Zachary Scott
INVESTMENT BANKERS

IN$IGHT
PERSPECTIVES ON THE CAPITAL MARKETS

REPRINT
SUMMER 2008

Adventures in Insolvency

As business conditions induce financial distress, business owners will find a new set of rules by which to play.

by Michael T. Newsome

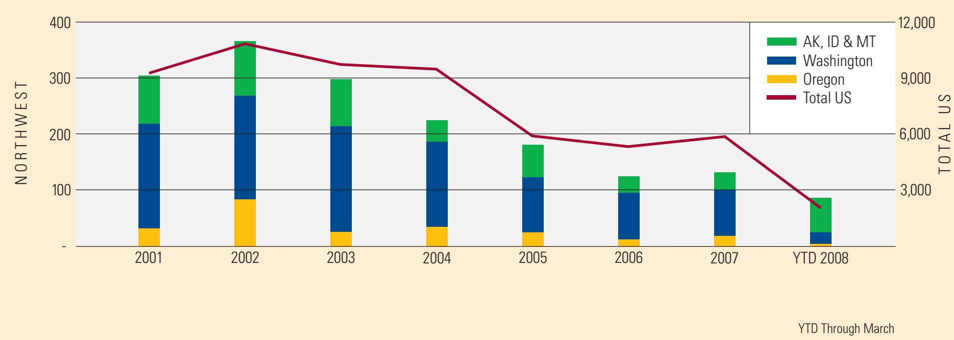
In today's deteriorating economic climate, the ranks of companies feeling the pinch are growing. Even in a fairly buoyant Northwest economy, we are entering a period of rationalization that will cut across industries. For a number of companies, depressed consumer confidence, ballooning energy costs, restricted credit access and, before long, higher interest rates will trigger sufficient financial distress to mandate restructurings and, in some cases, business sales or outright liquidations. As a result of changes to the bankruptcy code, owners and managers will find a more creditor-friendly environment, requiring credible restructuring plans buttressed by a strong case that the creditors will be better off. Hiding out in bankruptcy until the economy turns will be difficult.

Even as the wave of financial distress gathers strength, the tsunami of corporate bankruptcies widely anticipated by the insolvency industry has not yet materialized. In the first quarter of 2008, Chapter 11 filings were up 41% nationally and 85% in the Northwest, relative to very tepid activity in the first quarter of 2007. In spite of the uptick in filings, this remains well behind the pace set in 2001-2003 downturn. One reason partially credited for the lower-than-anticipated volume at this stage of the cycle is the proliferation of generous "covenant-lite" leveraged financings, where lenders progressively relaxed credit standards in a competitive frenzy that finally petered out last summer. There are a significant number of struggling companies that have not yet run afoul of their credit agreements. If the economy continues on its present course, many borrowers may soon be forced to face the music.

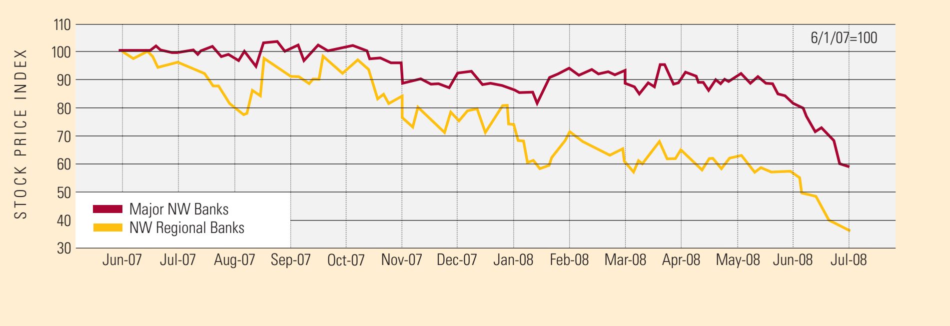
TROUBLE BREWS

Credit markets are tightening as pressure ratchets up on bank balance sheets. There are ominous signs credit problems are on the rise and both bankers and investors believe the bottom of this economic trough has not yet been seen. The stock prices of the major banks operating in the Northwest (BofA, Wells, Key, and US) are, in aggregate, off by 40% over the past year. Of course, this is the consequence of much weightier factors than just lending challenges encountered locally. But the problems are real and even more evident among Northwest regional banks, for which, collectively, stock prices have plunged nearly 65% in a year. Still, loan delinquencies are reported to be well below the 20-year mean on a national basis, while charge-offs are approaching the mean. Bankers and investors clearly expect that other shoes are poised to drop. And, they will. Thankfully, bankers are moving briskly to shut the barn door now that that the horses are gone, as the Federal Reserve's Senior Credit Officer Survey reports that more than 50% are tightening credit standards.

Northwest Chapter 11 Bankruptcy Filings



Northwest Bank Stock Price Trend



THE ROAD TO REORGANIZATION

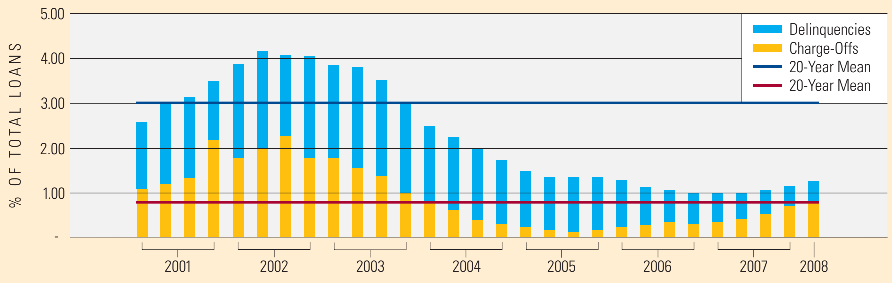
Bankruptcy reorganization has always been an expensive and an all-too-often challenging means for resurrecting a struggling business. Traditionally, Chapter 11 bankruptcy proceedings have been a forum in which middle-market business owners/managers could buy sufficient time to methodically restructure. Passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 marked a shift in the balance of power in favor of creditors. Some of the more pertinent revisions impacting corporate debtors are summarized in the table on page two.

THE REORGANIZATION ALTERNATIVE

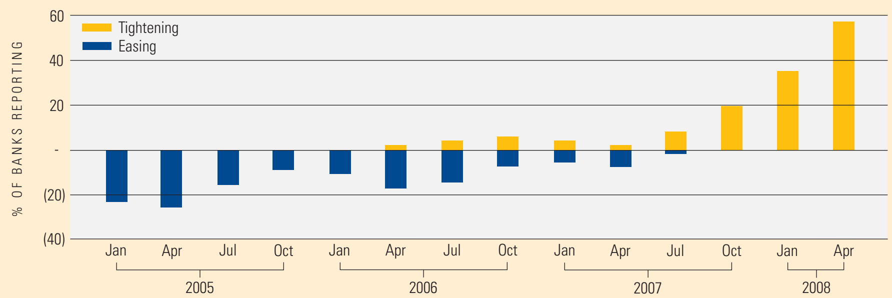
While these changes have been in place for a few years, in a robust economy with waning bankruptcy activity, they have attracted little attention. There seems to be a broad sense that bankruptcy has become a less-hospitable environment for debtors to restructure a flagging company. The administrative costs associated with a Chapter 11 proceeding make a protracted bankruptcy stint to orchestrate a reorganization plan impractical. Lenders and investors (if they still are in the money) have no appetite to watch the value of the business melt like an ice cube in a drawn-out bankruptcy proceeding. There is an old saying among

(continued p.2)

Bank Loan Performance Trends



Easing or Tightening Credit Standards



Source: Federal Reserve

veteran workout bankers, "The first loss is the best loss." In other words, take your lumps early and sell, rather than chase the elusive benefit of restructuring. Certainly, this does not hold in every case, but workout bankers can be sufficiently cynical to overlook viable reorganization alternatives. Over the long haul, it has proven true enough to squelch a lot of optimism regarding reorganization prospects.

For a middle-market business to run the gauntlet of Chapter 11, sufficient operating cash flow or access to debtor-in-possession financing is required to fund continuing operations without undermining the positions of secured creditors. Apart from access to essential liquidity, a successful reorganization generally requires most, if not all, of the following elements:

- A degree of creditor patience,
- Management credibility with creditors or new blood that can rekindle credibility,
- A viable business plan with a significant positive value gap between going-concern and liquidation alternatives, and
- A practical bankruptcy exit plan, conceived prior to filing.

For a middle-market business to run the gauntlet of Chapter 11, sufficient operating cash flow or access to debtor-in-possession financing is required to fund continuing operations without undermining the positions of secured creditors.

Even if these elements are in place, debtors and creditors are frequently choosing to restructure outside the confines of Bankruptcy Court. If there is value to be gained by running the business through bankruptcy (i.e. to reject leases, alter labor contracts, or cut off environmental or other liabilities), the shorter the transit time through bankruptcy, the better. Because time is money in bankruptcy, it is increasingly common to formulate a reorganization out-of-court, and then file for protection with a pre-packaged plan in hand, ready for court and creditor approval.

THE M&A SOLUTION

In the absence of the components of a viable reorganization, Chapter 11 proceedings are increasingly used to conduct expedited auctions of businesses, preferably marketing the debtor as a going concern and seeking the value benefits of a strategic combination. In lieu of the traditional sale as a bankruptcy plan of reorganization, the preferred mechanism has become a §363 sale process.

The mechanics of a §363 sale are comparable to a controlled auction, where an agreement detailing all of the terms of the sale is reached with an initial bidder, known as the "stalking horse," to purchase assets from the debtor. In return for undertaking the effort and expense to negotiate a deal that will be exposed to "higher and better" bids, the stalking horse bidder is granted a breakup fee (1% to 5% of the sale price) that is paid if it is outbid in the final run-off auction. Apart from the breakup fee, the stalking horse bidder also can expect an array of protections, includes qualifying standards for competing bids, a strict timeline for submission of competing bids and the run-off auction, minimum overbid increments, and expense reimbursement with an agreed cap. Following creditor scrutiny and

(continued p.3)

Lenders and investors (if they still are in the money) have no appetite to watch the value of the business melt like an ice cube in a drawn-out bankruptcy proceeding. There is an old saying among veteran workout bankers, "The first loss is the best loss."

KEY BANKRUPTCY CODE REVISIONS

Reorganization Plans	The Court's previously unlimited discretion to extend the debtor's exclusive 120-day period to file a reorganization plan has been strictly limited to 18 months.
Payment Assurance	The standards for support of certain post-petition obligations have been ratcheted up to require tangible security (i.e., cash deposits or letters of credit).
Trustee	The appointment of a trustee is now mandated upon reasonable evidence of fraud or dishonesty on the part of management or in financial reporting.
Real Property Leases	Real property leases are automatically rejected if not assumed within 210 days, as compared with the previous 60-day deadline that could be augmented with unlimited court approved extensions.
Key Employee Retention	Standards have been raised for approval of retention or severance packages for debtor insiders in an effort to limit employee leverage over creditors.
Trade-Creditor Rights	There are greater creditor protections for goods sold in the ordinary course preceding the filing. Goods delivered within 20 days are entitled to post-petition administrative expense priority, or within 45 days are subject to reclamation rights. Creditors defending preference claims only need to establish that the transfers were in the ordinary course, either with the debtor or within the industry.

consent, the Bankruptcy Court approves the stalking horse and precise rules for the sale process. In a typical §363 situation, efforts are made to engender competitive bidding among other prospective buyers, qualified bids are solicited, and then, a run-off auction is held. Following notice, the sale to the highest bidder usually closes within six weeks, and the stalking horse trots away with either the assets or the consolation of a break-up fee and expense reimbursement.

A §363 sale is an efficient vehicle for selling a troubled business, although the twists and turns of the process are often challenging and unpredictable. Its virtues can be compelling: speed, it can be accomplished in 60 to 90 days; it's clean, as assets are delivered free and clear of liens; otherwise restricted contracts can be transferred; and fraudulent conveyance exposure can be avoided.

THE IMPACT

Many companies are, or will be, caught up in the maelstrom of a very choppy economy. Thus far, much of the pain has been borne by the real estate, financial and retail sectors. But, it is reasonable to expect significant havoc among businesses in building products, transportation, consumer discretionary and consumer durable product sectors, as well as a host of industries where trouble has yet to emerge.

Bankruptcy is an arduous path to financial rejuvenation. If the prospects for financial survival are reasonable, a troubled business may find that working with creditors out-of-court is a more efficient route to recovery. ❖

Zachary Scott
INVESTMENT BANKERS

1200 Fifth Avenue, Suite 1500
Seattle, Washington 98101

www.ZacharyScott.com

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

Mark D. Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rrezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

Jay Schembs
206.838.5524
jschembs@zacharyscott.com

Brian J. Kremen
206.838.5526
bkremen@zacharyscott.com