

**UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK**

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**SOFTWARE FREEDOM
CONSERVANCY, INC., and ERIK
ANDERSEN,**

Plaintiffs,

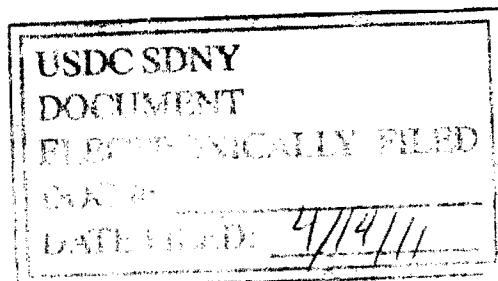
- against -

**BEST BUY CO., INC.,
WESTINGHOUSE DIGITAL
ELECTRONICS, LLC, WESTERN
DIGITAL TECHNOLOGIES, INC.,
PHOEBE MICRO, INC., ZYXEL
COMMUNICATIONS INC., WESTERN
DIGITAL CORPORATION, and
WESTINGHOUSE DIGITAL, LLC,**

Defendants.
----- X

OPINION AND ORDER

09 Civ. 10155 (SAS)



SHIRA A. SCHEINDLIN, U.S.D.J.:

I. INTRODUCTION

On December 14, 2009, the Software Freedom Conservancy, Inc. and Erik Andersen (“plaintiffs”) brought this action against fourteen commercial electronics distributors for copyright infringement.¹ Plaintiffs allege that Westinghouse Digital LLC (“WD”) is a successor in interest to one of those distributors, Westinghouse Digital Electronics, LLC (“WDE”), and move to join

¹ See Complaint (“Compl.”) ¶ 1.

WD as a defendant pursuant to Rule 25(c) of the Federal Rules of Civil Procedure.²

For the reasons discussed below, plaintiffs' motion is denied.

II. BACKGROUND

A. Overview

WDE was founded in 2002 as an independent designer, developer and distributor of a range of display products including liquid crystal display televisions and monitors.³ In 1999, Andersen developed software, which he contributed to an open source computer program known as BusyBox.⁴ Andersen later registered a copyright in the code.⁵ According to plaintiffs, WDE distributed the copyrighted BusyBox software — without plaintiffs' permission — within its

² See Plaintiffs' Memorandum of Law in Support of Its Motion to Join Successors in Interest of Defendant Westinghouse Digital Electronics, LLC ("Pl. Mem.") at 3. The Standard for joinder under Rule 25(c) is discussed in the Court's previous opinion and order. See *Software Freedom Conservancy, Inc. v. Best Buy Co., Inc.*, No. 09 Civ. 10155, 2010 WL 4860780 (S.D.N.Y. Nov. 29, 2010) ("*Software Freedom I*").

³ See 3/18/10 Fairness Opinion Prepared at the Request of Nexis, Inc. ("Fairness Op."), Ex. 1 to Binder of Materials Entered into Evidence during Evidentiary Hearing, at 3.

⁴ See 6/1/10 Declaration of Erik Andersen, plaintiff, in Support of Motion for Default Judgment, or in the Alternative, Summary Judgment against Defendant Westinghouse Digital Electronics, LLC ("Andersen Decl.") ¶¶ 3-4.

⁵ See *id.*

High Definition Television (“HDTV”) products.⁶

From 2007 through 2009, WDE experienced significant operating losses and its revenue decreased by seventy-seven percent.⁷ With these mounting losses, WDE also experienced severe liquidity problems.⁸ On April 2, 2010, WDE executed an assignment for the benefit of creditors under California law in favor of Credit Managers Association of California d/b/a Credit Management Association (“CMA”), a California non-profit corporation.⁹ CMA assists insolvent companies with work-outs or liquidations through alternatives to bankruptcy, including the

⁶ See Compl. ¶¶ 26-27.

⁷ See Fairness Op. at 6-7.

⁸ See *id.* at 7 (“[WDE] has been able to remain in business through the combination of funding from outside entities and aggressive management of its vendor payments. However, WDE has reached a point where it can no longer draw upon these liquidity options.”).

⁹ See Pl. Mem. at 2-3. An assignment for the benefit of creditors is a device under California state law by which an insolvent company may liquidate without filing for federal bankruptcy. See *Credit Mgrs. Assoc. of S. Cal. v. National Indep. Bus. Alliance*, 162 Cal. App. 3d 1166, 1169 (Cal. Ct. App. 1984). “The assignment is an assignment of all of the [assignor’s] assets that are transferable and not exempt from enforcement of a money judgment.” Cal. Code Civ. Proc. § 493.010. “The assignment is for the benefit of all the [assignor’s] creditors.” *Id.* Accord Respondent Credit Managers Association of California’s Memorandum in Opposition to Plaintiffs’ Motion for Joinder (“CMA Opp. Mem.”) at 4.

general assignment for the benefit of creditors.¹⁰ CMA assumed all of WDE's assets and liabilities and simultaneously sold a significant majority of those assets to Golden Star Electronics, LLC, which subsequently changed its name to Westinghouse Digital LLC ("WD").¹¹ The assets purchased by WD included the infringing HDTVs and web servers containing plaintiffs' BusyBox software.¹² Shortly after the sale ("Asset Sale"), WDE, now without any assets or liabilities, changed its name to Mora Electronics LLC ("Mora").¹³

As part of the Asset Sale, WD paid five hundred thousand dollars in cash to CMA and agreed to pay a percentage of future royalties up to one and a half million dollars.¹⁴ WD also assumed approximately eighteen million dollars of

¹⁰ See CMA Opp. Mem. at 4.

¹¹ See Fairness Op. at i.

¹² See Respondent Westinghouse Digital, LLC's Memorandum in Opposition to Plaintiffs' Motion for Joinder ("WD Opp. Mem.") at 6.

¹³ See *id.* Accord Deposition of Adam Meislik, principal of XRoads Solutions Group ("XRoads"), in Support of the Fairness of the Asset Purchase ("Meislik Dep."), Ex. B to Binder of Materials Entered into Evidence during Evidentiary Hearing, at 53: 22-25 ("Q: In your understanding, then, Westinghouse Digital Electronics assigned all of its assets to Credit Management Association? A: That's my understanding, and liabilities.").

¹⁴ See April 2010 Asset Purchase Agreement Between Golden Star Electronics, LLC and Credit Management Association ("Purchase Agreement"), Ex. 9 to Binder of Materials Entered into Evidence during Evidentiary Hearing, at 8. The royalty consisted of \$1.50 per television sold up to a total of one and a half million dollars. See Fairness Op. at 1.

WDE's liabilities.¹⁵ Prior to the Asset Sale, WDE had engaged XRoads to render an opinion as to the fairness of the Asset Sale.¹⁶ XRoads concluded that the Asset Sale would be fair to WDE's creditors because the creditors stood to recover more under the Asset Sale than under a liquidation,¹⁷ which XRoads believed would have been likely given the dire state of WDE's financial situation and its lack of financial alternatives.¹⁸

¹⁵ See Pl. Mem. at 2-3.

¹⁶ Notably, the valuations of WDE's assets and liabilities used by XRoads varied drastically from those used by CMA. XRoads had valued WDE's assets as of February 28, 2010 at \$12.3 million and its liabilities at \$50.8 million. See Fairness Op. at 2. CMA, in its creditor bulletin, showed WDE's assets as of April 2, 2010 (the Asset Sale date) at \$1.6 million and liabilities at \$42 million. CMA Opp. Mem. at 5. During his deposition, Meislik attributed this difference mainly to transactions that occurred after the publication of the Fairness Opinion. See Meislik Dep. at 57: 3-19. Meislik stated that he now believes the asset value was closer to the \$1.6 million figure CMA reported and perhaps even less. See *id.* at 60: 3-7 ("Q: . . . do you believe that the total assets of Mora actually assigned to CMA was less than \$1.6 million? A: My view of it will be that it's less than \$1.6 million at this point in time.").

¹⁷ See Fairness Op. at 3 ("The [Asset Sale] is estimated to provide a 7.9% recovery for [WDE's] general unsecured creditors . . . If the [Asset Sale] does not occur and WDE is forced into a liquidation event, the estimated cash proceeds could provide a 4.1% recovery for [WDE's] general unsecured creditors . . . Accordingly, the contemplated [Asset Sale] is estimated to provide a larger recovery for [WDE's] general unsecured creditors.").

¹⁸ See *id.* ("Without an approved assignment of the Westinghouse trademark to a buyer acceptable to [the licensor of the Westinghouse trademark] and a transfer of the Assumed Liabilities to a third-party buyer, the likelihood of the Assigned Assets remaining intact as a profit-seeking business enterprise is

B. Court Proceedings

In July of 2010, this Court granted plaintiffs' motion for a default judgment against WDE and awarded plaintiffs permanent injunctive relief as well as damages.¹⁹ In August of 2010, Plaintiffs sought to join WD and CMA as defendants under Rule 25(c) as WDE's successors in interest.²⁰ This Court denied plaintiffs' motion to join CMA; their motion to join WDE was stayed pending an evidentiary hearing on the issues of whether the Asset Sale amounted to a merger between WDE and WD and whether WD substantially continued WDE's business.²¹ Upon consideration of the evidence presented at that hearing,²² and reconsideration of the parties' arguments, plaintiffs' motion to join WDE is denied.

III. APPLICABLE LAW

A. Successor in Interest Liability Under California Law

Generally, "where a corporation sells or otherwise transfers all of its

doubtful. WDE would likely be forced to cease operating and to liquidate its assets to realize cash proceeds.").

¹⁹ See *Software Freedom Conservancy, Inc. v. Best Buy Co., Inc.*, No. 09 Civ. 10155, 2010 WL 2985320 (S.D.N.Y. July 27, 2010).

²⁰ See Pl. Mem. at 3.

²¹ See *Software Freedom I*, 2010 WL 4860780, at *7. I have not reconsidered any of plaintiffs' other arguments for successor liability.

²² See Transcript of Evidentiary Hearing held on 2/22/11 ("2/22/11 Tr.").

assets, its transferee is not liable for the debts and liabilities of the transferor.”²³

However, California courts have recognized certain exceptions to the general rule of nonliability where

(1) the purchaser expressly or impliedly agrees to such assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is merely a continuation of the selling corporation, or (4) the transaction is entered into fraudulently to escape liability for debts.²⁴

There is also an additional judicially created exception, known as the “product line successor” rule, which applies when a person has been injured by the predecessor’s product.²⁵

1. Assumption of Liabilities

To find an assumption of liability, a court must first consider the language of the Purchase Agreement itself.²⁶ If the language of the contract is clear and the contract itself is fully integrated, the court will adhere to the contract’s

²³ *Schwartz v. McGraw-Edison Co.*, 14 Cal. App. 3d 767, 780 (Cal. Ct. App. 1971).

²⁴ *Franklin v. USX Corp.*, 87 Cal. App. 4th 615, 621 (Cal. Ct. App. 2001) (quotations and citations omitted).

²⁵ *See id.* (citing *Ray v. Alad Corp.*, 19 Cal. 3d 22 *passim* (Cal. 1997)).

²⁶ *See id.* (looking to the contract to determine if a corporation assumed the liabilities of another) (“We must consider the language of the purchase agreement itself.”).

plain language and will not consider extrinsic evidence.²⁷

2. Mere Continuation and De Facto Merger

In order to determine whether a purported asset sale is a de facto merger, courts consider the following factors:

(1) was the consideration paid for the assets solely stock of the purchaser [or] its parent; (2) did the purchaser continue the same enterprise after the sale; (3) did the shareholders of the seller become the shareholders of the purchasers; (4) did the seller liquidate; and (5) did the buyer assume the liabilities necessary to carry on the business of the seller?²⁸

Although the mere continuation and de facto merger theories have traditionally been considered separate grounds for finding successor liability, courts have perceived “the second to be merely a subset of the first.”²⁹ “The crucial factor in determining whether a corporate acquisition constitutes either a de facto merger or a mere continuation is the same: whether adequate cash consideration was paid for

²⁷ See *id.* (“[B]ecause the unambiguous contract was expressly integrated, it was improper to consider extrinsic evidence to vary or alter its terms.”) (citing *Chknova v. Wilbur-Ellis Comp.*, Cal. App. 4th 962, 968 (1999) (“Matters extrinsic to an integrated contract will not be considered to modify the unambiguous language of those contracts.”)).

²⁸ *Id.* at 626 (citing *Marks v. Minnesota Mining and Mfg. Co.*, 187 Cal. App. 3d 1429, 1436 (Cal. Ct. App. 1986)).

²⁹ *Id.* at 625.

the predecessor corporation's assets.”³⁰

In applying the mere continuation theory, liability will be imposed on a successor corporation “only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors or stockholders of both corporations.”³¹ Although these two factors were listed in the disjunctive, “a review of the cases cited by the *Ray v. Alad* court . . . reveals that all of the cases involved the payment of inadequate cash consideration, and some also involved near complete identity of ownership, management or directorship after the transfer.”³² Therefore, “although other factors are relevant to both the de facto merger and mere continuation exceptions, the common denominator, which must be present in order to avoid the general rule of successor nonliability, is the payment of inadequate consideration.”³³

In order for a court to find inadequate consideration, “there must be a

³⁰ *Id.*

³¹ *Ray*, 19 Cal. 3d at 29.

³² *Franklin*, 87 Cal. App. 4th at 627.

³³ *Id.*

causal relationship between a successor's acquisition of assets (i.e., inadequate consideration), and the predecessor's inability to pay its creditors."³⁴ "The requirement of inadequate consideration in a successor liability case is premised on the notion that when a successor corporation acquires the predecessor's assets without paying adequate consideration, the successor deprives the predecessor's creditors of their remedy."³⁵ Therefore, "[w]here the predecessor files bankruptcy and its debts are discharged . . . it is the discharge and the lack of sufficient assets that deprive the predecessor's creditors of their remedy, not the acquisition of the predecessor's assets by another entity."³⁶

IV. DISCUSSION

A. Assumption of Liabilities

Section 2.3(n) of the Purchase Agreement, entitled "Litigations and Claims Not Assumed," lists this current action as one of the litigation claims

³⁴ *Katzir's Floor and Home Design v. M-MLS.com*, 394 F.3d 1143, 1151 (9th Cir. 2004) (citing *Monarch Bay II v. Professional Serv. Indus., Inc.*, 75 Cal. App. 4th 1213, 89 (Cal. Ct. App. 1999)).

³⁵ *Id.*

³⁶ *Id. Accord Sunnyside Dev. Co. v. Opsys Ltd.*, No. C 05 0553, 2010 WL 2462142, at *10 (N.D. Cal. Aug. 29, 2007) ("Where it is a 'lack of sufficient assets that deprives[s] the predecessor's creditors of their remedy, not the acquisition of the predecessor's assets by another entity,' successor liability cannot attach based on a theory of mere continuation.") (quoting *Katzir's Floor*, 394 F.3d at 1151).

excluded from the transaction and not to be assumed by WD.³⁷ Therefore, the Purchase Agreement unambiguously shows that the liabilities relating to this current action are not among those assumed by WD. Thus, assumption of liabilities cannot serve as a basis for successor liability.

2. Inadequate Consideration

WD directs the Court's attention to *Katzir's Floor*, emphasizing its holding that the inadequacy of consideration must be the cause of the predecessor's inability to pay its creditors in order to find successor liability. WD argues further that "[h]ere, it is clear that Mora was insolvent . . . before its assignment to CMA and before the asset sale to WD;" therefore, the "creditor's inability to get paid . . . is not caused by CMA's sale to WD (which actually benefits creditors by liquidating property into cash for distribution), but rather by Mora's pre-existing insolvency."³⁸ Indeed, the Fairness Opinion, which was not before the Court on

³⁷ See Purchase Agreement at Schedule 2.3(n).

³⁸ Def. Mem. at 16. I note that the facts of *Katzir's Floor* are not completely analogous. The predecessor corporation in *Katzir's Floor* was not merely "insolvent;" the corporation actually went into an involuntary receivership and the receiver sold the assets to the alleged successor corporation. See *Katzir's Floor*, 394 F.3d at 1147. Furthermore, the takeover by the receiver and the asset sale were distinct transactions, making clear that it was the lack of sufficient assets that deprived the creditors of their recovery and not the amount of consideration paid for the assets. See *id.* Here, the assignment for the benefit of creditors and the asset acquisition occurred simultaneously, making it more difficult to determine which factor caused plaintiffs' inability to recover. See Fairness Op. at 1. This

plaintiffs' original motion, found that WDE "ha[d] no enterprise value as a going-concern business Accordingly, the contemplated Transaction is estimated to provide a larger recovery for [WDE's] general unsecured creditors."³⁹ Plaintiffs' reply brief ignores *Katzir's Floor* and presents no evidence as to how WD's inadequate consideration rather than WDE's lack of financial alternatives to the

distinction between *Katzir's Floor* and the case at bar, however, does not alter my finding of adequate consideration because of plaintiffs' failure to show a causal link between WD's inadequate consideration and plaintiffs' inability to recover.

³⁹ Fairness Op. at 3. On plaintiffs' original motion, I reasoned that "[f]ive hundred thousand dollars plus one million five hundred thousand dollars of future royalties is inadequate cash consideration for [WDE's] assets" because "[a]n estate with only five hundred thousand dollars in cash will certainly leave many creditors 'out of the money.'" *Software Freedom I*, 2010 WL 4860780, at * 5. However, evidence submitted by WDE during the evidentiary hearing and now before the Court compels a different result. Drawing all reasonable inferences in plaintiffs' favor on their original 25(c) motion, see *Luxliner P.L. Export Co. v. RDI/Luxliner, Inc.*, 13 F.3d 69, 72 (3d Cir. 1993), the consideration appeared to be inadequate as a matter of law. However, in my capacity as a fact-finder following an evidentiary hearing – during which plaintiffs submitted no evidence disputing the Fairness Opinion's conclusion that the creditors were able to recover more under the Asset Sale than in a liquidation, see *id.* at 72-73 – I now conclude that the consideration was adequate. Plaintiffs have surely not carried their burden to show that the consideration was *inadequate*.

Asset Sale⁴⁰ deprived plaintiffs of their recovery.⁴¹ Given the absence of such evidence, I am constrained to find that plaintiffs have failed to demonstrate inadequate consideration.⁴²

Plaintiffs emphasize the other factors courts consider to find a mere continuation or a de facto merger. Plaintiffs have produced evidence showing an overlap of employees between WDE and WD,⁴³ that WDE liquidated⁴⁴ and that the liabilities assumed by WDE were merely the liabilities necessary to carry on the business of WD.⁴⁵ However, unlike the causal relationship between the inadequate

⁴⁰ See Fairness Op. at 3. *Accord* Meislik Dep. at 31: 6-12 (“WDE was not a going-concern business anymore in our opinion . . . if they had nobody to sell it to, they would have had to just liquidate the assets. That was their alternative.”). See also *id.* at 69: 4-7 (“Q: Do you have any personal knowledge of whether CMA received any other bids? A: My recollection is they did not receive any other bids.”).

⁴¹ Plaintiffs were especially critical of the Fairness Opinion’s reliance on WD’s promise of \$1.5 million in future royalties. See 2/22/11 Tr. at 39. This line of argument does little to address the fact that WDE was no longer a going concern and had limited financial alternatives to the Asset Sale.

⁴² See *Maloney*, 207 Cal. App. 3d at 4 (holding that the party asserting successor liability bears the burden of establishing inadequate consideration).

⁴³ See 8/2/10 WD’s response to defendant Darwin Chang’s Special Interrogatories, Set One (“WD Interrogatories”), Ex. 8 to Binder of Materials Entered into Evidence during Evidentiary Hearing, at 7-9.

⁴⁴ See WD Opp. Mem. at 6.

⁴⁵ See Fairness Op. at 1. (“It is our understanding that the Assumed Liabilities are owed to entities in which WDE maintains valuable vendor

consideration and the creditors' inability to recover, these factors are not dispositive.⁴⁶ Because plaintiffs have failed to prove the "crucial factor" of inadequate consideration, their de facto merger and mere continuation theories of successor liability must fail.

V. CONCLUSION

For the foregoing reasons, plaintiffs' motion to join WD is denied.

The Clerk of the Court is directed to close this motion (Docket No. 133).

relationships and been deemed critical to the future success of any continuing business enterprise involving the Westinghouse trademark."'). *Accord* Meislik Dep. at 78: 6-13 ("Q: CMA then sold roughly half of those liabilities or the book value of those liabilities to Golden Star; is that correct? A: . . . the liabilities that Golden Star felt like it needed to take on to assume in order to run the business went to Golden Star."').

⁴⁶ *See Maloney*, 207 Cal. App. 3d at 288-89 (finding that there was no mere continuation when plaintiffs were unable to prove inadequate consideration even though the purported successor corporation held itself out as a continuation of the predecessor and there was an overlap of employees) ("Plaintiffs correctly point out that the relationship between APC I and APC II involved two characteristics which can contribute to a finding that one corporation is a mere continuation of the other Plaintiffs, however, present no argument as to how the presence of these two characteristics can make up for the absence of the essential ingredient of inadequate consideration. In the absence of that ingredient, APC II is not a mere continuation of APC I."').

SO ORDERED:

A handwritten signature in black ink, appearing to read 'Shira A. Scheindlin', written over a horizontal line.

Shira A. Scheindlin
U.S.D.J.

Dated: New York, New York
April 14, 2011

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