07-BK-G

SIFMA

Securities Industry and Financial Markets Association

LSTA

The Loan Syndications and Trading Association

November 30, 2007

Re: Federal Rule of Bankruptcy Procedure 2019

Mr. Peter G McCabe
Secretary
Committee on Rules of Practice
and Procedure of the Judicial
Conference of the United States
Administrative Office of the United States Courts
Thurgood Marshall Federal Judiciary Building
One Columbus Circle, N.E.
Washington, D.C 20544

Dear Mr. McCabe:

The Loan Syndications and Trading Association ("LSTA") and the Securities Industry and Financial Markets Association ("SIFMA") submit that Federal Rule of Bankruptcy Procedure 2019 should be repealed, because it does not sensibly implement Federal bankruptcy law, has become obsolete due to changes in the nature of chapter 11 cases, and adversely affects, with no compensating benefit, the interests of key participants in the chapter 11 process.

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1. Who Are the LSTA and SIFMA?

LSTA and SIFMA are two large not-for-profit organizations that promote sound practices and advocate effective policies in relation to the commercial loan markets and securities markets On the issue of Rule 2019, LSTA and SIFMA have submitted jointly amicus briefs in four different chapter 11 cases in 2007 alone.[1]

LSTA is a not-for-profit organization that undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable principles for transactions among institutional investors engaged in buying and selling commercial loans.[2] Through its activities, the LSTA seeks to encourage cooperation and coordination with firms facilitating transactions in loans and related claims. The LSTA was formed by a small group of debt traders in an effort to develop standard settlement and operational procedures, market practices, and other mechanisms to more efficiently trade the increasing volume of both high-quality and distressed bank debt. The LSTA has become the principal advocate for the commercial loan asset market participants with the goal of promoting greater transparency, regularity and confidence among all market participants. LSTA membership provides member firms with the opportunity to participate in the decision-making process that ultimately establishes market practices, develops standard documentation related to loan transactions and strengthens and influences the direction of financial market infrastructure. The LSTA currently has over 250 members, including the

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1 Those briefs, in the LeNature, Musicland, Northwest Airlines and Scotia Development cases, can be accessed at SIFMA's website (www sifma org) under the "Regulatory/Legal" tab

2 All information concerning the LSTA comes from http //www lsta org.

leading broker-dealers, commercial banks, investment banks, mutual funds, hedge funds, fund managers, insurance companies and other major institutional investors worldwide.

The Securities Industry and Financial Markets Association, also a not-for-profit organization ("SIFMA"), brings together the shared interests of more that 605 securities firms, banks and asset managers.[3] SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. In pursuit of this mission, SIFMA provides its members with a network of access and forward-looking services as well as educational resources for the professionals in the financial services industry and the investors whom they serve Among its goals for 2007, SIFMA is seeking to encourage retirement savings and investment, promote effective and efficient regulation, and facilitate more open, competitive and efficient global capital markets. By accomplishing these goals, SIFMA hopes to earn, inspire and uphold the public's trust in the financial industry and the markets SIFMA works to represent its members' interests locally and globally It has offices in New York, Washington, D.C, and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong

2. <u>LSTA and SIFMA Urge the Committee to Recommend the Repeal of Rule 2019</u>

Pursuant to their respective missions and having the benefit of substantial consultation with their respective constituencies, both the LSTA and SIFMA oppose Federal Rule of Bankruptcy Procedure 2019 in its current form Rule 2019 requires certain

[3] All information concerning the SIFMA comes from http //www.sifma org

disclosures from "unofficial" or "*ad hoc*" committees and their members (and only from those entities). Specifically, Rule 2019 requires that:

> [I]n a... chapter 11 reorganization case, except ["official" committees], every . committee representing more than one creditor or equity security holder... shall file a verified statement setting forth·
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> (1) the name and address of the creditor or equity security holder;
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> (2) the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition,
>
> (3) a recital of the pertinent facts and circumstances in connection with the employment of the... committee.. [and] the names of the entity or entities at whose instance, directly or indirectly... the committee was organized or agreed to act; and
>
> (4) with reference to the time... the organization or formation of the committee.. the amounts of claims or interests owned by . the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof [4]

Earlier this year, in the *Northwest Airlines* bankruptcy case,[5] the bankruptcy court required eleven (11) members of an *ad hoc* committee of equity security holders (the "Ad Hoc Committee") to disclose the information required by Rule 2019—notably, the amount paid for the securities. The ruling came in response to the debtor's motion to compel the disclosure, which was itself a response to the Ad Hoc Committee's efforts to have an official equity-holders' committee appointed to challenge the debtor's self-valuation and plan of reorganization strategy to eliminate the equity holders' status in the company.

[4] Fed R Bankr P 2019(a).

[5] *In re Northwest Airlines Corp* , 363 B R 701 (Bankr S D N Y 2007)

There was no evidence that the Ad Hoc Committee's efforts violated any statute or were undertaken in bad faith.

Since *Northwest Airlines*, at least three other cases have generated litigation over Rule 2019 – *Le Nature, Mirant and Scotia Development* In the first two, the litigation was compromised without ruling In *Scotia Development,* the court found, on the specific facts of the dispute, that the rule did not apply to the investors against whom the debtor was litigating. LSTA and SIFMA submitted joint *amicus* briefs in each of those cases (except *Mirant*) in support of the investors who were the targets of the litigation. LSTA and SIFMA do not concede that *Northwest Airlines* correctly interpreted Rule 2019, but, in light of the failure of any subsequent case to generate a contrary precedential ruling, have concluded that *ad hoc* litigation about the application of the Rule will not provide a forum in which the soundness of the Rule itself can be properly debated, and have determined, therefore, to seek repeal of the Rule.

There are four important public policy reasons why Rule 2019 should not be maintained in its current form.

First, Rule 2019 actually has very little utility to the sound administration of chapter 11 cases The disclosures it requires are unlikely to provide information that could assist the court or any other party in applying bankruptcy law properly or in reaching a successful disposition of the case

Second, in the rare instance where Rule 2019 might provide relevant information, that information is already readily attainable through tried-and-true discovery methods, the Rule is, at best, redundant

Third, Rule 2019 irrationally and inefficiently singles out parties in interest who choose to form *ad hoc* committees, an efficient mechanism for participating in cases that ought to be encouraged, not penalized.

Fourth, by encouraging satellite disputes and discouraging active, efficient participation, Rule 2019 has the potential to affect the debtor's reorganization negatively.

In light of these reasons, Rule 2019 should be repealed in favor of reliance on traditional discovery.

3. Rule 2019 Does Not Perform any Vital Functions

Rule 2019 has very little utility in the chapter 11 process. The disclosures it requires will rarely add relevant information to the bankruptcy reorganization process.

The most troublesome provision of the Rule to credit market participants is subsection (a)(4), which requires that each *ad hoc* committee member disclose the price at which it acquired claims against, or equity in the debtor and when it acquired such claim or interest But it has long been established that information about when a claim was purchased, or for how much, has no legal relevance to the claim holder's rights under the Code or non-bankruptcy law, or to the amount the claim holder may recover in the case

An examination of several Code provisions supports that proposition. First, Section 1122(a) calls for claims and interests to be classified with other claims or interests that are "substantially similar." Second, Section 1123(a)(4) requires that a plan must provide the same treatment for each claim or interest in a particular class.[6] Third, Section 1129(a)(8)

[6] This provision is crucial because it reflects one of the most important policies of the Code, which is equality of distribution among claim and interest holders *See Begier v IRS*, 496 U S 53, 54 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code"), H R Rep No 595, 95th Cong , 1st Sess 178 (1977) (A "prime bankruptcy policy" is "equality of distribution

requires that each class of claims or interests accept the plan (by the required majorities specified in Section 1126) in order for it to be confirmed.[7]

Courts have consistently rejected classification and treatment schemes that are based on the price that an individual creditor may have paid for its claim. For example, in *Fairfield Executive Associates*, the district court explicitly rejected the debtor's attempt to classify a secured creditor's deficiency claim separately from other general unsecured claims on the ground that the secured creditor had purchased the claim at a discount.[8] The debtor argued that, because the creditor knew the loan was in default when it purchased the loan and the creditor paid less than the collateral for the loan was worth, the creditor did not expect at the time of purchase, and should not expect, to recover the face value on the loan.[9] Holding that a creditor's motivation for investing is an irrelevant basis for classification, the *Fairfield* court quoted from a 1946 opinion of the Third Circuit that "*the price paid for a claim does not affect the amount of the creditor's claim, or the creditor's voting power*."[10]

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among creditors of the debtor."), 5 Collier on Bankruptcy ¶ 547.01, at 547-10 & n.8 (15th ed. Rev. 2007).

7 Under Sections 1129(a)(8) and 1129(b), a plan may alternatively be "crammed down" on a dissenting class of claims or interests if certain requirements are met. Among the most important "cramdown" requirements is that the plan either provides for full satisfaction of the claims in the dissenting class, or eliminates the recoveries of those in classes, if any, junior to the dissenting class. Because the "cramdown" option is analyzed on a class-by-class basis, its existence does not alter the analysis set forth in the text and we omit further references to it solely for simplicity's sake.

8 161 B.R. 595, 602-603 (D.N.J. 1993).

9 *Id.*

10 *Id.* (emphasis added) (citing *In re Pittsburgh Rys. Co.*, 159 F.2d 630, 632-33 (3d Cir. 1946) ("In the absence of fraud, the prices which security holders pay for their securities do not affect the measure of their participation under the plan of reorganization."), *cert. denied*, 331 U.S. 819, 67 S.Ct. 1309, 91 L.Ed. 1837 (1947)).

Similarly, in *Hillside Park Apts., L.P.*, the bankruptcy court rejected a debtor's attempt to classify a secured creditor's deficiency claim separately from trade creditors on the ground that the secured creditor purchased the note and deed of trust for substantially less than the full amount of the claim—*i.e.*, less than the full market value of the property.[11] The debtor argued that, since the secured creditor "did not in fact expend the sums that make up its deficiency claim, [the secured creditor] does not have the concerns of a normal creditor in recovering the deficiency sum."[12] The court flatly rejected that argument [13] Specifically, the court held that *the price paid* for the note and the deed of trust was "irrelevant" and that the purchaser of a secured claim has the same interest in getting paid on its claim as do other unsecured creditors [14] Therefore, the court rejected the debtor's attempt to offer the deficiency claim holder and the trade creditors different treatment under the plan.[15] Clearly, the fact that the creditor purchased the claim at a discount could not lawfully support a disparity of treatment [16] It follows, then, that information about the amount paid and the other details of that purchase – the principal kind of information required under Rule 2019 – was legally irrelevant to the court's application of the law

A claim or interest holder's recovery in a chapter 11 case is contingent upon two legal principles. first, the debtor's obligation under the debt or equity instrument: and

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11 205 B.R 177, 188 (Bankr W D Mo 1997)

12 *Id*

13 *Id* at 189 The debtor proposed a 90% distribution to the trade creditors for their claims and a 1% distribution to the secured-creditor on its deficiency claim. *Id*

14 205 B R 177, 188 (Bankr W D Mo 1997)

15 *Id* at 189

16 *Id*

second, the claim's classification and ranking under the reorganization plan, as governed by the Bankruptcy Code.[17] That information is obtainable entirely by reference to the plan and the terms of the relevant debt contract or equity instrument (*e.g.*, a bond indenture or stock certificate). Even if a debtor were aware that two different holders of a particular class of its debt had acquired such debt at significantly different prices, or at different times (*e.g.*, following a default under a bond indenture), it has to classify and treat them in similar fashion to comply with Sections 1122 and 1123(a)(4). The disclosures required under Rule 2019 will not assist the debtor in doing that. Therefore, insofar as Rule 2019 requires the disclosure of such surplus information, such disclosure is, as a matter of law, irrelevant when applying the Code properly.

In similarly pointless fashion, Rule 2019(a)(3) requires that each *ad hoc* committee member disclose all employment arrangements made by the committee (*e.g.*, counsel's compensation). Clearly, under the Code, an *ad hoc* committee member's financial arrangements with its counsel or other representatives are irrelevant to determining that creditor or equity holder's rights under the Code or the outcome of the bankruptcy case.

4. <u>There are Alternative and More Efficient Means to Obtain the Information Required by the Rule</u>

Even in the rare case where the information required to be disclosed under Rule 2019 might be relevant to the chapter 11 case, the same information is readily obtainable through traditional discovery. To obtain information about what a particular creditor or interest holder paid for a certain claim or interest, or any other information

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17 *Amici* Brief for the Securities Industry and Financial Markets Ass'n, *et al.* *In re Scotia Development LLC, et al.* (No. 07-20027) at 4.

required to be disclosed under Rule 2019, traditional discovery under the Federal Rules of Civil Procedure, as incorporated into the Federal Rules of Bankruptcy Procedure[18] (the "Federal Rules"), has proven to be perfectly effective. On the other hand, to the extent that information such as the price at which claims are trading in general is valuable to the debtor's reorganization process, that information is readily obtainable from numerous sources every trading day. Finally, Federal Rule of Bankruptcy Procedure 2004 also empowers a court to order any needed investigation, including, for example, information related to the arrangements between *ad hoc* committee members and their counsel or representative.

(a) Prices Paid By Specific Holders

In the case where a chapter 11 debtor needs to know the price that a particular holder paid for its claims or equity interests, or the time when such claim or interest was acquired, routine discovery is quite sufficient to obtain that information For example, in the *Papercraft* bankruptcy case, the bankruptcy court found that an insider of the debtor secretly purchased claims at a discount, voted those claims to block the debtor's plan, coerced the debtor to file another plan, and consequently delayed the final disposition of the case [19] The court sanctioned the insider's conduct by limiting the insider's recovery to the amount it paid for the claims, without interest.[20] Because the insider was not a "committee," Rule

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18 *See* Fed. R Bankr P 7026, 7037 and 9014

19 *In re Papercraft Corporation*, 187 B R 486 (Bankr W D Pa 1995), *rev'd and remanded*, 211 B R 813 (W D Pa 1997), *aff'd and remanded*, 160 F 3d 982 (3d Cir 1998), *on remand*, 247 B R 625, 629-30 (Bankr W D Pa 2000)

20 *Id*

2019 was inapplicable. Yet, the debtor was able to uncover all the details regarding the insider's claim purchases without resort to Rule 2019.

In the *Mirant* bankruptcy case, the court appointed an examiner to investigate a distressed debt purchasing firm that allegedly used misleading documents to purchase trade claims from creditors at a fraction of their market value without the creditors' informed consent.[21] The examiner brought an adversary proceeding. The examiner requested that the court, pursuant to its authority under Section 105, "expunge" each trade-claim purchase and "restor[e] each purported [purchased] claim to the creditor originally holding such claim."[22] Completely independent of Rule 2019, the examiner was able to compile evidence about the firm's purchases (*i.e.*, the purchase prices and the timing of the purchases) in order to prove that the firm's scheme was in violation of the Code. The *Fairfield Executive Associates* and *Hillside Park Apts.* cases described in Part 3 also prove that Rule 2019 is unnecessary to uncover claim purchase price and related details.

Traditional discovery bears two very significant differences from Rule 2019. First, under the Federal Rules, discovery is limited to what is relevant.[23] By requiring relevance, the Federal Rules ensure that the time and expense of disclosure about one's business is not imposed pointlessly. Rule 2019 does not afford claim holders even the minimal protection of the relevance standard. Second, under the Federal Rules, the data produced in discovery are not automatically placed in the public docket for the world to

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[21] *See* Complaint, *Snyder v. DSA*, No. 03-46590 (Bankr. N.D. Tex. Oct. 25, 2005).

[22] *Id.*

[23] *See* Fed. R. Civ. P. 26 ("Parties may obtain discovery regarding any matter, not privileged, that is relevant to the claim or defense of any party . . . .").

view over the Internet. Conversely, Rule 2019 requires the publication of such data in a filing which is then posted on the court's electronic docket.

Remitting participants in bankruptcy cases to traditional discovery is an entirely reasonable and appropriate substitute for Rule 2019. For example, in the *Northwest Airlines* case, the debtor argued that disclosure was required to "test the credibility of the positions being taken into court" by the ad hoc committee.[24] The "credibility" of a position in a bankruptcy case can be adequately tested through traditional discovery and cross-examination, both of which are governed by relevance standards. Because traditional tools of discovery and cross-examination have repeatedly proved sufficient to "test credibility" in other settings (including in the bankruptcy context, as shown by the *Mirant* and *Papercraft* cases), reliance on them upon repeal of Rule 2019 will cause no harm. On the contrary, Rule 2019 presently requires disclosure without regard to relevance, and then publication of the disclosure in the Court's dockets and PACER.

Similarly, in the rare instance where the Bankruptcy Code provides that a party in interest's subjective state of mind is relevant — such as upon a motion under Section 1126(e) to designate an entity's acceptance or rejection of a plan, an inquiry into good faith of a proponent of a creditor plan under Section 1129(a)(3), or an examination of the adequacy of a creditor plan proponent's disclosure statement — traditional discovery fully equips courts to compel the information described by Rule 2019

[24] Jordan Siev, et al , *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http //www andersonkill com/webpdfext/CommitteeNewsletter pdf

(b) Purchase Prices in General

In addition to having the legal tools to compel disclosure of a particular investor's holdings, a debtor also has sufficient resources to obtain general information about the prices at which its claims or equity securities may be trading. Specifically, the debtor's financial personnel or outside financial advisors can (and do) contact trading desks and market makers who routinely make markets in distressed debt. Even easier, numerous print publications and electronic services like Bloomberg report daily on the prices being quoted for distressed debt, just as the Wall Street Journal publishes quotes for instruments being traded in other capital markets. (Some recent examples are attached as Exhibit A). Through those sources, the debtor can easily determine the price at which its debt may be trading on any given trading day, including past trading days. Because that market is sufficiently well developed and its quotations are readily accessible, the debtor is in a position to evaluate the prices being paid for its debt generally without need for Rule 2019.

(c) Rule 2004

We know of no case in which the information described in Rule 2019 was considered relevant, yet was not obtainable by means of traditional discovery. However, in the hypothetical instance when a debtor or some other party in interest might need information about a particular person's prior transactions in the debtor's debt or equity securities, yet, the Federal Rules' traditional discovery methods were for some reason unavailing, Federal Rule of Bankruptcy Procedure 2004 empowers the court to order an investigation of the matter[25] But, in contrast with Rule 2019, the court has discretion under

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[25] On motion of any party in interest, the court may order the examination of any entity. . The examination of an entity under this rule may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to

Rule 2004 to deny the request if it is irrelevant and to balance the interests of the target of the request.

5. The Rule Irrationally and Inefficiently Singles Out Holders Who Choose to Form *Ad Hoc* Committees

If the information required by Rule 2019 were truly important to bankruptcy reorganizations, it would be required of all active participants and not merely those who form *ad hoc* committees. Rule 2019 in its current form is therefore irrational because it only requires such purportedly important information from *ad hoc* committee members The primary explanation for this lies in bankruptcy history which varies dramatically from present bankruptcy practices. In light of that disparity, the Rule is irrational, because it is under-inclusive and does not apply to investors who are not members of *ad hoc* committees but who may nonetheless pursue the same strategies the Rule ostensibly deters

At the same time, the Rule is also inefficient because, as we show below, the truth of the matter is that Rule 2019 and the information disclosed pursuant to it are being used nowadays principally as weapons to deter *ad hoc* committee members from taking positions in court opposed to the debtor's strategies Thus, the Rule 2019 tends to create pointless satellite litigation and unproductive rhetorical sideshows. In addition, if compulsory disclosure under the Rule deters distressed investors from forming *ad hoc* committees, the efficiencies created by *ad hoc* committee representation may be eliminated

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any matter which may affect the administration of the debtor's estate and any other matter relevant to the case or to the formulation of a plan

Fed R Bankr P 2004(a)-(b)

(a) History of Rule 2019

In the early twentieth century, "protective committees" were organized by insider groups dominated by debtors and institutional investors "who would solicit smaller investors to enter into a deposit agreement whereby the smaller investors would deposit their securities with the committee and delegate to the committee the responsibility of negotiating with the debtor."[26] These committees often took advantage of small public investors rather than fairly representing their interests, while using the deposited securities to gain influence in support of their own initiatives.[27] The predecessor of Rule 2019 was adopted in reaction to those practices, to protect small investors. It did so by requiring the "disclosure of 'personnel and activities of those acting in a representative activity' in order to foster fair and equitable plans free from deception and overreaching."[28] In a 1937 Securities and Exchange Commission Report, future Supreme Court Justice Douglas stated that the predecessor Rule "is designed to ensure that the 'inside group' does not manipulate a pre-petition committee to 'secure a dominant position in the reorganization' and capture the 'emoluments of control.'"[29]

While that oversight was and is certainly important to protect small holders, the function of *ad hoc* committees in modern bankruptcy reorganizations is dramatically

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26 Brian S. Herman and James M. Millerman, *Ad Hoc Attack*, THEDEAL.COM JUDGMENT CALL, May 25, 2007, http://www.thedeal.com/servlet/ContentServer?pagename=TheDeal/TDDArticle/TDStandardArticle&bn=NULL&c=TDDArticle&cid=1179177764565

27 *Id.*

28 *Id.* (citing *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Committee*, 321 B.R. 147, 166 (D.N.J. 2005))

29 *Baron & Budd, P.C. v. Unsecured Asbestos Claimants Committee*, 321 B.R. 147, 166 (D.N.J. 2005)

distinguishable from pre-Code reorganizations. Most notably, distressed investors no longer "sneak" into bankruptcy cases such that potential committee members require warning and specifics about their fellow investors' holdings Today, the buying and selling of distressed claims is the rule rather than the exception, particularly with respect to large public debtors. Distressed investors are often among the largest claim holders in chapter 11 cases.[30] In addition, the *ad hoc* committees those players create do not solicit public investors in any way and do not claim to represent the interests of other investors. As a function of these differences, there is no longer any rational relationship between the original purposes of Rule 2019 and the current practices

(b) The Rule is Under-inclusive

To the extent that Rule 2019 provides the court and the debtor with an understanding of the motives of participants in the process, it is under-inclusive, because it does not require disclosures from all participants, just from *ad hoc* committees. Therefore, if transparency truly allows the court and the debtor to "root out" investors who act in bad faith or to uncover conflicts of interest between committee members and their representatives, then the Rule should apply *equally* to all participants in a bankruptcy case and not just to members of *ad hoc* committees. For example, in the *Papercraft* and *Mirant* cases, the wrongdoers were individual creditors, not *ad hoc* committees or members thereof. Thus, Rule 2019 is under-inclusive because it does not adduce disclosure from a suspect investor — distressed or not — unless the investor has joined a committee.

[30] Paul M Goldschmid, More Phoenix than Vulture: *The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUMBIA BUS L REV 191, 200 (2005)

Rule 2019 in its current form also explicitly exempts official creditors' and equity security holders' committees ("Official Committees") from its disclosure requirements At the same time, there is no federal rule analogous to Rule 2019 that requires the court to compel disclosure from members of Official Committees concerning their holdings of the debtor's claims or stock. More important to a comparison with Rule 2019, there is no rule or provision that requires that any such information obtained from Official Committees be published in the publicly accessible court docket. While Official Committees are identified to the court in a Notice of Appointment, such notice only contains the name and contact information for each committee member—*not* the amounts such member paid for the claim or interest, or when the claim or interest was obtained. Since Official Committees are representative, as a matter of law, of their constituency, whereas "*ad hoc*" committees typically disclaim any representative role, it calls into question any defense of Rule 2019 based on fear of distressed claim holders dominating representative bodies Rather, it is completely irrational to hold non-representative "*ad hoc*" committees to greater disclosure requirements than are imposed on members of Official Committees.

(c) Rule 2019 is Being Used as an Offensive Weapon against Activist Investors

In addition to being irrational, Rule 2019 in its current form is inefficient because it allows debtors to use the disclosure requirements as an offensive weapon to deter distressed investors from taking activist positions in chapter cases.[31] This creates inefficiencies because bankruptcy courts already have effective means independent of Rule

[31] Jordan Siev, et al , *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http //www andersonkill.com/webpdftext/CommitteeNewsletter pdf.

2019 to investigate and punish misconduct by participants. Conversely, collateral disputes over Rule 2019 disclosures in the absence of misconduct distract from the main issues in the case, compounding the inefficiency.

There are numerous examples of debtors using Rule 2019 as an offensive weapon to curb distressed-investor activity. It is important to stress that, in those cases, while the distressed investors' actions were certainly activist, and designed to protect their own economic interests, they cannot remotely be considered to have been illegal or unreasonably aggressive.[32]

For example, in the *Northwest Airlines* case, the debtor sought to compel Rule 2019 disclosures in response to the *ad hoc* committee's efforts to have an official equity committee appointed to represent all stockholders.[33] It is difficult to argue that the *ad hoc* committee was working to the detriment of small public stockholders in seeking appointment of an official committee to represent all stockholders

In a different context, in the *Le Nature's* bankruptcy case, a debtor's bank agent brought an adversary proceeding to compel various distressed investors to make disclosures under Rule 2019.[34] In the *Le Nature's* case, observers have theorized that the

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32 In *Fairfield Executive Associates*, the court held that a distressed claim holder's express representation that it would not vote for any plan does constitute bad faith 161 B R 595 at 603 The court, citing a 1993 Third Circuit case, noted that a creditor typically votes according to its economic interest *Id* (citing *John Hancock Mutual Life Ins Co v Route 37 Business Park Associates*, 987 F 2d 154, 161 (3d Cir 1993) The court concluded that "Section 1126(e) does not require a creditor to have an interest in seeing the debtor reorganize" 161 B R at 603

33 Paul D Leake and Mark G Douglas, *Ad Hoc Committee Disclosure Requirements – A Bitter Pill to Swallow for Distressed Investors*, JONES DAY, PUBLICATIONS (May/June 2007), *available at* http //www jonesday com/pubs/pubs_detail aspx?pubID=S4311

34 Dealflowmedia com, The Secured Debt Wire: Ruling Expected in August on Wachovia's Motion to Liquidate Le-Nature's, June 29, 2007, http //www dealflowmedia com

move was meant to pressure the distressed investors not to sue the bank agent for some of the debtor's losses that were allegedly due to the bank agent's conduct.[35]

In *Mirant,* a group of investors who had purchased claims against the debtor were appealing a bankruptcy court order approving a settlement by the debtor in which another creditor received a claim worth over $500,000,000 after the company had emerged from bankruptcy. While the matter was on appeal (*i.e.*, when the bankruptcy court no longer had jurisdiction over the controversy), a successor to the debtor moved the bankruptcy court for an order that the appellants comply with Rule 2019 After oral argument, the bankruptcy judge took the matter under advisement and, within a few weeks, the appellants agreed to drop the appeal [36]

Simply seeking relief that is statutorily authorized should not expose *ad hoc* committees to disclosure requirements. However, Rule 2019 does not give bankruptcy judges the discretion to consider, let alone weigh, the context of the case or the motives of the parties seeking disclosure in adjudicating Rule 2019 disputes.

The only recent instance in which a bankruptcy judge denied a Rule 2019 request was in *In re Scotia Development LLC*, where the judge concluded that the target of the motion, a self-styled "ad hoc noteholder group" that was opposing many of the debtor's motions was not "a committee" within the meaning of Rule 2019.[37] While the outcome was

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35 *Id*

36 *See* Motion of New Mirant Entities to Compel Certain Holders of Class 3 Claims to Comply with Rule 2019 of the Federal Rules of Bankruptcy Procedure, *In re Mirant Corp* , Case No 03-46590 (Bankr N D Tx May 16, 2007), "Mirant to Complete Settlement with Pepco," Press Release of Mirant Corporation, August 7, 2007 (www mirant com)

37 Order Denying Scotia Pacific Company LLC's Motion For An Order Compelling The Ad Hoc Noteholder Group To Fully Comply With Bankruptcy Rule 2019 By Filing A Complete and Proper

clearly correct, the very brief, unpublished and fact-specific ruling has no precedential value. Moreover, the "group" was forced to incur substantial expenses to defeat the motion, which relied heavily on the *Northwest Airlines* precedent discussed herein

(d) Ad Hoc Committees Facilitate a More Efficient Reorganization

Deterring *ad hoc* committee formation and participation can only decrease the efficiency of a bankruptcy case. In court, if numerous parties-in-interest choose to participate via a single *ad hoc* committee, proceedings will run much more efficiently than if they had appeared individually. Representation by an *ad hoc* committee also allows claim and interest holders to spread the costs of participating in the bankruptcy case. For many distressed investors, the costs of participating in a chapter 11 case can significantly diminish their returns on already risky investments. In an attempt to reduce these costs, it is economically prudent to employ single legal counsel to negotiate and institute legal process on their behalf. From the perspective of the estate, collective action avoids unnecessary delays and duplication of efforts in responding to, or negotiating with, the creditors [38] By eliminating inefficiencies, the estate is better able to retain its value, which will be passed on to the debtor's creditors and equity holders if the debtor successfully emerges from bankruptcy.

The efficiency that results from *ad hoc* committee participation is exactly what Congress envisioned in the Rules Enabling Act[39] when it authorized the federal

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Verified Statement Disclosing Its Membership and Their Interests, *In re Scotia Development LLC*, Case No. 07-20027(Bankr S D Tex Apr 18 2007)

[38] Brief for Securities Industry and Financial Markets Ass'n *et al* as *Amici Curiae* Supporting the Noteholders Group at 11, *In re Scotia Development LLC, et al* (No 07-20027).

[39] 28 U.S.C. §§ 2071-2077

judiciary to draft the rules of federal practice. Federal Rule of Bankruptcy Procedure 1001 states that the "rules shall be construed to secure the just, speedy, and inexpensive determination of every case and proceeding." Therefore, in the event that any of the Rules no longer serve these purposes, or conflicts with a stated policy of the Code, the rule must be repealed.

Rule 2019 cannot be said "to secure the just, speedy, and inexpensive determination of every case and proceeding" if it inhibits or penalizes collective action. In addition, by making it less likely that debt and equity holders with common interests will band together, Rule 2019 cannot be said to reflect and enhance the policies embodied in the Code—the most important of which is to solve complex business problems through *collective* action, negotiation, and compromise.[40]

6. <u>Rule 2019 Can Deter Distressed Investors and Harm the Reorganization Process</u>

If Rule 2019 remains in its current form, it will also negatively affect the debtor's reorganization and the interests of certain debt and equity holders.

First, revealing the purchase price and the time of acquisition of *ad hoc* committee members' holdings can have a potentially counterproductive effect. Theoretically, arming a debtor with the information about prices paid by the creditors with whom the debtor is negotiating its reorganization plan might enable the debtor to negotiate more effectively with those creditors to the benefit of the debtor's equity holders. But buyers of distressed debt are sophisticated investors. They know that they are entitled to a

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40 Posting of Bob Rasmussen to The University of Chicago Law School Faculty Blog, *Hedge Funds and Collective Action*, http://uchicagolaw.typepad.com/faculty/2006/06/hedge_funds_and.html (June 1, 2006, 2:51 PM).

full payout of the claims they hold regardless of the price paid for them, as courts have held for decades. *See* Part 3, *supra*. Therefore, it is naive to think that those creditors would gullibly take a low-ball price that is marginally above their acquisition price. Thus, if a particularly stubborn debtor actually tried to ground its reorganization plans on its knowledge of investors' purchase prices, it would likely waste everyone's time and money because the plan would have little probability of acceptance

Secondly, the reorganization process would also be negatively affected if distressed investors were to forgo investing in distressed companies altogether to avoid constantly having to disclose their investment positions. As a threshold matter, distressed investors have an interest in the confidentiality of their investment positions because of the nature of their investment strategies. Notably, distressed investors such as hedge funds employ aggressive and complex investment strategies that often include a combination of diversification, leverage, long, short and derivative positions The effectiveness of these strategies is dependent on the recognition of trends, inefficiencies, and valuations of the market that *have not been recognized* by other investors. Therefore, public disclosure of a hedge fund's investment positions could compromise a fund's ability to execute its own strategy and provide incremental value to its investors. Specifically, competitor funds will be able to access an *ad hoc* committee's Rule 2019 statement quickly and economically through electronic filing systems.[41] With that access, competitors will be better able to

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41 Jordan Siev, et al , *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http //www andersonkill com/webpdfext/CommitteeNewsletter.pdf

reconstruct the unique trading systems developed by the fund that was forced to disclose.[42] In addition, knowledge of a particular long or short position could allow a competitor fund with a significant market presence to trade in a manner that could move the market in a direction adverse to the fund that was forced to disclose. Furthermore, in the long term, if hedge funds are required to disclose their investment strategies, their incentive to innovate and take risks will decrease.[43] In addition, an exodus of distressed investors from the market of distressed securities would likely lead to a decrease in liquidity for the debt and equity of bankrupt companies, which would be detrimental to the original security holders. Liquidity is crucial because it allows pre-petition/pre-insolvency security holders to easily "cash out" of the bankruptcy process. Even banks and large institutional investors often do not want to participate in lengthy bankruptcy proceedings.[44] Other pre-petition security holders may choose to sell the securities at a loss for tax purposes.[45] Others may be subject to regulatory accounting requirements or fund restrictions that do not allow them to carry defaulted bonds.[46] Finally, many pre-petition security holders "purchased the claims on margin and owe debts of [their] own and, therefore, need to sell the claim to provide [their] own

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42 Nicholas F. Kajon, *Northwest Rulings May Chill Hedge Fund Participation in Chapter 11 Cases*, STEVENS & LEE PC BANKRUPTCY CLIENT ALERT, March 16, 2007, *available at* http://www.stevenslee.com/news/bankruptcy/Northwest_Ruling_0307.pdf

43 Kenneth Rogoff, *The Hedge Fund Hegemon*, PROJECT SYNDICATE, *available at* http://www.project-syndicate.org/commentary/rogoff28

44 The Journal of the Business Law Society, *Hedge Funds Active in Bankruptcy Proceedings*, September 27, 2006, http://iblsjournal.typepad.com/illinois_business_law_soc/2006/09/not_your_usual_.html

45 Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUMBIA BUS. L. REV. 191, 206 (2005)

46 *Id.* at 206-07

creditors with cash."[47] Thus, it is clear that many investors, for many different reasons, wish to exit the bankruptcy process or desire to cash out of their investments as soon as possible. Without distressed-investor participation, non-distressed investors will be unable to rid themselves of unwanted securities and will suffer a loss in the time value of money by losing the ability to cash-out and reinvest elsewhere.

Conclusion: An Appropriate Framework

For the reasons stated above, Rule 2019 should not be maintained in its current form because it does not provide any useful information, is unnecessary to support a modern administration of the Code, is inefficient because it is both over- and under-inclusive, and is potentially counterproductive to the reorganization process. Discovery under the Federal Rules is not only less burdensome to those forced to disclose, but it is more than adequate for those isolated cases when the *information* required by Rule 2019 may be helpful to the administration of the case, such as to investigate and punish investor misconduct

Multiple courts have permitted *in camera* disclosure as a middle ground between full mandatory disclosure and complete confidentiality. Under Section 107(b) of the Code, bankruptcy courts are authorized to "protect any entity with respect to a trade secret or confidential research, development, or commercial information " However, in making the decision to protect information, a court is also required to consider Section 107(a), which states that all papers filed in a bankruptcy case, including Rule 2019 disclosures, "are public records and open to examination by an entity at reasonable times without charge." However, because Section 107(a) begins with the modifier, "Except as

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47 *Id*

provided in subsection (b)," the language of the Code implies that there are times when transparency must yield to confidentiality. In the *Owens Corning* bankruptcy case, for example, the bankruptcy court employed this exact solution, which it found to "adequately balance the creditors' privacy interests with the public's competing interests in full disclosure."[48] In addition, the *Owens Corning* court noted that a showing by the requesting party that such disclosure is both "necessary" and "relevant" will not "violate anybody's substantial rights."[49]

Therefore, given the availability of an existing, more efficient, more equitable, and less intrusive alternative, Rule 2019 in its current form should be repealed. Courts and other parties in interest will retain the broad power to investigate and discover facts under Rule 2004 and Federal Rules 7026 – 7037.

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48 Jordan Siev, et al., *Heightened Rule 2019 Disclosure Obligations for Committee Members after Decisions in* Northwest Airlines *and* Owens Corning, ANDERSON KILL & OLICK, PC PUBLIC COMPANIES & CLAIMS TRADING COMMITTEE, ABI COMMITTEE NEWS, April 2007, *available at* http://www.andersonkill.com/webpdfext/CommitteeNewsletter.pdf (referring to Transcript of Argument on all Delaware Asbestos Cases Regarding 2019, *In re Owens Corning, et al.*, No. 00-3837, (Bankr. D. Del. Oct. 6, 2004) at 55 (order allowing counsel representing more than one creditor or equity security holder to file the 2019 statements under seal)), *see In re Mirant Corp., et al.*, No. 03-46590, (Bankr. N.D. Tex. May 24, 2005) (authorizing the members of an *ad hoc* committee to file under seal only the proprietary information contained in their Rule disclosures).

49 *Id.*

We would be pleased to discuss this subject further with the Reporter for the Committee. Please contact our counsel in this matter, whose contact information appears below.

Very truly yours,

SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

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THE LOAN SYNDICATION AND TRADING ASSOCIATION

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HELP FOR **DISTRESSED DEBT**

Search **DIS** <HELP> for:

Distressed Debt Screen

Once you enter DIS , the Distressed Debt screen appears, where you can display a list of all bonds that traded at a yield of at least 1000 basis points above the benchmark government debt on the Trade Reporting And Compliance Engine (TRACE) in the last five business days. The number of corresponding bonds appears in the top left corner of the screen. The following fields appear:

Issuer:
The name of the issuer of the bond.

Coupon:
The bond's coupon.

Maturity:
The bond's maturity date.

Price:
The most recent trade price for the bond.

GRAB

EquityDIS

Export to Excel 158 Bonds Found (TRACE Pricing from prev. day close) US Distressed Debt

	Issuer	Coupon	Maturity	Price	Yield	Sprd to Bench	Amt Out
1)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
2)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
3)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
4)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
5)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
6)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
7)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
8)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
9)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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11)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
12)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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14)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
15)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
16)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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19)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
20)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Homebuilder Stocks Seem Enticing, But Where's The Cash?

BY MICHAEL CORKERY

With home sales slowing to a crawl and buyers unable to qualify for mortgages, some home builders are struggling to keep their operations going

Already, Levitt Corp 's **Levitt & Sons** unit has filed for bankruptcy-court protection, and a second builder, Tousa Inc , said it is considering several "in and out of court restructuring and reorganization" options, including a possible Chapter 11 filing. While those small Florida-based builders were partly crippled by company-specific issues, the make-or-break matter for most builders — and for those who may be enticed by their cheap stock prices — is the ability to generate cash to service debt and to pay for the construction of new homes. Such liquidity risks could trap investors

"Liquidity is the No. 1 concern for builders, and rightly so," says Nishu Sood, an analyst at Deutsche Bank. "It's a matter of survival," he says of the many builders that borrowed heavily for the land they stockpiled during the housing boom

For months, builders have been slashing prices to move houses and generate cash But in recent weeks, Sood says, the new-home market in some regions is behaving like there already is a broad economic recession "In some communities, builders can't give away homes," he says "They will end up with fewer tools to come up with cash "

Amid the distress, investors may be tempted to go bargain hunting According to UBS, the home builders are trading on average near 40% of their tangible book value, which is typically a rough estimation of what the company would be worth if liquidated. That makes them appear extremely inexpensive

One red flag Some builders have violated, or are close to violating, credit agreements with their banks Until now, the banks have been willing to relax their rules to avoid technical defaults. But their patience could be wearing thin for some builders as the housing market deteriorates

WCI Communities Inc , which focuses on high-rise condominium towers in coastal Florida, is currently testing the banks' patience The company recently violated an "interest coverage" test, which requires a minimum ratio of earnings before interest, taxes, depreciation and amortization to the interest it owes on its debt, says Andrew Brausa, a debt analyst at Banc of America Securities

WCI received a waiver until Dec 7 and has negotiated with its banks for more breathing room James Dietz, WCI's chief financial officer, says the banks are close to signing off on a new agreement. "We believe we can generate sufficient cash to pay debt service and all our obligations," says Dietz

WCI may have little leverage to assuage its lenders As the condo market falters, WCI's cash-flow projections for this year have eroded to between $210 million and $460 million from an earlier range of $530 million to $730 million The company is expecting to generate significant cash by completing a large condo project, One Bal Harbour, near Miami But some analysts fear more home buyers will walk away from that project than the company expects amid falling property values

WCI has to pay about $120 million to service the interest on its debt next year, which it will be able to do if cash flow doesn't dip further But that isn't certain given the direction of sales in the Florida condo market. The company has about $200 million left to draw on its credit line, Dietz says

continued on page 10

ACTIVE BONDS

Active Bankrupt Bond Price Indications

The following table of bankrupt companies' bonds shows recent price indications for the issues listed.

Issuer	Description	Latest Session	Previous Session	Chg
Calpine Corp	7 75% Nts-9	100.50	100.50	
Dana Corp	5 85% Nts-15	71 25	71 75	-0 500
Delphi	6 55% Nts-06	68 50	68 25	0 250
Dura Automotive	8 625% Nts-12	28.00	28 00	
Movie Gallery	11% Nts-12	17 00	17 25	-0 250
Sea Containers Ltd	10 5% Nts-12	61 00	61 50	-0 500
Solutia	11 25% Nts-09	99 63	99.63	
Solutia	7 375% Nts-27	96.75	97 00	-0 250
Stelco Inc	FLT% Nts-16	108.75	108 75	

Source The High Yield Advantage, 617.261.9700, advantagedata com

Composite high yield bond price indications are compiled from various market sources, some of which may make a market in or have financial interest in the issues for which prices are provided PRICES ARE INDICATIVE ONLY The information contained herein does not represent a solicitation to sell or buy the underlying issues Dow Jones shall not be held liable for any reason for any errors or omissions, delays or inaccuracies in the indications or any decision made in reliance upon the indications Dow Jones shall not be liable to any person for any loss of business revenues or lost profits or for any indirect, special, consequential or exemplary damages whatsoever, whether in contract, tort or otherwise, arising in connection with the indications, even if Dow Jones has been advised of the possibility of such damages Dow Jones makes no warranty whatsoever, express or implied, including specifically any warranty of merchantability or fitness for a particular purpose with respect to the indications and specifically disclaims any such warranty

Date. 8 June 2007
Analyst· Howard Tang; 1-212-686-6559, howard.tang@debtwire com

DEBTWIRE
NORTH AMERICA

Movie Gallery USA, Consumer Retail Distressed	CREDIT RATING	Caa1 (Moody's) B- (S&P)	TOTAL DEBT	USD 1.1bn	TOTAL ASSETS	USD 1.14bn

DEBT STRUCTURE (in USD m):

Category	Amount Out	Interest %	Price (6/8/07)
Senior Unsecured Notes '12	322	11	81.94
Revolver	0	LIBOR + 2.5	N/A
First Lien Term Loan	600	LIBOR + 3.5	99.15
Second Lien Term Loan	175	LIBOR + 6.5	97.4
Other	3	N/A	N/A

DEBT MATURITIES (in USD m):

2007	2008	2009	2010	2011	Thereafter
3	-	-	-	-	1097

Financial Covenants (2007 credit facility):

- Maximum leverage ratio of 6.75x throughout FY07
- Maximum Secured leverage ratio of 4.75x throughout FY07.
- Interest Coverage Ratio cannot be less than 1.4 throughout FY07

SUMMARY FINANCIALS:

in USD m	1Q 07	1Q 06	2006	2005[1]
Revenues	648	694	2542	1967
EBITDA	57	113	210	139
Interest	27	30	120	69
EBITDA/Interest	**2.11**	**3.77**	**1.75**	**2.01**
Cash	27	33	33	135
Total assets	1136	1153	1153	1385
Equity	-251	-236	-236	-213
Total debt	1100	1092	1092	1161
Debt/EBITDA	**7.17[2]**	**5.2**	**5.2**	**8.35**
EBITDA	57	113	210	139
Interest	27	30	120	69
CAPEX	1	9	20	58
Available for Debt	**29**	**74**	**70**	**12**

1 Recognizes the consolidated results of Movie Gallery and Hollywood for the period subsequent to our merger on April 27, 2005.
2. TTM EBITDA = USD 153.384m

CREDITORS & BONDHOLDERS:

Goldman Sachs Credit Partners — Lead Arranger/Lender
Wachovia Bank— Lender
CT Investment Mgmt Group Inc—Bondholder
Putnam Investment Management—Bondholder
Wellington Management Co LLP—Bondholder

OFFICERS & DIRECTORS:

Name (Position)	Name (Position)
J.T. Malugen (Chairman, CEO)	S Page Todd (EVP, GC)
Thomas D Johnson Jr (EVP, CFO)	Keith A Cousins (EVP, CDO)
Jeffrey S Stubbs (EVP, COO)	H Harrison Parrish (VC, SVP)

ADVISORY ENGAGEMENTS:

Firm	Capacity	Date
Alvarez & Marsal	Financial Advisor	2007
Merrill Lynch	Financial Advisor	2007
Peter Solomon	Financial Advisor	2007

BUSINESS: Headquartered in Alabama, Movie Gallery has grown considerably since its initial public offering in 1994. Traded on the NASDAQ, the Company is the second largest specialty home video retailer in the US Movie Gallery rents out and sells DVDs, videocassettes and video games through approximately 4,590 retail stores throughout North America. The recent acquisition of Hollywood Entertainment on 27 April 2005 almost doubled the number of locations of Movie Gallery and added the Hollywood and Game Crazy brands to the Company's existing branches

SOURCES OF DISTRESS:

- **Hollywood Acquisition Financing:** Prior to the acquisition of Hollywood Entertainment, Movie Gallery had negligible debt obligations in its capital structure Post acquisition, the company added over USD 1bn in long-term notes, credit facilities, and acquired liabilities to its balance sheet
- **Deteriorating Business Fundamentals:** Movie Gallery is being besieged by a number of lower cost options that is rapidly changing the fundamentals of the movie rental business Consumers are quickly shifting their preference to online mail order options such as the Netflix service and Blockbuster's online rental service. Late to the game, Movie Gallery has begun to explore other alternatives for providing movie rentals Recently, the company has acquired MovieBeam, a service which provides digital delivery of movie rentals, and has begun testing movie rental kiosks in select locations How effective these new delivery platforms will be, is yet to be known as the company still needs to roll them out with some significance.

PROFITABILITY (1Q 07 vs. 1Q 06): Movie Gallery has shown little improvement in its profitability from last period. Total revenues fell by 6.72% driven mainly by reduced rental revenues of 10 41% on a YOY comparison. The bright spot in their results was a surge in product sales of 10 26% from 1Q 06 to 1Q 07 The company's gross margins have been somewhat resilient dropping only 138 bps YOY to 60.1% from 1Q 06. Movie's operating income fell by 50.2% reflecting the drop in total revenues and the increased cost of product sales EBITDA for 1Q 07 demonstrated a similar drop from 1Q 06 of 49 56% despite the elimination of one-time non-recurring charges Management continues to rationalize costs and generate cash flow through the shuttering of unprofitable stores and sub-leasing. During 1Q 07 the company closed 54 underperforming stores recognizing USD 0 9m relating to these closures. The operational restructuring has achieved little success as operating margins continue to deteriorate, YOY, margins fell by 453 bps to 5 19% in 1Q 07.

MAJOR RESTRUCTURING INITIATIVES:

- **March '07 Refinancing:** Movie Gallery refinanced its April 2005, USD 900m senior secured credit facility. The new facility consists of USD 100m revolver, USD 25m first lien synthetic letter of credit facility, USD 600m first lien term loan and USD 175m second lien term loan. The second lien term loan is a PIK, allowing the company to defer cash interest payments for a time
- **Lease Restructuring Initiatives:** The company has entered into a management agreement with Excess Space Retail Services to pursue subleasing opportunities at 2,200 store locations Movie expects that retail partners from this initiative will occupy an approx average of 2,500 square feet at each location In a separate agreement, Movie is working with Hilco Real Estate to restructure leases at 1,100 store locations

LIQUIDITY: The Company's liquidity position is bolstered by USD 27.3m in cash and cash equivalents and USD 100m availability on its revolver Cash provided by operations improved significantly on a YOY basis; for 1Q 07 the company generated USD 16 78m from operations as opposed to a deficit of USD 20.6m in 1Q 06. No major debt repayments are due for several years The company's interest and lease expenses are the major drain on the company's cash position amounting to USD 485m for 2007. Management expects that the company's capital expenditures for fiscal 2007 to be USD 38m which would go to fund store openings, maintenance on the existing store base and other strategic investments

Est. liquidity as of 1 April 2007 — USD 127.3m

USD 27.3m	Cash and Cash Equivalents
USD 100m	Revolver Availability

Est. one year capital requirements as of 1 April 2007 — USD 147m

USD 38m	Capital Expenditures
USD 109m	Interest payments on First & Second Lien, Senior Notes, and Capital Leases, reduced by Hedge agreement

LCD News
December 03, 2007

Deal Dossier

Movie Gallery (2nd Lien 3/07)

Related News

- Movie Gallery debt falls amid market weakness, sector woes (11/16/07)
- As defaults loom, accounts eye recovery values, ratings (10/24/07)
- Movie Gallery LCDS auction sets price at 91 5 (10/23/07)
- Movie Gallery DIP allocates, LCDS auction set for Tuesday (10/19/07)
- Movie Gallery shops $150M DIP loan to existing lender group (10/16/07)
- Movie Gallery files for Ch 11, hands 2nd-lien lender key stake (10/16/07)

All Related News

Related Deals

- Movie Gallery (DIP 11/07)
- Movie Gallery (RC 3/07)
- Movie Gallery (TL 3/07)
- Movie Gallery (Add-on 10/05)
- Movie Gallery (4/05)
- Movie Gallery (12/98)
- Movie Gallery (HY 5/05)

headlines only GO

Some distressed credits off lows, but general trend lower

New York, Nov 27 (LCD) - Several distressed credits have bounced from rec though the general trend over the past few weeks has been broadly negative

Movie Gallery first-lien bank debt rebounded from lows in the mid-70s touche today, gaining to 77/79, compared to 80/82 yesterday The lower levels were investor distaste for credits exposed to consumer and retail trends Markets in company's second-lien debt were scarce, sources said

Bonds backing stronger rival **Blockbuster** (9% notes due 2012) traded at 84/ one point lower since early last week, for a total drop of six points in one mont Blockbuster stock has tumbled 32% since the company reported a 6% fall in t revenue and losses of $0 20 per share, compared to losses of $0 15 per shar same quarter one year ago Blockbuster shares traded at $3.60 today, up 1 7

Another credit exposed to reduced consumer spending, restaurant chain oper **Buffets**, remains under pressure The company's term debt continued to fall, today, higher than bids at 85.5 in recent days but compared to 88.25/89.75 ea week The company's 12 5% notes due 2014 have steadied at 46/47 in antici restructuring, sources said

Housing credits remain in focus as negative headlines for the sector continue

WCI Communities revolving debt was at 91/93 today, unchanged with levels ago, sources said WCI 9.125% notes due 2012 traded at 60 today, steady w week, but down 10 points over two weeks WCI 6 625% notes due 2015 ease today, to 54/55, for a 14-point drop this month

Realogy's institutional strip changed hands today in an 87/88 context, compa 86 5/87.5 on Nov. 21 Realogy bonds have ticked steadily lower in recent wee company's 12.375% subordinated notes due 2017 fell three points today, to 6 compared to 68/70 three weeks ago Realogy 10 5% notes due 2014 slid two today, to 71/73, from an 80 context three weeks ago, sources said

ResCap term debt benefited from news that the company moved to strengthe metrics and stave off bankruptcy by tendering for $750 million of bonds The c term loan due 2008 traded today in an 85/86 context, compared to 72/73 earl Over the same time ResCap bonds have climbed 10 points - *Abby Latour*

abigail_latour@standardandpoors com

Printer Friendly Format

Published 27 Nov 2007 - 18 43 GMT
