

## **The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Senate Bill 256) To Usher in Changes to the Bankruptcy Code Affecting Business Reorganizations**

New York  
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### **I. Introduction**

On March 10, 2005, the United States Senate passed Senate Bill 256, also known as The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”), which is under consideration for passage by the United States House of Representatives. It is anticipated that the Act will likely be passed by the House and signed into law by President Bush without material amendment in the near future. The Act will make significant changes to the current Bankruptcy Code (the “Code”), and will generally take effect with respect to bankruptcy cases commenced 180 days after its enactment, with a few exceptions. Although the Act addresses both consumer and business bankruptcies, the changes in the consumer bankruptcy system to be wrought by the Act have received the most notoriety. However, the Act also makes changes to the Chapter 11 process that will affect business bankruptcies. This memorandum will focus on the Act’s amendments to the Code that will have the greatest effects on creditors and debtors in Chapter 11 proceedings of large businesses. This memorandum will also discuss (i) the new Chapter 15, which will replace current Section 304 of the Code, used by foreign debtors to gain recognition in the United States of foreign insolvency proceedings and (ii) provisions that clarify the treatment of certain financial contracts upon the insolvency of a counterparty.<sup>1</sup>

<sup>1</sup> Cleary Gottlieb has prepared a more detailed memorandum discussing the Act’s amendments to the Code provisions regarding financial contracts, as well as the Act’s corresponding amendments to the Securities Investor Protection Act, the Federal Deposit Insurance Act, the Federal Deposit Insurance Corporation Improvement Act of 1991 and the Federal Credit Union Act. To obtain this memorandum, please contact Zygmunt Wyka of Cleary Gottlieb via email ([zwyka@cgsh.com](mailto:zwyka@cgsh.com)) or telephone (212-225-3745).

## II. Significant Changes Affecting Business Chapter 11 Cases

### A. Limitations on Key Employee Retention Programs

The Act amends Code § 503 (governing the allowance of administrative expenses) by significantly cutting back on the ability of a debtor to pay officers and directors retention bonuses, severance pay and certain other payments (also known as Key Employee Retention Programs or KERPs). First, the Act provides that a debtor may not make any payment to its officers or directors for the purposes of inducing such person to remain with the debtor, *unless* the court finds that (i) the payment is “essential” to the retention of the person, because the person has a bona fide job offer from another business at the same or greater level of pay; (ii) the services of the person are “essential” to the survival of the business; and (iii) either (a) the payment is not greater than 10 times the amount of the mean transfer given to non-management employees for any purpose during the same calendar year or (b) if no such transfer described in (a) was made, the payment is not greater than 25% of any similar transfer made to such officer or director for any purpose during the previous calendar year. Second, the Act provides that severance payments to officers and directors may not be made, *unless* the payment is part of a program generally available to all full-time employees and such severance pay is not greater than 10 times the amount of the mean severance pay given to non-management employees during the same calendar year. Finally, the Act prohibits debtors from making any payments outside the ordinary course of its business to any officers, managers or consultants hired after the petition date that are not justified by the facts and circumstances of the case. This provision is presumably aimed at limiting compensation to firms that specialize in restructuring work-outs and often install employees at the management level of a debtor.

### B. Exclusivity Period for Debtors

The Act places limitations on a court’s ability to extend a debtor in possession’s exclusive right to file a plan of reorganization under Code § 1121 beyond the prescribed 120-day period commencing on the petition date. Whereas the Code currently allows a court to extend the exclusivity period indefinitely “for cause,” the Act provides that a court may not extend the exclusive period (i) for filing a plan by more than 18 months after the petition date and (ii) for solicitation of a plan by more than 20 months after the petition date.

### C. Executory Contracts and Unexpired Leases

The Act modifies Code § 365(d)(4)’s limitations regarding the timing for the assumption or rejection by a debtor of leases of nonresidential real property. Notably, Code § 365(d)(4), as modified by the Act, provides that if the debtor does not assume or reject a lease of nonresidential real property within the earlier of 120 days after the commencement of the bankruptcy case or the date of entry of an order confirming a plan, the lease will be

deemed rejected and the debtor will be required to surrender possession to the lessor. The court can grant a 90-day extension (for a maximum total of 210 days from the petition date) if the debtor shows cause, but can only extend the period beyond that 90 days if the lessor agrees to the extension in writing. This change will be very significant in cases involving retail chains or other businesses where nonresidential leased locations are material to the operation of the business or are a major asset.

**D. Debtor’s Retention of its Investment Bank as Financial Advisor**

The Act redefines “disinterested person” under Code § 101(14) to repeal proscriptions that currently disqualify a debtor’s pre-bankruptcy investment banker under Code § 327(a) (and its attendant attorney advisers) from continuing advisory services as part of the debtor’s bankruptcy proceedings. Thus, upon effectiveness of the Act, a debtor’s pre-bankruptcy investment banker will no longer be automatically disqualified from being retained as the debtor’s financial advisor in bankruptcy if it has underwritten securities of the debtor. However, in order to be retained, an investment bank or financial advisor must still not be a creditor or equity holder of the debtor and must not have any interest materially adverse to the interest of the debtors’ estate or any class of creditors or equity holders.

**E. Pre-Packaged Bankruptcies**

The Act makes two significant changes primarily affecting so-called “pre-packaged” bankruptcies, where a debtor normally solicits and obtains consents to a plan prior to filing its bankruptcy petition. First, the Act provides that a debtor can, after notice and a hearing, request that the bankruptcy court order that a meeting of creditors (mandated under Code § 341) not be convened, where the debtor has solicited consents on a plan prior to the commencement of the bankruptcy case. Second, the Act amends Code § 1125 (governing post-petition disclosure and solicitation of votes on a plan) by providing that debtors can, in fact, solicit creditors prior to commencing a bankruptcy case without a court approved disclosure statement, so long as such solicitation is performed in accordance with non-bankruptcy law (such as the securities laws). This appears to simply be a clarification and bolstering of Code § 1126(b) (governing acceptances of a plan), which already contemplates that solicitations prior to commencement of a case shall be performed in accordance with non-bankruptcy law.

**F. Modifications to the Automatic Stay**

The Act modifies Code § 362’s automatic stay to, among other things, except from the stay the commencement or continuation of investigations or actions by “securities self regulatory organizations” (which are defined as securities associations registered with the SEC or a national securities exchange) to enforce such organizations’ regulatory power, including enforcement of any of such organizations’ orders (other than for monetary

sanctions) or any act to delist, delete or refuse to permit quotation of any stock that does not meet applicable regulatory requirements.

Additionally, the Act further limits the stay by clarifying that the commencement or continuation of proceedings before the United States Tax Court against a debtor shall only be stayed with respect to taxable periods relating to such proceedings ending prior to the petition date. Finally, the Act grants taxing authorities the ability to set-off (as permitted under non-bankruptcy law) any debtor's tax refund against amounts owed to such taxing authorities by the debtor, each with respect to taxable periods ending prior to the petition date. If there is a pending action to determine the debtor's tax liability, then the taxing authority may hold the refund until resolution of the action, unless the court otherwise grants the taxing authority adequate protection.

### **G. Preferences and Fraudulent Conveyances**

As to preferences, the Act alters the requirements to prove an "ordinary course" defense to a debtor's preference claims under Code § 547(c)(2), by providing that a transferee show that (i) the transfer was made in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee and (ii) either (a) the transfer was made in the ordinary course of the debtor and transferee or (b) the transfer was made according to ordinary business terms. This change relaxes the showing required to establish the "ordinary course" defense by requiring that a transferee prove either (a) (which looks to the established course of conduct between the parties) or (b) (which looks to industry practices), rather than both, which is required under the current version of Code § 547(c)(2). The Act also excepts, in the case of business bankruptcies, transfers made by the debtor having a value of less than \$5,000.

As to fraudulent transfers, the Act increases the look-back period from one year to two years under Code § 548 (governing fraudulent transfers) prior to the date of commencement of the case. Thus, under new Code § 548, the debtor or trustee will be able to sue for any transfers it made in the two-year period prior to the petition date. This amendment will apply only to cases commenced more than one year after the date of enactment.<sup>2</sup> Additionally, the Act expands the criteria for fraudulent transfers to include payments made to an insider under an employment contract, outside of the debtor's ordinary course of business, where the debtor did not receive reasonably equivalent value in exchange for the payment. This amendment will apply to cases commenced immediately on or after the date of enactment.

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<sup>2</sup> It should be noted that these changes do not alter any applicable state law fraudulent conveyance statutes (where the look-back period is usually greater than two years), which can be applied by the debtor or trustee against a transferee pursuant to Code § 544.

## **H. Expanded Grounds for Dismissal/Conversion of a Case**

The Act expands the grounds upon which a party-in-interest can request conversion or dismissal of a chapter 11 case under Code § 1112. Under the Act, a court is directed to dismiss/convert a case if a movant establishes “cause,” unless the court finds unusual circumstances that establish that a conversion/dismissal is not in the best interests of creditors and the estate. The Act defines what constitutes “cause” to include, among other things, the following: gross mismanagement, loss to or diminution in value of the estate, failure to comply with a court order, unauthorized use of cash collateral, unexcused failure to timely satisfy any filing or reporting requirement under the Code, failure to timely pay post-petition taxes, failure to file or confirm a plan within the exclusivity periods described above and default or inability to substantially consummate a plan. However, under the Act, the court shall not convert/dismiss if (i) the debtor or another party-in-interest objects and establishes that (a) there is a reasonable likelihood that a plan will be confirmed within the exclusivity time periods or a reasonable time and (b) the grounds for granting dismissal/conversion include an act or omission on the part of the debtor for which there is a reasonable justification and which can timely be cured and (ii) the court finds that no unusual circumstances exist establishing that conversion/dismissal is in the best interests of the estate and creditors. Moreover, the court must hold a hearing on a conversion/dismissal motion no later than 30 days after the filing of the motion to convert/dismiss and must render a decision no later than 15 days after such hearing.

## **I. Certain Tax Provisions**

The Act makes certain changes to the treatment of tax claims in bankruptcy. The most notable changes are:

1. The Act clarifies that the rate of interest payable on tax claims is to be determined by non-bankruptcy law. This provision (to be added as Code § 551) appears to overturn prior court precedent that interpreted the Code as requiring application of a market rate of interest to tax claims, by mandating application of the interest rates specified by the IRS and other state taxing authorities.
2. The Act also limits the ability of a debtor in a plan to provide for deferred payments to taxing authorities, based on allowed tax claims. First, the Act alters the period in which debtors can incrementally extend payment of allowed tax claims under Code § 1129(a)(9) from six years after the date of the assessment of the claim to no more than five years from the petition date. Second, the Act requires that allowed tax claims be treated no less favorably than the most favorably treated unsecured, non-priority claim (other than a convenience class, normally consisting of nominal unsecured claims under Code §1122(b)). Third, the Act clarifies that secured tax

claims otherwise qualifying as priority tax claims are not to be treated as secured claims, but rather are to be treated in the same manner as other priority tax claims under revised Code § 1129(a)(9).

3. Finally, the Act places strict mandates on a debtor to file its tax returns in a timely manner. First, the Act supplements Code § 521 (governing the duties of a debtor) by providing that if a debtor fails to file a tax return (or obtain an extension) that becomes due after the commencement of the case, the taxing authority to whom such return is due may request conversion/dismissal of the case. Second, if the debtor does not file the return or obtain an extension within 90 days of a taxing authority making such a motion, the court must convert or dismiss the case, whichever is in the best interests of creditors.

### **III. New Chapter 15: Obtaining Recognition of Foreign Bankruptcy Proceedings**

The Act codifies a comprehensive framework for foreign debtors seeking recognition of foreign bankruptcy proceedings in the United States and for the cooperation and deference that U.S. bankruptcy courts are to afford foreign courts in dealing with increasingly complex transnational bankruptcy proceedings. To this end, Code § 304, which currently governs recognition of foreign proceedings by U.S. bankruptcy courts, will be repealed by the Act and replaced by Chapter 15. The genesis for Chapter 15 is the Model Law on Cross-Border Insolvency, promulgated by the United Nations Commission for International Trade Law (commonly referred to as “UNCITRAL”). Chapter 15 incorporates and tracks the Model Law with various changes and additions to conform to existing provisions of the Code, which will govern the initiation and conduct of ancillary proceedings in substitution for the provisions contained in Code § 304.

#### **A. Commencement of a Chapter 15 Proceeding and Obtaining Immediate Interim Relief**

Section 1515 of Chapter 15 provides that in order to commence a proceeding for recognition in the United States of a foreign proceeding,<sup>3</sup> a foreign representative (defined

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<sup>3</sup> It should be noted that the definition of “foreign proceeding” under Chapter 15 is more limiting than it was under prior bankruptcy law. The most important difference in the definition of “foreign proceeding” under Chapter 15 is the requirement that in such proceeding, “the assets and affairs of the debtor are subject to control or supervision by a foreign court.”

The Act also makes a distinction between a “foreign main proceeding” and a “foreign nonmain proceeding.” A foreign main proceeding is a foreign proceeding pending in the country where the foreign debtor has its main place of business, which is presumed to be where the debtor’s registered office is located, whereas a foreign nonmain proceeding is a foreign proceeding that is not a foreign main proceeding where the debtor carries out a non-transitory economic activity. It appears that the

as a person or body appointed and authorized in the foreign proceeding to administer the reorganization or act as representative of such foreign proceeding) of the foreign debtor<sup>4</sup> shall file a petition accompanied by (i) a decision commencing such foreign proceeding and appointing the foreign representative; (ii) a certificate from the foreign court affirming the existence of the proceeding and appointment of the foreign representative; or (iii) in the absence of (i) or (ii), any other evidence satisfactory to the U.S. bankruptcy court of the existence of the foreign proceeding and appointment of the foreign representative. Upon the filing of the petition and the information described in the previous sentence, but before the U.S. bankruptcy court rules on such petition, the U.S. bankruptcy court can grant provisional relief, if the debtor can show that such “relief is urgently needed to protect the assets of the debtor or the interests of the creditors” based on the same standards for U.S. courts to grant injunctive relief, such as a temporary restraining order or preliminary injunction. Such provisional relief includes, among other things, a stay against creditors’ execution against the foreign debtor’s assets, entrusting the administration of the foreign debtor’s assets to the foreign representative, suspending the right to dispose of the foreign debtor’s assets and any other relief that may be available to a U.S. bankruptcy trustee (save certain provisions regarding avoidance actions).

## **B. Obtaining Recognition and Relief**

After filing the petition as described above, the U.S. bankruptcy court will enter an order under § 1517 recognizing the foreign proceeding after a notice and hearing (which shall occur at the earliest possible time), so long as (i) the foreign proceeding is main or nonmain; (ii) the foreign representative is a person or body; and (iii) the petition meets the requirements set forth in § 1515 (described above).<sup>5</sup> The decision to grant recognition is not dependent upon any findings about the nature of the foreign proceedings of the sort

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U.S. bankruptcy court granting recognition of a foreign proceeding will make its own determination of whether a foreign proceeding is main or nonmain.

<sup>4</sup> It should be noted that Chapter 15 makes clear that foreign banks that have a branch or agency in the United States are not eligible for Chapter 15 relief (an issue, as it relates to Code § 304, that is currently being considered on appeal in the Second Circuit). This exclusion is presumably intended to protect the interests of federal and state bank regulatory authorities concerning the closure and liquidation of the U.S. offices of foreign banking entities and to forestall displacement of the insolvency processes established under state and federal banking statutes to liquidate locally licensed offices of foreign banks. This will not affect the ability of a foreign bank that does not have a branch or agency in the United States to commence a case under Chapter 15.

<sup>5</sup> Section 1517(a) requires recognition of a foreign proceeding if the foreign proceeding and foreign representative meet these requirements. However, § 1517 is expressly made subject to § 1506, which provides a U.S. bankruptcy court with the ability to deny recognition where such action “would be manifestly contrary to the public policy of the United States.”

previously mandated by Code § 304(c) (discussed below). However, the granting of recognition can be denied if such action “would be manifestly contrary to the public policy of the United States.” The requirements of § 1517 (which incorporate the definitions of § 1502 and “foreign proceeding” and “foreign representative”) are all that must be fulfilled in order to attain recognition.<sup>6</sup> The order granting relief can be modified or terminated if it can be shown that the grounds for granting relief have changed or no longer exist. Furthermore, the foreign representative is charged with keeping the U.S. bankruptcy court granting recognition apprised of any substantial change in the status of the foreign proceeding.

### **C. Relief Available under Chapter 15**

The relief granted by an order granting recognition of a foreign proceeding (whether main or nonmain) under § 1521 must be necessary to effectuate the purpose of Chapter 15 and to protect the assets of the debtor or interests of creditors and includes, among other things: (i) staying the commencement or continuation of actions concerning the debtor’s assets, rights, obligations or liabilities; (ii) staying execution against the debtor’s assets; (iii) suspending the right to transfer the debtor’s assets; (iv) providing for the examination of witnesses or taking of evidence; (v) entrusting the administration of the debtor’s assets to the foreign representative; and (vi) any additional relief available to a trustee under the Code (save certain avoidance actions). Again, the standards used for granting the foregoing relief are the same as those applied to the granting of injunctive relief. One type of ultimate relief available in an ancillary case, the turnover of property to the foreign representative, shall only be permitted where the court is satisfied that the interests of creditors in the United States are sufficiently protected. It should also be noted that in granting relief under Chapter 15, a U.S. court may not stay the exercise of various rights in respect of specified financial market transactions, excepted from the automatic stay under Code §§ 362(b)(6) (securities contracts, forward contracts and commodity contracts), (7) (repurchase agreements), (17) (swap agreements) or (27) (master netting agreements).

### **D. Effects of Granting Recognition**

Upon the granting of recognition under Chapter 15, subject to any limitations imposed by the U.S. bankruptcy court, the foreign representative can sue or be sued in U.S. courts and the foreign representative can apply for any appropriate relief from U.S. courts, including a request for comity or cooperation. Furthermore, upon recognition of a foreign

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<sup>6</sup> Although these are the only requirements appearing on the face of § 1517 needed to obtain recognition, it should be noted that in order to obtain relief under § 1521 (discussed in Section III.C. herein), a U.S. bankruptcy court must find that the interests of creditors and other interested entities, including the debtor, are sufficiently protected.

main proceeding, certain other sections of the Code will apply to the debtor and any U.S. assets of the foreign debtor, including, among other sections Code § 362 imposing the automatic stay, Code § 361 requiring adequate protection of the interests of secured creditors and Code § 363 limiting the use, sale or lease of the debtor's property. To achieve any U.S. bankruptcy court jurisdictional effects on property of the foreign debtor which is not within the territorial jurisdiction of the United States, the foreign representative would have to commence a case under another chapter of the Code (which is permitted upon recognition under § 1511 if the foreign debtor has assets in the United States).<sup>7</sup> This jurisdiction, however, is limited to assets that are not subject to the jurisdiction and control of a foreign proceeding recognized under Chapter 15.

#### **E. Obtaining “Additional Assistance” under Chapter 15**

U.S. bankruptcy courts also have the ability to grant “additional assistance” to foreign representatives under Chapter 15 upon the granting of recognition under § 1517. While Chapter 15 does not make clear the meaning of “additional assistance,” commentators have suggested that its inclusion in Chapter 15 will enable U.S. bankruptcy courts to fashion relief for foreign debtors beyond that specifically permitted under §§ 1519-1521 (described above) and as is currently available pursuant to Code § 304 (which many courts have interpreted as permitting them to mold relief in “near blank check fashion”). This preserves the ability of U.S. bankruptcy courts to use the case law decided under § 304 to fashion relief, where relief was granted relief beyond what would otherwise be available under §§ 1519-1521.

Under Chapter 15, such “additional assistance” shall be granted by U.S. bankruptcy courts where such additional assistance, consistent with the principals of comity, will reasonably assure: (i) just treatment of holders of claims against the debtor; (ii) protection of U.S. holders of claims against prejudice and inconvenience in the processing of such holders' claims; (iii) prevention of preferential or fraudulent transfers; (iv) distributions substantially in accordance with the order prescribed by the Code; and (v) provision of a fresh start for individual debtors. The foregoing factors are essentially the same used by U.S. courts under current Code § 304 to determine whether to grant recognition to a foreign proceeding in the first instance. Section 1517 is intended to permit the further development of international cooperation begun under Code § 304.

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<sup>7</sup> A U.S. bankruptcy court may continue to use current Code § 305 to dismiss or suspend a Chapter 11 or 7 case involving a foreign debtor (whether voluntary or involuntary) as part of such court's coordination and cooperation with foreign proceedings and where the purposes of Chapter 15 will best be served by such dismissal or suspension.

#### IV. Amendments to the Financial Contract Provisions of the Code

Certain provisions of the Act are intended to clarify the treatment of certain financial contracts upon the insolvency of a counterparty and to promote a reduction of systemic risk. In order to accomplish these goals, the Act amends the Code and certain other federal statutes.

The Act expands the Code’s definitions of “forward contract”, “repurchase agreement”, “swap agreement”, “commodity contract” and “securities contract” to account for relevant market developments and the phrase “or any other similar agreement” is also added to the definitions of “forward contract”, “repurchase agreement”, “commodity contract” and “securities contract” (and the phrase already in the definition of “swap agreement” is expanded) to make the definitions flexible mechanisms that would include existing similar agreements and new types of transactions developed over time.

The Act similarly expands the counterparties eligible for securities, forward and commodity contract protections. Most notably, the Act creates protections for “financial participants”, which are defined to include clearing organizations (as that term is defined in Section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991) and entities engaged in a certain minimum gross dollar value of enumerated transactions.<sup>8</sup>

In addition, the Act adds Code § 561, which provides for bilateral “cross-product” netting across “forward contracts”, “repurchase agreements”, “swap agreements”, “commodity contracts” and “securities contracts”, as well as by “master netting agreement participants” under “master netting agreements.” “Master netting agreement” is defined as “an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or closeout, under or in connection” with a securities contract, forward contract, commodity contract, repurchase agreement or swap agreement. “Master netting agreement participant” is defined as “an entity that, at any time before the filing of the petition, is a party to an outstanding master netting agreement with the debtor.”

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<sup>8</sup> To qualify as a “financial participant” based on transaction size, an entity must, at the time that it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract with the debtor, or at the time of the filing of the petition, have one or more “securities contracts”, “commodity contracts”, “forward contracts”, “repurchase agreements”, “swap agreements” or “master netting agreements” with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than \$1,000,000,000 in notional or actual principal amount outstanding on any day during the previous 15-month period, or have gross mark-to-market positions of not less than \$100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) on any day during the previous 15-month period.

The Act also provides that the Code provisions relating to securities contracts, forward contracts, commodity contracts, repurchase agreements, swap agreements or master netting agreements apply in a case under new Chapter 15 (discussed in Section III above).

The Act clarifies the damage measure in connection with a debtor's rejection of securities contracts, forward contracts, commodity contracts, repurchase agreements, swap agreements or master netting agreements by adding new Code § 562, which generally provides that damages will be measured as of the earlier of the date of rejection or the date or dates of any liquidation, termination or acceleration.

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The foregoing is only a summary of some of the more significant changes that will be made by the Act that will affect debtors and creditors in the Chapter 11 proceedings of large businesses. Please contact Zygmunt Wyka of Cleary Gottlieb via email ([zwyka@cgsh.com](mailto:zwyka@cgsh.com)) or telephone (212-225-3745) for a complete copy of the Act. If you have any questions regarding the Act, please contact:

Regarding Sections II and III of this Memorandum:

Thomas J. Moloney  
Tel.: 212-225-2460  
Email: [tmoloney@cgsh.com](mailto:tmoloney@cgsh.com)

Deborah M. Buell  
Tel.: 212-225-2770  
Email: [dbuell@cgsh.com](mailto:dbuell@cgsh.com)

Lindsee P. Granfield  
Tel.: 212-225-2738  
Email: [lgranfield@cgsh.com](mailto:lgranfield@cgsh.com)

James L. Bromley  
Tel.: 212-225-2264  
Email: [jbromley@cgsh.com](mailto:jbromley@cgsh.com)

Regarding Section IV of this Memorandum:

Seth Grosshandler  
Tel.: 212-225-2542  
Email: [sgrosshandler@cgsh.com](mailto:sgrosshandler@cgsh.com)

Sandra Rocks  
Tel.: 212-225-2780  
Email: [srocks@cgsh.com](mailto:srocks@cgsh.com)

Penelope Christophorou  
Tel.: 212-225-2516  
Email: [pchristophorou@cgsh.com](mailto:pchristophorou@cgsh.com)

Joseph Lamport  
Tel.: 212-225-2306  
Email: [jlamport@cgsh.com](mailto:jlamport@cgsh.com)

David Aman  
Tel: 212-225-2262  
Email: [daman@cgsh.com](mailto:daman@cgsh.com)

Pierre-Hughes Verdier  
Tel: 212-225-2264  
Email: [pverdier@cgsh.com](mailto:pverdier@cgsh.com)

Malda Hibri  
Tel: 212-225-2296  
Email: [mhibri@cgsh.com](mailto:mhibri@cgsh.com)

Gary Silber  
Tel: 212-225-2097  
Email: [gsilber@cgsh.com](mailto:gsilber@cgsh.com)

CLEARY GOTTLIEB STEEN & HAMILTON LLP

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*Office Locations*

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**NEW YORK**

One Liberty Plaza  
New York, NY 10006-1470  
1.212.225.2000  
1.212.225.3999 Fax

**WASHINGTON**

2000 Pennsylvania Avenue, NW  
Washington, DC 20006-1801  
1.202.974.1500  
1.202.974.1999 Fax

**PARIS**

41, Avenue de Friedland  
75008 Paris, France  
33.1.40.74.68.00  
33.1.45.63.66.37 Fax

**BRUSSELS**

Rue de la Loi 57  
1040 Brussels, Belgium  
32.2.287.2000  
32.2.231.1661 Fax

**LONDON**

City Place House  
55 Basinghall Street  
London EC2V 5EH, England  
44.20.7614.2200  
44.20.7600.1698 Fax

**MOSCOW**

Cleary Gottlieb Steen & Hamilton LLP  
CGS&H Limited Liability Company  
Paveletskaya Square 2/3  
Moscow, Russia 115054  
7.501.258.5006  
7.501.258.5011 Fax

**FRANKFURT**

Main Tower  
Neue Mainzer Strasse 52  
60311 Frankfurt am Main, Germany  
49.69.97103.0  
49.69.97103.199 Fax

**COLOGNE**

Theodor-Heuss-Ring 9  
50668 Cologne, Germany  
49.221.80040.0  
49.221.80040.199 Fax

**ROME**

Piazza di Spagna 15  
00187 Rome, Italy  
39.06.695.221  
39.06.69.20.06.65 Fax

**MILAN**

Via San Paolo 7  
20121 Milan, Italy  
39.02.72.60.81  
39.02.86.98.44.40 Fax

**HONG KONG**

Bank of China Tower  
One Garden Road  
Hong Kong  
852.2521.4122  
852.2845.9026 Fax

**TOKYO**

Cleary Gottlieb Steen & Hamilton LLP  
CGSH Law Offices  
Registered Association  
20th Floor Shin Kasumigaseki Building  
3-2, Kasumigaseki 3-chome  
Chiyoda-ku, Tokyo 100-0013, Japan  
81.3.3595.3911  
81.3.3595.3910 Fax