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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION**

In re:)	Case No. 07-_____
)	Jointly Administered
MOVIE GALLERY, INC., et al., ¹)	Chapter 11
)	
Debtors.)	
)	

**MOTION OF THE DEBTORS FOR AN ORDER AUTHORIZING, BUT NOT
DIRECTING, THE DEBTORS TO CONTINUE THEIR CUSTOMER PROGRAMS AND
HONOR PREPETITION COMMITMENTS RELATED THERETO**

The above-captioned debtors (collectively, the “Debtors”) hereby move the Court, pursuant to this Motion (the “Motion”), for the entry of an order, substantially in the form of Exhibit A, authorizing, but not directing, the Debtors to continue their customer programs and

¹ The Debtors in the cases include: Movie Gallery, Inc.; Hollywood Entertainment Corporation; M.G. Digital, LLC; M.G.A. Realty I, LLC; MG Automation LLC; and Movie Gallery US, LLC.



honor prepetition commitments related thereto. In support of this Motion, the Debtors respectfully state as follows:²

Jurisdiction

1. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2).
2. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409.
3. The statutory bases for the relief requested herein are sections 105(a), 363, 507(a)(7) and 1129(a)(9) of the Bankruptcy Code, 11 U.S.C. §§ 101-1532 (the “Bankruptcy Code”).

Background

4. On the date hereof (the “Commencement Date”), each of the Debtors filed a petition with the Court under chapter 11 of the Bankruptcy Code. The Debtors are operating their businesses and managing their property as debtors in possession pursuant to sections 1107(a) and 1108 of the Bankruptcy Code. No request for the appointment of a trustee or examiner has been made in these chapter 11 cases, and no committees have been appointed or designated. Concurrently with the filing of this Motion, the Debtors have sought procedural consolidation and joint administration of these chapter 11 cases.

5. The Debtors are the second largest North American home entertainment specialty retailer. They currently operate approximately 4,200 retail stores located throughout all 50 states. They rent and sell DVDs, videocassettes and video games through three distinct brands — Movie Gallery, Hollywood Video and Game Crazy.

² The facts and circumstances supporting this Motion are set forth in the Affidavit of William C. Kosturos, Chief Restructuring Officer of Movie Gallery, Inc., in Support of First Day Motions (the “First Day Affidavit”), filed contemporaneously herewith.

6. In 2006, the aggregate annual revenues of the Debtors and their non-Debtor affiliates, including rental revenue and product sales, exceeded \$2.5 billion. Of this amount, approximately 56% was attributed to DVD rentals, 15% to the sale of previously-rented DVDs, VHS cassettes and video games, 13% to the sale of new and used gaming products, 7% to game rentals, 4% to the sale of concessions and other miscellaneous products, 3% to the sale of movie-related products and merchandise and 2% to VHS cassette rentals. As of September 2, 2007, the Debtors and their non-Debtor affiliates employed approximately 38,800 employees, including approximately 7,500 full-time employees and 31,300 part-time employees.

7. Several factors have led to the filing of these chapter 11 cases. First, the video rental industry is highly competitive. The Debtors face direct competition from competitors such as Blockbuster and Netflix and indirect competition from pay-per-view, cable television and big-box retailers who sell DVDs at increasingly lower prices. Furthermore, recent box office receipts of rental releases have declined over the previous year, contributing to an industry-wide decline in demand for video rentals. Finally, as the Debtors' financial performance has deteriorated, they have experienced contracting trade terms, which have had a negative impact on the Debtors' liquidity, which, in turn, has contributed to the Debtors' inability to comply with certain financial covenants under their credit agreements.

8. Before the Commencement Date, in the ordinary course of their business, the Debtors engaged in certain practices to develop and sustain positive reputations in the marketplace for their products and services, including, but not limited to, offering gift certificates, membership programs, coupons, service contracts, damage waivers and a return policy for certain goods and participating in charity programs (collectively, the "Customer

Programs”). The common goals among the Customer Programs have been to develop customer loyalty, encourage repeat business and ensure customer satisfaction, thereby retaining current customers, attracting new ones and, ultimately, increasing revenue. The continuation of these Customer Programs is critical for the Debtors to retain their core customers.

A. Gift Certificates

9. Prior to the Commencement Date, the Debtors sold pre-paid and reloadable gift cards, pre-paid and reloadable electronic discount rental cards and gift certificates for use in the Debtors’ stores (collectively, the “Gift Certificates”). These Gift Certificates are available for purchase at the Debtors’ stores, through business-to-business sales and at certain third party retail locations. As of the Commencement Date, obligations on account of Gift Certificates remained outstanding as some Gift Certificates sold prepetition have not yet been redeemed. The Debtors estimate that the cash value of outstanding Gift Certificates as of the Commencement Date is approximately \$14.6 million, however, customers may only redeem the Gift Certificates for goods or services, not a cash refund (unless required by state law).³ Moreover, when customers redeem a Gift Certificate, they often purchase goods and services in excess of the amount of the Gift Certificate.

B. Store Credits

10. The Debtors offer several promotions through which their customers can purchase or earn store credits for free or reduced charges for rentals, goods or services (collectively, the “Store Credits”), which Store Credits include the following:

- a. The Debtors offer their customers the option of making an initial deposit toward the purchase of a game console, game or piece of equipment that

³ All financial information is based on the Debtors’ last accounting period, which closed on September 2, 2007.

has not yet been released so that a participating customer is assured that the item will be available to purchase immediately upon its release (the “Pre-Order Program”). Under the Pre-Order Program, when the item arrives and the customer purchases the item, their deposit is deducted from the purchase price.⁴

- b. The Debtors also provide customers with an early return credit (the “Early Return Credit Program”) for videos that are returned on the day following their rental. The Early Return Credit Program encourages customers to return their videos early, which contributes to higher inventory levels. Customers may not redeem early return credits for cash.
- c. The Debtors offer their Game Crazy customers the option of purchasing disc refurbishing punch cards (the “Disc Refurbishing Cards”), which entitle the purchaser to refurbish their game discs five times. Disc refurbishing helps maintain discs in their original condition by eliminating scratches. Disc Refurbishing Cards may not be redeemed for cash.
- d. The Debtors also offer their customers a trade-in program through which customers can pay for future purchases by trading in used game consoles, games, pieces of equipment, DVDs or VHS tapes.

11. The Debtors estimate that their total obligations as of the Commencement Date for the Store Credits are approximately \$8.6 million.

C. Rental Subscription Programs

12. Prior to the Commencement Date, the Debtors offered their customers monthly and yearly video and gaming membership subscription programs (collectively, the “Rental Subscription Programs”), which programs include the following:

- a. The Debtors’ Hollywood Video and Movie Gallery stores run a store-specific monthly rental subscription program, known as the “Movie Value Pass” or the “Member Value Pass” (collectively, the “MVP Program”). The MVP Program has three levels of membership with varying prices corresponding to varying numbers of movies that customers may have outstanding at a time. The MVP Program allows members to rent an unlimited number of titles during the month. There are approximately 600,000 MVP Program members. The Debtors also offer enrollment in

⁴ If the customer decides not to purchase the item when it arrives, the customer is entitled to a refund of the deposit.

Hollywood Access Pass, a store-specific membership program that allows members to rent an unlimited number of select game titles.

- b. The Debtors offer their Game Crazy customers the option of enrolling in an annual membership program, known as the Most Valuable Player program (the “GMVP Program”). Membership in the GMVP Program entitles members to additional credit for trade-ins, discounts on used games and accessories, a magazine subscription and free disc refurbishing. Members of the GMVP Program constitute some of the Debtors’ best and most loyal customers. There are approximately 500,000 GMVP Program members.
- c. Also, the Debtors run a pre-paid rental promotion in Hollywood Video stores whereby customers can pay a certain amount entitling them to one free rental with each corresponding paid rental during the month.

13. The Debtors’ obligations as of the Commencement Date for the Rental Subscription Programs are approximately \$9.5 million, however, members may only receive goods and services for such obligations, not a cash refund.

D. Service Contracts

14. When the Debtors sell new and used game consoles, they offer their customers the option of purchasing service contracts for the consoles (each, a “Game Console Service Contract”). These Game Console Service Contracts obligate the Debtors to either repair a damaged console or provide the customer with a replacement console.

15. The Debtors also give Hollywood Video and Movie Gallery customers the option to purchase damage waivers when they rent a video or game (the “Play Guard Program”). If a customer elects to purchase the Play Guard Program and the rental disc is damaged during the rental period, the Debtors will waive the claim for such damages.

16. The Debtors also offer a disc maintenance service (the “Game Guard Program”) for unlimited disc refurbishing of a customer’s game discs. The Game Guard Program obligates

the Debtors to either repair a damaged disc or provide the customer with a replacement disc. The Debtors refer to the Game Console Service Contracts, the Play Guard Program and the Game Guard Program as the “Service Contracts.” The Debtors’ obligations as of the Commencement Date for the Service Contracts are approximately \$5.0 million.

E. Free and Discounted Rental Coupons

17. The Debtors run various promotions in their stores in conjunction with certain third parties whereby the Debtors provide customers with coupons for free or reduced charges for video or game rentals (the “Coupons”). For instance, the Debtors’ Movie Gallery stores maintain a customer loyalty program through which customers can earn points for video or game rentals (the “Reel Player Program”). After members of the Reel Player Program accumulate a certain number of points, they receive Coupons that may be redeemed at the Debtors’ stores. Members of programs like the Reel Player Program, are generally loyal customers who will likely continue their membership in such programs if the Debtors continue to honor the Coupons. Further, such Coupons may only be redeemed for video or game rentals, not a cash refund.

F. Guarantees and Returns

18. Certain customers also hold contingent claims against the Debtors for refunds, returns, exchanges or free rentals relating to goods sold in the ordinary course of business prior to the Commencement Date (the “Guarantees”). It is difficult to estimate with precision the aggregate amount of potential Guarantee claims for goods purchased prior to the Commencement Date. Based on historical data, however, the Debtors estimate that outstanding obligations as of the Commencement Date for Guarantees are approximately \$350,000.

G. Charitable Programs

19. From time to time, the Debtors participate in charitable programs. One such program is the Debtors' commitment to Starlight, a charitable organization that raises money to provide entertainment to children in hospitals. Through contributions that the Debtors solicit from customers and employees and the Debtors' commitment to contribute a portion of their revenues from the Play Guard Program, the Debtors contribute approximately \$700,000 annually to Starlight. As of the Commencement Date, the Debtors had outstanding obligations to Starlight of approximately \$200,000. The Debtors participation with Starlight provides the Debtors and the community with significant benefits.

Relief Requested

20. By this Motion, the Debtors seek the entry of an order, authorizing, but not directing, the Debtors to continue their Customer Programs and honor prepetition commitments related thereto.

Basis for Relief

21. Certain obligations related to the Customer Programs arguably constitute prepetition priority liabilities of the Debtors under section 507(a)(7) and give rise to individual priority claims against the Debtors that must be paid in full prior to confirmation. In addition, section 363 of the Bankruptcy Code authorizes the Debtors to pay prepetition claims if supported by a business justification. Moreover, section 105(a) of the Bankruptcy Code permits the Court to use its broad equitable powers to authorize the Debtors' payment of a prepetition debt.

22. Section 507(a)(7) provides seventh-level priority treatment for
allowed unsecured claims of individuals, to the extent of \$2,425
for each such individual, arising from the deposit, before the

commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.

11 U.S.C. § 507(a)(7). The Debtors do not believe that any individual customer has a claim for Customer Program obligations in excess of \$2,425.

23. The claims of the Gift Certificates holders, Store Credits holders, members of the Debtors' Rental Subscription Programs, Coupon holders, Service Contract counterparties and Guarantee claim holders, while not specifically mentioned in section 507(a)(7), are similar to customer deposits and may therefore be treated in the same fashion. "The ostensible purpose of the seventh priority is to protect consumers who make deposits for goods or services . . . that were not provided to the consumers at the time the debtor filed for bankruptcy." 2 Collier on Bankruptcy, § 507.08 (15th ed. rev. 2007); see also In re Tart's T.V., Furniture & Appliance Co. Inc., 165 B.R. 171, 173 (Bankr. E.D.N.C. 1994) (holders of extended warranty claims, like the Service Contracts and Guarantee claims, are entitled to priority under section [507(a)(7)]).

24. To the extent the obligations under the Customer Programs represent priority claims, pursuant to section 1129(a)(9), the holders of Gift Certificates, holders of Store Credits, Rental Subscription Programs members, Service Contracts counterparties, holders of Coupons and Guarantee claims holders are entitled to receive payment in full under a chapter 11 plan. The Debtors, therefore, believe that other creditors of the estate will not be prejudiced by this Court's approval of the Debtors' request to honor the claims on account of these Customer Programs. In fact, honoring such claims now and thereby maintaining good customer relations will benefit all creditors by enhancing the value of the Debtors' business.

25. The Court may also grant the relief requested herein pursuant to section 363 of the Bankruptcy Code. Section 363 provides, in relevant part, that “[t]he [debtor], after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” 11 U.S.C. § 363(b)(1). Under this section, a court may authorize a debtor to pay certain prepetition claims. See In re Ionosphere Clubs, Inc., 98 B.R. 174, 175 (Bankr. S.D.N.Y. 1989) (affirming lower court order authorizing payment of prepetition wage claims pursuant to section 363(b)). To do so, “the debtor must articulate some business justification, other than the mere appeasement of major creditors.” Id. at 175.

26. Paying prepetition commitments under the Customer Programs will benefit the Debtors and their creditors by allowing the Debtors’ operations to continue without interruption. In essence, the Debtors hope to continue during the postpetition period those Customer Programs that they believe were effective prepetition. The Debtors also believe that the relief requested herein is necessary to preserve their customer relationships and goodwill for the benefit of their estates. The importance of the Debtors’ customers to their businesses cannot be underestimated. The Debtors’ Customer Programs have generated valuable goodwill and repeat business and have contributed to the Debtors’ overall revenue. If the Debtors do not honor their obligations under the Customer Programs, the Debtors risk alienating their customers and encouraging customers to procure products from the Debtors’ competition, all to the detriment of the Debtors and their business. The substantial benefit conferred on the Debtors by these Customer Programs justifies the granting of the relief requested in this Motion.

27. The Court may also rely on its general equitable powers to grant the relief requested in this Motion as codified in section 105(a) of the Bankruptcy Code. Section 105

empowers the Court to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].” 11 U.S.C. § 105(a). A bankruptcy court’s use of its equitable powers to “authorize the payment of pre-petition debt when such payment is needed to facilitate the rehabilitation of the debtor is not a novel concept.” Ionosphere Clubs, 98 B.R. at 175-176 (citing Miltenberger v. Logansport, C. & S.W. R.Co., 106 U.S. 286 (1882)). Section 105(a) authorizes a court to “permit pre-plan payment of a pre-petition obligation when essential to the continued operation of the debtor.” In re NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992); see also In re Just for Feet, Inc., 242 B.R. 821, 825 (D. Del. 1999).

28. Application of section 105(a) in the context of this Motion is appropriate because the relief requested herein is consistent with the rehabilitative policy of chapter 11 of the Bankruptcy Code. A debtor in possession is a fiduciary with a duty to protect and preserve the estates, including the value of the business as a going concern. In re CoServ, L.L.C., 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002) (“There are occasions when this [fiduciary] duty can only be fulfilled by the preplan satisfaction of a prepetition claim.”). Granting the relief requested in this Motion will enhance the likelihood of the Debtors’ successful rehabilitation, maximize the value of the estates’ assets and thus benefit the estates’ creditors.

29. The Customer Programs are a critical aspect of the Debtors’ business, which depends on their customers’ brand loyalty and repeat business. In addition, the Customer Programs generally provide the Debtors’ customers with non-monetary benefits, such as free movie rentals, as an incentive for their continued business. Thus, honoring the Customer Programs should not reduce funds in the Debtors’ estates and, in fact, should benefit the Debtors’ estates by maximizing sales.

30. Indeed, the Debtors' creditors and other constituents will also benefit from the relief sought herein because it is expressly calculated to maximize the value of the Debtors' estates. Moreover, the Debtors' decision to honor the Customer Programs will not result in significant payments from the Debtors' estates because the majority of these programs require the Debtors to provide customers with future goods and services. Thus, the Customer Programs will not harm the Debtors' creditors and instead will protect the Debtors' goodwill and help maintain the value of their estates during this critical time.

31. Where retaining loyalty and patronage of customers is critical to successful chapter 11 cases, courts in this district and others have granted relief similar to that requested here. See, e.g., In re US Airways, Inc., Case No. 04-13819 (SSM) (Bankr. E.D. Va. Sept. 14, 2004); In re Open Plan Sys., Inc., Case No. 02-64657 (DOT) (Bankr. E.D. Va. June 13, 2002); In re Motient Corp., Case No. 02-80125 (RGM) (Bankr. E.D. Va. Jan. 11, 2002); In re Heilig-Meyers, Case Nos. 00-34533-00-34538 (DOT) (Bankr. E.D. Va. Aug. 16, 2000); In re Best Prods., Inc., Case No. 96-35267 (DOT) (Bankr. E.D. Va. Sept. 24, 1996); see also In re Dura Auto. Sys., Inc., Case No. 06-11202 (Bankr. D. Del. Nov. 20, 2006); In re The Boyds Collection, Ltd., Case No. 05-43793 (Bankr. D. Md. Oct. 24, 2005); In re Tower Auto., Inc., Case No. 05-10578 (Bankr. S.D.N.Y. Feb. 3, 2005); In re Kmart Corp., Case No. 02-B02474 (Bankr. N.D. Ill. Jan. 25, 2002).

32. Accordingly, the Debtors request the authority to continue their Customer Programs and honor prepetition commitments related thereto in their sole discretion.

33. Nothing contained in this Motion is intended or should be construed as an admission as to the validity of any claim against the Debtors, a waiver of the Debtors' rights to

dispute any claim or an approval or assumption of any agreement, contract or lease under section 365 of the Bankruptcy Code. Likewise, if this Court grants the relief sought herein, any payment made pursuant to the Court's order is not intended and should not be construed as an admission as to the validity of any claim or a waiver of the Debtors' rights to subsequently dispute such claim.

Waiver of Memorandum of Points and Authorities

34. The Debtors respectfully request that this Court treat this Motion as a written memorandum of points and authorities or waive any requirement that this Motion be accompanied by a written memorandum of points and authorities as described in Rule 9013-1(G) of the Local Bankruptcy Rules for the Eastern District of Virginia.

Notice

35. The Debtors have provided notice of this Motion to: (a) the Office of the United States Trustee for the Eastern District of Virginia; (b) the entities listed on the Consolidated List of Creditors Holding the 30 Largest Unsecured Claims filed pursuant to Bankruptcy Rule 1007(d); (c) counsel to the agent for the Debtors' proposed postpetition secured lenders; (d) counsel to the agent for the Debtors' prepetition first lien facilities; (e) counsel to the agent for the Debtors' prepetition second lien facility; (f) the trustee for the Debtors' 11% senior unsecured notes; (g) counsel to Sopris Capital Advisors LLC; (h) the trustee for the Debtors' 9.625% senior subordinated unsecured notes; (i) counsel for certain movie studios; (j) the Internal Revenue Service; (k) the Securities and Exchange Commission; and (l) the banks that process disbursements in the Debtors' cash management system (Bank of America, Canadian

Imperial Bank of Commerce and Wachovia Bank). In light of the nature of the relief requested, the Debtors respectfully submit that no further notice is necessary.

WHEREFORE, for the reasons set forth herein and in the First Day Affidavit, the Debtors respectfully request that the Court enter an order, substantially in the form attached hereto as Exhibit A, (a) authorizing, but not directing, the Debtors to continue their Customer Programs and honor certain prepetition commitments related thereto and (b) granting such other and further relief as is just and proper.

Richmond, Virginia

Dated: October 16, 2007

/s/ Peter J. Barrett

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EXHIBIT A

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**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION**

In re:)	Case No. 07-_____
)	Jointly Administered
MOVIE GALLERY, INC., et al., ¹)	Chapter 11
)	
Debtors.)	
)	

**ORDER AUTHORIZING, BUT NOT DIRECTING, THE DEBTORS TO CONTINUE
THEIR CUSTOMER PROGRAMS AND HONOR PREPETITION COMMITMENTS
RELATED THERETO**

Upon the motion (the “Motion”)² of the above-captioned debtors (collectively, the “Debtors”) for the entry of an order (the “Order”) authorizing, but not directing, the Debtors to continue their customer programs, including, but not limited to, gift certificates, membership programs, coupons, service contracts, damage waivers, a return policy for certain goods and charitable programs (collectively, the “Customer Programs”) and honor prepetition commitments related thereto and the First Day Affidavit; it appearing that the relief requested is in the best

¹ The Debtors in the cases include: Movie Gallery, Inc.; Hollywood Entertainment Corporation; M.G. Digital, LLC; M.G.A. Realty I, LLC; MG Automation LLC; and Movie Gallery US, LLC.

² Capitalized terms used but not otherwise defined herein shall have the meanings set forth in the Motion.

interests of the Debtors' estates, their creditors and other parties in interest; the Court having jurisdiction to consider the Motion and the relief requested therein pursuant to 28 U.S.C. §§ 157 and 1334; consideration of the Motion and the relief requested therein being a core proceeding pursuant to 28 U.S.C. § 157(b); venue being proper before this court pursuant to 28 U.S.C. §§ 1408 and 1409; notice of the Motion having been adequate and appropriate under the circumstances; and after due deliberation and sufficient cause appearing therefor, it is hereby ORDERED

1. The Motion is granted in its entirety.
2. The Debtors are authorized, but not directed, to continue their Customer Programs and honor prepetition commitments related thereto.
3. This Order is not intended and should not be construed as an admission as to the validity of any claim against the Debtors, a waiver of the Debtors' rights to dispute any claim, or an approval or assumption of any agreement, contract or lease under section 365 of the Bankruptcy Code.
4. Any payment made pursuant to this Order is not intended and should not be construed as an admission as to the validity of any claim or a waiver of the Debtors' rights to subsequently dispute such claim.
5. The Debtors are authorized to take all actions necessary to effectuate the relief granted pursuant to this Order in accordance with the Motion.
6. The terms and conditions of this Order shall be immediately effective and enforceable upon its entry.

7. The Court retains jurisdiction with respect to all matters arising from or related to the implementation of this Order.

Richmond, Virginia

Date: October ____, 2007

United States Bankruptcy Judge