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Recovery:

Debt Recovery For Creditors And The Law Of Insolvency In The U.S.

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In connection with its global assignment of recovery and issue ratings, Standard & Poor's Ratings Services has assessed the insolvency regime of the U.S. as a Group A2 jurisdiction, based on its relative degree of "creditor-friendliness" as defined in Standard & Poor's report titled "Jurisdiction-Specific Adjustments To Recovery And Issue Ratings," published July 5, 2007, and available on RatingsDirect at www.ratingsdirect.com.

Executive Summary

The U.S. Bankruptcy Code's scheme for plans of reorganization is the paradigm for distressed companies' rehabilitation statutes. Under the Bankruptcy Code, distressed businesses have broad powers to restructure their operations and reshape their capital structures to give their enterprises a fresh start. The Bankruptcy Code's reorganization process is structured to enable debtors to preserve, protect, and enlarge their enterprises, resulting in greater value for the benefit of all stakeholders and, consequently, greater aggregate overall recoveries. Unlike the insolvency regimes in many other jurisdictions worldwide, business debtors under the U.S. Bankruptcy Code generally are not required to demonstrate that they are insolvent to take advantage of the process' protections and powers.

Compared with jurisdictions where liquidation, rather than rehabilitation, of distressed businesses is the norm, secured creditors in the U.S. reorganization process have less control over the timing and manner of the realization of value and less certainty regarding the form of a specific claim's recovery. Secured creditors must vigilantly participate in the reorganization process to protect their interests in their claims and collateral.

Rather than serve as a "stop loss" process, however, the objective of U.S. bankruptcy reorganization is to serve as a value maximization process. The efficiency of the process—and the dynamics of reorganization plan approval and confirmation—typically results in distributions of enterprise value that reflect the strength of the various stakeholders' positions within the parameters of the priorities of creditors' claims; the material protections afforded to, and the influence of, secured creditors; and the best interests of the reorganized debtor.

Introduction

While the creditworthiness of borrowers has always been of paramount concern to creditors, recent developments in the debt markets, including the deteriorating credit of some major corporate borrowers, the continuing growth of the credit default swap market, and the implementation of Basel II guidelines, have increasingly put a spotlight on their prospects for recovery of principal and interest after a borrower's default. From the creditors' perspective, it's no longer only a question of whether a particular borrower will default, but also whether (and to what extent) they will be repaid principal and interest after a default, and how long it will take. Standard & Poor's believes that the key to answering these questions begins with an assessment of how creditors may fare under the particular insolvency regime in which the borrower is located.

In this article, we review the distinctive characteristics of the U.S. Bankruptcy Code's regime from both a secured

and unsecured creditor's perspective, and assess how they may affect postdefault recovery prospects. This article updates the U.S. aspects of a survey of the insolvency regimes of the U.S. and five European jurisdictions titled "Jurisdiction Matters for Secured Creditors in Insolvency," published April 13, 2006, on RatingsDirect.

An Overview Of The U.S. Insolvency Regime

The Bankruptcy Code of 1978, as amended, provides the U.S. federal scheme for the comprehensive and definitive resolution of all claims against, and interests in, eligible distressed debtors. The establishment of a federal bankruptcy scheme that would preempt individual state insolvency statutes derives from a clause in the U.S. Constitution empowering Congress to pass "uniform laws on the subject of bankruptcies throughout the United States." Before 1898, Congress enacted bankruptcy laws in response to specific financial "panics" and subsequently repealed these laws. The Bankruptcy Act of 1898 established a permanent federal bankruptcy scheme that was comprehensively reformed by the Bankruptcy Reform Act of 1978 and its later amendments.

In the U.S., bankruptcy courts are units of the U.S. federal court system and their jurisdiction is dependent on their respective federal district courts. This court system results in a relatively efficient and consistent application of bankruptcy laws, with decisions subject to effective appellate procedures and cases relatively free from nonjudicial interference.

Although the substantive bases for many claims and interests in bankruptcy proceedings derive from state laws, in a bankruptcy proceeding the exercise or enforcement of these rights are subject to the Bankruptcy Code. State laws providing for the nonbankruptcy resolution of claims against distressed debtors, such as receiverships and assignments for the benefit of creditors, are infrequently used because they are unable to bind nonconsenting creditors and could not provide the breadth of discharge and certainty of resolution found under the Bankruptcy Code.

The Bankruptcy Code also has specific provisions for adjusting the debts of municipalities, individuals, family farmers or fisherman, small businesses and railroads; and for the liquidation of commodity brokers and, in certain cases, stockbrokers, which we do not address in this article. Most banks, insurance companies, and other similar entities that are covered by other state or federal regulatory regimes are subject to proceedings under those regulatory schemes and are not covered by the Bankruptcy Code. We also do not address these regimes in this article.

Under the Bankruptcy Code, distressed businesses can file "reorganization" cases under Chapter 11 or "liquidation" cases under Chapter 7, although a Chapter 11 case may result in a "liquidating" plan of reorganization without converting the case into a Chapter 7 case. From 1980 through 2007, the overwhelming majority of large, public company bankruptcies were initially filed as Chapter 11 cases, while less than one-tenth of these bankruptcies were initially filed under, or converted to, Chapter 7 proceedings.

In a Chapter 11 case, the debtor generally has greater control over the process than in many other jurisdictions and has significant flexibility to attempt to reorganize its enterprise. A notable feature of Chapter 11 is that the debtor generally remains in possession of its estate as "debtor in possession" and continues to operate its business while it prepares a Chapter 11 plan.

Under Chapter 11 or Chapter 7, the debtor is protected from most creditors, including secured creditors, through

the imposition of a comprehensive automatic stay for the duration of the proceedings. The debtor also may recover property of its "estate," avoid certain conveyances and other transactions, reject burdensome leases and executory contracts generally, and secure post-petition financing, which, in certain circumstances, may include the grant of a 'super-priority' lien to the lenders that provide the financing.

Even when a business ultimately is unable to reorganize successfully and emerge as a stand-alone enterprise, its sale or liquidation often proceeds while the debtor remains in control of the business as a Chapter 11 debtor in possession. In that case, Chapter 11 allows the debtor and its creditors to shape the disposition of the business and the distribution of its remaining value without turning over the business to a trustee and the less-flexible distribution priorities of a Chapter 7 liquidation proceeding.

Cases that are converted to a Chapter 7 liquidation proceeding, on the other hand, typically result from the irrevocable failure of the business and the inability of the debtor and the creditors to agree on the terms of its final disposition. The degree of a debtor's control of the Chapter 11 process and the strengths of its protections and powers are reflected in the substantially higher average aggregate overall recoveries for creditors that Standard & Poor's has observed for businesses that emerge from reorganization compared with those that are liquidated in the U.S.

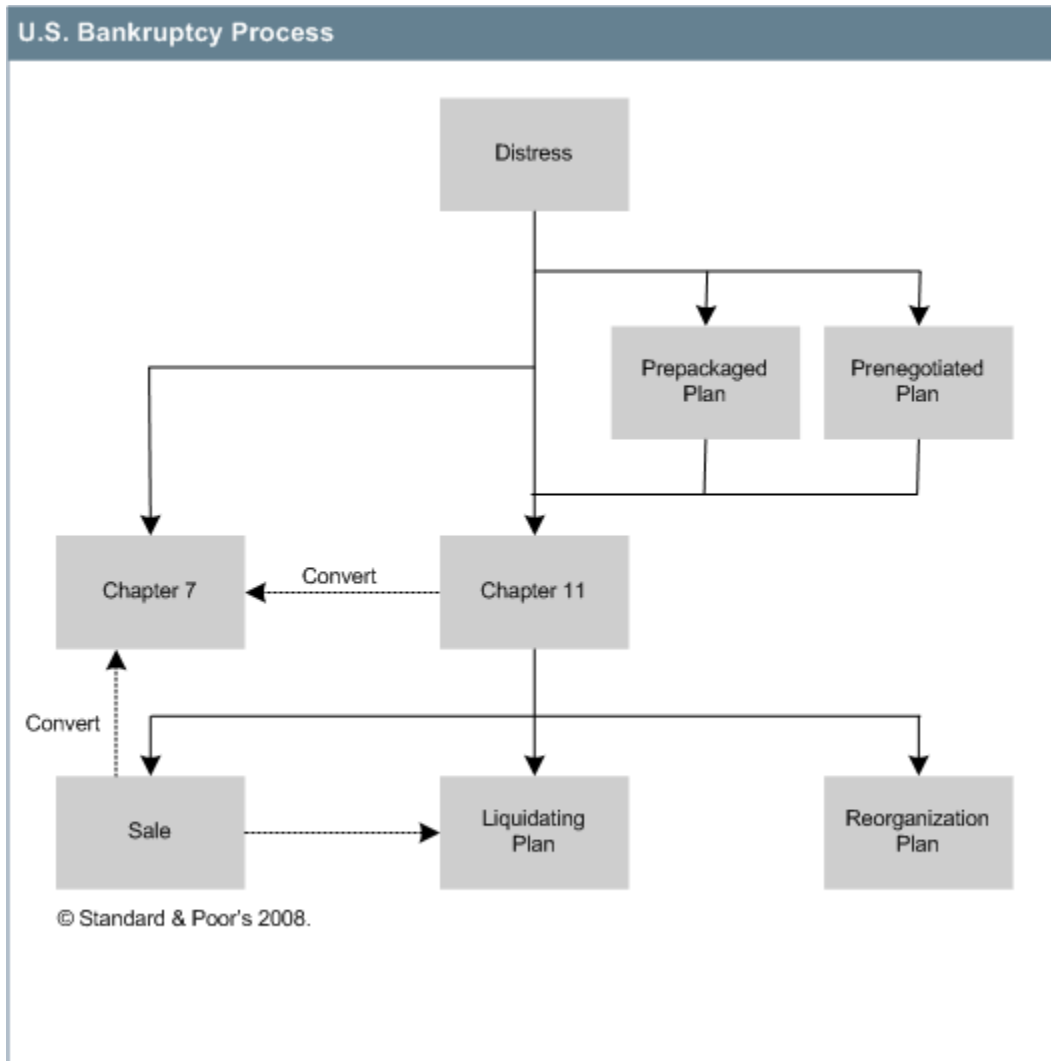
Although time in bankruptcy varies widely depending on the complexity of the debtor and its case and generally is unpredictable, the average duration of large, public company bankruptcies from 1980 through 2007 was between one and two years.

In many cases, the duration of bankruptcy cases may be shorter and more predictable. For example, from 1980 through 2007, almost one-quarter of large, public company bankruptcies were "prenegotiated" or "prepackaged" cases. A renegotiated case is one in which the debtor has negotiated the basic terms of the plan of reorganization with at least some of its major creditors before filing for bankruptcy. A prepackaged case is one in which the debtor has drafted the plan and has successfully solicited votes on it before filing for bankruptcy. These strategies can greatly reduce a debtor's time in bankruptcy, particularly in a prepackaged case where a solicitation of votes in compliance with applicable nonbankruptcy laws is recognized under the Bankruptcy Code. Prepackaged and renegotiated cases typically last less than one year.

Although other Chapter 11 and Chapter 7 cases generally average less than two years, it has not been uncommon in the past for some large and complex Chapter 11 cases to continue for many years. The 2005 amendments to the Bankruptcy Code established outside limits on the time periods for a debtor's exclusive right to file a reorganization plan at 18 months and its exclusive right to attain confirmation at 20 months. At this time, it is not clear how these limits will affect the duration of Chapter 11 cases. There is some evidence from recent cases that time in bankruptcy may be reduced, although a greater number of contingencies at emergence may materially delay some distributions.

Process

The following chart illustrates the U.S. Bankruptcy process.



A case under Chapter 11 or Chapter 7 may be commenced voluntarily by the debtor or involuntarily by its creditors. The Bankruptcy Code regime is not, strictly speaking, an "insolvency" process because a debtor is not required to be insolvent in order for it, or its creditors, to commence proceedings, except in an involuntary proceeding that the debtor contests. The threshold for jurisdiction by the bankruptcy court is relatively low and is intended to encourage access to the bankruptcy process before the irrevocable failure of the debtor's business. This relative ease of access is designed to encourage reorganizations and seeks to avoid "fire sales."

Most bankruptcy cases are voluntary. A voluntary case commences when the debtor files a petition with a bankruptcy court. As a legal matter, the petition constitutes an "order for relief" that has immediate effect without any further action required by the court and triggers all the protections and powers available under the Bankruptcy Code.

Upon commencement of the case, a broadly defined estate is created that includes virtually all of the debtor's property rights, including its rights to property recovered or subsequently acquired by the estate during the proceeding. Any party in possession of property of the estate can be compelled to deliver and account for the

property, or its value, to the estate. Clauses in contracts that purport to terminate the debtor's rights or interests on account of the debtor's bankruptcy are not enforceable under the Bankruptcy Code.

The Bankruptcy Code includes extensive provisions designed to preserve, protect, and enlarge the estate and they are immediately effective once the case commences. These provisions include a comprehensive automatic stay that freezes any proceedings or actions affecting the estate, including enforcement of security interests and set-off rights, and remains in place for the duration of the proceeding. In a notable exception, most actions with respect to swaps, repurchase agreements, commodity contracts, and other similar financial contracts are excluded from the automatic stay's effect.

During the case, creditors cannot exercise "self help" remedies and must apply to the court for relief from the stay if they wish to take any actions with respect to property of the estate. A secured creditor can apply to the court for relief from the automatic stay if its interest in its collateral is not "adequately protected" from diminution in value. Adequate protection typically consists of cash payments, additional or replacement liens, or other property sufficient to compensate the creditor for this diminution in value. If a secured creditor is over-secured, it would not be entitled to adequate protection until its collateral's value fell below the claim amount.

Reorganization

In a Chapter 11 case, except in unusual circumstances, the debtor remains in possession of the estate and may use, sell, or lease property of the estate, other than cash collateral, in the normal course of its business without the bankruptcy court's specific approval. The debtor may use cash collateral but the party secured by it must give its consent or be adequately protected. For other collateral, a secured party generally must be vigilant to apply to the court to prohibit or restrict the debtor's proposed actions to assure that its interest is adequately protected.

The Bankruptcy Code allows the debtor to reject burdensome leases and contracts generally. For most of these agreements, the bankruptcy court will defer to the debtor's business judgment that rejection is in the estate's best interests and necessary for its reorganization. The Bankruptcy Code also provides that the debtor may reject labor contracts and terminate retired employees' benefits, although these provisions are more protective of the affected employees' rights. Damage claims arising from the rejection or termination of these agreements constitute unsecured claims that would dilute the recoveries of prepetition unsecured creditors generally.

In Chapter 11 cases, debtors may require postpetition financing. The debtor may obtain unsecured financing, if available, as an administrative expense, payable prior to general unsecured claims. If not otherwise available, the debtor may obtain unsecured financing as a super-priority administrative expense, payable prior to other administrative expenses.

Frequently, however, lenders will not advance funds without the additional protection of security interests in property of the estate. The court may approve such financings with first-priority liens in otherwise unencumbered property of the estate, as well as with second-priority liens in previously encumbered property.

If financing still is not otherwise available, the court may approve postpetition financing secured by liens that are senior or equal in priority to existing secured debt. In that event, the interest of the existing secured creditors must be adequately protected from the diminution of value resulting from these liens.

Chapter 11 plans

A Chapter 11 plan provides for the satisfaction or discharge of all claims and interests in the debtor and its property and, when confirmed by the bankruptcy court, is binding on all holders of these claims and interests, even if the holder has not voted in favor of the plan. A Chapter 11 plan typically provides for the reorganization of an eligible debtor through a confirmed reorganization plan. Alternatively, a debtor may dispose of all or substantially all of its assets and be liquidated under Chapter 11 in a liquidating plan.

The plan's proponent, typically the debtor with the support of the official unsecured creditors' committee, has flexibility to classify claims into separate classes and structure the distribution of the debtor's enterprise value in the plan. Although the distributed value may take different forms, the plan confirmation process includes parameters designed to provide a "liquidation" value floor under recoveries and protect the equivalent of the present value of the secured creditors' interests in their collateral.

Since the Bankruptcy Reform Act of 1978, distributions under a Chapter 11 plan generally don't need to comply with an "absolute priority" rule that would assure that senior claims are paid in full before any lower ranking classes receive distributions. A plan now may be confirmed if it is approved by the requisite majority of each class whose rights are "impaired" under the plan (a consensual plan), even if junior classes receive distributions that would be inconsistent with an absolute priority rule.

Secured claims and unsecured claims are subject to the treatment of their respective classes in the plan of reorganization and generally are not subject to a rigid priority scheme. Distributed value may take many forms, such as cash, the cure and reinstatement of prepetition obligations, rescheduled obligations, other debt securities, equity securities, convertible securities, warrants, or other property. All claims within a class, however, must be treated the same, unless a particular creditor agrees to a less favorable treatment of its claim. Typically, preexisting equity interests are cancelled and any residual value in the enterprise is distributed in the plan to creditors and other stakeholders. To be confirmed, the plan must provide that administrative expenses will be paid in cash in full and that certain other priority claims will receive cash or deferred payments.

Impaired classes and objectors under the plan frequently raise issues regarding the debtor's enterprise value on which distributions under the plan would be based. The uncertainties inherent in the valuation process in a Chapter 11 proceeding in certain circumstances may provide incentives for senior classes to allow some distributions to impaired junior classes as an accommodation to ensure their approval of the plan and the debtor's timely and efficient emergence from bankruptcy.

Liquidation

Chapter 7 of the Bankruptcy Code provides for the liquidation of an eligible debtor's estate by a court appointed trustee. Chapter 7 is designed to provide for the estate's orderly liquidation and, for this purpose, the trustee may operate the debtor's business for a limited time. The trustee determines the disposition and timing of realization of the property of the estate, including property subject to security interests.

Chapter 7 has a fixed-priority scheme for distributions in which bankruptcy-related administrative expenses and preferred unsecured claims are paid prior to general unsecured claims. Various sections of the Bankruptcy Code also provide for super-priority administrative expenses that would be paid prior to other administrative expenses. Under Chapter 7's priority scheme, most general unsecured claims are categorized together. Although the Bankruptcy Code recognizes contractual subordination agreements, general unsecured creditors must be vigilant to assert their relative priorities.

Although the Chapter 7 trustee is charged with disposing of property of the estate and closing out the case as expeditiously as is compatible with the best interests of all of the parties in interest, distributions may be delayed pending the disposition of property of the estate and the payment of administrative expenses and priority claims.

Security

In the U.S., security may be granted over virtually all types of property. If the appropriate steps are not taken under applicable law, a security interest will not be enforceable against third parties, or perfected, and will be avoidable under the Bankruptcy Code. In certain circumstances, even perfected security interests may be avoided as preferences or fraudulent transfers and perfected secured claims may be equitably subordinated because of a creditor's improper conduct.

The U.S. doesn't have the concept of a "floating charge." Property acquired by the estate after a bankruptcy case commences is not subject to the lien of a prepetition security agreement unless the after-acquired property consists of proceeds of property subject to the security agreement before the bankruptcy case commenced.

Secured creditors are subject to the automatic stay and may not enforce their security outside of the bankruptcy process without the bankruptcy court's approval. The Bankruptcy Code recognizes set-off rights, but they also are subject to the automatic stay.

In a Chapter 7 case, a secured creditor is entitled to be paid from the net disposition proceeds of its collateral and any deficiency constitutes an unsecured claim. The Chapter 7 trustee may deliver the collateral to the secured creditor, particularly if the claim is undersecured, or conduct a sale at which the secured creditor may "bid in" the amount of its claim. Interest ceases to accrue on claims once the bankruptcy case commences, but postpetition interest will accrue on an oversecured claim to the extent it is oversecured.

As in many other jurisdictions, under the U.S. Bankruptcy Code, property that was transferred out of the estate before bankruptcy, including the grant of a security interest, also may be brought back into the estate through provisions for avoiding preferential transfers and actual or constructive fraudulent transfers. Typically, avoidable transactions are entered into when the transferor or grantor is insolvent, during a specified period before its bankruptcy, and either for insufficient consideration or to an existing creditor's preferential benefit. The specified period for an avoidable preference is 90 days for a transferee that is not considered an "insider" with respect to the debtor and one year for a transferee that is an insider. The 2005 amendments to the Bankruptcy Code notably increased the specified period for fraudulent transfers to two years before a bankruptcy filing.

For the estate's benefit, liens that are unperfected and property transfers that are incomplete at the commencement of the case may also be avoided. Claims may also be equitably subordinated to the payment of other claims because of a creditor's improper conduct that results in injury to, or an unfair advantage with respect to, other creditors.

Priority Ranking In Chapter 7

Chapter 7 has a fixed-priority scheme for distributions in which bankruptcy-related administrative expenses and preferred unsecured claims are paid prior to general unsecured claims. Secured claims are not included in Chapter 7's statutory priority scheme and secured creditors generally are entitled to be paid up to the full net realizable value of their collateral. Any super-priority administrative claims would be paid before other administrative claims. Any

remaining proceeds from the disposition of property of the estate would be distributed according to the Chapter 7 priorities summarized as follows:

- Administrative expenses, generally including costs, fees, and expenses that are incurred during the bankruptcy to preserve the estate and to compensate trustees, other bankruptcy officials, and professional service providers;
- Certain claims arising in an involuntary case before the trustee's appointment;
- Certain limited wage claims;
- Certain limited employee benefit plan contributions;
- Various unsecured claims for taxes, customs duties, and penalties for specified periods;
- General unsecured claims; and
- Secured or unsecured claims for prepetition punitive fines, penalties, and damages.

Although liquidation under the priority scheme in Chapter 7 is not the usual resolution of large, public company bankruptcies in the U.S., as discussed below under Creditors Rights, the priorities of Chapter 7 do provide the comparative "floor" for recoveries for an impaired class in the Chapter 11 confirmation process.

Financial Assistance And Guarantees

The U.S. generally doesn't have laws that limit guarantees for the benefit of, or among, affiliated entities or that prohibit support in connection with the purchase of the shares of a company or its affiliates. On the other hand, guarantees and other support, including the granting of security interests, may be subject to avoidance as preferences or fraudulent transfers under state laws and the Bankruptcy Code in circumstances discussed above under Security.

Consolidation

U.S. insolvency law recognizes substantive consolidation. A true "legal" substantive consolidation would collapse the assets and liabilities of an affiliated group of debtors into one legal entity for purposes of bankruptcy reorganization.

A "deemed" substantive consolidation typically treats one or more debtors as if their assets and liabilities were combined in a plan of reorganization for purposes of claims classification, voting on the plan, and distributions, without affecting the legal and organizational structure of the debtors. Typically, these deemed consolidations also eliminate intercompany guarantees, treat joint and several liabilities of the consolidated debtors as single claims against the consolidated group, and provide that there will not be distributions on any claims or interests between or among the consolidated debtors. This effectively would eliminate the credit support provided by unsecured guarantees or the pledge of intercompany loans or subsidiary stock, and dilute the recovery prospects for creditors that relied on these features to the benefit of those that did not.

From creditors' perspective, deemed consolidations are the economic equivalents of legal consolidations. Deemed consolidations in Chapter 11 plans or plans preceded by, or including, settlements of substantive consolidation litigation have become relatively common features of recent large, public company bankruptcies. These features may be viewed as an efficient way to implement Chapter 11 plans, particularly for complex corporate organizations with centralized policy making, administrative and financial systems, and numerous intercompany transactions, as well as where substantial negotiations have resulted in consensual plans.

Creditors' Rights

Once a debtor commences a case under the Bankruptcy Code, secured creditors don't have a procedure where they can control the timing or means of realization on their collateral apart from the process under the Bankruptcy Code.

Chapter 11 is a judicial procedure in which the debtor, except in unusual cases, remains in possession and control of the estate and sets the agenda in the case. In Chapter 11, unsecured creditors are represented by an official committee that has an important role in the administration of the case, including participating in the formulation of the debtor's plan of reorganization.

In a case where the Chapter 11 process has not resulted in sufficient enterprise value for a distribution satisfactory to a class of unsecured creditors, these creditors still may be able to leverage a more satisfactory distribution by seeking a formal valuation of the enterprise. A contest over enterprise value, which would be resolved by the bankruptcy judge after a trial, involves assumptions and methodologies that are inherently prospective and controversial and, if the plan is consensual, senior classes can avoid the risk of an adverse determination.

In Chapter 11, a secured creditor's bargaining position with the debtor derives from the importance of its collateral to the debtor's successful reorganization, the strength and certainty of its legal interest in its collateral, and the debtor's cost of retaining the collateral relative to current market alternatives. A secured creditor's bargaining position relative to other creditors derives from the strength of its bargaining position with the debtor and its relative priority in the capital structure. In addition to the strength of the secured creditor's bargaining position, its interest in its collateral has significant protections through provisions that require, or enable it to seek, adequate protection of its interest and through constraints on the debtor's ability to confirm the plan over the disapproval of its class.

Adequate protection typically consists of cash payments, additional or replacement liens, or other property or interests sufficient to compensate a secured creditor for the diminution in the value of its interest in property of the estate that the debtor uses, leases, sells, or pledges as security. As noted above, a secured creditor may also seek relief from the automatic stay if its interest in its collateral is not adequately protected. Although the debtor frequently proposes the form of adequate protection that will be provided, it is not unusual for the debtor and secured creditor to stipulate to an agreed form.

For a Chapter 11 plan to be confirmed, it must comply with certain requirements that generally protect creditors and, particularly for secured creditors, constrain the debtor's ability to cram down a plan on an impaired class that doesn't accept the plan.

One requirement effectively sets a "worst-case" floor under distributions to nonapproving creditors. For nonapproving creditors generally, if the rights of a class of claims are impaired under the plan, each holder of the class either must accept the plan or receive no less than it would have received in a Chapter 7 liquidation. A class of claims is impaired unless the plan leaves unaltered, or cures and restores, the holders' legal, equitable, and contractual rights under the claim. If this minimum distribution requirement is satisfied, a plan where each impaired class has not approved the plan may be confirmed, binding all holders under the plan, if the plan does not "discriminate unfairly," and is "fair and equitable," with respect to these classes.

In the case of a secured class, the fair and equitable test would be satisfied if the holders were to retain their liens on

their collateral, or proceeds of the sale of their collateral, and receive deferred cash payments equal to their interest in the collateral. Although realization of the secured creditors' interests in the collateral may be deferred, and payments may subject to the debtor's postbankruptcy default risk, the discounted present value of their bargained-for interest is preserved.

In the case of an unsecured class, the fair and equitable test would be satisfied if no distributions were to be made to any lower-ranking class of claims or interests. Since preexisting equity interests typically are wiped out in a reorganization plan, junior classes of unsecured debt clearly are at greatest risk of being crammed down and have little to lose by seeking a trial to determine the debtor's enterprise value, in the hope that an increase in value would benefit their class.

In Chapter 7, the debtor is dispossessed by a court appointed trustee with a mandate to dispose of property of the estate and close the proceedings as expeditiously as possible. A secured creditor's interest in its collateral may be exposed to the economic risk of a distressed disposition or of redeploying its collateral, but its recovery will not be exposed to the Chapter 11 process or the reorganization plan dynamics, in which it would have to diligently participate to protect its interests.

The Chapter 7 trustee's role effectively is to protect unsecured creditors' interests, but there is no mechanism or process for negotiating priorities or redistributing value and altering its form. As the last stop of an irrevocably failed business, Chapter 7's liquidation process is a "stop loss" process, rather than a value creation process, and unsecured creditors' recovery expectations should be realistically low.

Note: Specific references to data and statistics about large, public company bankruptcies in this article refer to studies we have conducted on Lynn M. LoPucki's Bankruptcy Research Database, at http://lopucki.law.ucla.edu/bankruptcy_research.asp.

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