

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE**

In re:	:	Jointly Administered
	:	Case No. 02-11573 (PJW)
NAPSTER, Inc.	:	
a Delaware corporation, <i>et al.</i> ,	:	Chapter 11
	:	Hearing Date: Aug. 29, 2002 @ 4:00 p.m.
Debtors.	:	Obj. Deadline: Aug. 23, 2002 @ 4:00 p.m.

**OBJECTION OF CERTAIN RECORDING COMPANIES
TO DEBTOR'S MOTION FOR AN ORDER, *INTER ALIA*,
(A) APPROVING ASSET AGREEMENT AND (B) AUTHORIZING
THE SALE OF SUBSTANTIALLY ALL OF THE DEBTORS' ASSETS**

(Related to Docket No. 52)

A&M Records, Inc., Geffen Records, Inc., Interscope Records, MCA Records, Inc., Island Records, Inc., Motown Record Company L.P., Capitol Records, Inc., Universal Records, Inc., Polygram Records, Inc. and Virgin Records America Inc. (collectively referred to as the "Recording Companies"), by their attorneys, Pepper Hamilton LLP, object to the Motion of Debtors and Debtors in Possession for an Order (A) Approving Asset Purchase Agreement; (B) Authorizing the Sale of Substantially All of the Debtors' Assets; (C) Authorizing Assumption and Assignment of Certain Related Executory Contracts and Unexpired Leases; and (D) Granting Other Related Relief (the "Sale Motion"). In support of their objection, the Recording Companies state as follows:

A. Introduction

1. Shortly after the Court approved the Debtors' bidding procedures motion, the Recording Companies initiated discovery directed at the Debtors, which include Napster, Inc. and Napster Music Company (the "Debtors" or "Napster") and Bertelsmann A.G. ("Bertelsmann"). That discovery included requests for production of documents aimed at exploring the relationship between Napster and Bertelsmann and the "loans" and other

indebtedness claimed to be due by Napster to Bertelsmann. Requests for production of documents were served on Napster and Bertelsmann on July 8, 2002 and, consistent with the expedited nature of the relief requested in the Sale Motion, called for responses and documents to be served by July 22. For the most part (and while reserving all of their rights), the Recording Companies believe that Napster made a good faith effort to respond to and produce documents by July 22, 2002. Bertelsmann's response is another matter. Without going into details that are not relevant for present purposes, it is sufficient to note that Bertelsmann's responses were untimely and incomplete. In fact, Bertelsmann produced additional documents at the beginning of the deposition of its 30(b)(6) witness on Tuesday, August 20, 2002. Moreover, and of greater concern, the Recording Companies have been unable to share the bulk of the documents produced by Bertelsmann, including the most important documents, with their clients because of Bertelsmann's insistence on the execution of confidentiality agreements *and* a protective order being entered by this Court *and* the excessive, unreasonable and unprecedented designation of documents as being for "counsel's eyes only" which precluded the undersigned counsel from sharing important information about this litigation with its clients.

2. Based on the limited discovery that the Recording Companies and the Songwriter/Music Publisher plaintiffs (the "Publisher Creditors") have been able to take to date, the Recording Companies believe that there are very significant reasons for the Court to deny the Sale Motion. Those reasons are set out in detail in the objection filed by the Publisher Creditors to the Sale Motion (the "Objection"). Rather than repeat the bulk of the Objection here, the Recording Companies join in the Objection as if fully set forth herein. In addition to the facts adduced and the arguments made in the Objection, the Recording Companies believe that the facts set forth below provide further support for the conclusion that the relief requested in the

Sale Motion must be denied.

B. Additional Facts

3. Konrad Hilbers, Napster Chief Executive Officer, is 39 years old. He worked for Bertelsmann for nine years before leaving to head Bertelsmann's initiative at Napster. From the time he went to work at Bertelsmann at the age of 30, he was assigned to a variety of positions at different businesses run by Bertelsmann both in Europe and in the United States, each time taking on positions with greater and greater responsibility. (Ex. A, Hilbers Tr. at 6-20). Both before and after leaving Bertelsmann, Hilbers had open and direct access to Thomas Middlehoff, Bertelsmann's Chief Executive Officer. Bertelsmann has revenues in excess of \$20 billion a year and operates around the globe. (Ex. A, Hilbers Tr. at 54-5).

4. The \$72.5 million in funding provided by Bertelsmann to Napster was advanced, in each case, in a lump sum and without any procedures put in place to assure that it would not be used to run Napster's illegal copyright infringing business. The loans were not advanced in a series of weekly or monthly draws pursuant to draw requests. Importantly, a significant portion of the loan proceeds were used to pay defense costs in copyright infringement litigation brought by the Recording Companies. (Ex. B, Jensen Tr. at 52).

5. Among the assets being "sold" to Bertelsmann are any claims Napster has against Bertelsmann. The Recording Companies believe that neither the Debtors nor the Committee of Unsecured Creditors have done any analysis of whether or not Napster has claims against Bertelsmann.

6. For nine or ten months after Bertelsmann decided to initiate its partnership with Napster, Napster continued to operate its illegal business. During this time, thousands or perhaps

millions of recordings that are the subject matter of copyrights owned by the Recording Companies were illegally copied.

7. On or about October 30, 2000, Napster and Bertelsmann entered into a series of agreements entitled, "Purchase of Warrant for Series D Preferred Stock and \$50,000,000 Secured Loan by Bertelsmann AG to Napster, Inc." (the "October 30, 2000 Agreement") (attached as Exhibit "C" to the Objection of the Songwriter/Music Publisher Plaintiffs). While the October 30, 2000 Agreement is couched in the form of a "loan," Bertelsmann never had any expectation that these monies would ever be repaid. Napster's first interest payment was due on January 31, 2002, and interest payments were due quarterly after that date. (Ex. B, Jensen Tr. at 59-60). However, Napster never paid any interest or principal under the October 30, 2000 Agreement. (Ex. B, Jensen Tr. at 60; Ex. A, Hilbers Tr. at 44, 50). Nor did Napster make any interest or principal payments on Bertelsmann's additional so-called loan to Napster of a \$10,000,000 secured promissory note on or about January 31, 2001. (Ex. B, Jensen Tr. at 93; Ex. A, Hilbers Tr. at 44, 50). While the first interest payment on these alleged loans was due on January 31, 2002, Bertelsmann never served Napster with a notice of default and acceleration until April of 2002, which occurred, not coincidentally, immediately after Napster had rejected Bertelsmann's offer to purchase the equity of Napster for \$16.5 million, plus an additional \$12 million for Napster's creditors. (Ex. A, Hilbers Tr. at 54). Bertelsmann was purportedly relying on alleged revenues from the "New Napster Pay Service" as Napster's source of revenue to repay the alleged loans, but Mr. Sorenson candidly admitted in his deposition that Bertelsmann has no expectation of when, if ever, the "New Napster Pay Service" will be launched. (Ex. C, Sorenson Tr. at 176). Indeed, Napster's CEO, Mr. Hilbers, estimates that additional funding of no less than \$30,000,000 is necessary to launch the "New Napster Pay Service." (Ex. A, Hilbers Tr. at 81).

8. Bertelsmann pursued a funding strategy that enabled Napster to continue its operation of the illegal file sharing service at the expense of copyright owners. (Ex. C, Sorenson Tr. at 103-08). At the same time, Bertelsmann allowed Napster to use that funding to pay the legal costs necessary to continue its frivolous defenses and delay the inevitable judgments in favor of the major record labels, songwriter/music publishers, and other copyright owners in the copyright infringement litigation. (Ex. C, Sorenson Tr. at 38-41). Indeed, from January to July 2001, Napster's CFO, Ms. Jensen, estimates that in excess of \$10,000,000 of Bertelsmann's alleged loan proceeds were used to fund the copyright infringement litigation. (Ex. B, Jensen Tr. at 52). By investing in the further infringement of copyrights in connection with funding both the operation of Napster's illegal file sharing service and its defense in the copyright infringement litigation, Bertelsmann deliberately chose a path designed to further damage copyright owners. Now, Bertelsmann wants to buy substantially all of Napster's assets for a paltry sum that will leave almost nothing to pay the copyright owner creditors, upon whom Napster's valuable brand name was built and Bertelsmann purposely injured.

9. In July 2001, Bertelsmann installed its corporate protégé, Konrad Hilbers, as CEO of Napster. (Ex. A, Hilbers Tr. at 20). As noted above, Mr. Hilbers had served with the Bertelsmann family of companies since 1992 and in January 2001 had just begun service for Bertelsmann as the Executive Vice President and Chief Administrative Officer of Bertelsmann Music Group. (Ex. A, Hilbers Tr. at 6-20). Hilbers consulted with a number of officers of Bertelsmann before taking the CEO position at Napster, including Thomas Middlehoff, the CEO of Bertelsmann AG, Klaus Eierhoff, the CEO of Bertelsmann Direct Group, Andreas Schmidt, the CEO of the Bertelsmann eCommerce Group, and Rolf Schmidt-Holtz, the CEO of the Bertelsmann Music Group. (Ex. A, Hilbers Tr. at 23-27). After consultation, Bertelsmann

waived its rights under Hilbers' employment agreement, including the right to enforce a covenant not to compete, to permit Mr. Hilbers to take the CEO position at Napster. (Ex. A, Hilbers Tr. at 40-42). Since May of 2002, Mr. Hilbers has served as the sole director on Napster's Board of Directors. (Ex. B, Jensen Tr. at 24). Mr. Hilbers in turn hired another Bertelsmann employee, Oliver Schusser, to serve as Napster's Vice President of Marketing, as well as David Phillips as the Vice President of Services and Product Management, with whom Hilbers had worked at AOL Europe, which was part of the Bertelsmann family of companies through a 50% joint venture partnership with AOL, Inc. (Ex. A, Hilbers Tr. at 28-31).

10. Bertelsmann was the sole source of funding available to Napster to continue operation of its illegal file sharing service and the defense of Napster in the copyright infringement litigation. Napster's CFO, Ms. Jensen testified that at the time of the October 30, 2000 Agreement, Napster's attempt to secure other sources of funding had failed and that Napster had about \$1-2 million available that would allow Napster to continue operating for about two months. (Ex. B, Jensen Tr. at 83-86, 91-92).

11. Both Mr. Hilbers (Napster's CEO) and Ms. Jensen (Napster CFO) conceded that Bertelsmann's purported loans, which are secured with Napster's valuable intellectual property rights, have interfered with its ability to obtain other sources of funding or investors to buy Napster's assets. (Ex. B, Jensen Tr. at 126-27; Ex. A, Hilbers Tr. at 112-13). Accordingly, Bertelsmann's position of control over Napster has had (and continues to have) a chilling effect on its ability to obtain a fair value for the sale of its assets.

12. Based on solely on a purported increase in Napster's short term accrued liabilities from April to May 2002, and with no formal valuation or appraisal of Napster's assets, Bertelsmann decreased its cash offering price for Napster from \$16.5 million to \$5 million, a

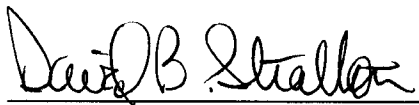
decrease of more than \$11 million dollars in about a one month time period. (Ex. C, Sorenson Tr. at 154-60). While Bertelsmann subsequently increased its cash offering price to \$8 million and then to \$9 million, it conducted no valuation or appraisal of Napster's assets in connection with these increases. (Ex. C, Sorenson Tr. at 161-62, 168-69). Instead, Bertelsmann increased its cash offering price to \$8 million in an effort to gain agreement from Napster on the asset-purchase agreement, and to \$9 million to obtain the agreement of the unsecured creditor's committee in this proceeding. (Ex. C, Sorenson Tr. at 161-62, 168-69).

C. Conclusion.

The facts and arguments set forth above and in the Publisher Creditors' Objection paint a startling and disturbing picture of the relationship between Napster and Bertelsmann. It is evident that there has been no legitimate effort to sell Napster's assets to a buyer acting in good faith as the result of arms' length negotiations. As a consequence, the relief requested in the Sale Motion must be denied.

Dated: August 23, 2002

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