

I N S I D E T H E M I N D S

The Industries Most at Risk in Bankruptcy

*Legal and Financial Experts on What to Expect,
Avoiding Financial Trouble, and
Thoughts on the Future*



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Saving Technology and Service Companies from Chapter 11

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Technology...is a queer thing. It brings you great gifts with one hand, and it stabs you in the back with the other.

~C.P. Snow, *New York Times*, 15 March 1971

From the end of the Second World War until the time of the Continental Illinois National Bank & Trust Co. bankruptcy (May 1984), while the U.S. generally enjoyed economic prosperity across many industries, a relatively few large corporate bankruptcies reflected the general U.S. economy and featured “hard assets,” e.g., railroads, steel companies, coal mines, real estate trusts, airlines, farm equipment, automobile manufacturer, etc.

Hard assets rust. You can hit them with a hammer, or leave them to sit in the Pennsylvania countryside or Arizona desert for several years without losing much of their practical production value. Large corporate bankruptcies took an orderly, some would say leisurely, time in those post-war days, and these cases were generally stewarded by a small cadre of workout specialists from large money-center banks with their captive law firms.

The few soldiers of what would become a burgeoning army of financial advisers, interim managers, and investment bankers that concentrated on “special situations” were just starting to emerge during the Reagan Recession (July 1981 to November 1982), and it would not be until the end of the decade that cases stemming from the highly leveraged “junk bond” excesses would create and inspire many of the roles and responsibilities that we see in 2008 throughout U.S. bankruptcy.

Conventional wisdom held that technology and service companies were not good candidates to emerge from a Chapter 11 bankruptcy preceding, because these companies were made up of “soft assets.” Broadly defined, soft asset companies—including computer manufacturers, information technology (IT) services, software, consulting, life science, medical devices, e-commerce, Internet, telecom, and many others—were companies whose key production asset usually went home at night. Human beings, not brick-and-mortar assets, possessed the intellectual capital necessary for production, plus patents and other types of intellectual property with know-how that was hard to value, difficult to account for, and challenging to transfer. These “value creators” could not practically go into stasis. It was

thought that the uncertain process and time frames of the Chapter 11 prevented these soft asset companies to use it as a financial engineering tool.

Of course, much has changed in the U.S. and international economies since the early 1980s, and over the past twenty-five years, many of these enterprises have frequently turned to the U.S. bankruptcy courts for protection and a successful corporate recovery. In fact, there was a dynamic flood of telecom and technology bankruptcies from the implosion of the Internet dot-com bubble in the second quarter of 2000 to the end of telecom's "nuclear winter" that ran until Q3 of 2006.

While virtually every company filing for Chapter 11 will have an uphill struggle for viability, some technology and service companies have successfully pursued this path toward corporate recovery, reengineering, and redemption and this chapter will focus on the differences and similarities germane to these bankruptcies.

Importance of Technology and Service to the U.S. Economy

It may be a sublime statement of the obvious that with each passing year since 1980, the part of the economy associated with soft assets has grown faster and larger than the hard stuff. Using a little reverse engineering to calculate its size, according to 2006 GDP figures from the U.S. Department of State, "A Service Economy: Banking, Insurance, Investment," *USA Economy in Brief*, Bureau of International Information, Washington, DC, July 2007, about 20 percent of the GDP is made up of manufacturing, construction, mining, agriculture, and oil and gas drilling (computer manufacturing is included in this number). Meanwhile, 12 percent of the GDP is accounted for by federal, state, and local governments, while the balance of approximately 68 percent of the GDP falls into the broader definition of services, including wholesale and retail sales, transportation, health care, consulting, software, legal, scientific, management services, and other—an aggregate value in excess of \$8 trillion.

First described by Joseph A. Schumpeter, the U.S. economy has consistently transformed over the years through the dynamic of "creative destruction." Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*,

Harper, New York, 1975 [orig. pub. 1942], pp. 82-85. It is interesting to note that from our humble roots as mostly subsistence farmers a little more than 200 years ago, the U.S. became a world manufacturing powerhouse during the nineteenth and twentieth centuries. “The Times They are a Changing,” *USA Economy in Brief*, Bureau of International Information, Washington, DC, July 2007. Today, the U.S. remains a powerhouse in agriculture and manufacturing, as it becomes the world’s top producer of technology and services.

The growth in the soft assets economy is well documented, as companies like Wal-Mart have grown from Sam Walton’s modest Arkansas roots in the 1940s into the world’s largest public corporation by revenue according to the *2008 Fortune Global 500*. CNNMoney.com/Fortune, a Time Warner Company, from the July 21, 2008 issue. The emergence of e-commerce—the sales of goods and services over the Internet—has grown from essentially zilch in 1997 to over 5 percent of all U.S. retail sales in 2007. Matt Richtel & Bob Tedeschi, *Online Sales Lose Steam*, The New York Times, June 17, 2007.

Soft assets companies have more than overcome the conventional wisdom that they cannot turn to Chapter 11. Looking at the five largest bankruptcies since 1980, the largest two are soft asset companies:

Company Name	Filing Date	Pre-BK Assets in \$Billions
Worldcom Inc	7/21/2002	\$ 103.9
Enron Corp.	12/2/2001	\$ 63.4
Conseco Inc.	12/18/2002	\$ 61.4
Texaco Inc.	4/12/1987	\$ 35.9
Financial Corp. of America	9/9/1988	\$ 33.9

Source: BankruptcyData.com, a division of New Generation Research Inc., Boston, MA, 2008.

Schumpeter tells us that creative destruction will not change in a market economy, and as technology and service companies continue to grow, with productivity improvements, despite the best intentions of the legion of

thoughtful and creative business leaders, not everything works out well. Then, the bankruptcy professionals earn their living.

Pitfalls All Companies Face

The best laid schemes o' mice an' men aft go astray.

~Robert Burns, *To a Mouse* (1786)

Technology and service companies face all of the pitfalls of hard asset enterprises, including three major challenges that force many companies to consider bankruptcy:

1. Losing Customer Focus
2. Failing to Integrate an Acquisition
3. Ignoring Management Succession

Examining each point separately, companies run a risk of bankruptcy whenever they stop listening to their customer. In the competitive global business environment, customers enjoy all kinds of access to alternatives, and companies that fail to effectively listen often find their “value relationship” is out of whack with other alternatives.

Bankruptcy courts are filled with companies that lost customer focus. Consider the sad tale of the bankruptcy of Cannondale Corporation (January 2003). Joe Montgomery, Cannondale’s brilliant founder and a classic entrepreneur, created one of the world’s best known high-end customer bicycle manufacturers—more than half of its revenue at the time of the bankruptcy came from overseas. From modest beginnings in 1971 (the company was named after a Metro-North commuter rail stop), these American-made beautiful machines were sold through the specialty shop distribution channel, creating a nearly cult-like following willing to shell out thousands of dollars each year for the privilege of cruising on the next Cannondale generation. Unfortunately, Cannondale was seduced into an IPO, and, once public, the investment bankers demanded more growth. Montgomery responded by boldly, bravely, and unwisely entering the market for high-end motorcycles and all-terrain vehicles (ATVs). After three tough years, an \$80 million investment, a failed attempt to build an engine from scratch, and a massive divergence of management attention

away from bikes, Cannondale had alienated many of the powerful specialty bike shop owners. More tragically, the end consumer had been abused. Cannondale has lost its distinctive snap and buzz. Under severe liquidity pressure, the company was forced into bankruptcy, and the Montgomery family lost control of the franchise. Cannondale emerged under the ownership of its former mezzanine lender, the value investor Pegasus Partners, and it was eventually sold to Dorel Industries (February 2008) for \$200 million.

Next, especially in these days of aggressive financial expectations, companies are often tempted by the “Siren Song” that an acquisition can be an efficient and easy way to create revenue growth and bolster shareholder value. The majority of corporate enterprises may consider and complete an acquisition every few years, despite the fact that the M&A process is especially fraught with risks. Not only does a merger candidate need to make good business sense with a comparable corporate culture—which can only be determined after extensive and expensive due diligence—but even if you buy it right, the integration challenge is generally well beyond the expertise of most in-house and homegrown management teams. Then, only after you buy it right, and integrate it effectively, can operating management focus on implementing the original business plan that got everyone excited about the acquisition in the first place.

Bankruptcy courts are filled with acquisitions gone bad stories. In the case of “roll-ups,” investors pumped millions of dollars in the 1980s and 1990s into these roll-up business plans, where smaller and highly fragmented mom-and-pop companies were consolidated into a leader, and the leader marched into the public market. The classic roll-up model made acquisitions whereby the seller was paid one-third in cash, one-third in earn-out (a payout based upon future performance), and the final one-third in stock (sometimes call the lottery ticket). Generally, an early seller to the public market was a happy seller, as many of the lead companies flopped from high leverage and poor operating performance reflecting willy-nilly integration. US Office Products Company (March 2001) and US Floral Products (April 2001) found themselves in Chapter 11 following wretched post-acquisition integration.

Finally, there is always a saga when leadership transitions. Professional bankruptcy analysts frequently seek predictive tools for bankruptcy. The Altman's Z-Score is one of these examples, and like many of these analytical approaches, the effectiveness of the prediction depends upon reliable input data—sort of a rearview mirror perspective. (Developed in 1968 by Edward I. Altman, professor at the Leonard N. Stern School of Business at New York University, the Z-Score has been refined over the years, and it is widely recognized as the industry leading predictive factor.) In practice, a change in chief executive most often indicates a company's turn toward troubled waters, as boards look to new leadership to fix deep-seated problems. Unfortunately, in many cases a new leader cannot fully grasp the magnitude of the challenges facing the enterprise until it is too late. Management succession is a nettlesome issue, because it puts people out of their comfort zone. Despite ample evidence to the contrary, senior management wants to believe they will manage the business in perpetuity. Bankruptcy courts are filled with companies that have changed senior management within twelve months of the Chapter 11 filing.

Unique Challenges

European merchants supply the best weaponry, contributing to their own defeat.

~Saladin

Unlike the miner, manufacturer, smelter, or bottler, management teams that operate in the broadly defined technology and service space face some unique challenges, including:

1. Managing technological obsolescence
2. Projecting critical cash
3. Cutting expense limitations

Taking these three unique challenges in their parts, unlike most hard asset businesses, nearly all companies operating on the tumultuous technology curve run the real risk that at some point they may fall behind it. This summons can come from two sources. First, technology transfer into offshore, lower-cost producing regions, often without the benefits of patent protections or recourse, has historically pressured technology business models with low-cost/high-value copycats. The U.S. Chamber of

Commerce is leading a global effort to enhance the protection of intellectual property IP, *see further* Phillip Kurata, *Economics & Trade | Open Growth Through Open Markets*, U.S. Department of State, March 25, 2008, citing specifically China, India, Thailand, and Brazil for infringements ranging from fake handbags to innovative pharmaceuticals. Without adequate IP protection, there is no incentive for innovation, and without innovation, economic growth may be harmed.

Even in the best of times, new technology has a limited shelf life to harvest the investment of time and resources for a positive return on investment; many business models have been challenged.

Then there is risk from the unforeseen technology breakthroughs that transfigure the competitive platform—think true floppy disks to hard disks to CD/DVDs to hard drives. Each rapidly innovative technology effectively annihilated the previous form, and unless the business managed successive generations of technology, it probably failed to survive. For example, many of the businesses that were once known as “record stores” actually benefited from the introduction of the compact disk, as consumers restocked their album libraries with the new delivery system. However, dozens of these companies were turned into dust as things in the digital age like MP3, iPhone, and computer downloads made most retail music business models completely unprofitable, untenable, and unsalvageable.

“Cash is King” is a mantra of the corporate recovery professional, and no doubt it will be used countless times by other authors throughout this text. However, the challenge of understanding and managing cash flow is much harder for many technology and service business models, especially those where the business is at a pre-revenue development stage. Cash burn is an art form, and uncontrollable external variables could wreck even the most conservative plan, leaving the enterprise countless millions of dollars in capital away from viability. Back in the nascent days immediately preceding telecom’s nuclear winter, heretofore brilliant management teams were pitching furiously across a variety of capital sources for that last \$100 million to complete the network to become cash positive. If one reads the earlier prospectus or Confidential Information Memoranda, most of these companies were implanting the business plan according to the strategic

intentions, but few had the foresight to predict that additional capital markets would seal shut.

Other examples include venture capital backing of AIDS research companies, and dozens of lithium-ion battery ventures that raised hundreds of millions of dollars in risk capital, but were left many millions short of nirvana. IT services, as an industry segment, have fallen in and out of favor with the capital markets, and pity the IT CFO that miscalculates the cash burn at the incorrect time.

The accounting profession has also been challenged by technology and service companies. Examine the mystery of revenue recognition policies for progress payments. Complexities and controversies surrounding the accounting policies can be nearly impenetrable, and yet senior management has fiduciary responsibility for making sure everything comes out right for a large payoff in the end.

Likewise, accountants have a hard time recognizing and valuing IP. Under FASB No. 141 patents, trademarks, IP, and copyrights must be valued as they are acquired, but it is hard to predict what—if anything—a third-party might bid for these assets if they are sold in a Chapter 11 process. Valuation methods can yield a high degree of disparity in this asset class, and investors have been reticent to bid in the case of most dot-com situations.

Finally, it is generally much easier in more traditional hard asset business models to cut expenses than in the pure technology play. In many instances, the personnel implementing the business plan are “big ticket items”—engineers, PhDs, scientists, programmers—and many of them have multiple alternatives to the job they currently hold. Stock and stock option programs are one of the tools used to motivate and retain the key value-creation employees, but many of these folks are sophisticated, smart, and fast learners who will bolt upon the first sign of trouble.

The Top Five Strategies to Avoid Technology and Service Bankruptcies

Many of the five top strategies to avoid technology and service bankruptcy also address the unique risks in this broadly defined soft asset business segment. These include:

1. Eating the Dog Food
2. Knowing What's Left in the Tank
3. Keeping the Troops Happy
4. Scouting the Next Opponent
5. Making the Right Exit

Eating the Dog Food refers to the challenge that technology and service management teams have in making sure the business plan strives for commercial relevance. A spectacular technical breakthrough in the research and development front of a life science company needs to survive the clinical trials and regulatory approval ordeals before it can be effectively and profitably delivered to a patient. Experienced venture capitalists investing in new life science technology project a \$300 to \$500 million expense to get a new drug compound into commercial application, and few senior managers have the depth to make the entire journey. To avoid the danger of bankruptcy, management needs to continually ask the question, “Will the dogs eat the dog food?” to test the commercial viability of the enterprise.

Knowing What's Left in the Tank goes back to earlier comments about projecting and managing cash burn, but the concept goes even further. A main focus of classic academic economic study analyzes the interrelationship between scarce resources. In many soft asset businesses, especially in the early stages, the challenge is especially acute. In addition to limited cash balances and capital access, there may be critical bandwidth constraint among senior management and production personnel. The algorithm software that works great in the lab may not be as successful in the implementation phase with a real client. Managing implementation of successive generations of a software prototype may get bogged down in legacy systems. While scarce resource management is a challenge in all businesses, to effectively and successfully manage this dynamic in technology and service is harder.

Keeping the Troops Happy is also difficult in many business segments, but generally, in the hard asset world higher pay can yield adequate workforce for the right competitive mix of labor. This pattern is not necessarily so in many technology and service fields—for example, many middle market IT service companies with local business models can grow to \$10 to \$12 million in annual sales, but then discover they have essentially

hired all the IT consulting resources available in that local market. Employee retention and satisfaction is critical to avoiding bankruptcy on the long road to keeping a soft asset company out of trouble.

Scouting the Next Opponent refers to management's task to understand competitive products, offerings, and technologies. More Schumpeter creative destruction here, as business is tough, and a lot of capital is spread around many business models within a technology or service paradigm to support various pathways to prosperity. It is extremely important for management to understand the positives and negatives of a product offering within the competitive continuum, and it helps to stay flexible with the game plan as the company scouts its opponents.

Finally, ***Making the Right Exit*** refers to the serial nature of soft asset companies—precious few go from the garage to board rooms, but many, many companies have the option to partner, merge, or sell with larger enterprises. Few software, life science, IT services, or medical device companies break much beyond the \$100 million revenue barrier before hooking up as a product line or market extension with a larger partner. Many that attempt to journey much beyond a timely exit may end up on the steps of the courthouse.

Keys to Successfully Reorganizing a Technology Bankruptcy

We have tried to explain how technology and service companies are unique enterprises to manage, and the impact that those differences may have in the corporate recovery process. As we have discussed, even though Chapter 11 filings were not always considered a practical alternative for these companies, many companies have nonetheless tried and succeeded after a trip to the bankruptcy court. Some of the primary factors behind success include:

1. Articulating a clear vision
2. Maintaining the confidence of your people
3. Driving a swift process onto a long runway

Leading the corporate recovery of a technology business through a bankruptcy involves the paramount task of narrowing and focusing the

business' objectives. As we will discuss in the example below, many large corporate technology recoveries benefited greatly from astute management's ability to pull out the jewel of the business, and chuck the distractions. Being able to identify and articulate a clear business vision is incredibly important when one does not have hard assets or much bricks and mortar to liquidate as an alternative recovery strategy.

At the beginning of this chapter, the point was made that the critical production units of companies generally go home at the end of the work day. Without gaining the confidence, loyalty, and trust of the people who need to stay through the restructuring process and beyond, it is virtually impossible to construct a successful technology and service bankruptcy. If the people believe in the leadership, these companies can be enormously successful after Chapter 11. The case of the Wang Technology (April 1992), discussed in detail below, is an excellent example of clear management thinking.

Finally, leaders need to drive the speed of the restructuring process. The psyche of human beings is too fragile for a long, drawn-out, and uncertain Chapter 11, and yet too often court bureaucracy and professionals can bog down the bankruptcy process. Many professionals work with a time-and-material compensation formula that may lead to peculiar incentives that are not perfectly aligned with other interests of the estate. In addition to driving speed to an end point, management also needs to ensure that the resulting enterprise has sufficient cash and resources to survive and meet its post-petition obligations. Hard asset models will use more debt in a plan. Soft asset models need to rely on more debt-to-equity capital conversion. The new balance sheet needs to avoid leverage. An expedited timeline is often the only way these companies can survive, and leaders and other professionals need to understand that fundamental truth or face a conversion to Chapter 7 or administrative insolvency.

Wang versus Memorex Telex: All Bankruptcies are Bad, but Some Bankruptcies are Better than Others Are

Right around the time that conventional wisdom began to reevaluate whether a technology or service company could use a Chapter 11 process to corporate recovery, two remarkable technology companies were actually in

court battling to survive—Memorex Telex and Wang Technology. The principles outlined earlier in this chapter are exemplified in the good, the bad, and the ugly of these two contrasting bankruptcy cases.

Wang Technology filed for bankruptcy protection on August 18, 1992. Since 1951, first the famous father, Dr. An Wang, and then son Fred of the Wang family—named as head of R&D and then CEO by Dr. Wang—had built computers into a global business with more than \$3.5 billion in revenues, mainly based upon slick and innovative technology that was critically not IBM. The “go-it-alone” approach won many converts in the geek world, but it was a difficult business model to sustain as product innovations multiplied.

Approximately \$1.2 billion of the company’s revenue was related to network servicing of the installed computer base, and this business benefited from “sticky” long-term contracts and many satisfied customers. In 1989, Dr. Wang replaced his son as CEO with Robert W. Miller, who started Wang Technologies down a path of massive restructuring, although the company then suffered from similarly massive operating losses. Miller had a sharp vision, and he brought in Joe Tucci from the outside to lead a rapid and successful bankruptcy. Both Miller and Tucci made the commitment to reorganize the enterprise around this networking service model and chuck the traditional manufacturing of computers and peripherals. Tucci was an articulate spokesperson, both internally and externally, driving the restructuring process through the courts.

Tucci transformed Wang Technology from a muddled mid-range computer manufacturer into a worldwide leader of network technology services and solutions. The answer to Wang’s redemption was already there, but to succeed Tucci had to amputate two-thirds of Wang’s core revenue—over \$2 billion worth of unprofitable sales. Tucci mercilessly shut down the original business. It was a brave move, and a good one.

Within two years of the filing, Wang emerged with more than \$200 million in cash (note the long runway). Tucci stayed on for six years, acquiring and integrating ten computer services companies, including the Olsy division from Olivetti. By 1999, the company was back up to \$3.5 billion in annual

revenues and was acquired by Getronics of The Netherlands, for a handsome stock price over 20 times the post-bankruptcy equity value.

"Beware of computer programmers that carry screwdrivers."

~ Leonard Brandwein

While Wang deserves its sterling reputation for the success of its restructuring efforts, the stark contrast is Memorex Telex (see further Lynn M. LoPucki's Bankruptcy Data Base, WebBRD)—a technology business with a base of \$3 billion of revenue that endured Chapter "33," i.e., three separate Chapter 11 filings in 1991, 1993, and 1996. This highly leveraged company was a product of two successive leveraged buyouts organized by financier Eli S. Jacobs starting in 1988. Each buyout added more debt as the scope and reach of the parent company expanded, and once again management failed on the integration front. Like Wang, Memorex Telex serviced computers and manufactured peripheral equipment, and once maintained a leading reputation in certain services and peripheral segments, especially in Europe.

Unlike Wang, through the bankruptcies Memorex Telex was unwilling to admit its excesses relating to the astoundingly high leverage ratios, and too much senior bank debt and bond debt was permitted to remain after the first and second bankruptcies. Instead of crystal clear vision on the products and services that would come out of the reorganized enterprise, David J. Faulkner, the company's vice chairman and chief financial officer, kept several business lines in place in the hope that multiple revenue sources would eventually somehow yield profitable operations. In addition, while the U.S. business units were problematic, the European units may have generated substantial interest in a sale during the first and the second bankruptcies. Most of the European units had been separate and independent businesses before the bankruptcy, and there may have been a better recovery for creditors with more debt-for-equity exchange, coupled with a brisk sale or spin-off of Europe, instead of keeping all the business units under a pile of debt that in the end resulted in the enterprise's demise. Because Memorex Telex NV failed to address core problems, by October 15, 1996 it filed the third bankruptcy predicated on an expedited sale of some U.S. operations, and the shutdown of the remaining businesses for the benefit of creditors.

Conclusion

With the continuing shift in the U.S. economy toward service and technology companies, a Chapter 11 restructuring is possible with streamlined, focused, and swift corporate recovery strategies. Hard assets one can hit with a hammer. To restructure soft assets, the restructuring professional needs to use different tools from the toolbox.



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