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7
8 Proposed General Bankruptcy Attorneys for
Debtor and Debtor in Possession

9
10 UNITED STATES BANKRUPTCY COURT
11 CENTRAL DISTRICT OF CALIFORNIA
12 LOS ANGELES DIVISION

13 In re:
14 RHYTHM AND HUES, INC.,
15 Debtor and Debtor in Possession.

Case No. 2:13-bk-13775-NB

Chapter 11

**DECLARATION OF JOHN PATRICK
HUGHES IN SUPPORT OF FIRST DAY
MOTIONS**

*Emergency Motion For Order (1) Prohibiting
Utilities From Altering, Refusing Or
Discontinuing Service, (2) Deeming Utilities
Adequately Assured Of Future Performance,
And (3) Establishing Procedures For
Determining Adequate Assurance Of Payment
Under Section 366 Of The Bankruptcy Code;*

*Emergency Motion For Order Setting Notice
Procedures;*

*Emergency Motion For Interim And Final
Orders Approving Post-Petition Financing
Agreement With Universal City Studios LLC
And Twentieth Century Fox;*

*Emergency Motion For Order Authorizing
Debtor In Possession To Honor Certain Pre-
Petition Wages, Commissions And Benefits In
The Ordinary Course Of Business;*

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*Emergency Motion For Order Approving
Debtor's Assumption Of Executory Contracts
As Amended; and*

*Emergency Motion For Order Extending
Time For Debtor To File Its Schedules Of
Assets And Liabilities And Statement Of
Financial Affairs*

filed concurrently herewith

Emergency Hearing:

Date: [To Be Set]
Time: [To Be Set]
Place: Courtroom 1545
255 E. Temple Street
Los Angeles, CA 90012

I, John Patrick Hughes, being fully sworn, hereby declare that the following is true to the best of my knowledge, information and belief:

1. I am the President and Chief Financial Officer of Rhythm And Hues, Inc., a California corporation, the debtor and debtor-in-possession in the above referenced Chapter 11 case (the "Debtor", the "Company" or "R&H"). I am one of the founders of the Company, and have been responsible for and have overseen the overall operations of the Company since its establishment. In this capacity, I am familiar with the history, day-to-day operations, business and financial affairs of the Company. Except as otherwise indicated, all facts as set forth in this declaration are based upon my personal knowledge, my discussion with other employees and representatives of the Company, my review of relevant documents, or my opinion based upon my experience and knowledge of the Company's operations and financial condition. If I were called to testify, I would and could testify competently to the facts set forth in this declaration.

2. I submit this declaration to assist the Court and other parties in interest in understanding the circumstances that compelled the commencement of this Chapter 11 case and in support of (i) the Company's voluntary Petition for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code") filed on February 13, 2013 (the "Petition Date") and

1 (ii) the relief, in the form of emergency motions, that the Company has requested of the Court
2 (the “First Day Motions”).

3 3. This declaration is intended to provide a summary overview of the Company’s
4 business and the present bankruptcy case (the “Chapter 11 Case”). Section A provides an
5 overview of the Company’s business, history, organizational structure, financial conditions and
6 pre-petition indebtedness; Section B explains the circumstances giving rise to the commencement
7 of this case; and Section C, under various sub-headings, summarizes the facts stated in support of
8 the First Day Motions and describes the relief sought therein, which the Company believes is
9 crucial to its successful reorganization.

10 **A. The Debtor’s Business**

11 4. The Company is one of the world’s leading producers of visual effects (“VFX”)
12 and computer-generated (“CG”) animation for the entertainment industry. Since its beginning in
13 1987, the Company has provided top-quality VFX and CG animation services for some of
14 Hollywood’s highest-grossing feature films. As the largest VFX and CG animation studio in Los
15 Angeles (and among the top eight globally), R&H has contributed to more than 150 feature films
16 and has received numerous industry awards and accolades for its work, including Academy
17 Awards (Best Visual Effects) for *Babe* and *The Golden Compass*, an Academy Award
18 nomination for *The Chronicles of Narnia*, and Technical Achievement Academy Awards in 1994,
19 1998, 2008 and 2010. With its 25-year history of industry excellence, R&H is one of the top
20 providers in the \$2.2 billion VFX and CG animation industry, an industry that has continued to
21 grow in the recent past.

22 5. R&H maintains long-standing relationships with all of the major Hollywood
23 studios and provides these studios with a highly resourceful and creative production team,
24 offering a wide range of VFX and CG animation services. In addition to films, the Company is
25 also one of the leaders in the production of commercial advertising and for cinematic game design
26 and special venue and theme park films. It has created filmed attractions for several of Disney’s
27 and Universal’s theme parks around the world, as well as filmed attractions installed in Las
28 Vegas.

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1 6. R&H is headquartered in El Segundo, California, where its 135,000 square foot
2 facility is located. Until shortly prior to the Petition Date, R&H employed more than 700
3 permanent and temporary employees. Now the Company employs approximately 460 employees.
4 In addition to the El Segundo location, the Company carries out its services in three wholly-
5 owned subsidiaries outside of the United States in Canada, India and Taiwan, as well as a sister
6 company located in Malaysia, with collectively over 600 employees abroad.

7 7. R&H is frequently sought after to support the development of many of
8 Hollywood’s highest profile feature films. R&H’s three largest customers, Warner Brothers
9 (“WB”), 20th Century Fox (“Fox”), and Universal Studios (“Universal”), represent approximately
10 97% of the Company’s gross revenues over the past three years. R&H is one of the top two
11 providers of VFX services for Fox and Universal, and it was a preferred provider of VFX services
12 for WB. In addition, the Company has begun cultivating relationships with “mini major” studios
13 like Legendary Pictures (“Legendary”) and Summit Entertainment (“Summit”).

14 8. The top quality of work that the Company provides for movie studios is well
15 known in the industry. Among R&H’s recent work, the VFX and CG animation in Yaan Martel’s
16 *Life of Pi*, directed by Ang Lee, won widespread acclaim from critics and reviewers as well as an
17 Academy Award nomination for Best Visual Effects in a Motion Picture. R&H’s work on the
18 Bengal tiger, central to the second half of the film, redefined and elevated the bar on photo-real
19 animation and reaffirmed the Company’s standing as one of the top VFX and CG animation
20 studios in the world. R&H also supplied water simulations for most shots along with sky and
21 cloud backgrounds. R&H also was the lead visual effects supplier for *Snow White and the*
22 *Huntsman*, also nominated for an Academy Award for Best Visual Effects.

23 9. In addition to films, the Company is also engaged in the production of commercial
24 advertising and cinematics for game design and special venue and theme park films. R&H is
25 currently in advanced discussions to create several theme park attractions for a theme park in
26 China. Other types of business opportunities for the Company include cloud computing. In
27 2011, R&H entered into a collaborative venture with Taiwan-based Chunghwa Telecom. The
28 collaboration is named CAVE, which stands for Cloud Animation and Visual Effects. CAVE is a

1 commercial venture to provide computer intensive industries with cost effective solutions for
2 processor time and disk storage. The product of this effort will both lower the cost of technology
3 and provide an additional revenue stream to R&H.

4 Feature Film Investments

5 10. The Company has historically been active in the early stages of feature film
6 production, both in the planning and choreographing phases as well as, more recently, through co-
7 investing and co-producing blockbuster hits such as *Yogi Bear 3D* and *Hop*.

8 11. In 2010, R&H co-produced its first feature film, *Yogi Bear 3D* (with WB), which
9 achieved a worldwide box office of over \$200 million. R&H financed part of the cost of the film,
10 and also did most of the CG computer animation and VFX work on the film. In the same year,
11 R&H also invested in *Hop* (Universal) and did most of the CG animation and VFX for the film.
12 *Hop* achieved a worldwide box office of more than \$180 million. In 2012 R&H invested in
13 Legendary's *Seventh Son*, which has yet to be released.

14 12. Investing in the feature projects of R&H's clients is advantageous in two respects.
15 First, the Company is much more likely to be awarded the contract for the CG and VFX work if it
16 invests in the project, and second, many of the films that R&H works on are successful in the
17 commercial marketplace and are thus likely to provide a good return on the Company's
18 investment.

19 Intellectual Property

20 13. The nature of R&H's work requires the Company to constantly pioneer new
21 technologies, and to push existing technologies to their limits, so as to continue eliciting the
22 "wow" response from both movie-goers and industry insiders. In support of this goal, the
23 Company has developed its own proprietary animation, lighting, simulation, rendering and
24 compositing software. The following provides brief descriptions of some of the other major
25 technologies developed by R&H over the years.

26 a. *Distributed Production System*: proprietary system for managing all of the
27 Company's digital assets created by R&H artists globally.

28 b. *Queue*: the Company's management technology used to manage the
millions of hours of computation that is necessary to create the photo-realistic

1 imagery that the Company generates.

2 c. *DDR System/Eve*: the Company's multi resolution playback system used
3 to conduct all digital reviews.

4 d. *Jobtracker*: R&H's distributed global production tracking system.

5 e. *PTSFS*: a database-driven virtual file system used to define the Company's
6 global namespace.

7 *Global Expansion and International Operations*

8 14. R&H and its affiliates and subsidiaries have six world-wide locations, with the
9 majority of the personnel located at its El Segundo headquarters. It also has two facilities in India
10 – one each in Mumbai and Hyderabad – another in Kuala Lumpur, Malaysia, which it uses on a
11 contract basis, another in Vancouver, Canada, and its latest facility which was opened last year in
12 Kaohsiung, Taiwan. All of these international facilities are integrated into the Company's
13 worldwide production pipeline and allow for consistent standards of quality and training and
14 cross-border collaboration for all post-production projects. The India, Canada and Taiwan
15 facilities are all owned by separate foreign entities, each of which is in turn 100% owned and
16 controlled by R&H. The Malaysia entity is owned by a sister company, not directly owned by the
17 Company, but instead by the same shareholders which own the equity of R&H. (All of these
18 entities are referred to as the "Foreign Affiliates" or "Non-Debtor Affiliates".)

19 15. Because of the lower wage levels paid by the Foreign Affiliates and various local
20 governmental tax incentives, using their services is very cost-effective for the Company. As long
21 as the Foreign Affiliates can continue to operate for and with the support of the Company, we
22 have no plans to close any of them.

23 *Ownership Structure and Management*

24 16. R&H is a privately-held California corporation with three shareholders, Keith
25 Goldfarb, Pauline Ts'o, and me. The Company's board of directors consists of Ms. Ts'o,
26 Prashant Buyyala and me. The R&H management team consists of me as the Company's
27 President and Chief Financial Officer, Lee Berger, President of the Feature Film Division,
28 Gautham Krishnamurti, Chief Technology Officer, and Prashant Buyyala, Managing Director-

1 International, as well as a group of highly experienced senior executives.

2 The Company's Financial Condition

3 17. Over the three years (2009-2011), R&H has generated, on average, \$105.9 million
4 in annual revenue with an average EBITDA of approximately 6%. For the years 2006 to 2011 the
5 average revenue was approximately \$100m and the average EBITDA was approximately 9%. In
6 2012, R&H had revenue of approximately \$93.5 million.

7 18. R&H's EBITDA was \$6.4 million in 2009 and \$10.8 million in 2011, but the
8 Company had losses of \$2.6 million in 2010 and approximately \$22.5 million in 2012. R&H's
9 ability to maintain profitability is directly related to its gross revenues. The gross revenues for
10 2009 to 2011 were \$108.9 million, \$86.7 million and \$121.4 million, respectively. Revenue in
11 2012 was only \$95.0 million, leading to the net loss of approximately \$22.5 million.

12 19. The Company's revenue, in turn, is highly correlated to feature production and
13 release schedules of the major Hollywood studios. As such, revenue generation can be, at times,
14 difficult to project. Also, with a high level of fixed overhead, significant fluctuations in feature
15 film production at Hollywood studios have a direct impact on the Company's profitability. The
16 decline in revenue in 2012 was partly due to a decrease in feature film work, driven
17 predominately by a slight decrease in film production at Fox and Universal (historically two of
18 R&H's largest customers).

19 20. R&H competes on a global stage for high-end visual effects and animation
20 projects. We compete primarily with companies in Canada, the U.K., Australia and New
21 Zealand.

22 21. We established a facility in Vancouver, Canada in September of 2011. But as
23 projects award about a year before delivery, it was too late to take advantage of the subsidies on
24 most of our projects delivering in 2012 and 2013. This affected the Company's revenues. For
25 instance, if a project was a \$30 million project, if awarded in Canada the government would
26 subsidize about 33% of the project, or about \$10 million. If R&H wanted to compete for that
27 project we had to agree to do the project for \$20 million. If we had established our facility in
28 Vancouver earlier, we could have had much higher revenues for the current projects. This is an

1 advantage of 20% to 33% or more depending on the location.

2 22. The strong U.S. dollar also hurts U.S. companies that compete internationally.
3 Compared to 2008, the dollar is about 20% stronger versus the pound. This is effectively an
4 additional 20% discount for U.K. based productions providing a strong incentive for the film
5 producers to do their work and provide jobs in the U.K. rather than in Los Angeles.

6 23. In the U.K. most visual effects and animation employees do not get paid overtime.
7 At R&H about 17% of our total production labor costs are overtime. We understand the benefits
8 to the employees of these overtime rules. These rules provide a significant cost advantage to our
9 U.K. competitors.

10 24. Cumulatively these factors provide cost advantages in the other English-speaking
11 countries of from 35% to 60% relative to our costs in Los Angeles.

12 25. Since opening the Vancouver office in September of 2011, it has now become
13 widely known that the Company has a facility in a government-subsidized location, and the
14 Company has been included in considerably more requests for bids as a result. Furthermore,
15 because R&H's Asian facilities are very efficient economically due to the lower labor costs, the
16 Company has been able to further lower costs and hence increase its profits as it increases the
17 amount of work it does in Asia. R&H is actively bidding on projects for 2013 and beyond. All of
18 this will enable it to emerge from Chapter 11 protections and continue in business as a
19 reorganized entity.

20 26. As of the year-end in 2012, the Company's assets based on its unaudited balance
21 sheet, totaled approximately \$27.2 million. Also of this amount, R&H had approximately \$4.1
22 million in accounts receivable; \$2 million in investments in feature films (under participation
23 agreements with major Hollywood studios, the Company contributes equity to the production of
24 certain feature films; in exchange, the Company receives a percentage of defined proceeds); \$5.6
25 million (net of depreciation) of fixed assets, with original cost of \$21.4 million; and \$14.6 million
26 in notes receivable from related parties.

27 27. As of the year end 2012, R&H's unaudited balance-sheet liabilities totaled
28 approximately \$33.8 million, virtually all of which were current liabilities. This amount includes

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1 about \$12.2 million in accrued expenses; \$19.4 million in billings in unearned revenues (as the
2 Company's cash balance reflects advance proceeds for work yet to be completed, the Company
3 records the unearned revenues to offset the cash balance); and \$1.2 million in accounts payable.

4 28. The Company's current obligations are of basically three types. First, R&H owes,
5 or potentially owes, amounts to WB, Universal, Fox and others on account of existing projects for
6 which R&H's cost to complete exceeds the remaining amounts due on the agreements which
7 R&H has with each of those studios. Universal and Fox have agreed to provide the DIP Facility
8 to R&H to allow for completion of the work on their projects. WB, on the other hand, has
9 demanded return of all materials related to its three projects. WB further asserts that R&H owes
10 it the combined amount of at least \$4.9 million on account of its projects.

11 29. Second, R&H owes approximately \$4,686,124 in accrued wages for the period
12 from January 16, 2013 to February 10, 2013 for those employees who will remain employed with
13 the Company post-petition. R&H owes approximately \$1,786,955 in accrued wages to its
14 recently terminated employees for that same period. The Company also owes approximately
15 \$9,063,953 to its employees (both retained and terminated) on account of accrued "paid time off"
16 and "sabbatical" leave, when measured in their last or current salaries. Although R&H expects
17 much of the "paid time off" and "sabbatical" leave amounts to constitute general unsecured
18 claims against the Company, it remains the case that it is a large liability. Additionally, as of the
19 Petition Date, the Company has accrued and unpaid medical obligations under its self-insured
20 medical plan of approximately \$1.7 million.

21 30. Third, R&H owes its vendors more than \$1,415,000 which, while not an
22 insignificant amount, is not great in relation to its total creditor body or the size of its business.
23 This amount, however, does not include the pre-petition fees owed by R&H to its Foreign
24 Affiliates for their services provided under their service contracts with R&H.

25 **B. Events Leading to Chapter 11 Filing**

26 31. In an effort to strengthen the Company's financial position, the Company was
27 involved in discussions with a prospective buyer in January and early February of 2013.
28 Unfortunately, the buyer ultimately could not secure the necessary financing in a timely manner

1 to consummate the transaction.

2 32. R&H's work for WB, Universal and Fox constitutes by far the majority of the
3 Company's business. Unfortunately, with respect to current projects, the Company will be unable
4 to complete them at the bid amount, and therefore needs additional funding to pay the costs
5 (mostly labor) for the projects to be completed, or it will default under its agreements with these
6 entities. Moreover, because of what R&H believes to be temporary softness in the market for
7 VFX work, the Company does not have enough new work to allow it to absorb the overages
8 needed to pay for completion of these existing contracts.

9 33. With the Company's Chief Restructuring Officer ("CRO"), John Hedge of
10 Scouler & Company, LLC, we have worked with WB, Universal and Fox in an attempt to
11 restructure the agreements with WB, Universal and Fox or to provide a method by which
12 sufficient funds can be injected into R&H so that it can finish the projects and maintain its
13 operations until it can attract additional projects. The result of these discussions is the proposed
14 DIP Facility to be provided to the Company by Universal and Fox, jointly. WB has so far chosen
15 not to participate in the DIP Facility, but the DIP Facility is designed to allow them to participate
16 post-petition if they so choose.

17 34. To respond to the challenges the Company faced, to ensure the continuity of its
18 operations, and to secure the DIP Facility, on February 13, 2013, the board of directors authorized
19 and I caused the Company to commence this bankruptcy case. We look forward to rapidly
20 stabilizing the Company's operations and exiting bankruptcy protections as a financially stronger
21 company, which can continue to provide the highest quality of VFX services to its present and
22 future customers.

23 **C. First Day Motions**

24 *(1) Emergency Motion for Order (1) Prohibiting Utilities from Altering, Refusing*
25 *or Discontinuing Service, (2) Deeming Utilities Adequately Assured of Future*
26 *Performance, and (3) Establishing Procedures for Determining Adequate*
27 *Assurance of Payment Under Section 366 of the Bankruptcy Code ("Utilities*
28 *Motion")*

35. In connection with the operation of the business, the Company obtains electricity,

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1 internet, telephone, water, trash, and gas services from for the Company from various utility
2 companies (the “Utility Company(ies)”). A table that (i) lists each Utility Company, its addresses
3 and the Company’s account number(s) with such Utility Company; and (ii) specifies the type of
4 utility service provided by each Utility Company and (iii) the average monthly payment made to
5 each Utility Company by the Company, calculated as a historical average during the three (3)
6 months prior to the Petition Date (where applicable) is attached as Exhibit “3” to the Utilities
7 Motion. I believe that the list of Utility Companies set forth in Exhibit “3” to the Utilities Motion
8 is complete as of the Petition Date.

9 36. Uninterrupted utility services to the Company office are essential to its ongoing
10 operations and the success of its reorganization. Moreover, we cannot easily find replacement
11 services for the Company. Should any of the Utility Companies refuse or discontinue services,
12 especially electricity, internet and telephone, even for a brief period, the Company’s business
13 operations would be severely disrupted. The impact of this disruption on the Company’s business
14 and revenue would be extremely harmful and would jeopardize the Company’s reorganization
15 efforts. It is therefore critical that utility services from the Utility Companies continue
16 uninterrupted. We expect that the Company will be able to pay all of its post-petition obligations
17 to the Utility Companies.

18 (2) *Emergency Motion For Order Setting Notice Procedures (“Limit Notice*
19 *Motion”)*

20 37. At the time the Debtor filed its Petition, as required by the Bankruptcy Rules and
21 the Local Bankruptcy Rules, it filed a list of creditors. This list contained over 830 entities and
22 individuals, including the 718 former and current employees of the Company who are owed pre-
23 petition wages and salaries, including any accrued “paid time off” and “sabbatical” leave
24 amounts. The employees of the Non-Debtor Affiliates were not included in the list as they are
25 not creditors of the Company.

26 38. The Debtor has concurrently filed herewith its *Emergency Motion for Order*
27 *Authorizing Debtor in Possession to Honor Certain Pre-Petition Employee Wages and Benefits*
28 (the “Employee Wages Motion”), requesting the authority to pay its remaining employees (the

1 “Retained Employees”) their accrued, but unpaid pre-petition wages and salaries but only to the
2 extent of \$11,725 per Retained Employee. If the Employee Wages Motion is granted and the
3 Retained Employees are paid accordingly, this will extinguish the Debtor’s obligations to most of
4 the Retained Employees in full (without taking into account any allowed unsecured claims for
5 contributions to an employee benefit plan). However, even without counting the Retained
6 Employees to whom the Debtor owes pre-petition wages and salaries but who will be paid in full,
7 the Debtor will still have approximately 400 pre-petition creditors. Therefore, it would be
8 burdensome for the Debtor to be required to notify all the creditors and interested parties as
9 required by Rule 2002.

10 39. I believe it makes sense to only provide notice to all interested parties with the
11 more significant documents in the case, and it does not make sense to give every notice to parties
12 that have not otherwise indicated an interest in receiving such notices. If any party wishes to be
13 served with all documents filed in the case, the party will have the option to request courtesy
14 notice using the court forms attached to the Limit Notice Motion as Exhibits “1” and “2”,
15 whichever form is applicable to that party. We are working hard to get the Company’s business
16 back on track. I strongly believe that limiting notice in certain cases and on certain procedures as
17 further set forth in the Motion to Limit Notice will ease the administrative burden and cost of
18 mailing hundreds of notices in this case.

19 40. Furthermore, because the Company has a large number of creditors, we anticipate
20 that we will need to expend a considerable amount of time and effort to meet the noticing
21 requirements of this bankruptcy case. In order to utilize the Company’s limited resources more
22 efficiently, with the advice of the Company’s general bankruptcy counsel, we intend to hire a
23 third party noticing and claims agent to serve notices required to be sent to a large number of
24 creditors.

25 *(3) Emergency Motion For Interim And Final Orders Approving Post-Petition*
26 *Financing Agreement With Universal City Studios LLC And Twentieth Century*
27 *Fox (“DIP Financing Motion”)*

28 41. The Company has with each of its foreign affiliates a Memorandum of

1 Understanding (“MOU”) pursuant to which each of these foreign affiliates performs work critical
2 to the services provided by the Company. Without the continuing work provided by the Foreign
3 Affiliates, it is my understanding that the DIP Lenders would not be willing to fund the DIP Loan
4 because the work on the required projects would not be completed.

5 *(4) Emergency Motion for Order Authorizing Debtor in Possession to Honor*
6 *Certain Pre-Petition Wages, Commissions And Benefits In The Ordinary Course*
7 *Of Business (“Employee Wages Motion”)*

8 42. Before the bankruptcy, we were working on feature film projects for Universal,
9 Fox, WB and Legendary. However, only Universal and Fox have agreed to provide the DIP
10 Facility to the Company to allow for completion of the work on those projects. Warner Bros., on
11 the other hand, has demanded return of all materials related to its three projects. As a result, I
12 have instructed employees to cease working on projects backed by Warner Bros. (the
13 “Terminated Projects”) and have had to terminate a large number of employees that were working
14 on these projects.

15 43. We will continue during the bankruptcy to work on the film projects backed by
16 Universal and backed by Fox (the “Ongoing Projects”). Based on a recent agreement, it also
17 appears that we will continue to work on the project backed by Legendary.

18 44. It is our intention during the bankruptcy to implement an exhaustive program of
19 management and operational improvements to reorganize and emerge from bankruptcy as a
20 stronger and healthier company, for the benefit of all creditors. We are hopeful that we can
21 quickly engage in a sale process to identify qualified purchasers, or in the event of a financing, we
22 will file a plan of reorganization.

23 45. Prior to the bankruptcy, the Company employed a total of approximately 718
24 people through our Los Angeles office. Approximately half of the employees were regular full-
25 time permanent staff employees (“Staff Employees”), while the other half were semi-permanent
26 staff comprised of both short-term (“Short-Term Freelancers”) and long-term freelancers (“Long-
27 Term Freelancers”). To my knowledge, only six (6) employees are subject to collective
28 bargaining agreements (the “CBAs”).

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1 46. On February 10, 2013, we gave notice of termination of the employment of 254 of
2 the Company's employees, effective February 11, 2013 ("Terminated Employees"). We based
3 our decision to terminate on whether the employees were critical to the performance of our
4 continued obligations to the Studios for Ongoing Projects. We were only able to retain the
5 critical employees and the employees working on Terminated Projects that have been pulled by
6 their respective Studios were either terminated or shifted to Ongoing Projects that we will
7 continue to perform on. As of the bankruptcy, we determined that only 464 of the Debtor's U.S.
8 based employees were absolutely necessary to complete or manage the Ongoing Projects
9 ("Current Employees").

10 47. I believe that the Current Employees are critical to the Company's successful
11 operations and its reorganization efforts. The Current Employees are responsible for the
12 Company's general operations including visual effects, character animation work, and film
13 production, and some employees also perform crucial administrative, financial management, and
14 human-resource services needed to operate the business. During the bankruptcy case, in addition
15 to handling their current responsibilities and dealing with the effects of the Company's current
16 financial difficulties, many of our office employees will need to be heavily involved in reviewing
17 and assisting with the requirements of the bankruptcy.

18 48. The Company's permanent Staff Employees include studio and production
19 management, information technology ("IT"), human resources ("HR") and accounting personnel
20 (collectively, the "Support Personnel"). As of the Petition Date, there were approximately 89
21 Support Personnel, including certain independent contractors as further described below.

22 49. The remaining 316 employees, comprising both permanent Staff Employees and
23 Short- and Long-Term Freelancers, include the Artists, Lead Artists, and Production Supervisors
24 (all collectively the "Production Personnel") who produce the effects which the Company creates
25 for its customers. Each of the Artists and Lead Artists has specialized duties. The Artists include
26 composite and lighting technicians, animators, effects creators, modelers and riggers. Lead
27 Artists are highly skilled and experienced artists with leadership capabilities. They have
28 demonstrated their ability on more than one film in the past and their experience is crucial to the

1 creation of effects shots which are required by the studios. Production Supervisors and Lead
2 Artists, of which there are approximately 125, have extensive experience and have all been with
3 the Company for at least two (2) years. With respect to the Ongoing Projects, in almost all cases
4 they have worked on the project since inception and are necessary to its completion.

5 50. In my experience, it would be extraordinarily difficult to replace these personnel
6 because, in most cases, as of the Petition Date the Production Personnel have been working on the
7 shots (or sometimes a single shot) for over two (2) months. Any replacements would take weeks
8 to be “brought up to speed” on the project, and would need significant training tailored to the
9 customer’s needs.

10 51. Support Personnel include the ultimate managers of the Production Personnel, all
11 of whom report ultimately to me. Lee Berger, the President of the Film Division, has an
12 immediate team which is comprised of 6 producers and executive producers who actually manage
13 the work on the Studio projects. The producers and executive producers are in direct
14 communication with our clients, they supervise production of the shots, manage the designated
15 budgets and respond and manage any issues that arise in the production. They are crucial to the
16 success of the Company’s work on Ongoing Projects and are also responsible for obtaining future
17 projects for the Company.

18 52. Support Personnel also includes Prashant Buyyala, President of International
19 Operations, David Weinberg, the former CFO and now a consultant to the Company, Janell
20 Perez, Vice President of finance, and Gautham Krishnamurti, Chief Technology Officer and
21 manager of the IT department, which as of the Petition Date included 47 programmers and
22 support staff. Prior to the Petition Date, Mr. Weinberg and Ms. Perez were retained by the
23 Company as independent contractors to the Company. After the Petition Date we may pay them
24 as salaried employees. I do not believe that either of them are insiders of the Company as I
25 understand that term to be defined by the Bankruptcy Code.

26 53. I am confident that all of the Support Personnel are crucial to the Company’s post-
27 petition operations and restructuring herein. The IT department has already been reduced by 39
28 employees as part of the reduction in force that occurred on February 10, 2013. I believe that the

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1 remaining Support Personnel are needed to perform crucial administrative functions, as well as to
2 respond to and fulfill the many added inquiries and duties that come with a chapter 11 bankruptcy
3 case. Without the remaining Support Personnel, our communications with customers would be
4 crippled. Also, our ability to manage our international affiliates and subsidiaries would also be
5 severely impacted, jeopardizing the delivery of work product from these locations, and the timely
6 completion of the Company's current projects.

7 54. I believe that in order to prevent defections and bolster employee morale, it is
8 essential for the Company to be able to honor its pre-petition employee obligations and to
9 continue making payments on a going forward basis for post-petition work. Failing to honor
10 payroll commitments and discontinuing employee-benefit programs would at any time be
11 devastating to our employees, but this is especially the case at this time.

12 55. It has been our business practice to provide our employees with benefit plans and
13 programs designed to assist them in meeting certain financial burdens and to keep employee
14 morale positive for the benefit of the business. These programs include such standard benefits as
15 paid time-off (intended to include vacation, sick time, and sabbatical); legal holidays;
16 bereavement leave and time off for jury duty; health insurance benefits through a self-insured
17 medical program; vision and dental benefits; life and disability insurance; and workers'
18 compensation insurance.

19 56. It is my belief that many of our employees live from paycheck to paycheck and
20 rely exclusively on receiving their full compensation or reimbursement of their expenses to pay
21 their daily living expenses. Our employees and their families would suffer undue hardship if we
22 are not permitted to pay and/or honor the wages and benefits owed to these employees.

23 57. Prior to the Petition Date, it was the Company's policy to provide all permanent
24 Staff Employees with a generous amount of paid time-off ("PTO") each year, including time for
25 vacation, sick leave, and sabbatical. Semi-permanent employees, including both Short-Term and
26 Long-Term Freelancers were not eligible for PTO. Base PTO amounts accrued immediately
27 upon employment. Employees initially accrued 15 days of PTO. Higher levels of PTO begin
28 accruing after 2 years of service with the Debtor. After the first two years of permanent,

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1 continuous full-time employment with R&H, employees accrued 20 days of PTO each year.
2 During years six through ten, this increased to 25 days per year and after ten years, this increased
3 to 30 days each year. PTO is paid at the employee's regular straight time rate. The accrued PTO
4 was capped at no more than twice the employee's annual PTO accrual. Under this prior PTO
5 policy, full-time staff employees were also granted a paid sabbatical of four weeks (20 working
6 days) at the end of each five years of cumulative service with R&H. Part-time staff employees
7 were granted a shorter paid sabbatical at the end of each five years of service, based on the
8 fraction of time they worked during the applicable five-year period compared to the amount of
9 time a full-time employee worked during the same five years. R&H's PTO policy provided that
10 if an employee's employment was terminated, he or she would be paid for any unused PTO that
11 had accrued.

12 58. Unfortunately, when we were forced to end the Terminated Employees'
13 employment with the Company, we were not in a financial position to pay them for their unused
14 PTO upon termination. We informed the Terminated Employees on February 12, 2013, that their
15 accrued PTO would be frozen and that this would remain an outstanding obligation of the
16 Company. A true and correct copy of the *Change of Benefits Notice – Terminated Employees*, is
17 attached as Exhibit "9" to this declaration.

18 59. On February 12, 2013 because we knew that we were going to file bankruptcy but
19 that we also needed to retain the Current Employees, we decided to modify the PTO policy
20 ("Modified PTO Policy"). Attached hereto as Exhibit "10" is a true and correct copy of the
21 *Change of Benefits Notice – Current Employees* (including an errata to the Notice), which
22 explained the modifications. The modifications include the following: (1) All existing accrued
23 PTO will be frozen and remains an outstanding obligation of the Company; (2) Going forward, all
24 Current Employees are entitled to 14 days of PTO each year, earned prospectively; (3) PTO is
25 capped at a maximum carryover amount not to exceed three weeks; and (4) The sabbatical plan
26 has been terminated. These modifications to the PTO policy leveled the PTO entitlements for all
27 employees, regardless of their length of service, which I believe was necessary in order to
28 encourage all Current Employees to continue working post-petition.

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1 60. The Company also offers a self-insured medical program to all employees and
2 their dependents (the “Medical Plan”). It is my understanding that the Medical Plan, as it has
3 been historically offered, provides commensurate, if not generous, coverage and benefits
4 compared to other similarly sized industry plans. During the 180 days prior to the Petition Date,
5 718 employees were covered employees under the Medical Plan (“Covered Employees”).

6 61. Covered Employees’ premiums under the Medical Plan are deducted from the
7 employee’s semi-monthly paychecks, in an amount that is calculated based on whether the
8 employee is a Staff Employee, Long-Term or Short-Term Freelancer and the number of
9 dependents covered. See the *2013 Employee Contribution Schedule* attached as Exhibit “11” to
10 this declaration for the current contribution calculations. Under the Medical Plan, the Company
11 pays 80-100% of the cost of covered medical services and the Covered Employee is responsible
12 for the remainder of the claim. Each Covered Employee has a maximum out-of-pocket amount
13 ranging from \$580 to \$2,550 annually depending on the employee’s annual salary. See the *2013*
14 *Plan Document and Summary Plan Description* attached as Exhibit “12” to this declaration for a
15 summary of the benefits provided under the Medical Plan.

16 62. The Company offers its employees, upon separation, the opportunity to continue
17 the medical benefits provided by the Medical Plan under COBRA. As of February 12, 2013, 16
18 former employees were covered under the COBRA program. The Third Party Administrator
19 collects the monthly premiums for the COBRA program from participants in the COBRA
20 program and remits the premiums to the Debtor. For COBRA coverage under the Medical Plan,
21 the monthly premiums are as follows: (1) For an individual - \$515; (2) For an Employee and 1
22 Dependent - \$820; and (3) For an Employee and Family - \$1,125. Claims submitted by the
23 participants in the COBRA program are processed and paid by the Debtor through the Third Party
24 Administrator, in the same manner as claims submitted under the Medical Plan. Upon
25 termination of the 254 employees on February 11, 2013, the Medical Plan's termination
26 provisions went into effect. Pursuant to the terms of the Medical Plan as I understand them, the
27 Terminated Employees will remain covered by the Medical Plan until the last day of the calendar
28 month, or February 28, 2013. At that time, the Terminated Employees will have the opportunity

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1 to continue to receive the benefits provided by the Medical Plan by electing COBRA continuation
2 coverage. I am not certain at this time the number of Terminated Employees that will elect
3 COBRA coverage.

4 63. It was brought to my attention several days ago that despite the R&H's financial
5 condition, it was required to comply with existing health care law which prohibits the
6 modification or termination of the Medical Plan without giving Covered Employees 60 days'
7 notice in advance of the modification or termination ("PHS Notice Requirement"). In an effort to
8 comply with our statutory obligations, on February 12, 2013, we provided Covered Employees
9 and COBRA participants with notice that the Medical Plan would terminate 60 days from the date
10 of the notice (the "Plan Termination Date"). Attached hereto are true and correct copies of the
11 Notices sent: (1) *Change of Benefits Notice – Terminated Employees*, attached as Exhibit "9" to
12 this declaration; (2) *Change of Benefits Notice – Current Employees*, attached as Exhibit "10" to
13 this declaration; and (3) *Change of Benefits Notice – COBRA Participants*, attached as
14 Exhibit "13" to this declaration, all of which were provided to Covered Employees and COBRA
15 participants on February 12, 2013.

16 64. The Company also has Stop Loss Medical Insurance ("Stop Loss Policy") through
17 Sun Life Assurance Company of Canada ("Sun Life"), which is triggered at a threshold of
18 \$175,000 per Covered Employee's annual claims under the Medical Plan. A true and correct
19 copy of the *Sun Life Stop Loss Policy* is attached hereto as Exhibit "16". We intend to promptly
20 give notice to Sun Life of our intent to terminate the Stop Loss Policy at the Plan Termination
21 Date for the Medical Plan.

22 65. Before the bankruptcy, we offered life insurance to all employees and their
23 dependents. R&H is the policyholder of a group term life insurance policy with Sun Life for Life,
24 Accidental Death and Dismemberment ("AD&D"), and Long Term Disability Insurance
25 ("LTD")(collectively "Life Insurance"). R&H's employees cease to be insured under the Life
26 Insurance policies on the date their employment terminates, subject to certain limited exceptions.
27 By its terms, the Life Insurance policy ceased to cover the Terminated Employees on the date of
28 their termination. See the relevant excerpt from the *Sun Life Insurance Policy* attached hereto as

1 Exhibit “15” for the termination provision. On February 12, 2013, we gave the Current
2 Employees notice that the Life Insurance benefits would be terminated, effective immediately. A
3 true and correct copy of the *Change of Benefits Notice – Current Employees*, attached as Exhibit
4 “10” to this declaration. We will not continue the Life Insurance benefits post-petition and will
5 provide notice of termination to Sun Life promptly.

6 66. Pursuant to our Employee Handbook, the Company reimburses our employees for
7 qualified business expenses, such as work-related travel, cellular phone service, work-related
8 meals, and shipping. Reimbursement for these expenses is necessary for the retention of these
9 employees post-petition and the cost of reimbursement is minimal. If our Current Employees
10 cannot rely on us to comply with our existing policies and statutory obligations, it is my opinion
11 that this would encourage them to seek employment elsewhere.

12 67. The Company offers a Flexible Spending Plan (sometimes called a Cafeteria Plan)
13 to its employees. The purpose of the Flexible Spending Plan is to provide employees with a
14 means of paying for some benefits with their own pretax income. Only certain medical expenses
15 are reimbursable under the “health” flexible spending account. The benefits currently offered by
16 our Flexible Spending Plan are health care expense reimbursement (out of pocket health care
17 costs) and dependent care assistance (reimbursement for dependent care expenses).

18 68. The Company offers its permanent staff 5 days of paid bereavement leave and 10
19 days of paid leave of absence for jury duty. R&H also offers paid holidays (One Floating
20 Holiday [set by HR], New Year’s Day, Presidents’ Day, Memorial Day, Independence, Labor
21 Day, Thanksgiving Day, Day after Thanksgiving, Christmas Eve and Christmas Day) to all
22 permanent Staff Employees and Long Term Freelance Employees. I am not aware of any
23 meaningful pre-petition liabilities associated with these employee benefits.

24 69. We also provide Staff Employees and Long Term Freelance Employees with a
25 401(k) plan on their first day of employment. Eligible employees are automatically enrolled in the
26 plan at a 3% pre-tax contribution level after the first 30 days of employment, with the funds being
27 invested in the appropriate Fidelity Freedom Fund unless they elect to opt out of the plan. The
28

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1 Company has the discretion to make matching contributions to the plan but is currently not
2 making any contributions.

3 70. The Company will not make any payments to the insiders, including myself,
4 Pauline Ts'o, and Keith Goldfarb, until such time as the insider compensation for us has been
5 approved.

6 71. Several parties have already expressed an interest in acquiring the Company. We
7 intend, shortly after the Petition Date, to engage an investment banker to undertake this process.

8 *(5) Emergency Motion for Order Authorizing and Approving Debtor's Assumption*
9 *of Executory Contracts As Amended ("Assumption Motion")*

10 72. Prior to the Petition Date, the Company entered into certain contracts with some of
11 its Non-Debtor Affiliates, under which the Non-Debtor Affiliates provided CG graphics and
12 software development services to the Debtor in accordance with the Debtor's specifications and
13 requirements. In turn, the Debtor reimbursed the Non-Debtor Affiliates for overhead and labor
14 costs of a rate set forth in the contracts. Of these contracts, in the Assumption Motion the Debtor
15 seeks an order authorizing and approving the assumption of the following executory service
16 contracts (the "Service Contracts") for the India, Malaysia and Vancouver Operations:

- 17 • Memorandum of Understanding, dated August 1, 2011, by and between Rhythm and
18 Hues, Inc., California corporation, and Rhythm & Hues Studios Ltd., a company
19 incorporated in Canada, as amended by the First Amendment thereto dated February
20 12, 2013;
- 21 • Memorandum of Understanding, dated November 1, 2010, by and between Rhythm
22 and Hues, Inc., California corporation, and Rhythm & Hues Studios India Pvt Ltd, a
23 company incorporated in India, as amended by the First Amendment thereto dated
24 February 12, 2013; and
- 25 • Memorandum of Understanding, dated November 1, 2008, by and between Rhythm
26 and Hues, Inc., California corporation, and Rhythm & Hues Sdn. Bhd., a company
27 incorporated in Malaysia, as amended by the First Amendment thereto dated February
28 12, 2013 (but not including any rights and obligations arising under Addendum B
annexed thereto, which is to be unaffected by the Assumption Motion).

1 True and correct copies of the Service Contracts, with relevant addenda and first
2 amendment for each annexed thereto, are attached to the Assumption Motion as Exhibits
3 “4”, “5” and “6”, respectively, and are incorporated herein by reference.

4 73. On February 12, 2013, in contemplation of filing this Chapter 11 Case, the Debtor
5 and the Non-Debtor Affiliates who are parties to the Service Contracts amended the respective
6 Service Contracts so that the Debtor’s obligations arising out of the Service Contracts would be
7 limited to the extent that there are sufficient funds available in the Debtor’s bankruptcy estate and
8 would be paid only in accordance with the Debtor’s budget filed with and approved by the Court
9 in this bankruptcy case. Further, the work performed under the Service Contracts is to be
10 provided only at the direction of the Debtor. In addition, the Service Contracts were amended to
11 provide, for the absence of doubt, that the terms of the Service Contracts would be automatically
12 renewed for successive one (1) year periods unless terminated by either party in writing as
13 provided in the Service Contracts. Moreover, each of the Service Contracts is terminable on one
14 month’s written notice by either party.

15 74. The Service Contracts, including as amended call for the payment from the
16 Company to the Non-Debtor Affiliates in exchange for the performance of services at the rates of
17 \$850, \$1,000 and \$2,500 per “man week” for, respectively, the India, Malaysia and Vancouver
18 Operations. These rates included both the cost of labor as well as an overhead allocation. As of
19 the Petition Date, there were outstanding unpaid fees, owed by the Debtor to each of the Non-
20 Debtor Affiliates as follows:

- 21 • India: \$712,000 for services rendered through Feb. 10, 2013.
- 22 • Malaysia: \$195,000 for services rendered through Feb. 10, 2013.
- 23 • Canada: \$1,036,000 for services rendered through Feb. 10, 2013.

24 75. To ensure the continuity of operations at the India, Malaysia and Vancouver
25 Operations, I believe that these amounts must be paid under the terms of the Service Contracts. I
26 am not aware of any additional pre-petition amounts owing on account of the Service Contracts.

27 76. The Company’s management has evaluated the benefits of and business reasons
28 for the maintenance of the Service Contracts and we have concluded in the management’s sound

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1 business judgment that they are essential to its successful reorganization. Because the Non-
2 Debtor Affiliates and their services are so closely integrated into the Company's worldwide
3 production pipeline and are essential to the consistent standards of quality demanded by the
4 Company's customers, there are simply no substitutes to replace the existing services provided by
5 these entities.

6 77. Without the services provided under these Service Contracts, the Company will
7 literally be unable to finish existing projects for Universal and Fox, two of its most significant
8 customers, who are also providing the Debtor with its post-petition DIP financing so that the
9 Debtor can continue to work on the existing projects and remain in business for additional time as
10 new work is bid and secured. This period will also allow the Company to continue to market its
11 business to third party buyers with the goal of entering into a sale or other financing transaction
12 allowing it to exit from Chapter 11. The continued provision of services under the Service
13 Contracts is therefore critical in order to maintain the continuity of the Debtor's ongoing
14 operations, which are, in turn, essential to its reorganization efforts.

15 78. The Company's management has carefully reviewed the economic benefits of
16 assumption of the Service Contracts and I believe that its decision to assume these Service
17 Contracts is within the Debtor's sound business judgment, in compliance with and contemplated
18 by the DIP Financing Agreement, and in the best interests of its estate and creditors herein.

19 79. The Debtor has concurrently filed herewith its *Emergency Motion for Interim and*
20 *Final Orders Approving Post-Petition Financing Agreement with Universal City Studios LLC and*
21 *Twentieth Century Fox* (the "DIP Financing Motion"). In this regard, the Debtor's Budget filed
22 with the DIP Financing Motion provides for the cure amounts under line items labeled
23 "Vancouver" (\$1,036,000 included in the payment of \$1,338,474 during the week of Feb. 15,
24 2013), "India" (\$280,000 during the week of Feb. 15, 2013 and \$432,000 during the week of Feb.
25 22, 2013) and "Malaysia" (\$195,000 during the week of Feb. 15, 2013).

26 80. Again, the services provided by the Non-Debtor Affiliates are critical to the
27 survival of the Debtor's operations. Unless the Debtor pays the Non-Debtor Affiliates, the Non-
28 Debtor Affiliates will not, or will not be able to, continue to provide those critical services to the

1 Debtor because without continued funding from the Debtor, the Non-Debtor Affiliates will be
2 unable to continue to operate, leading to their shutdown and, in certain cases, the loss of the value
3 of the entities to the Debtor.

4 81. Any interruption of work by the Non-Debtor Affiliates would cause immediate,
5 significant, and irreparable harm to the Debtor and the Debtor's going concern value. There are
6 no alternatives other than payment of the obligations.

7
8 *(6) Emergency Motion For Order Extending Time For Debtor To File Its Schedules Of
Assets And Liabilities And Statement Of Financial Affairs ("Extension Motion")*

9
10 82. In addition to addressing numerous Chapter 11 transition matters during the first
11 several weeks of its bankruptcy case, the management will be required to focus its time and
12 energy on continuing to operate the Company's business in an orderly and efficient manner,
13 responding to inquiries by its vendors, customers, creditors, party-in-interest and media, the
14 restructuring efforts and exit transaction(s) that will enable the Debtor's prompt exit from Chapter
15 11, and the administrative requirements of the Office of the United States Trustee. Given the
16 many competing and immediate demands on its time and resources, I anticipate that we will not
17 be able to complete the Debtor's Schedules of Assets and Liabilities ("Schedules") and Statement
18 of Financial Affairs ("SOFA") within the 14-day period set by the Bankruptcy Rules or by
19 February 27, 2013, the date by which they are currently due.

20 83. While attending to many tasks attendant to the filing of this Chapter 11 Case, we
21 are working around the clock to finalize and consummate a transaction(s) that would enable the
22 Debtor to exit from Chapter 11 in a prompt and efficient manner. We also continue to work
23 toward the completion of the various existing CG/VFX projects, work with the DIP lenders on
24 DIP Facility-related matters, maintain the Company's existing relationships with customers, and
25 address the flurry of media inquiries that have resulted from the bankruptcy filing. We are also
26 making every effort to comply with the administrative requirements of the Office of the United
27 States Trustee at the same time. I anticipate that the Company will successfully meet these
28 challenges, but I believe that our attention must necessarily remain focused on the myriad of

1 business and legal issues that arise in connection with the administration of the Chapter 11 Case.

2 84. We are diligently working on locating, reviewing and organizing relevant
3 information, but we will need additional time to complete the Debtor's Schedules and SOFA
4 because it will take significant time and effort on the part of the Debtor's management,
5 accountants and advisors to review, analyze and sort through the Debtor's business records,
6 especially those pertaining to the Debtor's assets and obligations to complete the Schedules and
7 SOFA in a proper and complete manner. If the Debtor is forced to file its Schedules and SOFA
8 prior to February 27, 2013, it is very likely that the Debtor later will have to revise or amend
9 much of them, leading to additional administrative cost and uncertainty.

10 85. I do not believe that any of the Company's creditors will be prejudiced by the
11 extension of the Debtor's deadline to file its Schedules and SOFA for an additional two weeks, or
12 to and through March 15, 2013, because the requested extension is only for a limited time period.

13 I declare under penalty of perjury under the laws of the United States that the foregoing is
14 true and correct. Executed at El Segundo, California on this 13th day of February, 2013.

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17 
18 _____
19 JOHN PATRICK HUGHES
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