



INSIGHT

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

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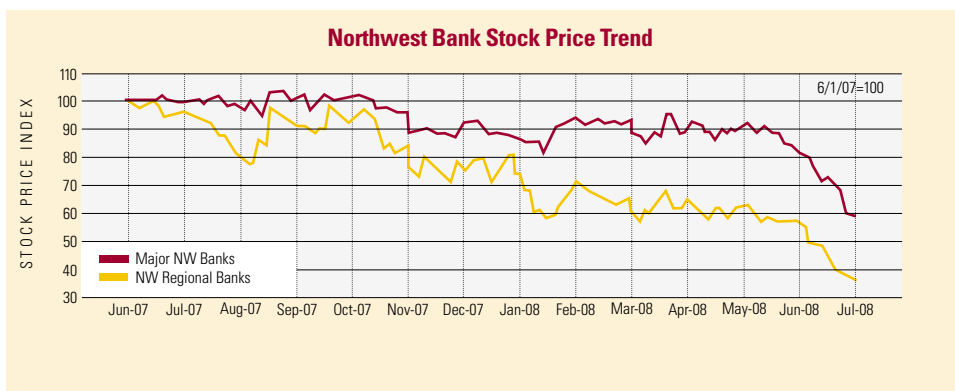
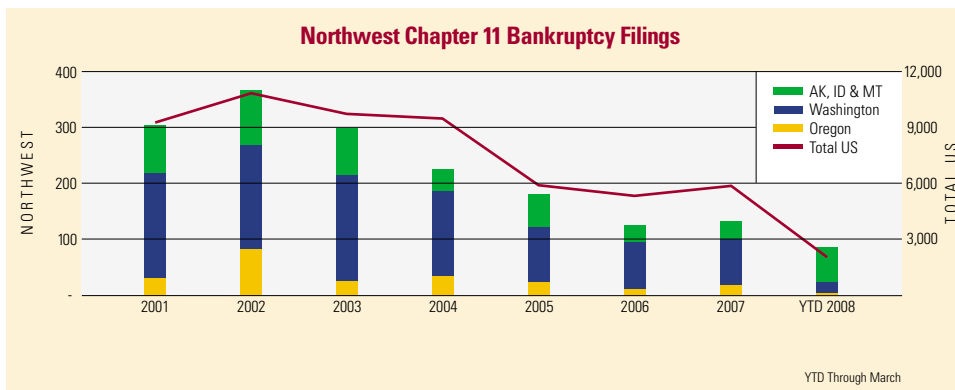
until the economy turns will be difficult. Even as the wave of financial distress gathers strength, the tsunami of corporate bankruptcies widely anticipated by the insolvency industry has not yet materialized. In the first quarter of 2008, Chapter 11 filings were up 41% nationally and 85% in the Northwest, 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.

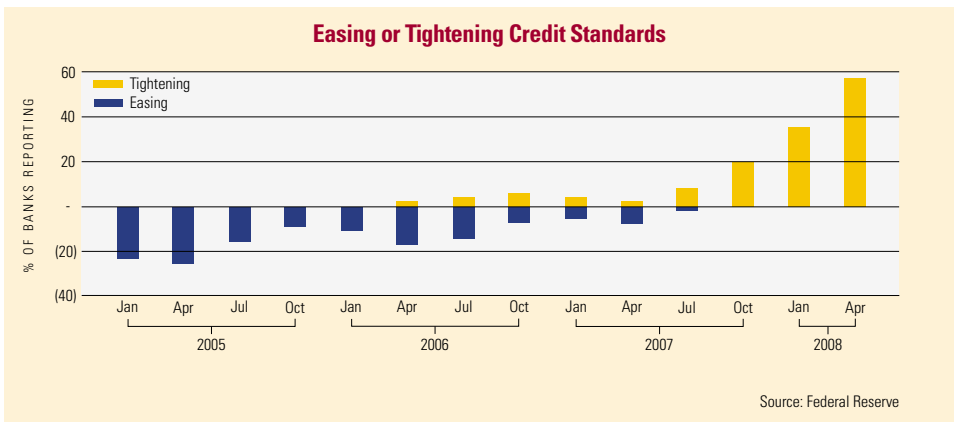
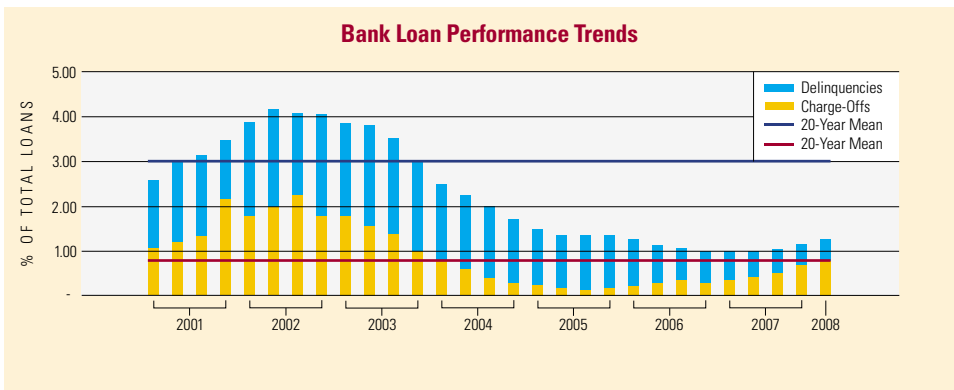
TROUBLE BREWS

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 the horses are gone, as the Federal Reserve's Senior Credit Officer Survey reports that more than 50% are tightening credit standards.

THE ROAD TO REORGANIZATION

Bankruptcy reorganization has always been an expensive and an all-too-often challenging means for resurrounding a struggling business. Traditionally, Chapter 11 bankruptcy proceed-





ings 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 adjacent table.

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

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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

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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
- A practical bankruptcy exit plan, conceived prior to filing

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

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.

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 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 so-

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licitated, 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. ♦

Capital Gains Tax Rates **Up** = Value of Businesses **Down**?

Will increasing the top capital gains tax rate harm sellers of businesses?

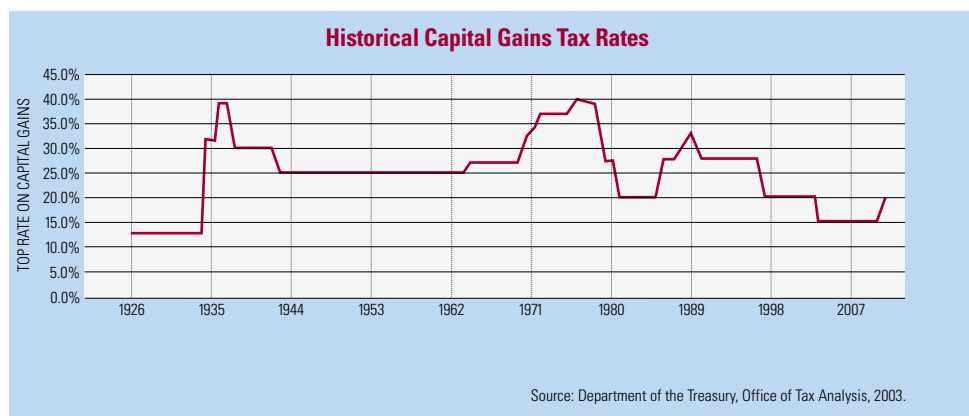
by Ray Rezac and Brian Kremen

Given the discussion in today’s political environment about whether to extend, make permanent, change or scrap President Bush’s tax cuts, an issue that merits analysis is whether an increase in the top capital gains tax rate will depress business values.

All business owners are acutely aware that an increase in the capital gains tax rate will result in lower net after-tax proceeds when they sell their businesses. What we think is a more interesting question is whether higher tax rates will have an additional indirect and negative effect on the value of the underlying business, due to an increase in the cost of capital for buyers of businesses.

BACKGROUND ON CAPITAL GAINS TAX RATES

Earlier this decade, Congress passed the Jobs and Growth Tax Relief Reconciliation Act of 2003 (“2003 Tax Act”) to spur investment and rekindle the economy. Immediately prior to the 2003 Tax Act, long-term capital gains (arising from the sale of capital assets held for more than one year) were taxed at 20% for higher income bracket taxpayers (25% or above). Additional rules governed gains on the sale of capital assets acquired after December 31, 2000, and held for more than five years.



These were taxed at a maximum rate of 18%. The 2003 Tax Act temporarily cut the top capital gains tax rate, effective from May 6, 2003 through the end of 2008, from 20% to 15% for higher income bracket taxpayers and for recipients of qualified dividends from C corporations, and ended the 18% rate for five-year holding period property. The 20% rate was mandated to reappear in 2009. However, the 15% rate was extended through 2010, due to the passage in May 2006 of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). As depicted in the graph above, the top tax

rate on capital gains has varied widely over the past 80 years. For most of that time, the top rate has been at least 25%. It peaked in 1976-77, and since then has followed a general downward trend to the current 15%, the lowest rate since before and during the Depression. President Bush has advocated making these tax cuts permanent on numerous occasions, and did so again in the most recent budget submitted to Congress. However, the consensus is that the current Congress is more likely to raise the capital gains tax rate, possibly before it is due to expire at the end of 2010.

Capital Gains *continued from p.3*

THE LINKAGE OF TAXES, COST OF CAPITAL, AND VALUE

All business owners recognize that the net proceeds from the sale of a business will be less if the capital gains tax rate is increased. What may not be as clearly understood is that, if buyers believe they ultimately will be taxed at higher rates, they must reduce their purchase offers in order to maintain the same return on investment.

Accepted valuation theory states that the value of a business is a function of the after-tax cash flows it generates, discounted by an appropriate risk-adjusted, after-tax rate of return.

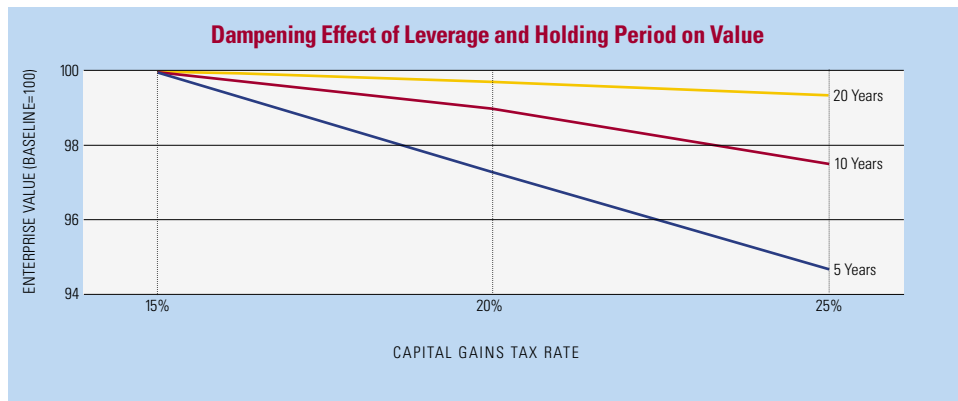
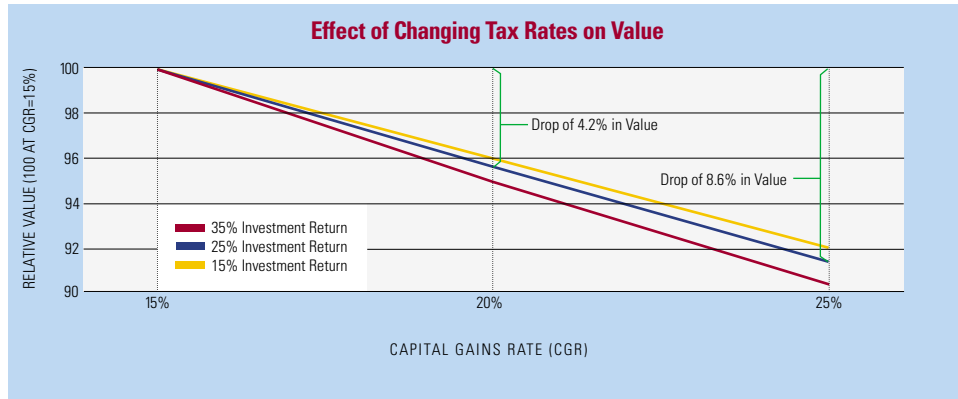
Accepted valuation theory states that the value of a business is a function of the after-tax cash flows it generates, discounted by an appropriate risk-adjusted, after-tax rate of return. As tax rates on income or capital gains change, the cost of capital changes, as does the present value of the business' future cash flow stream.

To more fully understand the effect of increased taxation on the cost of equity capital, we first analyzed how much of a decrease in initial investment (or value) would occur as a result of increasing the capital gains tax rate, to keep the after-tax return to the investor constant. The top chart illustrates that effect for a 5% and a 10% increase in the capital gains tax rate (from a base rate of 15%). As one would expect, the prices of higher risk investments are more negatively impacted by higher capital gains rates.

To determine how higher capital gains tax rates would affect the price buyers should be willing to pay for businesses, we applied this concept to an average company in which two-thirds of the post-sale capital structure is debt. The bottom chart illustrates the effect on the enterprise value of the business under varying capital gains tax rates and holding periods.

Greater leverage in the buyer's capital structure and longer holding periods each dilute the impact on value of a higher capital gains tax rate. This is primarily due to the time-value of money.

All buyers would not be affected in the same way. In the case of a public corporation, which is taxed at a single corporate rate and for which the holding period of an acquired business is expected to be long, the effect is lessened. Likewise, the effect is minimized for investors that are tax-exempt entities, such as pension funds and endowments.



Taxes of all kinds create friction that causes a drag on investment returns, and an increase in the capital gains tax rate will undoubtedly have this effect.

Because the economy consists of many different types of entities that are subject to a variety of taxes and tax rates, it is almost

impossible to precisely ascertain the actual amount of value reduction that results from an increase in the top capital gains tax rate. Nevertheless, taxes of all kinds create friction that causes a drag on investment returns. An increase in the capital gains tax rate undoubtedly will have this effect. Although prospective sellers of businesses should consider the immediate and direct reduction of after-tax proceeds due to higher capital gains rates, they should not lose sight of its subtle influence on the cost of capital and the resulting consequences for the value of the business. ❖

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, go to ZacharyScott.com.

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