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DIP Lending and the Death of Emergence: Reorganisation Outcomes Post-Crisis¹

Aditya (Adi) Habbu, Adjunct Professor, Fordham Law School, New York, USA and **Nikhil Abraham**, JD/MBA, The University of Chicago, Chicago, USA

Introduction

The bankruptcy process has evolved during the last century to provide economically sound businesses with a mechanism for dealing with temporary financial distress. Although the amount of time a company must spend in bankruptcy has decreased, the process remains lengthy and companies seeking to emerge turn to debtor-in-possession ('DIP') financiers to fund ongoing operations.² To incentivize DIP financiers to lend to troubled companies, the Bankruptcy Code dangles a carrot by providing automatic administrative expense priority for DIP loans. Further, if the DIP loan is difficult to obtain, the court grants the loan super-administrative expense priority or even secures the loan with a senior lien.³ Many courts encourage existing lenders to provide new funding by allowing the proceeds of the DIP loan to be applied against pre-petition debt, in effect 'rolling up' pre-petition debt into post-petition debt with administrative priority.⁴

The social benefit of DIP loans is intensely debated. Some scholars have opined that DIP loans effect a transfer of wealth from existing debt holders to the DIP lender, and induce managers to undertake excessively risky negative NPV projects.⁵ Other scholars have

found that the use of DIP loans results in faster resolution of the Chapter 11 process, greater likelihood of emergence, and liquidity for those firms unable to borrow on an unsecured basis.⁶ Regardless of whether DIP loans are socially optimal, DIP lending has increased dramatically over the last decade.⁷

The recent credit crisis dramatically altered the DIP landscape.⁸ Major DIP lenders pulled out of the market, and those continuing to lend demanded higher interest rates and shorter loan maturities.⁹ Presumably, these changes affected debtors' post-bankruptcy outcomes. In this paper we examine bankruptcy successes and failures before and after the credit crisis for those debtors that sought DIP loans. We found significant differences between our Pre- and Post-Crisis Data sets. In particular, we found that emergences are lower (percentage-wise) in our Post-Crisis data set. Further we found that sales are statistically significantly greater in the Post-Crisis data set than in the Pre-Crisis data set. In conjunction with our practitioner interviews, we believe that while DIP loans were once a path to emergence, DIP loans are now a path to sale. Companies who can obtain a DIP loan in these turbulent economic times are the most likely to be strong companies who are merely suffering from

Notes

- 1 This paper was prepared as part of the Turnaround Management Association of Chicago Research Fellowship program. We thank the TMA Chicago Chapter for their generous support along with Bill Hass, Douglas Baird, David Johnson, and Molly Grovak for their helpful comments. We also thank Judge Christopher Sontchi, Judge Robert Gerber, Bradford Couri, and Scott Victor for agreeing to be interviewed as part of this study.
- 2 DIP lending has its roots in the American railroad industry, which provided receiver certificates that functioned similarly to the way DIP loans function today. David A. Skeel, Jr, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton University Press 2001) 48–51.
- 3 11 USC § 364(a)–(d).
- 4 See generally, for example, *In re Lyondell Chemical Co*, 402 BR 571 (Bankr SDNY 2009).
- 5 See, for example, Lucian A. Bebchuk and Jesse M. Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy', 105 *Yale LJ* 857, 857–91 (1996); George G. Triantis, 'A Theory of the Regulation of Debtor-in-Possession Financing', 46 *Vand L Rev* 901, 901–35 (1993).
- 6 See, for example, Sandeep Dahiya, et al., 'Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence', 69 *J Fin Econ* 259, 261 (2003); Steven L. Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy', 47 *Duke LJ* 425, 428–89 (1997).
- 7 Dahiya, 69 *J Fin Econ* at 266 (cited in note 6). In 1988, of the publicly held debtors that filed for Chapter 11, less than 10 percent obtained a DIP loan, while that number rose to 50 percent almost 10 years later.
- 8 The Lehman Brothers bankruptcy is the date we use for the start of the crisis (15 September 2008).
- 9 'Double DIP: Bankruptcy Loans Scarce and Scary Expensive', Reuters (19 January 2009), online at <www.financialweek.com/article/20090119/REG/901139993/-1/FWIssueAlert01> (visited 11 May 2010) ('DIP financing is not easily available. It's expensive. It's scarce – and that used to be the easiest part of a bankruptcy filing').

an overly onerous debt load. If even these companies are no longer heading towards emergence, we believe this is strong evidence that emergence is no longer the end goal of the bankruptcy process. Section I describes DIP lending historically and the current DIP financing climate. Section II presents a literature review and current understanding of DIP loans on debtor outcomes, primarily bankruptcy success or failure. Section III outlines our testable hypotheses. Section IV states the details of our data selection, methodology, and analysis. Section V discusses our major results and interpretations. Section VI outlines case-studies of different debtor outcomes pre- and post-crisis. Section VII concludes with our predictions for the future.

I. DIP lending

A. History

Under Chapter 11, a debtor may continue operating the business while in bankruptcy. However, to fund operations the company may need additional cash as it undergoes what is often a lengthy bankruptcy process. The debtor's options are to either use cash collateral or obtain DIP financing.¹⁰ Cash collateral includes cash on the balance sheet, or cash raised through a § 363 sale or a liquidation.¹¹ DIP financing includes loans issued on a secured or unsecured basis.

Without some type of protection, lenders will hesitate before loaning additional funds to a firm in financial distress. The lender will not want to be last in line behind other claims on the firm's assets, even for positive net present value projects.¹² Alternatively, the lender may not have the experience to judge whether the debtor can effect a successful recovery. In the early railroad restructurings, courts addressed this issue by providing post-petition lenders with receivership

certificates, which served as promissory notes issued in exchange for cash secured by the railroad's entire estate with priority over all other claims.¹³ For decades, these receivership certificates were a product of common law. In the 1930s, amendments to the bankruptcy law formally codified the use of receivership certificates for railroads and non-railroads alike.¹⁴ In 1978 Congress enacted Chapter XI of the Bankruptcy Code, which marked the birth of DIP financing as we know it today.¹⁵ The new DIP statute eliminated the common law requirement that the financing from the receivership certificate be used for companies in the 'public interest' or for the 'preservation of collateral', and instead the trustee only had to ensure 'adequate protection' of the debtor's assets.¹⁶

Since the passage of the 1978 Bankruptcy Act, DIP loans have come in two flavors: loan oriented financing and loan-to-own financing. In a loan-oriented financing the lenders may reduce the duration of the loan term and require the debtor to meet certain cash flow targets. There will be some flexibility in these negotiations because in the majority of cases, the debtor's existing lenders provide the DIP financing.¹⁷ The DIP loan may also contain other covenants to influence and control debtor behavior. For example, the FAO Schwarz DIP filing required that the firm be liquidated unless it sold all its assets or confirmed a plan of reorganization by a certain deadline.¹⁸

In a loan-to-own financing, the DIP lender exerts some control over the company as a condition of providing financing. For example, in the US Air bankruptcy, the lender received five of thirteen seats on US Air's board along with 37.5% of the stock when the debtor emerged from bankruptcy.¹⁹ In another example, American Airlines provided TWA with a DIP loan that required TWA to auction its assets, with American Airlines as the expected buyer.²⁰ In cases where the DIP lender is a hedge fund or private equity fund, the

Notes

10 Triantis, 46 *Vand L Rev* at 904–908 (cited in note 5).

11 Before the cash can be used, any secured party with an interest in the cash collateral must consent or court must approve the transaction. 11 USC § 363(c)(2).

12 Commonly referred to as 'debt overhang', debt holders do not provide new financing for positive NPV projects because the project earnings are partially appropriated to existing debt holders.

13 Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* at 59–60 (cited in note 2) ('Railroads could only keep running if suppliers continued to supply coal. Unfortunately ... any contributions a supplier made would be mostly for the bondholders' benefit ... To remedy this problem ... receivership certificates gave special priority to suppliers of essential goods and services.');

David A. Skeel, Jr, 'The Past, Present and Future of Debtor-In-Possession Financing', 25 *Cardozo L Rev* 1905, 1911–14 (2004).

14 Skeel, 25 *Cardozo L Rev* at 1915 (cited in note 13); Bankruptcy Act of 1933, § 77, 47 Stat 1474; Bankruptcy Act of 1934, § 77B, 48 Stat 915, 11 USC § 207(b).

15 Bankruptcy Act of 1978, § 364, Pub L No 95-598, 92 Stat 2549.

16 *Id.*

17 Skeel, 25 *Cardozo L Rev* at 1918 (cited in note 13).

18 *Id.*

19 *Id.* at 1921.

20 *Id.*

option value of these ownership provisions can make for attractive investment returns.²¹

B. Current DIP landscape

Commentators predicted that DIP lending was dead early in 2009 because of the poor credit markets.²² Initial reports confirmed that General Electric and other major DIP lenders had stopped issuing new money DIP loans, though lenders were prepared to make defensive DIP loans. However, after the financial markets stabilized, lenders provided DIP loans at record levels. In 2009, debtors raised 404 DIP loans totaling more than USD 60 billion, compared with 345 DIP loans totaling USD 18.6 billion, the highest amount from 2001 to 2008.²³ See Table 1. Even without the Chrysler and General Motors DIP loans, which totaled almost USD 40 billion, 2009 DIP lending was higher than in any previous year. Still, DIP lending volume must be viewed within the context of the bankruptcy climate in general. In 2009, 360 debtors with at least USD 100 million in assets filed for bankruptcy, while in 2008 there were 211 such filings.²⁴ This trend may be explained by the increase in corporate bankruptcy filings over this period. See Figure 1.

The DIP lender mix has also changed in the last 18 months. Existing lenders provided 45% of the DIP loans raised in 2009, and debtors chose traditional banks as lenders.²⁵ When third party DIP lenders did enter the market they typically used the DIP loan as a bridge to a § 363 sale.²⁶ The traditional banks had little appetite for bankruptcy lending, and made DIP loan terms more conservative. This conservatism was not unfounded. In an environment in which asset prices were falling precipitously, DIP lenders were hesitant to lend based on assets. DIP loan duration, traditionally as long as two years, shrunk to three to six months, giving debtors less time to emerge and possibly leading to more sales.²⁷

Lenders also sought creative ways to lend to over-leveraged debtors who owned few assets with which to secure a new loan. The Lyondell Chemical and Aleris International DIP loans included dollar for dollar rollups of pre-petition debt. Practitioners are split on the trend in rollups going forward. Some believe that rollups 'are a sign of a fractured market' which will disappear once markets rebound,²⁸ while others believe that rollups will continue until judges push back.²⁹ As another example, the General Growth Properties and the ION Media Networks DIP loans both included an equity conversion feature that allowed the DIP to be repaid by converting the facility to a fixed equity stake upon exiting bankruptcy. Finally, interest rates jumped with many speculating that the Lyondell Chemical represented the peak of the market, having paid an interest rate of approximately 13% and 7% in fees.

II. Literature review

Dahiya et al. (2003) tests the common tension existing in post-petition financing by examining whether DIP financing leads to overinvestment or the funding of positive NPV projects that increase the likelihood of emergence and reduce the time in bankruptcy.³⁰ Dahiya uses a sample of 685 filings, which represent all the public firms that filed for Chapter 11 protection between January 1988 and December 1997. The paper finds that (i) debtors that obtain DIP financing are likely to have less leverage and more current assets than firms that do not obtain DIP financing; (ii) firms that obtain DIP financing are more likely to emerge from bankruptcy; (iii) after taking the firm's assets into account, firms that obtain DIP financing spend less time in the bankruptcy process, which reduces time for emergence; and (iv) firms that obtain DIP financing from existing lenders emerge from Chapter 11 more quickly than firms that use a new lender.³¹

Notes

- 21 In the reorganization of Lang Holdings, the DIP lender, Sun Capital, came out with a significant equity stake in the company. Santosh Nadgir, 'UPDATE 2-Private equity firms buy Lang Holdings for \$25 mln', Reuters (13 October 2009), online at <www.reuters.com/article/idUSBNG35247420091014> (visited May 21, 2010). Similarly, the DIP lender received an equity stake in EnviroSolutions. Santosh Nadgir, 'EnviroSolutions files pre-negotiated Chapter 11', Reuters (11 March 2010), online at <www.reuters.com/article/idUSSGE62A0G720100311> (visited 21 May 2010).
- 22 Jeffrey McCracken and Paul Glader, "'DIP' Loans are Scarce, Complicating Bankruptcies', *Wall St J Online* (17 October 2008), online at <online.wsj.com/article/SB122421475294443955.html> (visited 27 May 2010).
- 23 The Deal, 'Bankruptcy Debtors Database', online at <www.thedeal.com> (visited 12 May 2010).
- 24 Id.
- 25 Id. The biggest lenders of 2009 were Citigroup (USD 2.4 bn, 7 DIPs), General Electric (USD 1.12 bn, 22 DIPs), UBS (USD 953 m, 7 DIPs), and Goldman Sachs (USD 912 m, 2 DIPs).
- 26 John Blakely, 'The New DIPs', *Deal Magazine* (22 January 2010), online at <www.thedeal.com/newsweekly/features/special-reports/the-new-dips.php> (visited 27 May 2010).
- 27 Interview with Judge Christopher Sontchi, Delaware Bankruptcy Judge, on 22 April 2010.
- 28 Blakely, 'The New DIPs' (cited in note 26) (quoting Mark Cohen, head of restructuring at Deutsche Bank AG).
- 29 Interview with Judge Sontchi (cited in note 27).
- 30 See generally Dahiya, et al., 69 *J Fin Econ* 259 (cited in note 6).
- 31 Observation (iv) is consistent with the theory that insiders have the informational advantage to facilitate faster outcomes.

Carapeto (2010) continues to explore DIP financing outcomes.³² The paper investigates whether the size of the DIP financing affects recovery rates, whether DIP financing increases the probability that the business will survive as a going concern, and finally whether management turnover is larger in firms with DIP financing. Carapeto uses a sample of 389 public firms with over USD 50 million in assets that initiated bankruptcy proceedings between 1 January 1983 and 31 December 1997. The paper concludes that the size of the DIP financing does contribute to larger unsecured creditor recoveries. Debtors with DIP financing are more likely to reorganize with their independence preserved (72% versus 54%), are less likely to be merged or acquired (8% versus 18%), and are less likely to liquidate (10% versus 16%).

Another valuable feature of a DIP is the increased probability of debtor success in the bankruptcy process through better monitoring. DIP lenders use loan covenants to keep a watchful eye on the debtors. Both Chatterjee et al. (2005)³³ and Elyan and Meyer (2001)³⁴ have studied the equity market reaction to DIP announcements. Both papers find significant positive abnormal returns to equity, suggesting the market views DIP loans favorably. One theory is that DIP loans create value because the loan documents contain affirmative covenants that increase the debtor's financial reporting and disclosure. In addition, loan documents contain negative covenants that restrict risky operating activities and financial expenditures. Further, these covenants trigger defaults if certain financial ratios are not maintained. In this manner, the DIP lender serves as a monitor, providing more information and a positive signal to all creditors.

III. Hypothesis

A. Did pre- and post-crisis bankruptcy outcomes differ among debtors who secured DIP loans?

The crisis and the ensuing recession created great demand for DIP financing, as companies looked for post-petition financing to continue operations during bankruptcy. However, capital was in short supply as lenders reduced the level of their DIP loan commitments. For those who did lend, interest rates rose and DIP loan duration shrank to three to six months. Under

such incredible pressure and with little time to emerge, we would expect that emergences would decrease and sales or liquidations would increase.

B. Do these post-crisis outcomes differ from the outcomes found by Carapeto (2010)?

We compare the results of firm outcomes post-crisis to the outcomes of firms from 1983 to 1997 in the Carapeto paper. Such a comparison allows us to see if the crisis and the ensuing recession altered the pre-existing status quo. In addition, we supplement the analysis by interviewing industry experts to predict whether any changes we observe in the post-crisis period are temporary or permanent.

IV. Data selection & analysis

A. Data selection

The data used in this paper was compiled from multiple sources. We used the Lehman Brothers bankruptcy (15 September 2008) to mark the start of the credit crisis, and downloaded data from The Deal Pipeline DIP Database on all firms that filed for DIP loans six months before and after September 30, 2009. There were 175 DIP financings in the pre-crisis period that totaled USD 12.50 billion, and 213 financings in the post-crisis period that totaled USD 17.38 billion. See Table 2. We then examined these filings and screened for those firms with at least USD 100 million in debt and with publicly available information on the DIP loan and post-loan outcomes. The resulting database includes 24 filings pre-crisis and 35 filings post-crisis.

B. Methodology and analysis

Of those companies that received a DIP loan six months before or after the crisis, we then created a database with a number of data points. Using original court documents, SEC filings, company press releases, and LexisNexis news searches, we compiled DIP loan data including interest rate, maturity, DIP structure, and debtor financial results (i.e. emergence, sale, liquidation) up to 15 months after the date of the last DIP loan approval.³⁵

Notes

32 Maria Carapeto, 'Does Debtor-in-Possession Financing Add Value?' (unpublished working paper, London Business School, 2010).

33 See generally Sris Chatterjee, Upinder S. Dhillon, and Gabriel G. Ramirez, 'Debtor-in-Possession Financing', 28 *J Banking & Fin* 3097 (2004).

34 Fayez A. Elayan and Thomas O. Meyer, 'The Impact of Receiving Debtor-In-Possession Financing on the Probability of Successful Emergence and Time Spent under Chapter 11 Bankruptcy', 28 *J Bus Fin & Account* 905 (2001).

35 In addition to this data, we compiled data on DIP Loan Size/Liability ratios and information on debt structure. We used this data to run a series of logistic regressions to determine if Interest Rate, Industry, DIP Loan Size/Debt, Debt Structure, or DIP Lender Type served as valuable predictors of a company's emergence, sale, or liquidation. While our regressions suggest many interesting avenues for further research, we found no statistically significant predictors of bankruptcy outcomes in our data set.

We then conducted Fisher Exact Tests and simple t-tests to determine whether statistically significant differences existed between the pre-crisis and post-crisis data for both data sets.³⁶

V. Results

Our findings present a number of statistically significant conclusions. Firms receiving DIP loans after the crisis faced higher interest rates (7.63% versus 10.73%). See Table 3 for a detailed analysis and range of interest rate differences. In addition, Figure 2 provides a visual representation of how rate ranges and means have changed over the sample periods. Table 4 and Table 5 contain descriptive information on relevant DIP loan attributes, and compares these attributes pre- and post-crisis.

Table 4 contains an analysis of debtor outcomes 15 months after obtaining a DIP loan. Debtors did not experience a statistically different level of emergences from before the crisis but did experience a statistically significantly greater number of sales. We also observed a statistically significant increase in private equity fund involvement in the DIP. See Table 5. In the pre-crisis period, at least one private equity fund was a lender in the DIP facility 25% of the time compared to 53% of the time in the post-crisis period.

We compared our findings to the findings in the Carapeto paper to see if the post-crisis reorganization outcomes differed from the reorganization outcomes of firms who filed for bankruptcy between 1983 to 1997. While the Carapeto paper showed 66% of firms who received a DIP loan emerged from bankruptcy, our sample set of firms show that, post-crisis, only 17% of similarly situated firms emerged from bankruptcy. Additionally, in Carapeto's sample set 17% of firms exited bankruptcy through a sale, while our data set of similar firms show 46% of firms exited bankruptcy through a sale.³⁷ See Table 6.

The significant increases in sales and involvement of private equity players have a number of drivers and practical implications for management and post-petition financiers, specifically DIP lenders. Commentators we spoke to, including Judge Sontchi and Judge Gerber, agreed that sales for companies receiving DIP loans had increased and the end of the post-crisis recession would not cause this trend to disappear. Previously, courts were unwilling to allow debtors to sell their companies as courts seemed to prefer to see companies emerge. Over time this view has changed, and the courts have given their blessing to sales. Sales may also be increasing in popularity because a sale is faster, cheaper, and easier to execute than an emergence.³⁸ One alternate interpretation of the data is that the recession may have made it impossible for a lender to make a full recovery in the short run, and thus lenders were essentially forced into a defensive dip.³⁹ This interpretation is also consistent with our data, which revealed that the vast majority of DIP loans in our data set were defensive DIP loans. Nonetheless, our additional evidence suggests that sales among DIP borrowers may not be a temporary trend.

Lender mix has affected the percentage of sales as well. Traditional banks may be biased toward emergence, since banks are more interested in providing financing to newly reorganized entity than in retaining an ownership stake in an entity.⁴⁰ Additionally, traditional DIP lenders, such as large commercial banks and finance companies, were balance sheet constrained and unable to extend DIP loans.⁴¹ Consequently, private equity and hedge funds increased their DIP lending. One practitioner noted that in 2007, only 1% of their assets were invested in DIPs, however their DIP lending grew to 10% of their assets during 2009.⁴² In addition, funds are much more willing to exert control of the debtor, either through a majority stake of the equity or board control. One DIP lender commented that the causation could be reversed. Instead of assuming that companies that seek a DIP loan are more likely to be sold than

Notes

- 36 Since time is a variable in the data there is a concern that the data is serially correlated. This is particularly relevant in the interest rate calculations. To alleviate this problem we studied scatter plots of the data and ensured that there were no trends in the plots of the residuals.
- 37 Carapeto's data set was not a perfect analogue to our data. Carapeto had no 15 month cut off point as we had in our data. Since emergences take longer than sales, we would expect a data set with a longer time horizon to have more emergences. However, the difference in sales is still startling and a strongly statistically significant difference. In addition, Carapeto's data set only looked at public companies with over USD 50 million in assets while we looked at companies with debt of over USD 100 million. Thus, while the data sets are not entirely analogous, we find the result still compelling.
- 38 Interview with Judge Sontchi (cited in note 27).
- 39 Interview with Scott Victor, MD SSG Capital Advisors, on 4 May 2010. Mr. Victor argued that sales have long been the predominant trend in the restructuring profession. He did not agree with our hypothesis that this trend has been significantly exacerbated by the recession.
- 40 Interview with Judge Robert Gerber, SDNY Bankruptcy Judge, on 27 April 2010. To clarify this argument, traditional lenders do not benefit from immediate payment. These lenders are most interested in deploying capital and charging interest. When repaid early these lenders are forced to find another borrower to lend to and charge interest. All things being equal, a traditional lender would rather have an emerged company from whom they can continue to collect interest.
- 41 Interview with Bradford Couri, MD at Chicago Fundamental Investment Partners, on 21 April 2010.
- 42 Id.

emerge, he suggested that companies that are unable to secure a DIP loan cannot successfully reorganize, and that obtaining a DIP loan is a prerequisite for selling the company out of bankruptcy.⁴³

DIP loans may increasingly have 'fast track' sale provisions which require the sale of the company within just a few weeks or months. These provisions will naturally increase the volume of sales overall. For example, Fluid Routing Solutions received a DIP loan from Sun Capital Partners that required the company to sell its fuel systems business within 35 days. Sun Capital served as the stalking horse bidder and submitted the only bid, leading the company to cancel its planned auction.⁴⁴ In another example, Wells Fargo supplied a DIP loan to sporting goods retailer Joe's Sports and Outdoor requiring the company find a buyer within 30 days.⁴⁵

These developments have several implications. First, existing management may feel threatened by the rise of sales over emergencies. The sale of the business as a going concern may be more valuable than a § 363 sale of all, or substantially all, of a debtor's assets. However, such a sale creates an uncertain future for existing management. The buyer may opt to replace some or all of the existing management with its own personnel. Debtor management may respond to this uncertainty by authorizing lucrative retention bonuses or incentive payments.⁴⁶ Post-petition retention payments are subject to creditor approval and Bankruptcy Code restrictions. Pre-petition retention bonuses granted on the eve of bankruptcy, if assumed, must also comply with similar restrictions. Nonetheless, practitioners should still pay careful attention to this issue.⁴⁷ Second, the role of restructuring consultants in a company that has acquired a DIP loan may decrease. If the company is likely to be sold, the acquirer (either strategic or private equity) may have the in-house expertise to put the debtor's affairs in order without the support of

a restructuring professional. This is markedly different than a distressed company facing internal political battles and angst about how and when to emerge.

VI. Case studies

To illustrate the dynamics of DIP financings post-crisis, we examine two post-crisis restructurings. See Table 9 for summary information.

A. Sale: Pliant Corporation bankruptcy

In 2007, Pliant Corporation, with over USD 1 billion in revenue, was one of the leading manufacturers of films and packaging for food, personal care, medical, agricultural, and other industrial applications.⁴⁸ In 2006, the company filed for bankruptcy due to challenging industry conditions, including an increase in raw material prices and a tightening of trade terms by Pliant's key suppliers.⁴⁹ The 2006 reorganization called for Pliant's first lien and second lien holders to remain unimpaired, while the senior subordinated note holders would exchange their debt for a mix of debt and equity.

On February 11, 2009, the company filed for bankruptcy again, citing an increase in raw material prices and the inability to refinance its first and second lien notes. In addition to its bankruptcy petition, Pliant also filed a prepackaged plan of reorganization. The plan called for the first lien holders to exchange their debt for all the equity in the company, and the second lien holders to receive warrants, which were reportedly worth 'pennies on the dollar'.⁵⁰ Pliant also filed and received approval for USD 75 million DIP loan at an interest rate of LIBOR plus 1200 basis points. The DIP was provided by the first lien holders, including private equity funds

Notes

43 Id.

44 Ben Fidler, 'Sun Capital Buys FRS Division', *The Deal Magazine*, (31 March 2009).

45 Ben Fidler, 'Quick Sale DIPs are Proliferating', *The Deal Magazine*, (6 March 2009), online at <www.thedeal.com/dealscape/2009/03/quick-sale_dips_are_proliferat.php> (visited 30 March 2010).

46 See, for example, Amy Borrus, 'Creditors Will Crack the Whip: Tough New Rules Will Make Corporate Bankruptcies "Quicker and More Brutal"', *BusinessWeek Online*, (4 July 2005), online at <www.businessweek.com/magazine/content/05_27/b3941102_mz020.htm> (visited 27 May 2010).

47 11 USC § 503(c). Section 503(c)(1) and 503(c)(2) of the Bankruptcy Code limit payment to ten times the amount given to non-management employees, and § 503(c)(3) requires any executory contracts that are assumed be 'justified by the facts of the case'. Under the 2005 BAPCPA amendments, outsiders can still enjoy retention plans, and companies can enter into consulting agreements with CEOs and then assume them in bankruptcy with bonuses intact (e.g., Pilgrim Pride bankruptcy). In some cases, the court has allowed the debtor to pay the incentive plan bonus even when the target hasn't been reached, by allowing the debtor to modify the plan as if the target had been reached (e.g., Nellson Nutraceutical bankruptcy).

48 Pliant Corp, Form 10-K (2007), online at <www.sec.gov/Archives/edgar/data/1049442/000110465907024182/0001104659-07-024182-index.htm> (visited 27 May 2010).

49 Pliant Corp, 'Disclosure Statement', No 09-10443 (D Del Feb 11, 2009); *PR Newswire*, 'Pliant Corporation Files for Chapter 11 Reorganization', online at <www2.prnewswire.com/cgi-bin/stories.pl?ACCT=109&STORY=/www/story/01-03-2006/0004241590&EDATE=>> (visited 27 May 2010).

50 Pliant Corp, 'Debtor's Joint Plan of Reorganization', No 09-10433 (D Del Feb 11, 2009); Reuters, 'Pliant's Apollo-Shaped Bankruptcy Plan Goes to Vote', (18 August 2009), online at <www.reuters.com/article/idUSN1832255720090818> (visited 27 May 2010).

Wayzata Investment Partners, DDJ Capital Management, and Watershed Capital Management.⁵¹ The second lien holders, which included private equity fund Apollo Management ('Apollo'), objected to the plan of reorganization and complained that the DIP financing agreement was 'not representative of the best financing available to the Debtors'.⁵² Eventually, Apollo submitted and received approval for a revised plan whereby the first lien holders would receive a mixture of cash and new first lien notes, and the second lien holders would receive 17.5 cents on the dollar. See Table 7. In addition, Apollo would contribute USD 193 million to receive a 75% equity stake in the company, and Berry Plastics, an Apollo portfolio company, would contribute its Max Tech and Palle Tech brands to Pliant in exchange for a 25% equity stake. Shortly after the plan was confirmed, Berry Plastics announced its intention to acquire the remaining 75% of Pliant.⁵³ The synergies between Berry Plastics and Pliant, along with top line growth and improved multiples in the packaging industry, could make for an attractive return for Apollo in the event of an IPO.⁵⁴

The Pliant case is an example of the increased involvement of private equity funds in the debt ladder, and the benefits of the resulting competition. Wayzata Partners and the other private equity first lien holders initially tried to execute a loan-to-own strategy by providing the DIP loan and submitting a pre-packaged plan of reorganization. However, Apollo was able to propose a more valuable plan, wrestle control of the company from the DIP lenders, and shepherd Pliant to an eventual sale.⁵⁵ With Pliant underperforming its 2006 Chapter 11 targets by 67%,⁵⁶ substantial commodity fluctuations, and a weak macroeconomic climate, a stable standalone emergence seemed unlikely.

B. Emergence: Key Plastics bankruptcy

At one point in time, Key Plastics was the largest independent automotive supplier of plastic door handle assemblies, decorative bezels and pressurized bottles in North America.⁵⁷ From 1995 to 2000 the company grew from nine to 34 facilities worldwide through debt-financed acquisitions, but eventually the company missed a coupon payment leading to the filing of a Chapter 11 bankruptcy.⁵⁸ The Carlyle Group acquired the firm out of bankruptcy in 2001, and sold it to Ewing Management in 2004.⁵⁹

In 2008, the firm would file for bankruptcy again citing a sharp decline in auto demand.⁶⁰ Accompanying this filing, the firm also filed an approved pre-packaged plan of reorganization which provided a 31% recovery to the Senior Notes, a 26% recovery to the Series A Unit Claims, no recovery for holders of existing Key Plastics Units or exiting finance corporation stock, and full recovery for other claims. See Table 8. The plan allowed the Senior Note Holders, of which private equity firms Wayzata Partners and DDJ Capital Management comprised over 75% of the class, to exchange their debt for equity or receive cash payment equal to 16% of the face value of the senior note.

Key Plastics also filed and received approval for a USD 20 million DIP loan at an interest rate of 15% funded by Wayzata Partners.⁶¹ The company emerged from bankruptcy on February 16, 2009 having eliminated USD 115 million in secured debt, 1,500 jobs (25% staff reduction), and 15 plants.⁶² Wayzata Partners converted enough senior notes into equity such that it became the company's controlling shareholder, and had the right to nominate up to three of five seats on the board of directors.

The Key Plastics reorganization and emergence is an example of the traditional loan-to-own strategy and the accompanying risks. Key Plastics management had expanded too quickly, and needed to cleanse the

Notes

- 51 RR Donnelley Private Equity Market Report, 'Deals in the Market', online at <pereport.rrd.com/pereport/Docs/2009/PE_Report_02_17_09.pdf> (visited 27 May 2010).
- 52 Pliant Corp, 'Pliant Ad Hoc Committee Objection to DIP Filing', No 09-10433 (D Del Feb 11, 2009).
- 53 Press Release, 'Berry Plastics Corporation to Acquire Pliant Corporation', online at <www.berryplastics.com/catalog/content/index.jsp?url=corporate/news/news%20articles/berry%20plastics%20corporation%20to%20acquire%20pliant%20corporation> (visited 27 May 2010).
- 54 Andrew Ragsly, 'Apollo Management Seeks Redemption in Pliant-Berry Tieup', *Financial Times Online*, (29 September 2009), online at <www.ft.com/cms/s/2/0c16a078-ad1e-11de-9caf-00144feabdc0.html> (visited 27 May 2010).
- 55 Until a court order compelled the disclosure, Pliant initially refused to provide Apollo with updated financial data in order for Apollo to propose an alternative bankruptcy financing plan. See 'U.S. Judge Orders Pliant to Provide Data to Apollo', Reuters, (5 March 2009), online at <www.reuters.com/article/idUSN0533498920090305> (visited 10 May 2010).
- 56 *Id.*
- 57 Key Plastics Inc, 10-K at *2 (31 December 1998).
- 58 Key Plastics Inc, 8-K at Exhibit 99.1 (31 March 2000).
- 59 See 'Ewing Buying out Key Auto Stakes', *The Daily Deal*, (29 July 2004).
- 60 'Key Plastics Files for Prepack Chapter 11 Bankruptcy', *Forbes Online*, online at <www.forbes.com/feeds/afx/2008/12/16/afx5827273.html> (visited 30 May 2010).
- 61 Key Plastics Inc, 'DIP Financing Agreement', No 08-13324 (D Del Apr 6, 2009).
- 62 Press Release, 'Key Plastics LLC Announces Completion of Prepackaged Reorganization', online at <www.keyplastics.com/news/February_16_2009.html> (visited 30 May 2010).

balance sheet to preserve the healthy part of its business. The pre-packaged plan, created by management, bartered control of the company in exchange for debt relief. Normally, management faces the risk that an impaired creditor below the fulcrum security might object to the management plan of reorganization and propose a financially superior plan which contemplates a sale of the company and a replacement of management. This was illustrated in the Pliant reorganization. This risk was not as much of a concern for Key Plastics management, as there was no other creditor incentivized to propose such a plan. Additionally, Wayzata Partners risked that the pre-packaged plan approval would not come quickly, hurting returns, or in the worst case scenario the plan would not be approved at all. However, these risks did not materialize as the court approved the pre-packaged plan in just 45 days.

Conclusion

While DIP financing appears to positively affect outcomes for companies filing for bankruptcy, the recent credit crisis dramatically altered the DIP lending landscape. DIP loan maturities shrank providing debtors with less time to emerge with their independence preserved. Modern lenders, comprised of private equity and hedge funds, were more willing to exert control and ownership over debtors than traditional DIP lenders. Under such pressure, going-concern sales increased in prominence as a cheaper and faster method of reorganization than emergences. If debtors who were strong enough to receive a DIP during a recession are being led toward sales instead of emergences, then emergence may no longer be a debtor's goal. The trend is here to stay, and management and turnaround professionals should view DIP lending within the Chapter 11 context as a bridge to a sale rather than a stand-alone emergence.

Additional research is required to verify some of our observations. Qualitative evidence suggests that sales are cheaper and more effective. Further research may attempt to quantify and compare the costs of an emergence versus sale from bankruptcy. As discussed above, DIP sale clauses may have played a significant role in the increase of sales during this period. Cataloguing reorganizations including such clauses would provide new insight into the rise of sales. Finally, not enough research has been done on how the 2005 bankruptcy code amendments have influenced emergence. Many have argued that the bankruptcy code amendments have made bankruptcy and emergence more difficult,

possibly powering the preference for sales.⁶³ In addition, one could explore whether the preference toward sales versus emergences is equally reflected in reorganizations conducted without a DIP loan.

Table 1. Debtor-in-possession lending from 2001-2009

Year	No. of deals	Volume*
2001	85	USD 7.70
2002	130	USD 13.60
2003	134	USD 7.60
2004	151	USD 7.70
2005	165	USD 14.00
2006	218	USD 9.50
2007	235	USD 13.60
2008	345	USD 18.60
2009	404	USD 62.40

Source: Deal Pipeline Database

* Dollar values in millions.

Table 2. Key statistics from sample DIP periods*

	Pre-Crisis (4/1/2008 - 9/30/2008)	Post-Crisis (10/1/2008 - 3/31/2009)
Total Dip Value	USD 12,499.79	USD 17,337.09
No. of Dips	175	213
Avg Interest Rates (libor)	580.88 bps	790.00 bps
Avg Interest Rates (prime)	332.92 bps	447.82 bps
Biggest Dip	Delphi Corp. (USD 4,354.00)	Lyondell Chemical Co. (USD 8,500.00)
Smallest Dip	Waterbrook Peninsula LLC (USD 0.04)	We Recycle! Inc (USD 0.03)
Top Industry by Dip Value	Manufacturing (USD 6,649.32)	Manufacturing (USD 13,029.83)
Top Industry by No. of Dips	Manufacturing (46)	Manufacturing (66)
Top Lender by Value of Dips	GE Capital (USD 5,980.70)	Oaktree Capital (USD 10,115.85)
Top Lender by No. of Dips	Bank of America (11)	Bank of America (15)

Source: Deal Pipeline Database

* Dollar values in millions

Notes

63 Jeff Jones, 'Getting the Most Out of Distressed Company Quick Sales', (19 February 2009), online at <www.turnaround.org/Publications/Articles.aspx?objectID=10644> (visited 14 May 2010).

Table 3. Interest rate charts – comparison of pre-crisis and post-crisis data sets

	<i>Base Rate</i>	<i>Add Rate</i>	<i>Total Rate</i>
Pre-Crisis			
Maximum	16.50%	8.36%	16.50%
Mean	3.47%	4.15%	7.63%
Minimum	0.50%	0.00%	2.00%
Post-Crisis			
Maximum	20.00%	12.00%	20.00%
Mean	4.85%	5.88%	10.73%
Minimum	0.50%	0.00%	4.25%
Two-Tail P-Value For Mean	0.201	0.026*	0.002*

Code Interpretation Key

Success Code 1	= Plans Submitted, Emergence, Sales
Success Code 2	= Emergence
Success Code 3	= Emergence and Sale
M&A Code	= Sales only
Failure Code	= Liquidation

* Statistically significant at 5%

Table 4. Comparison of pre-crisis and post-crisis data sets

	<i>Sample Size</i>	<i>Success Code 1</i>	<i>Success Code 2</i>	<i>Success Code 3</i>	<i>M&A Code</i>	<i>Failure Code 1</i>
Pre-Crisis	24	13	6	12	6	4
Alt Count		11	18	12	18	20
Post-Crisis	35	25	6	22	16	6
Alt Count		10	29	13	19	29
Pre-Crisis Percentage		54.17%	25.00%	50.00%	25.00%	16.67%
Post-Crisis Percentage		73.53%	17.65%	64.71%	47.06%	17.65%
One-Tail P-Value		0.139	0.856	0.238	0.089*	0.650
Two-Tail P-Value	alpha = 0.05	0.268	0.521	0.423	0.170	1.000

* Statistically significant at 10%.

Note: For each data point in this data set the progress of the company's restructuring was recorded after 15 months from the filing data as either 'Plan Submitted', 'Bought', 'Emerged', 'Liquidated' or 'Attempting'.

Each data point has been coded on five different metrics: Success Code 1, 2, 3, M&A Code, and Failure Code. If a given code applied to a data point the entry was coded with a "1". The number of data points for which each code applied are then compared using percentages. A Fisher-Exact was used to prove statistic significance.

Table 5. Comparison of pre-crisis and post-crisis data sets

	<i>Sample Size</i>	<i>Bank in DIP</i>	<i>PE Fund in DIP</i>	<i>Strategic in DIP</i>	<i>Defensive Dip</i>
Pre-Crisis	24	20	6	1	21
Alt Count		4	18	23	3
Post-Crisis	35	23	18	3	32
Alt Count		12	17	32	3
Pre-Crisis Percentage		83.33%	25.00%	4.17%	87.50%
Post-Crisis Percentage		67.65%	52.94%	8.82%	96.97%
One-Tail P-Value		0.115	0.038*	0.460	0.470
Two-Tail P-Value	alpha = 0.05	0.233	0.060**	0.639	0.679

* Statistically significant at 5%, ** Statistically significant at 10%

Note: This table quantifies which parties provided a DIP for the debtor and whether the DIP was defensive.

Table 6. Comparison of post-crisis data and data in Carapeto Paper (2010)

	<i>Sample Size</i>	<i>Success Code 2</i>	<i>Success Code 3</i>	<i>M&A Code</i>	<i>Failure Code 1</i>
Post -Crisis Data	35	6	22	16	6
Alt Count		29	13	19	29
Carapeto Data	132	87	109	22	23
Alt Count		45	23	110	109
Post-Crisis Data Percentage		17.14%	62.86%	45.71%	17.14%
Carapeto Data Percentage		65.91%	82.58%	16.67%	17.42%
Two-Tail P-Value	alpha = 0.05	0.000*	0.019*	0.001*	1.000

* Statistically significant at 5%

Note: Each data pointed has been coded on five different metrics: Success Code 2, 3, M&A Code, and Failure Code. Success Code 1 was omitted since it is unclear which data points for Carapeto had 'Plans Submitted' at his cut off point. If a given code applied to a data point the entry was coded with a '1'. The number of data points for which each code applied are then compared using percentages. Fisher-Exact tests were used to prove statistical significance.

Table 7. Apollo Management's plan of reorganization for Plain Corporation

<i>Class</i>	<i>Claim/Interest</i>	<i>Treatment</i>	<i>Estimated Allowed Amt 1</i>	<i>Estimated Recovery</i>
N/A	Administrative Expense Claims	Unimpaired	USD 18.80	100.00%
N/A	DIP Facility Claims	Unimpaired	USD 40.00	100.00%
N/A	Priority Tax Claims	Unimpaired	USD 3.90	100.00%
Class 1	Priority Non-Tax Claims	Unimpaired	N/A	100.00%
Class 2	Other Secured Claims	Unimpaired	USD 20.80	100.00%
Class 3	Prepetition Credit Facility Claims	Unimpaired	USD 145.00 1	100.00%
Class 4	First Lien Notes Claims	Impaired	USD 393.80 2	89.00%
Class 5	Second Lien Notes Claims	Impaired	USD 262.40	17.50%
Class 6	General Unsecured Claims	Impaired	USD 11.30	17.50%
Class 7	Senior Subordinated Notes Claims	Impaired	USD 26.50	0.00%
Class 8	Small Claims	Unimpaired	USD 1.10	100.00%
Class 9	Intercompany Claims	Unimpaired	N/A	N/A
Class 10	Section 501(b) Claims	Impaired	--	N/A
Class 11	Pliant Preferred Stock Interests	Impaired	N/A	N/A
Class 12	Pliant Outstanding Common Stock Interests	Impaired	N/A	N/A
Class 13	Subsidiary Interests	Unimpaired	N/A	N/A

Source: The Plan of Reorganization for Pliant Corporation

1. Dollar values are in millions

2. The Estimated Allowed Amount for the Prepetition Credit Facility includes an outstanding principal amount of approximately USD 139.0 and approximately USD 6.0 million outstanding with respect to letters of credit.

3. The Estimated Recovery of the First Lien Notes Claims is based upon the distribution to holders of the First Lien Notes of New Senior Notes with a face amount of USD 250 million and cash consideration of USD 100 million.

Table 8. Pre-packaged plan of reorganization for Key Plastics

Class	Claim/Interest	Treatment	Voting Result	Estimated Recovery
Class 1	Senior Notes Claims*	Impaired	Accepted	31.00%
Class 2	Other Secured Claims	Unimpaired	Deemed to Accept	100.00%
Class 3	Lease Rejection Claims	Unimpaired	Deemed to Accept	100.00%
Class 4	General Unsecured Claims	Unimpaired	Deemed to Accept	100.00%
Class 5	Series A Unit Claims	Impaired	Accepted	26.00%
Class 6	Existing Key Plastics Units	Impaired	Deemed to Reject	0.00%
Class 7	Existing Finance Corp. Stock	Impaired	Deemed to Reject	0.00%

Source: The Plan of Reorganization for Key Plastics

* Senior Notes Claims holders will receive either (a) a pro rata share of 65% of the fully-diluted new common units to be issued by the new entity, which will be converted into an equal portion of new common stock, and the right to participate in a rights offering, or (b) cash equal to 16% of the face value of such holder's senior notes.

Table 9. Reorganization comparison of case studies*

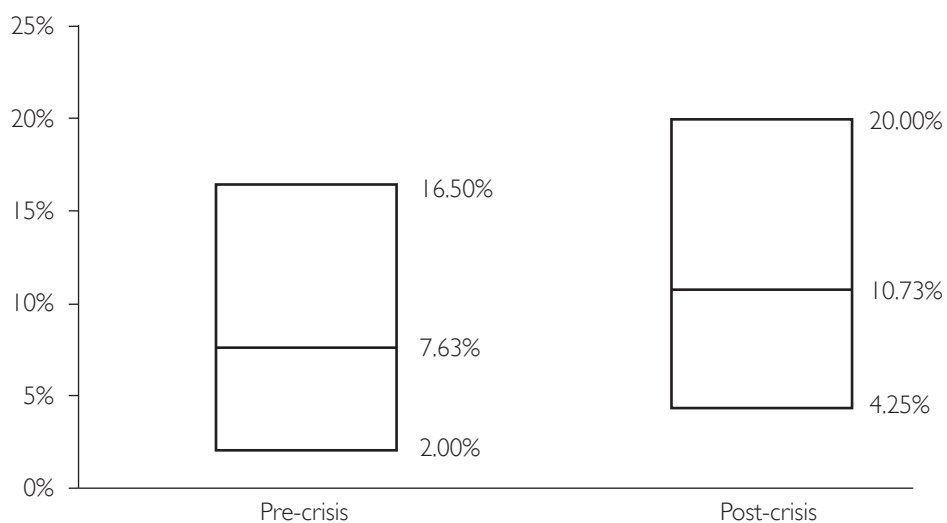
	<i>Pliant Corp</i>	<i>Key Plastics LLC</i>
Prior Bankruptcy Filing	2006	2000
Prepackaged Plan Filed	Yes	Yes
DIP Loan Amount	USD 75	USD 20
DIP Loan Interest Rate	L + 1200 bps	15%
PE Fund as Creditor	Yes	Yes
PE Fund in DIP	Yes	Yes
Creditor Objection to Plan	Yes	No
Result	Sale	Emergence

* Dollar values in millions

Figure 1. Corporate bankruptcy filings 1994-2009



Figure 2. Debtor-in-possession interest rate



This chart visually depicts how interest rates have changed between the pre-crisis and post-crisis data sets. The top line represents the maximum rate in the respective data set and the bottom line represents the minimum rate in each data set. The mean rate is represented by the centre line.

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