER: I would think shortly after the holidays, maybe even before, a few months.
>
> THE COURT: For a trial date?
>
> MS. EHLER: Right. Maybe two months of discovery, and then we could move very quickly to trial. So January?"

Transcript, dkt. #255, page 74, lines 8-23.

8. In fact, when the trial occurred many months after January, in June 2019, the Studios called seven witnesses to the stand, including three experts, after conducting six depositions. (The Studios sought 14 depositions, but the Magistrate Judge restricted them.) The number of titles on which they alleged infringement ballooned from 104 to 819, and the number of documents offered increased commensurately. Harmon Decl., ¶ 6. *See* Memorandum Decision, dkt. #252, p. 18 ("The Court expressed its concern at the hearing that if relief from stay is granted, the Studios might attempt to bury VidAngel in litigation.")

9. Just prior to trial, the Studios rejected the Debtor's settlement offer (and second offer for entry of judgement) that included a $4,500 per work damages award, permanent injunction and attorney's fees. This offer would have paid the studios more than any revenue VidAngel ever earned from the Studios' content. Perhaps, it would have paid more to the Studios than their cost of trial. The Studios refused to accept this offer not because $3.7 million plus attorney's fees was not enough to satisfy justice, but because those numbers would surely allow the Debtor to reorganize (not be put out of business). Harmon Decl., ¶ 7.

10. The last words of the Studios' closing argument in the California jury trial are telling:

> [VidAngel says] the award that we're asking you to make is completely out of line, it has no connection to any of the numbers in this case. That's not right. Remember that slide I showed you with all those big numbers on it -- $105 million, $400 million, $1.25 billion? Those aren't my numbers. Those were VidAngel's numbers. So I started off by saying that your job is to make sure there are consequences for breaking the law. VidAngel wants a pass. Do not let them avoid responsibility. Just think of the message that would send to the next VidAngel. *A damages award that is not at the high end of this range is just an invitation for more piracy.* Thank you.

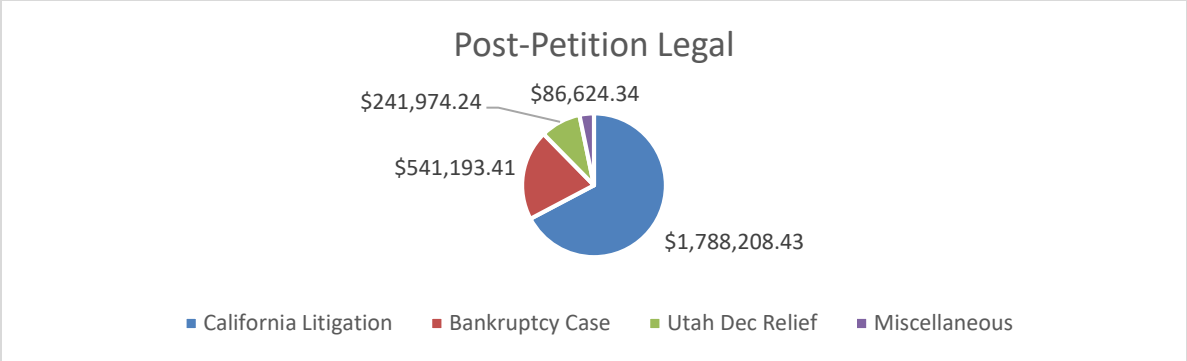
(June 17th, page 1042, lines 1-11) (emphasis added). The Studios do not want there to be a "next VidAngel." They wanted an award that VidAngel could not pay, so they could put VidAngel (and, with it, family-friendly filtering) out of business for good.

11. After the jury awarded the Studios an unprecedented $62.4 million—lightning stuck again—the Los Angeles Times reported that "it was one of the highest per-work judgments ever in a massive infringement case, *according to the studios' lawyers*." Ryan Faughnder, VidAngel, a start-up that cleaned up movies for streaming, must pay $62.4 million to studios. LATimes (Jun. 17, 2019, 6:45 PM), https://www.latimes.com/business/hollywood/la-fi-ct-vidangel-piracy-judgment-20190617-story.html (emphasis added).

12. The Debtor intends, consistent with its fiduciary duties, to seek a new trial or remittitur and, most likely, an appeal (expedited, if possible) to the Ninth Circuit. The Debtor does not expect any judgment in the California action to be entered before next fall. Harmon Decl., ¶ 8.

13. VidAngel has always been entirely transparent that its motivation is to provide family-friendly entertainment as expressly allowed by the Family Movie Act of 2005. Its punishment for having done so is unprecedented and unwarranted. The Debtor believes it has very good grounds for appeal. Harmon Decl., ¶ 9.

14. Post-petition, the Debtor has spent $2.66 million on lawyers. VidAngel spent the lion's share of that, about 67% ($1.79 million), defending the California action. It spent another 20% ($541,000) on its bankruptcy case. Most of the remainder ($242,000) was spent on the unsuccessful Utah declaratory judgment action. Reilly Decl., ¶ 5.



15. Currently (as of May 31, 2019), the Debtor has $1,781,840 in cash and $3,845,868 in total assets. MOR, dkt. # 315. The Debtor's MOR for June 2019 will be filed on July 15.

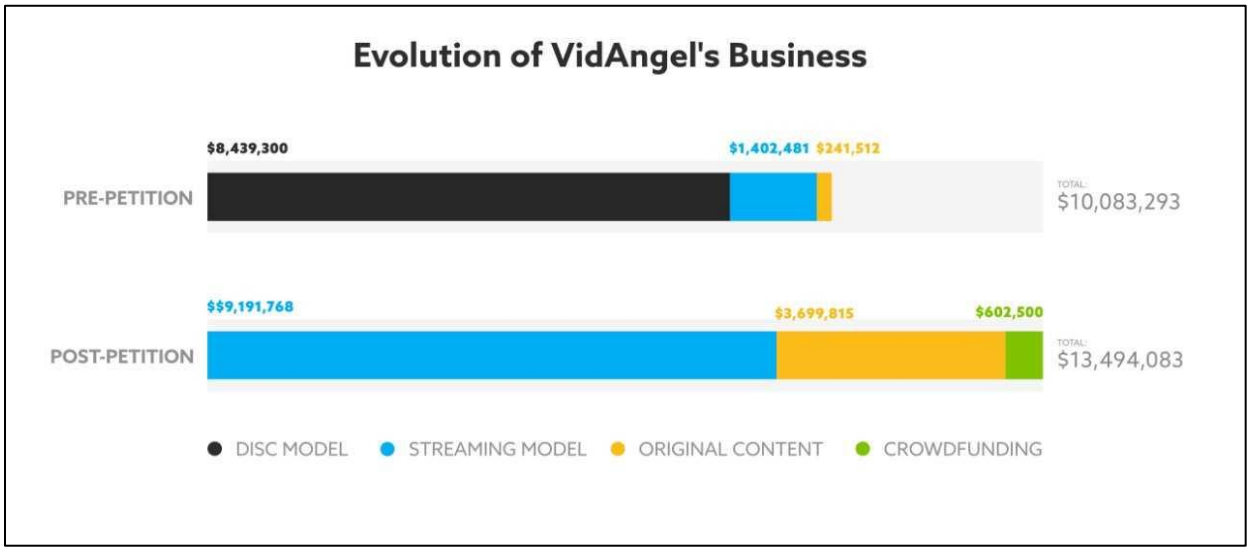
16. The Studios complain that the Debtor's total assets have declined post-petition from $6 million to $3.9 million, a difference of $2.1 million. Studios' Conversion Motion, p. 2. But they ignore the fact that $1.8 million of that difference was the cost of its defense against the Studios' litigation. Another $611,000 is related to the "book depreciation" of the Debtor's fixed assets and its inventory of DVD and Blu-Ray discs. Without those items, the Debtor's total assets would have *increased* since the petition date by approximately $300,000. Reilly Decl., ¶ 6.

17. The Studios note that, "last September, the Debtor predicted a dramatic financial turnaround by the summer of 2019 after the release of its original television series." Studios' Conversion Motion, p. 13. Then they conclude that, "that prediction has proved to be disastrously incorrect." *Id.* But they ignore the fact that that prediction was predicated on the California trial being delayed until their reorganization took hold. It was not. Harmon Decl., ¶ 10.

18. Finally, the Debtor's earning potential has grown *substantially* since the petition date. Since then, Dry Bar Comedy has generated over 1.5 billion views and $3.5 million in revenues. The Chosen, a TV series, rated 9.8 on IMDB, was funded with nearly $10 million by over 16,000 investors. Finally, since the petition date, the Debtor has created a FINRA-qualified

broker-dealer (application pending) and a crowdfunding portal, both of which will allow VidAngel Studios to realize further revenue growth going forward. Harmon Decl., ¶ 11.

19. The Studios claim that this Court found that "VidAngel has done very little to reorganize in the 20 months it has been in bankruptcy." Studios' Conversion Motion, p. 16. The Court made no such finding. In any event, VidAngel has grown and reorganized its business substantially while operating under the protection of the Bankruptcy Code. Prepetition, the Debtor derived nearly all its revenues from the disc-based technology that it has since abandoned. Post-petition, the Debtor has derived *all* its revenues from its three new lines of business:



Harmon Decl., ¶ 12; Reilly Decl., ¶ 7.

CONCLUSION

Last fall, the Debtor predicted it would have a breakthrough spring unless the stay was lifted for the California jury trial. Instead, this Court lifted the stay, and the Debtor had to deploy its assets to defend itself in California when the stay was lifted. The result, in what the Ninth Circuit called "a case of first impression," *Disney Enterprises, Inc. v. VidAngel, Inc.*, 869 F.3d 848, 852 (9th Cir. 2017), was an unprecedent verdict that exceeded $62 million. Regardless, in the

meantime, the Debtor actually improved its financial condition substantially while the Studios made every effort to bury it in litigation.

If the Studios were motivated by a desire to increase recoveries on their claims (regardless of whether those claims were for $62 million or $6.2 million), they would want VidAngel to continue to grow its businesses, as its reorganization takes hold, pending appeal, and then, if necessary, sell one or more of them as going concerns. The last thing the Studios would want, if they were motivated to increase their recoveries, is to shut VidAngel down by converting this case to chapter 7. Those recoveries will increase only if VidAngel remains a growing going concern; they will decrease if the Debtor's assets are sold in a post-shutdown liquidation.

The Studios do not want to increase their recoveries. They do not want what's in the best interest of any other stakeholder. Notwithstanding that the Studios represented to this Court "very clearly on the record," that they had "no desire for VidAngel to go out of business," putting VidAngel out of business—in order to put family-friendly filtering out of business—is the only plausible explanation for their motion.

The Court should deny the Studios' Conversion Motion.

Dated this 12th day of July, 2019.

/s/ *J. Thomas Beckett*

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PROOF OF SERVICE

I hereby certify that on July 12, 2019, I caused a true and correct copy of the foregoing **DEBTOR'S OBJECTION TO THE STUDIOS' MOTION TO CONVERT CASE TO CHAPTER 7** be served as follows:

I electronically filed the foregoing with the Clerk of the Court using the CM/ECF system, which sent notification of such filing to the following:

- Laurie A. Cayton tr laurie.cayton@usdoj.gov, James.Gee@usdoj.gov;Lindsey.Huston@usdoj.gov;Suzanne.Verhaal@usdoj.gov
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On July 12, 2019, I also caused a true and correct copy of the foregoing documents to be served on the following parties by email:

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/s/ *J. Thomas Beckett*
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