Jones Day Charts Dana Corporation’s Path to Successful Emergence from Chapter 11

Corinne Ball led a team of Jones Day professionals representing Dana Corporation and its affiliates in connection with their filing and successful emergence from chapter 11.

On January 31, 2008, less than two years after the institution of their bankruptcy cases, Dana Corporation and its affiliated debtor companies became one of the first large manufacturing entities with fully funded exit financing to emerge from chapter 11 under the recently revised Bankruptcy Code. Having achieved nearly half a billion dollars in annual cost savings, rationalized its global business structure, resolved approximately $3 billion in unsecured claims, and secured $2 billion in exit financing, Dana emerged from bankruptcy protection well positioned to compete vigorously in the global automotive supply market.

As primary debitors’ counsel, Jones Day was a key contributor to Dana’s remarkable achievement. Even prior to the filing of Dana’s bankruptcy petitions, Jones Day’s restructuring professionals understood the necessity of conceiving, implementing, and executing a comprehensive strategy for the sprawling, global restructuring ahead—a strategy designed to be achieved in discrete segments, yet consistently focused on the reorganization of the whole enterprise and the ultimate endgame of confirmation and fully funded emergence from chapter 11.

The foundation of this strategy was the identification of parties that had a vested interest in Dana’s continued survival and success. Core constituencies such as
Dana’s customers (who require a viable tier-one supplier of automotive drivetrains), its suppliers (many of which depended on the business they transacted with Dana for survival) and, especially, its largely unionized workforce immediately presented themselves as potential negotiating counterparties and, ultimately, sources of savings for Dana. Jones Day and Dana defined what concessions would be necessary to emerge from chapter 11 as a healthy competitor in the automotive parts industry and then set about achieving that goal—developing a staged plan to approach, in turn, Dana’s suppliers, its customers and, finally, its unions, emphasizing the shared sacrifice necessary to produce the long-term benefits desired by all parties. After obtaining such concessions and establishing a viable business profile, Dana would be able to approach its financial constituencies, as well as potential new investors, in order to craft and fully fund a plan of reorganization premised upon the already committed contributions of its customers, vendors, and workforce.

Thus, emphasizing collaboration with Dana’s primary stakeholder constituencies and exhibiting a willingness to pursue and embrace innovative solutions to Dana’s problems, Jones Day was able to help chart and navigate a strategic course for Dana’s reorganization. This course included:

• Identifying those domestic Dana entities that would file petitions in bankruptcy and those that could be profitably restructured out of court and achieving a “soft landing” in chapter 11 for those entities that filed;

• Stabilizing and maintaining Dana’s existing vendor and customer relationships, with no interruption of the business activities of either Dana or its customers;

• Implementing an integrated global business strategy, including the development of a business plan for Dana’s domestic operations, the rationalization of Dana’s cost structure, and the protection and realignment of Dana’s profitable offshore operations;

• Altering the nature of Dana’s ongoing pension obligations;

• Having obtained as much savings from other sources as possible, working consensually with Dana’s unions and employees to renegotiate and restructure the parties’ existing relationships and legacy obligations;

• Building consensus with Dana’s bondholder constituency and potential investors to obtain fully committed equity and debt financing; and

• Proceeding to confirmation of a plan of reorganization that enjoyed the support of all major constituencies.

The presentation of this well-developed strategy to each of Dana’s major constituencies—and showing them what concessions/forbearance/investment Dana needed and why—promoted consensus at all steps of the company’s reorganization. The ultimate results of this strategy—achieved within the abbreviated time frames and uncharted legal territory of the substantially revised Bankruptcy Code—speak for themselves. To date, Dana is the only major manufacturing company to have successfully negotiated the revised Bankruptcy Code and emerged from chapter 11 with a fully committed exit facility. As lenders in troubled credit markets either abandon their lending commitments to other chapter 11 debtors (as is happening in the Delphi bankruptcy) or reduce their initial funding (as happened in the Calpine bankruptcy), Dana’s unassailed funding commitments, negotiated by Jones Day, stand alone. The game plan that produced these results should serve as the template for the successful restructuring of large global businesses in chapter 11 going forward.

IMPLEMENTING A STRATEGY: THE FIRST DAYS OF BANKRUPTCY

In February of 2006, Dana’s circumstances were less than enviable. A 100-year history of ad hoc acquisition and divestiture activity left Dana with a decentralized and labyrinthine corporate structure that did not necessarily correspond to the manner in which the businesses were operated. Lack of integration between business units had left the company with little room for operational error and little ability to react quickly to business downturns. In 2005, these vulnerabilities
met the perfect storm: Rapidly increasing commodity costs, increasing pricing pressure from both vendors and customers, and an inability to repatriate cash from profitable overseas operations led to massive and unexpected domestic losses and a crushing liquidity shortfall.

In response to this crisis, Dana turned to Jones Day’s restructuring team. Within three weeks of receiving the green light to prepare a chapter 11 filing in mid-February 2006, Jones Day had helped Dana achieve the quintessential “soft landing” in the United States Bankruptcy Court for the Southern District of New York. In addition to obtaining the full panoply of standard “first day” relief (including approval of a $1.45 billion debtor-in-possession financing facility), Jones Day further advised Dana on the implementation of the first steps of its comprehensive plan for emergence from chapter 11.

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The first step towards the rehabilitation of Dana’s business was the stabilization of Dana’s vendor and customer relationships. Although Dana would not shy away from litigation where necessary (e.g., litigating with recalcitrant vendors to enforce compliance with existing executory contracts), Dana’s plan called for a methodical, fact-intensive, and collaborative approach to the maintenance and readjustment of the supply and revenue sides of its business.

On the supplier side, Jones Day took care to ensure that Dana received the first-day relief necessary to maintain its vendor relationships with no interruption of supply. Among other things, Dana obtained the authority to make payments to vendors entitled to priority of payment pursuant to recently enacted section 503(b)(9) of the Bankruptcy Code. This relief proved the first of many chapter 11 innovations effected by Dana and Jones Day. Prior to Dana’s chapter 11 cases, section 503(b)(9) of the Bankruptcy Code had been a blank slate. Subsequently, a debtor’s ability to make payments to vendors of goods in its sole discretion—i.e., the approach approved in Dana’s case—has become standard operating procedure for chapter 11 debtors. Armed with the ability to relieve pressure from vendors with, among other things, the judicious application of such “503(b)(9)” payments, Dana successfully prevented any interruption in its supply of goods.

The ability to preserve the continuity of Dana’s vendor relationships produced the added benefit of helping maintain Dana’s customer relationships as well. That is, Dana’s ability to maintain a continuous supply of goods from vendors ensured that Dana could prevent an interruption of its own supply of parts to its original equipment manufacturing customers. Avoiding such an interruption was crucial to Dana’s overall strategy, as Dana and Jones Day were contemporaneously attempting to persuade those very customers that doing business with a healthy Dana going forward, and working consensually to negotiate revised business terms that would make that possible, were in their common interest.

Requiring pricing support from its customers in order to improve liquidity, Dana ultimately was able to negotiate price increases and, in some circumstances, the rollback of certain price reductions with the famously hard-bargaining large automobile manufacturers. In so doing, Dana became the first automotive parts supplier to effect and implement new pricing with the original equipment manufacturers on a consensual basis (standing in stark contrast to other parts suppliers that remained mired in customer squabbles throughout their chapter 11 cases).

Just as notable as this initial success enjoyed by those entities that filed for chapter 11 protection is the success arising from the decision regarding which Dana entities would not file. Rather than simply drop every domestic Dana subsidiary
into the chapter 11 process, Jones Day assisted Dana Credit Corporation, a domestic financial subsidiary carrying in excess of $500 million in publicly traded debt, in effecting an out-of-court restructuring of its liabilities and assets (which assets included more than $480 million in claims against the Dana debtors' estates). This decision to reorganize Dana Credit Corporation outside the chapter 11 context ultimately bore substantial dividends. Because of this out-of-court restructuring, Dana Credit Corporation was able to narrow an anticipated loss of nearly $200 million to less than $45 million, which resulted in a reduction of more than $435 million in claims against the Dana debtors' estates.

EXECUTING THE STRATEGY: THE GROUNDWORK FOR REORGANIZATION

Having successfully filed for bankruptcy protection with a minimum of disruption to its day-to-day operations, Dana began to lay the groundwork for its ultimate reorganization. Traditionally, companies comparable in size and scope to Dana would remain in bankruptcy for years, with bankruptcy courts generally approving extensions of the debtor's exclusive period within which to file a plan of reorganization. In amending the Bankruptcy Code, however, Congress had severely circumscribed this open-ended period of exclusivity, requiring a debtor to file its plan of reorganization within 18 months of its petition date. Accordingly, Dana's reorganization needed to be effected in far less time than that used by many debtors.

This abbreviated time period further emphasized the need to adopt and execute a highly coordinated strategy for successful emergence, and Dana hit the ground running by attacking a host of discrete yet interrelated problems on parallel tracks. Dana immediately undertook a comprehensive realignment of its business structure. To this end, Dana exhaustively reviewed its manufacturing "footprint," ultimately adopting an acquisition and divestiture strategy designed to move its sourcing to lower-cost countries and shed its non-core businesses and joint ventures. Dana further reviewed and reduced selling, general, and administrative costs at all levels of its organization, which resulted in anticipated annual savings of $40 to $50 million. Finally, Dana and Jones Day began crafting what would become the corporate structure of the reorganized debtors, with an eye towards creating the most investment-friendly structure possible in the service of promoting maximum optionality and a fully funded emergence from chapter 11.

At the same time, Dana worked with Jones Day's New York, Cleveland, and European lawyers to restructure its profitable overseas operations to provide for sustainable financing and cash management independent of Dana's domestic entities, while permitting the tax-efficient repatriation of profits to the parent company. This parallel out-of-court restructuring of a debtor's international business—replete with major offshore financing and the contemporaneous resolution of group pension legacies through a company voluntary arrangement—is a notable achievement in chapter 11. Jones Day's international experience proved indispensable to these efforts.

Dana's efforts to maintain its current management throughout the chapter 11 process—through the implementation of incentive-based compensation plans—were similarly successful. Traditionally, debtors had kept management in place primarily through the payment of simple retention bonuses. The revised Bankruptcy Code, however, imposed significant restrictions on a debtor's ability to make such retention payments. Despite the lack of clear precedent on the issue, Jones Day successfully guided Dana toward an incentive-based executive compensation system that (i) implemented "best practices" on executive compensation under the revised law, and (ii) was ultimately approved by the bankruptcy court over significant opposition.

Perhaps most important, Dana embarked upon the comprehensive restructuring of its employee-related obligations. At the outset of its chapter 11 proceedings, Dana was saddled with massive legacy costs (paying approximately $10 million per month for medical benefits owing to union retirees) and a byzantine pension structure comprising more than 35 different pension plans (some of which were holdovers from divested operations). Once again drawing upon Jones Day's nonbankruptcy experience, Dana, in constant consultation and collaboration with the Pension Benefit Guaranty Corporation, was able to freeze and consolidate its existing pension plans and effect the shift of its pension obligations from such "defined benefit" plans to "defined contribution"
plans, while ensuring the full funding of its previous pension liabilities. The complementary restructuring of Dana's non-pension retiree benefits, however, ultimately would require the cooperation of Dana's varied labor constituencies and form the cornerstone of Dana's plan of reorganization.

SELLING THE STRATEGY: STRUCTURING AND CLOSING THE DEAL

To compete in the automotive supply industry following emergence from bankruptcy, it was essential for Dana, in addition to adopting the restructuring initiatives described above, to remove itself from the business of supplying retiree medical care. At the same time, Dana was committed to proceeding to confirmation of its plan of reorganization with overwhelming support from its major constituencies, including its unions—the United Auto Workers and the United Steelworkers. These competing objectives necessitated that Dana reach some form of agreement with organized labor and with its Official Committee of Non-Union Retirees (the creation of which Jones Day had actively sought in order to provide Dana with a much-needed negotiating counterparty), a task complicated by the further necessity of the agreement's being palatable to Dana's Official Committee of Unsecured Creditors and Ad Hoc Committee of Bondholders.

Committed to a consensual resolution of its labor problems, and to the pursuit of that consensus through collaboration with various constituencies on common goals, Dana achieved...
its goals by way of a global settlement, implemented through three discrete agreements. First, Dana entered into comprehensive settlement agreements with both the UAW and the USW. Among other things, those agreements (i) established a two-tier structure for employee wages, (ii) provided for certain buyouts of union employees and the shutdown of certain unionized facilities, and (iii) eliminated Dana’s obligations to provide nonpension retiree benefits to union employees in exchange for a contribution of approximately $764 million to voluntary employee benefit associations (or VEBAs) established by the unions. Dana also eliminated its nonunion retiree welfare benefits from its balance sheet by instituting a Veba for its nonunion retirees.

The importance of these labor settlements to Dana’s ultimate reorganization and the innovations they represented in the chapter 11 context cannot be overstated. Seldom has a large chapter 11 debtor’s strategy for emergence been so firmly embraced by its unions. Indeed, these settlements represented not only the first major coordinated settlement with both the UAW and the USW in the chapter 11 context, but the first agreement by the UAW in any context to provide for retiree benefits through a union-specific Veba. Dana and Jones Day understood the necessity of earning the unions’ goodwill and the benefits to be derived from adopting a strategy that produced the best outcomes for all parties in pursuit of a common goal. In executing that strategy, Dana and Jones Day provided a road map for future labor-intensive reorganizations.

Both Dana and Jones Day understood, however, that addressing the cost side of Dana’s business would have been of little utility without simultaneously tending to the funding of that business. To this end, Dana entered into an investment agreement with Centerbridge Partners, L.P., and certain of its affiliates. Pursuant to this investment agreement—and after Dana and Jones Day implemented and navigated a complex alternative investment process during which various investors were granted similar opportunities to offer Dana equity financing on better terms—Centerbridge and holders of $1.3 billion of Dana’s $1.6 billion in unsecured bond debt agreed to purchase and/or backstop up to $790 million in new preferred stock issued by a new Dana entity.
Of crucial importance—which looms ever larger as the current credit market hamstrings other chapter 11 debtors trying to emerge—was the commitment behind this investment. Dana could not risk a failure to obtain the cash necessary to fund the VEBAs central to the union settlement agreements. Accordingly, Dana forswore a traditional, but inherently uncertain, rights offering in favor of an innovative hybridized private placement offered only to certain qualified investors and backstopped by Dana’s bondholders. This novel investment mechanism, navigated with Jones Day’s assistance, not only guaranteed the funds necessary to implement Dana’s union settlements but also served as the means through which Dana could garner and marshal the support of its bondholder constituency. Again, Jones Day and Dana successfully employed careful planning, imaginative problem solving, and an emphasis upon consensus and certainty to further the cause of Dana’s restructuring.

Finally, Dana cemented the global settlement through entry into a “plan support agreement” with the unions, Centerbridge, and those bondholders participating in the preferred stock offering. This plan support agreement—which generally bound Dana to propose a plan of reorganization consistent with the union settlement agreements and the investment agreement and bound the other parties to support any such plan—is emblematic of the approach adopted by Dana and Jones Day throughout Dana’s chapter 11 case to ensure careful documentation of agreements and leave counterparties with little ability to back out of their commitments. This careful documentation by Jones Day would serve the company in good stead, not only in connection with its plan of reorganization, but in connection with its ultimate exit financing as well.

This global settlement exemplified Dana’s commitment to work with its various stakeholder constituencies to achieve mutually satisfactory outcomes in an environment of certainty and virtually no conditionality. At the time of the filing of Dana’s chapter 11 cases, Dana had worked hard to develop lines of communication with and among its management, employees, unions, and creditors and was loath to sacrifice them. Instead, Dana adopted a “velvet glove” strategy, litigating only where absolutely necessary. This proved a success and allowed Dana to proceed to confirmation with the support of all major constituencies and nearly $800 million in committed equity financing.

**CONFIRMATION AND EMERGENCE**

With agreements with its unions, new equity investor, exit lenders, and the overwhelming majority of its bondholders in hand, Dana moved toward confirmation of its plan of reorganization with the support of its Official Committee of Unsecured Creditors; only a smattering of opposition; and minimal, if any, conditions upon confirmation. Dana received only 11 objections to its plan (a small number, considering the scope of Dana’s restructuring), all but two of which were resolved consensually prior to confirmation (each of the remaining objectors, eventually overruled, were asbestos personal-injury claimants). Moreover, Dana’s success in securing nearly $800 million in committed equity financing from fewer than 25 investors prior to confirmation enhanced its ability to secure exit financing. Indeed, prior to confirmation, Dana received solid commitments for up to $2 billion in secured exit financing—an achievement that only becomes more notable as the turmoil in the credit markets grows (and claims victims in chapter 11). The order confirming Dana’s plan of reorganization was entered on December 26, 2007, and the plan became effective on January 31, 2008.

Given the troubles experienced by other tier-one automotive suppliers in chapter 11 (e.g., the collapses of Collins & Aikman, Amcast, and Tower Automotive and the continuing troubles besetting Delphi Corporation and DURA Automotive), Dana’s simply emerging from chapter 11 likely would have been considered a success. Emerging from bankruptcy with $2 billion in committed financing, a successfully rationalized corporate structure, a deleveraged cost structure, and new union agreements in place—all achieved within the new and substantially abbreviated deadlines imposed by the revised Bankruptcy Code—is nothing short of remarkable. Yet to call Dana’s success remarkable is not to say that it was a surprise. Rather, it was the intended result and culmination of a carefully designed and assiduously pursued reorganization strategy. Jones Day’s contribution to this success required the marshalling of all of the Firm’s diverse and international experience and two years’ worth of exceedingly hard work.
If an international airline that is a member of the International Air Transport Association (“IATA”) goes into insolvent external administration under the Australian Corporations Act 2001 (Cth) (the “Act”), will the IATA Clearing House Regulations (effective January 1, 2006) (the “CH Regulations”) continue to govern the relationship between IATA, the insolvent airline, and the other members of IATA? A recent judgment of Australia’s High Court clarifies these issues.

**ANSETT AIRLINES: BACKGROUND**

Prior to appointing external administrators to the company (broadly, the equivalent procedure to that contained in chapter 11 of the U.S. Bankruptcy Code and Schedule B1 of the U.K. Insolvency Act 1986) on September 12, 2001, Ansett Australia Holdings Ltd (“Ansett”) had operated as an airline in Australia and abroad for more than 50 years. Ansett had been a member of the IATA Clearing House since 1951.

At its simplest, the IATA Clearing House allows participating international airline operators to sell and issue tickets to passengers for journeys, or parts of journeys, where the carrier of the passenger will be another IATA member. Instead of the airlines making and receiving between themselves numerous payments in respect of these operations, the Clearing House operates so that debits and credits in accounts of the participating airlines are netted out at the end of every month. Airlines with a net credit balance receive a payment from the Clearing House, whereas those with a net debit balance are obliged to pay that balance to the Clearing House.

As part of the external administration process, the creditors resolved that Ansett should execute a deed of company arrangement (“DOCA”), which binds Ansett, its officers, and certain creditors. Creditors bound by the DOCA, which is comparable to a chapter 11 plan under U.S. bankruptcy law, are prevented under the Act from seeking to recover their claims other than pursuant to the DOCA.

**THE ISSUES**

In *International Air Transport Association v. Ansett Australia Holdings Limited* [2008] HCA 3 (6 February 2008), Australia’s High Court considered whether or not IATA is a creditor of Ansett with respect to net debit balances and therefore bound by, and entitled to assert a claim under, the DOCA. The High Court also considered whether or not the administrators of Ansett were permitted to sue individual members of the Clearing House (as distinguished from the Clearing House itself) for direct payment of net indebtedness allegedly due and owing to Ansett.

The starting point for answering these questions depended upon interpreting the CH Regulations. The interpretation of the CH Regulations was not, however, the end of the matter. This was because the administrators of Ansett argued that if the CH Regulations, as interpreted by the High Court, produced a result that was different from, or repugnant to, the relevant insolvency provisions of the Act, the court should refuse to apply the CH Regulations.

Similar issues were determined by England’s House of Lords in *British Eagle International Airlines Ltd v. Compagnie Nationale Air France* [1975] 1 WLR 758. Decisions of the House of Lords are persuasive but not binding on Australia’s High Court. In *British Eagle*, the House of Lords held that the CH Regulations (as they stood at that time) provided for a distribution of the property of the insolvent company different from that prescribed by the insolvency legislation of the U.K. (In particular, the CH Regulations did not apply the *in pari passu* (pro rata distribution) principle contained in the Companies Act 1948 (U.K.).) The House of Lords held that this effective contracting-out of the domestic insolvency regime was contrary to public policy and on this basis refused to give effect to the CH Regulations.

The effect of *British Eagle* was that the IATA Clearing House was rendered ineffective to capture and set off assets of British Eagle, which were required to be available for distribution to the general creditors of British Eagle in accordance with the *in pari passu* principle contained in the UK Companies Act. The CH Regulations were amended post-*British Eagle* in an attempt to circumvent the effect of the ruling. Specifically, clause 9(a) of the CH Regulations now...
provides in substance that direct contractual rights to payment and liabilities shall exist only between each IATA member and the Clearing House, rather than between members.

THE DECISION

By a majority of 6 to 1, the High Court found that the CH Regulations (most relevantly, clause 9(a)), as they pertain to monthly clearances, operate so that:

The property of Ansett did not include debts owed to it by other airline operators and the liabilities of Ansett did not include debts owed by it to other airline operators. The relevant property of Ansett was the contractual right to have a clearance in respect of all services which had been rendered on the contractual terms and the right to receive payment from IATA if on clearance a credit in favour of the company resulted.

Accordingly, if the CH Regulations were the end of the matter, those regulations operate so that the only debit or credit that arose under the Clearing House was that between IATA and member airlines in relation to the final balance each month. As such, IATA (rather than individual airlines) was bound by the DOCA and was entitled to assert a claim in the insolvency proceeding of Ansett for any shortfall after the monthly setoff, but the administrators of Ansett could not pursue individual airlines for alleged amounts owing to Ansett.

However, as noted above, the administrators of Ansett argued that if the CH Regulations operate in the way found by the majority, the CH Regulations amounted to a contracting-out of the operation of the DOCA and, thereby, the Act. It was further submitted that the High Court should follow British Eagle and find that the CH Regulations were ineffective or void by reason of public policy, at least insofar as they operated to render IATA a creditor of Ansett.

The administrators of Ansett submitted that it is a “fundamental tenet of insolvency law” recognized generally in various common-law jurisdictions that the whole of the debtor’s estate should be available for distribution to all creditors and that no one creditor or group of creditors can lawfully contract in such a manner as to defeat other creditors not parties to the contract. It was further submitted that the CH Regulations, as interpreted by the High Court, were contrary to this policy and, as such, should be rendered ineffective or void. The administrators complained that airlines that had provided services to or on behalf of Ansett did not assert a claim under the DOCA but sought satisfaction under the Clearing House system. Therefore, these airlines, unlike Ansett’s ordinary creditors, received satisfaction in full of their claims against Ansett.

The factual scenario presented by Ansett will arise in other jurisdictions. While these cases will be determined on their own facts, and by reference to the domestic insolvency laws of those jurisdictions, the reasoning of the majority of the Australian High Court provides clarity to the international aviation community as to how the CH Regulations operate in the event of insolvency.

The High Court dismissed the public-policy arguments for the following reasons:

1. There were significant differences between Ansett and British Eagle, including the fact that, unlike in British Eagle, no claim was made between individual members of the Clearing House. Also, as noted above, the CH Regulations were materially different post-British Eagle.

2. The High Court found that the rule of public policy for which the administrators contended was not based on any provisions of the Act, and therefore the CH Regulations were not inconsistent with the Act. Public policy should not be used to supplement or vary an Act of Parliament.

3. Having found that no relationship of debtor and creditor exists between Ansett and other members of the Clearing House, the High Court found that the public-policy argument was an impermissible attempt to use public policy to create for the parties a new agreement different from the agreement made by IATA and its members.
THE RAMIFICATIONS OF IATA V ANSETT

The factual scenario presented by Ansett will arise in other jurisdictions. While these cases will be determined on their own facts, and by reference to the domestic insolvency laws of those jurisdictions, the reasoning of the majority of the Australian High Court provides clarity to the international aviation community as to how the CH Regulations operate in the event of insolvency. In particular:

1. IATA is a creditor of the insolvent airline, with the ability to assert a claim in the airline's insolvency proceeding.

2. The insolvent airline has a right to receive from IATA any credit balance arising as a result of the monthly setoff operated by the Clearing House.

3. There is no debtor/creditor relationship between the individual airline members of IATA. Therefore, the insolvent airline may not assert a claim directly against a co-member of IATA for any credit balance arising as a result of the monthly setoff operated by the Clearing House, and vice versa.

4. The continued operation of the CH Regulations when a member enters insolvent external administration is not repugnant to the policy that the whole of a debtor's estate should be available for distribution to all creditors.

PETITION RATHER THAN TRANSFER DATE VALUATION OF COLLATERAL APPROPRIATE IN DETERMINING SECURED CREDITOR’S PREFERENCE LIABILITY

Mark G. Douglas

Valuation is a critical and indispensable part of the bankruptcy process. How collateral and other estate assets (and even creditor claims) are valued will determine a wide range of issues, from a secured creditor’s right to adequate protection, post-petition interest, or relief from the automatic stay to a proposed chapter 11 plan’s satisfaction of the “best interests” test or whether a “cram-down” plan can be confirmed despite the objections of dissenting creditors. Depending on the context, bankruptcy courts rely on a wide variety of standards to value estate assets, including retail, wholesale, liquidation, forced sale, going-concern, or reorganization value.

When assets are valued may be just as important as the method employed to assign value. In the context of preference litigation, for example, whether collateral is valued as of the bankruptcy petition date or at the time pre-bankruptcy that a debtor made allegedly preferential payments to a secured creditor can be the determinative factor in establishing or warding off avoidance liability. This controversial valuation issue was the subject of a ruling recently handed down by an Eighth Circuit bankruptcy appellate panel in Falcon Creditor Trust v. First Insurance Funding (In re Falcon Products, Inc.).

Taking sides on an issue that has produced a rift among bankruptcy and appellate courts, the bankruptcy appellate panel ruled that, in assessing whether a defendant in preference litigation received more as a consequence of pre-bankruptcy payments than it would have been paid in a chapter 7 liquidation, the creditor’s collateral must be valued as of the bankruptcy petition date rather than the date of the payments.

AVOIDANCE OF PREFERENTIAL TRANSFERS

One of the fundamental goals underlying U.S. bankruptcy law is the equitable distribution of assets. To that end, the automatic stay generally prevents an individual creditor from pursuing its claim against a debtor after the initiation of a bankruptcy case, in part to prevent one creditor from recovering a greater proportion of its claim relative to other similarly situated creditors. In addition, the Bankruptcy Code
recognizes that the goal of providing equal treatment to similarly situated creditors would be thwarted if debtors, voluntarily or otherwise, had an unfettered ability to pay certain favored creditors on the eve of a bankruptcy filing more than they would otherwise receive in a bankruptcy case. Accordingly, Bankruptcy Code section 547(b) provides that a chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee may "avoid" any transfer of the debtor’s interest in property—whether a transfer is preferential must be determined “not by what the situation would have been if the debtor’s assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results.” The other four elements of a preferential transfer in section 547(b) are determined at the time the transfer is made.

1. To or for the benefit of a creditor;
2. For or on account of an antecedent debt owed by the debtor before such transfer was made;
3. Made while the debtor was insolvent;
4. Made on or within 90 days before the date of the filing of the petition (or up to one year if the transferee is an “insider”); and
5. That enables such creditor to receive more than it would have received if the transfer had not been made and the debtor’s assets had been liquidated under chapter 7 of the Bankruptcy Code.

Although a debtor is presumed to be insolvent within 90 days of filing for bankruptcy, the DIP or trustee bears the burden of proving each of these five elements.

The fifth element is important. It requires a comparison between what the transferee actually received and what it would have received in a hypothetical chapter 7 liquidation. The requirement is based upon the common-sense principle that a creditor need not return a payment received from the debtor prior to bankruptcy if the creditor is no better off vis-à-vis other creditors than it would have been had the creditor waited for the estate to be liquidated and its assets distributed in accordance with the Bankruptcy Code’s distribution scheme.

Section 547(b)(5) codifies the U.S. Supreme Court’s ruling in Palmer Clay Products Co. v. Brown. In Palmer, the Court held that, in construing a section of the former Bankruptcy Act of 1898 providing for avoidance of preferential transfers,

FALCON PRODUCTS

Business furniture manufacturer Falcon Products, Inc. ("Falcon"), entered into a commercial premium finance agreement in 2004 with First Insurance Funding ("First Insurance") to finance several insurance policies. Under the agreement, Falcon made a $470,000 down payment on the policies and agreed to repay the $1.4 million balance, plus interest, in 10 monthly installments. Falcon granted First Insurance a security interest in the unearned premiums under the policies to secure the premiums financed. The value of the unearned premiums diminished each day by an amount equal to the value of the daily insurance coverage provided under the policies. In the event that Falcon failed to make a payment, First Insurance had the right to cancel the policies and apply any unearned premiums to the unpaid balance owed to it.

On December 6, 2004, Falcon paid the first monthly installment of approximately $145,000. Immediately prior to the payment, Falcon owed First Insurance $1.45 million, and the unearned premiums (the collateral) had a value of $1.7 million, such that First Insurance was oversecured by approximately $240,000. Falcon paid the second $145,000 premium installment (plus a $7,000 late fee) on January 10, 2005. Immediately
prior to this payment, Falcon owed First Insurance $1.3 million, and the unearned premiums had a value of approximately $1.5 million, so First Insurance was oversecured by approximately $215,000.

Falcon and its affiliates filed for chapter 11 protection on January 31, 2005, in Missouri. On the petition date, Falcon owed First Insurance $1.16 million, and the unearned premiums had a value of $1.4 million. The bankruptcy court confirmed Falcon's chapter 11 plan in October 2005. The plan vested authority to prosecute estate avoidance actions in a creditor trust (the “Trust”). The Trust later sued First Insurance to recover as preferential the December 2004 and January 2005 payments (approximately $297,000) made by Falcon under the premium finance agreement.

The only disputed issue in connection with the preference litigation was whether, in applying section 547(b)(5), First Insurance’s collateral should be valued as of the petition date or the dates on which the challenged transfers took place. The bankruptcy court ruled that the hypothetical liquidation test should be applied as of the transfer dates. Because the evidence established that the value of the collateral exceeded the amount of Falcon’s debt on both transfer dates, the bankruptcy court concluded that neither transfer allowed First Insurance to recover more than it would have received in a hypothetical chapter 7 liquidation. It accordingly granted summary judgment in favor of First Insurance. The Trust appealed.

THE APPELLATE PANEL’S RULING

An Eighth Circuit appellate panel reversed, ruling that the hypothetical liquidation test set forth in section 547(b)(5) must be conducted as of the petition date rather than the transfer date(s). Acknowledging that the statute does not specifically indicate when the hypothetical test should be applied, the panel concluded that the Supreme Court’s ruling in Palmer mandates that the test be conducted as of the petition date. Addressing the unworkable nature of a contrary approach, the Palmer court stated:

We may not assume that Congress intended to disregard the actual result, and to introduce the impractical rule of requiring the determination, as of the date of each payment, of the hypothetical question: What would have been the financial result if the assets had then been liquidated and the proceeds distributed among the then creditors?

Faulting the bankruptcy court for failing even to address Palmer, the panel rejected First Insurance’s contention that Palmer was not controlling because it dealt only with payments to unsecured creditors. Nothing in Palmer, the panel explained, expresses any such limitation, and the statute the Court was construing (section 60a of the former Bankruptcy Act) is substantially similar to section 547(b). Moreover, it emphasized, the concern articulated in Palmer over the “impracticality” of applying the hypothetical test on the date of each transfer “is no less (and is probably greater) when payments on secured claims are involved.”

Notwithstanding what would appear to be formidable authority to support the approach championed by the bankruptcy appellate panel in Falcon Products, courts continue to disagree on whether the transfer date or the petition date should control in applying section 547(b)(5)’s hypothetical liquidation test.

Many courts, the appellate panel noted, improperly conflate a preference analysis with a preference defense analysis by concluding that a secured creditor did not receive a preference because it was fully secured on the date of the transfer even though it would have been undersecured as of the petition date. By reasoning that there is not a preference because the payment to the secured creditor results in a release of an equivalent value of collateral, the appellate panel emphasized, these courts confuse the analysis required by section 547(b)(5) with the “contemporaneous exchange for new value” defense set forth in section 547(c). According to the appellate panel, this approach is flawed. A bankruptcy court must conclude that all of the elements of a preference under section 547(b) have been satisfied before considering whether the transferee can rely on any of the defenses set forth in section 547(c). The appellate panel reversed the bankruptcy court’s grant of summary judgment and remanded the case below.
ANALYSIS

Common sense dictates that transfers to a secured creditor should not ordinarily be preferential because the creditor, which has recourse to its collateral up to the value of its claim in the event of a default or a bankruptcy filing, is not unfairly preferred as a consequence of the payments. Designation as a secured creditor, however, does not end the inquiry. As illustrated by Falcon Products, a creditor’s status as fully or only partially secured may change over time, particularly in situations involving a series of ongoing transfers and changes in valuation of collateral. In this context, whether a transfer is preferential may hinge on when the creditor’s collateral is valued.

Notwithstanding what would appear to be formidable authority to support the approach championed by the bankruptcy appellate panel in Falcon Products, courts continue to disagree on whether the transfer date or the petition date should control in applying section 547(b)(5)’s hypothetical liquidation test. The Falcon Products court’s criticism of selecting the transfer date to apply the test in cases involving secured creditors was not limited to its conclusion that such an approach defies Supreme Court precedent and conflates one of the basic elements of a preference with a preference defense stated in section 547(c).

The court also faulted other courts for concluding that the “add-back” method for analyzing alleged preferences does not apply to transfers to fully secured creditors. Section 547(b)(5) provides that, in determining whether a creditor would have received more as a consequence of a transfer than that to which it would have been entitled in a chapter 7 liquidation, the calculation is to be performed assuming that “the transfer had not been made”—an approach sometimes referred to as the “add-back” method. Some courts have determined that the add-back method does not apply to transfers to fully secured creditors because, in rather circular logic, payments to a fully secured creditor cannot be preferential.

Emphasizing that the language of section 547(b)(5) does not support this position, the Falcon Products court observed that refusal to apply the add-back method in these cases is more of a veiled rejection of a petition-date hypothetical liquidation test than a true objection to the add-back method since the status of the secured creditors in these cases was determined using the add-back method, i.e., by considering the creditor’s secured status immediately prior to the transfer.

The upshot of Falcon Products for the litigants involved is as yet unclear. The evidence indicated that, assuming First Insurance had not received the $297,000 in alleged preferential payments, it would have been owed $1.456 million, while its collateral would have had a value of no more than $1.418 million as of the bankruptcy petition date. This would mean that part of the payments would qualify as a preference, unless First Insurance could establish that it is entitled to rely on one of the preference defenses stated in section 547(c) (e.g., contemporaneous exchange for new value, ordinary-course business payment or subsequent new value).

Falcon Creditor Trust v. First Insurance Funding (In re Falcon Products, Inc.), 381 B.R. 543 (Bankr. 8th Cir. 2008).


In re Rocor Intern., Inc., 380 B.R. 567 (B.A.P. 10th Cir. 2007).


Sloan v. Zions First National Bank (In re Castletons, Inc.), 900 F.2d 551 (10th Cir. 1993).


REFUSAL TO PARTICIPATE IN CONFIRMATION PROCESS DOOMS BID FOR STAY OF ORDER CONFIRMING CHAPTER 11 PLAN

Mark G. Douglas

One of the hallmarks of chapter 11, and bankruptcy jurisprudence in general in the U.S., is the fundamental right of creditors and other stakeholders to have a meaningful voice in the proceedings concerning matters that affect their economic interests. In a chapter 11 case, this means that any stakeholder has the right to bring to the court’s attention any grievance or concern that it may have concerning any aspect of the bankruptcy case, including, among other things, any perceived inadequacy in measures proposed by the debtor-in-possession (“DIP”) or trustee to protect a creditor’s interest in collateral; the propriety of a DIP’s request to use, sell, or lease estate property other than in the ordinary course of business; or a DIP’s efforts to remain in control of the chapter 11 process by obtaining extensions of its exclusive periods to propose and solicit objections for a chapter 11 plan.

Chapter 11 creates a framework of procedures for creditors, shareholders (either individually or through committees), and other stakeholders to participate in the plan formulation and confirmation process. Those who neglect to take full and timely advantage of these mechanisms do so at the risk of undermining the ultimate recovery on their claims or interests.

The ability of stakeholders to participate in the plan-confirmation process, either by voting to accept or reject a chapter 11 plan or articulating their concerns regarding the terms of a proposed plan as part of a confirmation hearing, are arguably the most important rights given to creditors and interest holders. As demonstrated by a ruling recently handed down by a New York bankruptcy court, however, a stakeholder can forfeit its right to seek certain kinds of relief following confirmation of a chapter 11 plan if it refuses to participate fully in the confirmation process. In In re Calpine Corp., the bankruptcy court denied a request made by certain shareholders for a stay pending their appeal of an order confirming a chapter 11 plan because even though the shareholders had voted against the plan, they chose not to participate in any other way in the confirmation process.

RIGHT TO BE HEARD AND PARTICIPATE IN CHAPTER 11

Among the chapters of the Bankruptcy Code, chapter 11 is unique in explicitly conferring a broad right to participate in the case upon creditors, equity interest holders, and other stakeholders. Section 1109(b) provides that “[a] party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter.”

Complementing this general right of access is the basic right of any stakeholder to participate in the plan-confirmation process. Any creditor or interest holder whose claim or interest is “impaired” by a chapter 11 plan (i.e., not paid in full and/or otherwise conferred with its full panoply of pre-existing rights) has the right to vote to accept or reject the plan, which can be confirmed by the bankruptcy court only if the requisite majorities of creditors and interest holders vote in favor of it and the plan otherwise satisfies certain statutory benchmarks designed to ensure that it is feasible and fair. Apart from voting rights, all stakeholders have the right to participate in the confirmation process by voicing any objections that they may have to the terms of the proposed plan. Both of these entitlements are important. Calpine demonstrates that reliance on only one of them is ill-advised, particularly if it appears that a stakeholder idly sits on its rights during the confirmation process and then, after confirmation, springs to action in a perceived effort to obtain a greater recovery.

BACKGROUND

Major U.S. power producer Calpine Corporation and various affiliates (“Calpine”) filed for chapter 11 protection on December 20, 2005, in New York. In the months following the bankruptcy filings, the Office of the U.S. Trustee appointed an official committee of Calpine’s unsecured creditors as well as an official equity security holders’ committee. Between March
and September 2007, a group consisting of private equity and hedge funds as well as other sophisticated investors (the “Objecting Shareholders”) collectively acquired more than 5 percent of Calpine’s common stock.

Calpine filed a chapter 11 plan and accompanying disclosure statement in June 2007. After approving Calpine’s disclosure statement in September 2007, the bankruptcy court implemented plan-solicitation procedures and established a discovery schedule to govern the confirmation proceedings. The creditors’ and equity committees engaged in extensive discovery and commissioned expert opinions concerning Calpine’s anticipated enterprise value, as distributions to creditors and shareholders under the proposed plan depended on it. The Objecting Shareholders did not participate in discovery or the confirmation hearing, nor did they object to confirmation. They simply voted against the plan, which initially distributed nothing to common stockholders.

On December 18, 2007, Calpine sought court approval of modifications to the plan that it characterized as “immaterial,” such that votes on the plan need not be resolicited. Under the revised plan, common stockholders were guaranteed the right to receive warrants for a portion of the 300 million shares of new Calpine stock to be issued to creditors under the plan. With this revision, the equity committee settled its remaining objections, and the bankruptcy court confirmed Calpine’s chapter 11 plan on December 19, 2007.
The Objecting Shareholders moved for reconsideration of the confirmation order on December 31, 2007, claiming, among other things, that the plan modifications were material and that they had no meaningful opportunity to be heard in connection with confirmation, having relied on the equity committee to pursue any objections. The bankruptcy court denied the motion, characterizing the request for a “do-over” as inappropriate:

Despite the size of their investments, the risks involved, the existence of notice of the confirmation hearing and all other applicable deadlines, the Objecting Shareholders as a matter of volition did not participate in the confirmation process and despite their acquired stake, apparently did not monitor the Chapter 11 Cases, nor request electronic notice.

The Objecting Shareholders appealed the confirmation order on January 18, 2008. On that same date, they also filed a motion in the bankruptcy court seeking to stay that portion of the order providing for the distribution of stock and warrants pending the outcome of the appeal.

THE BANKRUPTCY COURT’S RULING

The bankruptcy court denied the motion for a stay pending appeal. Rule 8005 of the Federal Rules of Bankruptcy Procedure establishes the procedure for obtaining a stay of an order, judgment, or decree that is the subject of an appeal. According to Second Circuit precedent, such a stay will be granted only if the party seeking it can satisfy the “heavy burden” of demonstrating that:

1. It would suffer irreparable injury if a stay were denied;

2. Other parties would suffer no substantial injury if the stay were granted;

3. The public interest favors a stay; and

4. There is a substantial possibility of success on the merits of the appeal.

Most courts agree that all four criteria must be satisfied before a stay can be granted.

According to the bankruptcy court in Calpine, demonstration of irreparable harm is the “principal perquisite” for the issuance of a stay under Rule 8005. The court rejected the Objecting Shareholders’ contention that they would be irreparably harmed absent a stay because (i) their appeal would likely be mooted once new stock and warrants were issued under the plan, and (ii) Calpine was grossly undervalued. Given their “dilatory conduct” in refusing to participate in the confirmation process and the absence of any evidence submitted to support their undervaluation claims, the court emphasized, the risk that the Objecting Shareholders’ appeal would be mooted by substantial consummation of the plan fell “well short” of the requirement that harm be “actual and imminent.”

By contrast, the bankruptcy court explained, staying the confirmation order “would cause potentially substantial, irreparable injury” to Calpine, its creditors, and other stakeholders. The court explained that Calpine’s $7.6 billion exit-financing commitment was conditioned upon the absence of any stay of the order, and the costs of negotiating new exit financing and remaining in chapter 11 would be significant (as much as $250 million for professional fees and post-petition interest for a three-month delay in exiting bankruptcy). Calpine’s new common stock and warrant holders would also be harmed, the court emphasized, because the issuance of a stay would “inevitably drive down stock prices” and put the new warrants further out of the money.
The bankruptcy court further concluded that the Objecting Shareholders failed to demonstrate a substantial likelihood of success on the merits of their appeal. They could not show that the court made a manifest error of law or fact, nor did they produce new evidence that would have changed the court’s decision to approve the plan modification or enter the confirmation order. Moreover, the bankruptcy court explained, the relief sought by the Objecting Shareholders was tantamount to a material modification of the confirmed plan, a remedy to which only a plan proponent or the reorganized debtor is entitled under the circumstances specified in section 1127(b) of the Bankruptcy Code, which requires, among other things, notice and a hearing.

Finally, given the appeal’s apparent futility and motivation by private investment concerns, the bankruptcy court concluded that the public interest would be better served by allowing distributions under the plan to proceed in an expeditious manner. “Clearly,” the court remarked, “the public interest does not support favoring the interests of those who idly sit on their rights.”

ANALYSIS

At heart, Calpine is a cautionary tale concerning the consequences of a lack of diligence. Even so, a strong subtext imbues the bankruptcy court’s denial of what it considered to be dilatory tactics; having done nothing other than vote against the plan in connection with the confirmation process, the Objecting Shareholders sprang into action only when it appeared that there actually might be some value available for distribution in respect of their interests. The court clearly viewed such 11th-hour tactics as being out of bounds. Chapter 11 creates a framework of procedures for creditors, shareholders (either individually or through committees), and other stakeholders to participate in the plan-formulation and confirmation process. Those who neglect to take full and timely advantage of these mechanisms do so at the risk of undermining the ultimate recovery on their claims or interests.


IN BRIEF: AUTOMATIC STAY DOES NOT BAR CALL FOR SHAREHOLDER MEETING

Mark G. Douglas

Principles of corporate governance that determine how a company functions outside of bankruptcy are transformed and in some cases abrogated once the company files for chapter 11 protection, when the debtor's board and management act as a “debtor-in-possession” (“DIP”) that bears fiduciary obligations to the chapter 11 estate and all stakeholders involved in the bankruptcy case. Upon a bankruptcy filing, major corporate decisions, such as significant asset sales, are no longer subject to shareholder approval, except to the extent that any proposed restructuring must be approved by “impaired” creditors and shareholders pursuant to the chapter 11 plan-confirmation process. Instead, decisions involving nonordinary-course business transactions must be approved by the bankruptcy court as an exercise of the DIP's sound business judgment. As illustrated by a ruling recently handed down by the Delaware Chancery Court, however, certain aspects of corporate governance are unaffected by a bankruptcy filing. In Fogel v. U.S. Energy Systems, Inc., the court held that the automatic stay did not preclude it from directing a chapter 11 debtor to hold a meeting of the corporation's shareholders in the absence of any showing that the call for a meeting amounted to “clear abuse.”


U.S. Energy encountered significant problems in 2007 with its operations and projects in the U.K. The company's board resolved to meet on June 29, 2007, for the purpose of interviewing and hiring a financial advisor or restructuring officer. Convinced that Fogel was responsible for the problems, the remaining board members conferred before the meeting and decided to terminate Fogel's employment. They accordingly confronted him at the June 29 meeting and demanded that he resign by the end of that day, failing which he would be fired. Fogel refused to resign and was informed by one of the remaining directors later that day by telephone that he had been terminated.

On July 1, 2007, Fogel exercised the right given to the CEO/chairman in U.S. Energy's bylaws to demand that the board call for a special meeting of stockholders for the purpose of voting on the removal of the other directors and electing replacements. The board ignored the demand and formally terminated Fogel's employment at a board meeting convened later that day. Fogel sued to compel the board to call the special meeting.

On December 13, 2007, the Delaware Chancery Court ruled that the June 29 meeting at which Fogel was given the option to resign or be fired did not qualify as a board meeting under Delaware law and that as a consequence, Fogel was authorized to exercise his right under the bylaws to call for a special shareholder meeting on July 1 because the board did not formally remove him until later that day. The court ordered U.S. Energy and its board to hold such a meeting.

Instead, the remaining directors moved first to modify the court's order and then to have it re-argued. Concerned that the directors were trying to evade the court's ruling, Fogel asked the court to order that the shareholder meeting be held on January 7, 2008. U.S. Energy filed for chapter 11 protection before the court could rule on the motion.

The bankruptcy filing, however, did not prevent the Delaware Chancery Court from ruling on Fogel's request that a date be established for the meeting. Acknowledging that scheduling a shareholder meeting is not the sort of “ministerial act” that would be excepted from the automatic stay, the court concluded that the stay did not bar it from scheduling a meeting under the circumstances:

This Court is the proper forum for resolving the issue. Indeed, I have already resolved the question of whether a meeting should be held and need now only to set a
Moreover, this Court, the Delaware Supreme Court, and federal bankruptcy courts have held that corporate governance does not cease when a company files a petition under Chapter 11 and that issues of corporate governance are best left to the courts of the state of incorporation.

According to the court, it is only in cases where the challenger to a call for a shareholder meeting can demonstrate that the party calling for the meeting is “guilty of clear abuse”—a determination that turns on “whether rehabilitation [of the debtor] will be seriously threatened, rather than merely delayed”—that bankruptcy law or bankruptcy courts will interfere with the “well-settled rule” that the right to compel a shareholder meeting for the purpose of electing a new board continues during a chapter 11 case. Concluding that the remaining directors had made no showing of clear abuse, the court directed that a shareholder meeting be convened by the end of January 2008.

U.S. Energy Systems is the second notable ruling from the Delaware Chancery Court in recent years on the effect of a bankruptcy filing on traditional corporate governance rules. In a 2006 ruling, Esopus Creek Value LP v. Hauf, the court determined that a board of directors’ decision to structure the corporation’s asset sale as a bankruptcy sale amounted to inequitable conduct because the corporation was financially sound, although delinquent in its Securities and Exchange Commission filings, and its single self-admitted purpose for seeking bankruptcy protection was to effect the asset sale transaction without complying with common-stock voting requirements.

Principles of corporate governance that determine how a company functions outside of bankruptcy are transformed and in some cases abrogated once the company files for chapter 11 protection.

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Esopus Creek Value LP v. Hauf, 913 A.2d 593 (Del. Ch. 2006).
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