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End of the Texas Two-Step? Impressions on *LTL* and *Aero*

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OVERVIEW OF DIVISIONAL MERGERS

Overview – Operation and Rationale

Operation of Divisional Merger Statutes

- Statutes provide a mechanism for a business entity to divide into:
 - Two or more new entities, with no surviving entity; or
 - A surviving entity and one or more new entities
- Assets and liabilities of the dividing entity are allocated among the new entities or among the surviving entity and the new entity or entities, as provided in a written plan

Rationale for Division Statutes

- Facilitation of business objectives
- Provide more efficient means to effect internal restructurings

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Overview – Inefficiencies Addressed

- Divisional merger statutes permit internal restructurings to be accomplished more efficiently by operation of law
- Consent to assignment requirements can be avoided
 - Divisional merger statutes provide that, as a matter of state law, the allocation of assets does not involve a transfer or assignment
- Divisional mergers can be used to isolate and address contingent liabilities
 - Under common law principles, an entity that assigns its obligations to another entity remains contingently liable for those obligations
 - Divisional merger statutes provide for the allocation of obligations to a new entity with no other entity having liability for them
- Divisional mergers are subject to fraudulent conveyance and similar laws

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Overview – State Division Statutes

State	Statutory Reference	Year of Initial Enactment
Arizona	Arizona Entity Restructuring Act § 29-2601, <i>et seq.</i>	2015
Delaware	Delaware Limited Liability Company Act § 18-217, <i>et seq.</i>	2018
Kansas	Kansas Revised Limited Liability Company Act § 17-7685a, <i>et seq.</i>	2019
Pennsylvania	Pennsylvania Entity Transaction Law § 361, <i>et seq.</i>	1988
Texas	Texas Business Organizations Code § 10.001, <i>et seq.</i>	1989

TEXAS DIVISIONAL MERGERS

BACKGROUND ON TEXAS DIVISIONAL MERGERS

- The Texas divisional merger statute, contained in the Texas Business Organizations Code (TBOC), permits a single entity to divide itself into either two or more new entities or a surviving entity and one or more new entities (TBOC, § 1.002(55)(A))
- A plan of merger specifies how the assets and liabilities of the original entity will be allocated among the surviving/new entities (TBOC, § 10.003)
- If the original entity divides itself into two or more new entities, the separate existence of the original entity ceases (TBOC, § 10.008(a)(1))

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EFFECT OF TEXAS DIVISIONAL MERGER

- All title to the property of the original entity is allocated to and vested in the surviving/new entities as provided in the plan of merger without any transfer having occurred (TBOC, § 10.008(a)(2))
- All liabilities of the original entity are allocated to the surviving/new entities in the manner provided in the plan of merger (TBOC, § 10.008(a)(3))
- If the original entity divides itself into two or more new entities, no new entity will be liable for the obligations allocated to another new entity in the plan of merger (TBOC, § 10.008(a)(4))
- If the original entity divides itself into a surviving entity and one or more new entities, no new entity will be liable for the obligations allocated to the surviving entity or another new entity, but the surviving entity will continue to be secondarily liable for obligations allocated to a new entity (TBOC, § 10.008(a)(4))

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DIVISIONAL MERGER RESTRUCTURING CONSIDERATIONS

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USE OF DIVISIONAL MERGERS TO ISOLATE LIABILITIES

- Pursuant to a plan of merger, assets and liabilities of original company would be allocated between two entities, as appropriate
- As a result, liabilities can be isolated in a separate entity within the corporate enterprise
 - Companies may obtain a solvency opinion to mitigate fraudulent conveyance risk and support a defense against a later fraudulent conveyance claim

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USE OF DIVISIONAL MERGERS AS STEP TO RESTRUCTURE LIABILITIES

- Pursuant to a plan of merger, assets and liabilities of original company would be allocated between two new entities, as appropriate
- New entity to which relevant liabilities are allocated could then file for bankruptcy protection, if necessary, with the other new entity created by divisional merger process remaining outside the bankruptcy process
 - In an effort to mitigate fraudulent conveyance risk and provide a defense against a potential fraudulent conveyance claim, the entity remaining outside the bankruptcy process could provide a keepwell/funding agreement to backstop the filing entity's obligation

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FRAUDULENT CONVEYANCE CHALLENGE

Fraudulent Transfer Claims

Creditors may seek to unwind the divisional merger as a fraudulent transfer

- **Constructive Fraudulent Transfer**
 - (a) the debtor received less than reasonably equivalent value in return for the transfer; and
 - (b) the debtor was insolvent, or became insolvent, at the time of the transfer
- **Intentional Fraudulent Transfer**
 - Transfer made with actual intent to hinder, delay, or defraud creditors
 - Courts look for presence of “badges” or “indicia” of fraud

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FRAUDULENT CONVEYANCE CHALLENGE

Fraudulent Transfer Claims

- After obtaining court orders granting derivative standing, complaints asserting counts for both intentional and constructive fraudulent conveyance filed by claimant representatives, and remain pending, in Aldrich/Murray and DBMP cases
 - *See Official Comm. of Asbestos Personal Injury Claimants v. Ingersoll-Rand Glob. Holding Co. Ltd. (In re Aldrich Pump LLC)*, Adv. No. 22-03028 (JCW), Adv. Dkt. 1 (Bankr. W.D.N.C. June 18, 2022)
 - *Official Comm. of Asbestos Personal Injury Claimants v. CertainTeed LLC (In re DBMP LLC)*, Adv. No. 22-03000 (JCW), Adv. Dkt. 14 (Bankr. W.D.N.C. Feb. 10, 2022)
- Talc claimants' committee has sought derivative standing to assert, among others, actual and constructive fraudulent transfer claims in second LTL case; claims focus on termination of funding agreement before second filing and, alternatively, original divisional merger
 - *In re LTL Mgmt. LLC*, No. 23-12825 (MBK) (Bankr. D.N.J. May 11, 2023), Dkt. 489
 - A hearing has not yet been scheduled

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SUBSTANTIVE CONSOLIDATION CHALLENGE

Substantive Consolidation

- Creditors may seek to effectively reverse the divisional merger by pursuing substantive consolidation of the divided entities
 - Complaints asserting count for substantive consolidation of debtor with non-debtor affiliate filed and remain pending in Aldrich/Murray and DBMP cases
 - *Official Comm. of Asbestos Personal Injury Claimants v. Aldrich Pump LLC, Murray Boiler LLC, Trane Technologies Company LLC, and Trane U.S. Inc. (In re Aldrich Pump LLC)*, Adv. No. 21-03029 (JCW), Adv. Dkt. 1 (Bankr. W.D.N.C. Oct. 18, 2021)
 - *Official Comm. of Asbestos Personal Injury Claimants v. DBMP LLC (In re DBMP LLC)*, Adv. No. 21-03023 (JCW), Adv. Dkt. 1 (Bankr. W.D.N.C. Aug. 23, 2021)
 - Derivative standing not required for this cause of action

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OTHER CHALLENGES TO DIVISIONAL MERGERS

Attempt to Abridge Creditor Rights

Plastronics Socket Partners, Ltd. and Plastronics H-Pin, Ltd. v. Dong Weon Hwang, Hicon Co., Ltd. and Hicon Company, No. 20-1739, Dkt. No. 76 (Fed. Cir. Jan. 12, 2022)

- Plastronics used Texas divisional merger to reduce royalty payments under licensing agreement
- Court found that, while TBOC allows for the allocation of rights and obligations, the statute expressly provides that it does not abridge the rights of creditors under other existing laws
- Under contract law, the assignment of contract rights in a merger cannot adversely affect the rights of counterparties, who are free to enforce those rights

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POTENTIAL BANKRUPTCY ISSUES

Bad Faith Filing Challenge

LTL Management, No. 21-30589 (Bankr. D.N.J. Oct. 14, 2021)

- Chapter 11 case filed after an internal corporate restructuring of Johnson & Johnson Consumer Inc. using a Texas divisional merger
- The talc claimants' committee and certain plaintiffs' firms filed motions to dismiss asserting that
 - The case should be dismissed under section 1112(b) as a bad faith filing because, among other reasons, LTL was not in financial distress and the case was filed as a litigation tactic
 - The case was a bad faith effort to shield LTL and J&J from liability, cap plaintiff recoveries, and eliminate plaintiffs' right to a jury trial

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

LTL Management – continued

- The bankruptcy court denied the motions, finding no bad faith and that:
 - Filing chapter 11 for the express aim of addressing present and future talc claims is a proper bankruptcy purpose
 - LTL and its predecessor were in financial distress as a result of the talc litigation
 - LTL did not undertake the restructuring and bankruptcy filing solely to gain a litigation advantage
 - Use of the Texas divisional merger statute to facilitate a chapter 11 filing is not unlawful or improper
 - Continued litigation in state and federal courts is not in the best interests of personal injury claimants

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

LTL Management – continued

- The bankruptcy court certified the order for direct appeal to the Third Circuit
- Third Circuit accepted the appeal, reversed the bankruptcy court, and ordered the chapter 11 case to be dismissed
 - Recognized that LTL “inherited massive liabilities” and faced “thousands” of future claims
 - But found that LTL was not in financial distress due to the funding agreement, which included a J&J backstop, because “LTL did not have any likely need in the present or the near-term, or even the long-term, to exhaust its funding rights to pay talc liabilities”
 - Determined that, absent financial distress, filing was not in good faith and the case had to be dismissed

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

LTL Management – continued

- Following dismissal, LTL filed a new chapter 11 case **No. 23-12825 (Bankr. D.N.J. Apr. 4, 2023)**
 - The filing was accompanied by plan support agreements with certain plaintiff firms
 - Plan proposes to fund a trust with \$8.9 billion
 - LTL, its direct parent, and J&J terminated the initial funding agreement and, in substitution therefor, entered into a new funding agreement and support agreement prior to filing
- Talc claimants' committee, certain plaintiff law firms, the U.S. Trustee, and state attorney generals have moved to dismiss
 - The motions assert that LTL is still not in financial distress, claimant support is illusory, and filing is otherwise in bad faith
 - Movants also contend that changes in LTL's financing represent the largest fraudulent transfer in U.S. history

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Bestwall LLC, No. 17-31795 (Bankr. W.D.N.C. Nov. 2, 2017)

- Chapter 11 case filed after internal corporate restructuring of Georgia-Pacific using a Texas divisional merger
- Asbestos claimants' committee filed motion to dismiss case as a bad faith filing
 - Arguments were similar to those advanced by talc committee in LTL
 - Bankruptcy court denied motion; appeal is pending in District Court
- Recently, certain claimants and asbestos claimants' committee filed new motions to dismiss the case
 - Motions rely on Third Circuit's opinion in *LTL* and, in the case of the committee, "Constitutional" subject matter jurisdiction arguments based on the Bankruptcy Clause
 - Hearing conducted May 17, 2023; ruling expected July 28, 2023

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Aldrich Pump LLC and Murray Boiler LLC, No. 20-30608 **(Bankr. W.D.N.C. June 18, 2020)**

- Chapter 11 cases filed after internal corporate restructurings of Ingersoll-Rand Company and Trane U.S. Inc. using Texas divisional mergers
- Asbestos claimants' committee and certain claimants have recently filed motions to dismiss these cases
 - Arguments are similar to those advanced in both Bestwall and LTL
 - Motions are scheduled to be heard in July 2023

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Aearo Technologies LLC, No. 22-02890 (Bankr. S.D. Ind. **July 26, 2022)**

- Chapter 11 cases filed by 3M subsidiaries to resolve lawsuits regarding liability from allegedly defective Combat Arms Earplugs and certain other personal injury claims
- The Combat Arms Earplugs Committee, the Respirator Committee, the U.S. Trustee, and certain plaintiffs' law firms moved to dismiss
 - The motions rely on the Third Circuit's *LTL* decision and Seventh Circuit law, and contend debtors are not in financial distress, the cases were a litigation tactic, and there is not a reasonable likelihood of reorganization
 - The bankruptcy court held a five-day trial in April 2023; ruling is pending

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Extension of Automatic Stay/Preliminary Injunction

LTL Management

- In its first case, LTL filed a motion to extend the automatic stay and issue a preliminary injunction staying all personal injury litigation against LTL, non-debtor Johnson & Johnson, other affiliates, retailers, and insurance companies
 - Relief was sought to ensure global resolution of all talc claims in the bankruptcy case
 - Over objections, the bankruptcy court granted the motion and later certified its order for direct appeal to the Third Circuit
 - Given ordered dismissal of chapter 11 case, Third Circuit did not address automatic stay/injunction ruling

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

LTL Management – continued

- In its second case, LTL again filed a motion to extend the automatic stay and issue a preliminary injunction staying all personal injury litigation against LTL, non-debtor Johnson & Johnson, and more limited list of affiliates and retailers
 - Over objections by the talc claimants' committee and certain plaintiff law firms, the court granted the motion in part
 - Court stayed and enjoined trials (and certain appeals) against protected parties; all pretrial activity was allowed to proceed
 - Injunction runs through June 15, 2023; hearing on further extension set for June 13, 2023
 - Ruling was appealed, but requests for a writ of mandamus and direct certification to the Third Circuit were denied

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Bestwall LLC

- Bestwall likewise sought and obtained a preliminary injunction in its case, preventing parties from pursuing Bestwall asbestos claims against Georgia-Pacific and other non-debtor affiliates
 - Preliminary injunction was upheld by District Court and then was appealed to Fourth Circuit by asbestos committee and future claimants' representative
 - Fourth Circuit argument conducted on Dec. 6, 2022; awaiting a ruling

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Aearo Technologies

- Aearo filed a motion for declaratory and injunctive relief to confirm the automatic stay applies to certain non-debtors and to preliminarily enjoin certain actions against non-debtors
 - After briefing and an evidentiary hearing, bankruptcy court denied preliminary injunction, finding that an injunction should only be issued in "extraordinary circumstances" and such circumstances were lacking
 - Order denying injunction was certified to Seventh Circuit
 - Seventh Circuit heard oral argument on April 4, 2023 and took the appeal under advisement

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Potential Bankruptcy Issues (CONT'D)

Venue

- Divisional merger enables companies to determine state of incorporation of new entities
- Creditors may seek to challenge and transfer venue of the case, which was successful in first LTL case

Creditor Representative Derivative Standing

- Alter-ego, veil piercing claims
- Fraudulent transfer claims
- Successor liability claims

Discovery Disputes

- Possible challenges to common interest of debtor and non-debtor affiliates
- Possible privilege challenges based on at-issue waiver or crime-fraud exception

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POTENTIAL BANKRUPTCY ISSUES (CONT'D)

Plan Issues

- Obtaining required voting approval (at least 75% for asbestos tort class)
- Voting process, including who has the right to vote
- Claims estimation
- Bar date
- Availability of non-consensual third-party releases

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Nondebtor Release Prohibition Act

- Bill sponsored by Rep. Jerrold Nadler, Chair House Judiciary Comm.; Senator Dick Durbin, Chair Senate Judiciary Comm.
- Bill, as drafted:
 - Would end the discharge of liabilities for non-debtors in bankruptcy and stop the use of “divisive mergers” as a means of assigning substantial liabilities
 - Would prohibit plans containing non-consensual third-party release of non-debtors and limit companies from utilizing bankruptcy following assignment of mass tort liabilities to newly formed subsidiaries
- Contains proposed amendment to Section 1112
 - A court should dismiss a Chapter 11 case if the debtor or its “predecessor” was subject to, “formed[,] or organized in connection with a divisional merger or equivalent transaction” which “had the intent or foreseeable effect of separating material assets from material liabilities” and “assigning or allocating all or a substantial portion of those liabilities to the debtor” during the ten-year period before the date of filing the petition

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Nondebtor Release Prohibition Act (Cont’d)

- Bill voted out of House Judiciary Committee on November 3, 2021. The bill has not yet been called for a floor vote.
- Senate Judiciary subcommittee held a consensus hearing on the bill on February 8, 2022.

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CONCLUSION

Faculty

Hon. Melanie L. Cyganowski is a partner with Otterbourg P.C. in New York and chairs its Bankruptcy practice. She joined the firm in 2008 after serving a full 14-year term as a U.S. Bankruptcy Judge for the Eastern District of New York and as its Chief Judge from 2005-08. She is currently co-counsel to the Ad Hoc Committee in *Purdue Pharma*, and was appointed as a member of a blue-ribbon committee by the Rockville Center Diocese with former Chief Bankruptcy Judge Arthur Gonzalez and former Comptroller of the City of New York Harrison J. Goldin. Judge Cyganowski's fiduciary appointments include receiver in *SEC v. Platinum Partners*; CRO and temporary operator of Brooklyn's Interfaith Medical Center; patient care ombudsman in *Randolph Hospital Inc.*, *Promise Healthcare*, *Orianna Health Systems*, *21st Century Oncology* and *California Proton*; auditor of Capital One; and various trusteeships. She also served as special master in *Vivendi* and *Neogenix Oncology*, a court-appointed expert in Orion HealthCorp, and an arbitrator/mediator in cases including *Madoff* and *Lehman*. Judge Cyganowski has testified as an expert in international cases involving U.S. bankruptcy laws. She is a Fellow in the American College of Bankruptcy, sits on the editorial advisory board of the *Norton Journal of Bankruptcy Practice & Law*, and is an adjunct professor at St. John's University School of Law in the Bankruptcy LL.M. Program. She also is active in philanthropic organizations, including Tina's Wish. Judge Cyganowski received her J.D. *magna cum laude* from the State University of New York at Buffalo School of Law in 1981.

Gregory M. Gordon is a partner with Jones Day in Dallas, where he represents clients in complex, high-profile chapter 11 cases and corporate restructurings. His experience includes out-of-court restructurings, prepackaged bankruptcies, distressed M&A transactions and cross-border insolvencies. In recent years, Mr. Gordon has assisted clients in achieving permanent resolutions of mass-tort liabilities, including asbestos and talc liabilities. He represented RadioShack in its successful chapter 11 reorganization, including in connection with a going-concern sale of a substantial portion of RadioShack's business following a contentious auction and sale hearing, and Bondex and Specialty Products in their successful § 524(g) chapter 11 reorganization, which resolved their asbestos liabilities. Mr. Gordon also represented the owners of the Vogtle nuclear plant in Westinghouse's chapter 11 case, which resulted in a full recovery on their approximately \$3.7 billion dollar claim. He is currently representing LTL Management, an affiliate of Johnson & Johnson, in a chapter 11 case it filed to resolve its talc liability, and is representing Bestwall, an affiliate of Georgia-Pacific, and DBMP, an affiliate of CertainTeed, in chapter 11 cases they filed to resolve their asbestos liabilities. Mr. Gordon is also representing Hanson Permanente Cement and Kaiser Gypsum in chapter 11 cases they filed to resolve asbestos and environmental liabilities. Other significant engagements include the successful chapter 11 reorganizations of Swift Energy, achieved in less than four months through a prepackaged plan of reorganization, and Kaiser Aluminum, which included successful restructurings of pension, retiree medical, environmental and asbestos liabilities. Mr. Gordon is a Fellow in the American College of Bankruptcy. He received A.B. *summa cum laude* and Phi Beta Kappa from Muhlenberg College in 1977 and his J.D. in 1980 from Duke University.

Hon. David S. Jones is a U.S. Bankruptcy Judge for the Southern District of New York in New York, sworn in on Feb. 19, 2021. He previously clerked for Hon. Morris E. Lasker, U.S. District Judge for the Southern District of New York, from 1990-92, and was in private practice in New York from

1992-96. From 1996 until he was appointed to the bench, Judge Jones served as an Assistant U.S. Attorney for the Southern District of New York, and at different times served as the chief of the U.S. Attorney's Office's Tax and Bankruptcy Unit, the Office's chief civil appellate attorney and as deputy chief of the Civil Division. He was awarded the Justice Department's Director's Award and the New York City Bar Association's Henry L. Stimson Medal, among other awards. Judge Jones also served as an instructor at the National Advocacy Center, and as an evaluator of U.S. Attorney's Offices throughout the nation. He received his A.B. *magna cum laude* from Brown University in 1985 and his J.D. *cum laude* from Harvard Law School in 1990.

Albert J. Togut is the senior member of Togut, Segal & Segal, LLP in New York, where he pioneered the use of conflicts counsel in mega-cases, and co-chaired ABI's Commission to Study the Reform of Chapter 11. For the past 46 years, he has specialized in bankruptcy law to the exclusion of all other areas of practice. Since Mr. Togut formed the firm in 1980, he has served as counsel to the debtor, official committee, or principal owner in some of the largest and highest-profile chapter 11 cases, including LATAM Airlines, McClatchy Newspapers, Pacific Drilling, Westinghouse, American Airlines, Kodak, Lehman Brothers Aurora, General Motors, Chrysler Automotive, Enron, Toisa Shipping, Dewey & LeBeouf, Relativity Media, Avaya, Nautilus, Ambac Financial, SunEdison, Aeropostale, A&P, Delphi Automotive, Collins & Aikman, St. Vincent's Hospitals, Charter Communications, Loehman's, Frontier Airlines, Tower Automotive, Winn-Dixie, Ames Department Stores, Loew's Cineplex, SK Global, Daewoo International (America) Corp. (which together with its Korean parent underwent the largest non-sovereign debt restructuring in history with aggregate liabilities exceeding \$70 billion), Allegiance Telecom, OnSite Access, Joan and David Helpen Inc., and ContiFinancial Corp. Since 1981, he has been an active member of the trustee panel maintained by the Department of Justice in the Southern District of New York and has served as trustee in several thousand bankruptcy cases under chapter 11 and chapter 7 of the Bankruptcy Code. Mr. Togut is registered as a mediator in the Southern District of New York and was appointed mediator for a dispute with the noteholders of Solutia that was settled for \$220.5 million. He is a Fellow of the American College of Bankruptcy, a Fellow of the International Insolvency Institute, co-chair of ABI's Commission to Study the Reform of Chapter 11, and a former ABI director and chair of its New York City Bankruptcy Conference. He also served on the ABI's fee-study commission, which has provided the most comprehensive, independent look at professional fees in chapter 11 cases to date. Mr. Togut was twice a member of the Committee on Bankruptcy and Reorganization of the Association of the Bar of the City of New York, a member of the International Bar Association, and a past president of the Bankruptcy Lawyers Bar Association of New York. In 2019, he was honored by the Lincoln Center Corporate Council for his leadership in corporate reorganizations. Mr. Togut received his B.S. from New York University in 1971 and his J.D. from St. John's University School of Law in 1974.

Paul H. Zumbro is a partner in Cravath, Swaine & Moore LLP's Corporate Department in New York and heads the firm's Financial Restructuring & Reorganization practice. His practice focuses on restructuring transactions and related financings, both in and out of court, as well as on bankruptcy M&A transactions. Mr. Zumbro recently represented PG&E in one of the largest and most complex bankruptcy cases in U.S. history to fairly and efficiently resolve liabilities resulting from the 2017 and 2018 Northern California wildfires. He also represented The Weinstein Co. (TWC) in its voluntary petition for chapter 11 bankruptcy. Under Mr. Zumbro's leadership, Cravath's FR&R practice was named a 2020 and 2019 Practice Group of the Year by *Law360*, and Cravath was named the 2019 "Restructuring Advisory Firm of the Year" by *The Deal*. Mr. Zumbro received his B.A. *cum laude*

and with distinction from Yale College in 1992 and his J.D. from Columbia Law School in 1997, where he was a Harlan Fiske Stone Scholar.