

**UNITED STATES BANKRUPTCY COURT
DISTRICT OF ARIZONA**

In re

ZOUNDS, INC.,

Debtor.

Chapter 11

Case No. 2:09-bk-06053-GBN

**DISCLOSURE STATEMENT IN SUPPORT
OF PLAN OF REORGANIZATION**

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Appendix 1 – Plan of Reorganization

Appendix 2 – Order Approving Disclosure Statement

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I. INTRODUCTION AND SUMMARY

A. Overview

Zounds, Inc. (the “Debtor”) filed its voluntary petition for relief under Chapter 11 of Title 11 of the United States Code (the “Bankruptcy Code”) in the United States Bankruptcy Court for the District of Arizona (the “Bankruptcy Court”) on March 30, 2009 (the “Petition Date”). The Bankruptcy Court has approved this disclosure statement (the “Disclosure Statement”) under Bankruptcy Code § 1125 in connection with confirmation of the Plan of Reorganization (the “Plan”) proposed by the Debtor in this Chapter 11 case (the “Chapter 11 Case”). The Plan was filed with the Bankruptcy Court on June 1, 2009. The following introduction and summary is a general overview only and is qualified in its entirety by, and should be read in conjunction with, the more detailed discussions, information, and financial statements appearing elsewhere in this Disclosure Statement and the Plan. All capitalized terms not defined in this Disclosure Statement have the meanings given to them in the Plan. A copy of the Plan, separately filed in the Chapter 11 Case, is **Appendix 1** to this Disclosure Statement.

This Disclosure Statement sets forth certain information regarding the Debtor’s prepetition operating and financial history, the need to seek Chapter 11 protection, significant events that have occurred during the Chapter 11 Case, and the anticipated reorganization of the Debtor. This Disclosure Statement also describes terms and provisions of the Plan, including certain alternatives to the Plan, certain effects of confirmation of the Plan, certain risk factors associated with the Plan, and the manner in which distributions will be made under the Plan. In addition, this Disclosure Statement discusses the confirmation process and how voting on the Plan will occur. Certain provisions of the Plan, and thus the descriptions and summaries contained in this Disclosure Statement, may be the subject of continuing negotiations among the Debtor and various parties, may not have been finally agreed on, and may be modified. Those modifications, however, will not have a material effect on the distributions contemplated by the Plan.

The Debtor is a proponent of the Plan within the meaning of Bankruptcy Code § 1129. The Plan contains separate Classes and proposes recoveries for holders of Claims against and Equity Interests in the Debtor. After careful review of the Debtor’s current business operations, estimated recoveries in a liquidation scenario, and the prospects of ongoing business, the Debtor has concluded that the recovery to Creditors will be maximized by the reorganization of the Debtor as contemplated by the Plan.

Specifically, the Debtor believe that continued operations after confirmation of the Plan provides Creditors and holders of Equity Interests with the maximum possible recovery under the circumstance. This conclusion is demonstrated by the liquidation analysis prepared by the Debtor’s management.

B. Notice to Holders of Claims and Equity Interests

This Disclosure Statement is being used to solicit votes on the Plan only from holders of impaired Claims, and is being transmitted to Creditors with unimpaired Claims and to Equity Holders other parties in interest for informational purposes. The purpose of this Disclosure

Statement is to provide adequate information to enable the holder of an impaired Claim to make a reasonably informed decision with respect to the Plan before voting to accept or reject the Plan.

On [REDACTED], 2009 the Bankruptcy Court entered an order, attached as **Appendix 2** to this Disclosure Statement, approving this Disclosure Statement as containing information of a kind and in sufficient and adequate detail to enable Creditors to vote on the Plan as required by Bankruptcy Code § 1125. The Bankruptcy Court's approval of this Disclosure Statement does not constitute either a guaranty of the accuracy or completeness of the information contained in this Disclosure Statement or the Bankruptcy Court's endorsement of the Plan.

Holders of Claims are encouraged to read this Disclosure Statement and its appendices carefully and completely before deciding to accept or reject the Plan. If a description in this Disclosure Statement and a term of the Plan conflict, the Plan governs.

This Disclosure Statement and the other materials included in the solicitation package are the only documents authorized by the Bankruptcy Court to be used in connection with the solicitation of votes on the Plan. No solicitation of votes may be made except after distribution of this Disclosure Statement, and no person has been authorized to distribute any information concerning the Debtor or the Plan other than the information contained in this Disclosure Statement.

Certain of the information contained in this Disclosure Statement is by its nature forward-looking and contains estimates, assumptions and projections that may be materially different from actual or future results. Except as otherwise specifically stated, this Disclosure Statement does not reflect any events that may occur after the date of this Disclosure Statement and that may have a material impact on the information contained in this Disclosure Statement. Neither the Debtor nor Reorganized Zounds intend to update the information contained in this Disclosure Statement.

Except where specifically noted, the financial information contained in this Disclosure Statement has not been audited by a certified public accountant and may not have been prepared in accordance with generally accepted accounting principles.

This Disclosure Statement has been prepared in accordance and compliance with Bankruptcy Code § 1125 and Bankruptcy Rule 3016(b) and not necessarily in accordance with federal or state securities laws or other non-bankruptcy law. This Disclosure Statement has been neither approved nor disapproved by the Securities and Exchange Commission (the "SEC"), nor has the SEC passed on the accuracy or adequacy of the statements contained in this Disclosure Statement.

This Disclosure Statement may not be construed to be conclusive advice on the tax, securities, or other legal effects of the Plan on holders of Claims against, or Equity Interests in, the Debtor.

C. Summary Of Treatment Of Claims And Equity Interests Under The Plan

The Plan constitutes a plan of reorganization for the Debtor. The Plan contains definitions and rules of interpretation and provides the treatment of separate classes for holders of Claims

against, and Equity Interests in, the Debtor. As provided by Bankruptcy Code § 1123(a)(1), Administrative Claims and Priority Tax Claims are not classified.

The table below summarizes the classification and treatment of the principal prepetition Claims and Equity Interests under the Plan. The classification and treatment for all Classes are described in more detail in Section IV of this Disclosure Statement and Articles 2 and 3 of the Plan.

Class	Description	Treatment
1	Priority Claims (Unimpaired; deemed to accept)	Each holder of an Allowed Priority Claim other than a Priority Tax Claim will receive Cash in an amount equal to its Allowed Priority Claim on the later of: (i) the Effective Date, or as soon after that date as practicable; and (ii) 30 days after the Priority Claim is Allowed; unless, before the later of these two dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date.
2	Secured Tax Claims (Unimpaired; deemed to accept)	Each holder of an Allowed Secured Tax Claim will receive Cash in an amount equal to its Allowed Secured Tax Claim on the latest of: (i) the Effective Date, or as soon after that date as practicable; (ii) any date the Bankruptcy Court may fix, or as soon after that date as practicable; (iii) 30 days after the Secured Tax Claim is Allowed; and (iv) the date on which the Secured Tax Claim is scheduled to be paid in the ordinary course of business under applicable law or regulation; unless, before the latest of the above dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date. Each holder of an Allowed Secured Tax Claim retains all Liens on applicable property of the Estate arising under applicable law until that holder's Allowed Secured Tax Claim is paid in full under Section 3.02.b of the Plan. If any portion of any Allowed Secured Tax Claim is not paid in accordance with Section 3.02.b of the Plan and Reorganized Zounds does not make that payment within ten days after notice of non-payment is received from the holder of the Claim, the holder may proceed with applicable state law remedies for collection of all amounts owing but not paid in accordance with Section 3.02.b of the Plan.

Class	Description	Treatment
3	Miscellaneous Secured Claim (Unimpaired; deemed to accept)	Each holder of an Allowed Miscellaneous Secured Claim will receive Cash in an amount equal to its Allowed Miscellaneous Secured Claim on the latest of: (i) the Effective Date, or as soon after that date as practicable; (ii) any date the Bankruptcy Court may fix, or as soon after that date as practicable; (iii) 30 days after the Miscellaneous Secured Claim is Allowed; and (iv) the date on which the Miscellaneous Secured Claim is scheduled to be paid in the ordinary course of business under applicable law or regulation; unless, before the latest of the above dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date. Each holder of an Allowed Miscellaneous Secured Claim retains all Liens on applicable property of the Estate arising under applicable law until that holder's Allowed Miscellaneous Secured Claim is paid in full under Section 3.03.b of the Plan. If any portion of any Allowed Miscellaneous Secured Claim is not paid in accordance with Section 3.03.b of the Plan and Reorganized Zounds does not make that payment within ten days after notice of non-payment is received from the holder of the Claim, the holder may proceed with applicable state law remedies for collection of all amounts owing but not paid in accordance with Section 3.03.b of the Plan.
4	Secured Notes Claims (Impaired; entitled to vote)	Each holder of an Allowed Secured Notes Claim will receive a Pro Rata portion of 100% of the New Common Stock, subject to dilution by: (A) 5% by the New Common Stock issued to holders of Settled Notes Claims in Class 5; (B) any stock authorized and issued under any incentive plan or similar program for members of Reorganized Zounds's senior management as the board of directors of Reorganized Zounds may approve after the Effective Date; and (C) any future stock offerings as the board of directors of Reorganized Zounds may approve after the Effective Date in accordance with the Reorganized Certificate.
5	Settled Notes Claims (Impaired; entitled to vote)	Each holder of a Settled Notes Claim will receive, in full and final satisfaction of its Allowed Unsecured Notes Claim a Pro Rata portion of 5% of the New Common Stock, subject to dilution by any shares issued under a stock incentive plan or similar program for members of Reorganized Zounds's senior management and any future stock offers, each as the board of directors of Reorganized Zounds may approve after the Effective Date in accordance with the Reorganized Certificate.

Class	Description	Treatment
6	Unsecured Claims (Impaired; entitled to vote)	Each holder of an Allowed Unsecured Claim will receive, in full and final satisfaction of its Allowed Unsecured Claim, a Pro Rata portion of the beneficial interests in the Unsecured Creditor Trust, which will be vested with the Avoidance Actions and will be the payee under the Unsecured Creditor Note.
7	Securities Claims (Impaired; deemed to reject)	Under Bankruptcy Code § 510(b), each Securities Claim is mandatorily subordinated to all other Claims. Accordingly, the holders of Securities Claims will not receive or retain any rights, property, or distributions on account of their Securities Claims under the Plan.
8	Equity Interests (Impaired; deemed to reject)	As of the Effective Date, all Equity Interests will be canceled and extinguished without further action under any applicable agreement, law, regulation, order, or rule. The holders of Equity Interests will not receive or retain any rights, property, or distributions on account of their Equity Interests under the Plan.

D. Voting Procedures, Ballots, and Voting Deadline

Accompanying this Disclosure Statement are, among other things, copies of: (1) the Plan (**Appendix 1** and separately filed in this Chapter 11 Case); (2) the notice of, among other things, the time for submitting Ballots to accept or reject the Plan, the date, time, and place of the hearing to consider confirmation of the Plan, and the time for filing objections to the confirmation of the Plan (the “Confirmation Hearing Notice”); and (3) if you are entitled to vote, one or more Ballots (and return envelopes along with detailed instructions accompanying the Ballots) to be used in voting to accept or reject the Plan.

After carefully reviewing the Plan, this Disclosure Statement, and (if you are entitled to vote) the detailed instructions accompanying your Ballot, please indicate your acceptance or rejection of the Plan by completing the appropriate Ballot. You must provide all the information requested on the Ballot; failure to do so may result in your vote being disqualified.

In order for your vote to be counted, your Ballot must be properly completed and **ACTUALLY RECEIVED** no later than **July 31, 2009** at 5:00 p.m. Arizona Time (the “Voting Deadline”) by counsel for the Debtor (the “Debtor’s Counsel”). Your Ballot contains the address and contact information for Debtor’s Counsel. Ballots should not be sent or delivered to the **Debtor, the Bankruptcy Court, or any other party other than Debtor’s Counsel. Ballots not received by the Voting Deadline by Debtor’s Counsel will not be counted.**

If: (1) you have any questions about the procedure for voting or the packet of materials that you have received; or (2) you wish to obtain an additional copy of the Plan, this Disclosure Statement, or any exhibits to either of those documents, please contact: Bradley A. Cosman, Esq.; Squire, Sanders & Dempsey L.L.P.; 40 North Central Avenue, Suite 2700; Phoenix, AZ 85004; Telephone: (602) 528-4000; e-mail bcosman@ssd.com

E. Confirmation Procedures

Under Bankruptcy Code § 1126(f), if a class of claims or interests is unimpaired under a plan, that class (and each member of that class) is conclusively presumed to have voted in favor of the plan and is not solicited to vote on the plan. In this Chapter 11 Case, the Plan contains seven Classes of Creditors and one Class of Equity Interests and Equity Related Claims. All Unclassified Claims and Claims in Classes 1, 2 and 3 are unimpaired by the Plan and holders of such Claims are presumed to have voted in favor of the Plan and will not be solicited to vote on the Plan. All Claims in Classes 4, 5 and 6 are impaired and holders of such Claims are entitled to vote to accept or reject the Plan. Classes 7 and 8 under the Plan (Securities Claims and Equity Interests) are impaired under the Plan and members of those Classes will neither receive nor retain any property on account of their Securities Claims or Equity Interests. Accordingly, members of Classes 7 and 8 are deemed to reject the Plan and will not be solicited to vote on the Plan.

The Bankruptcy Court has scheduled the Confirmation Hearing to begin on [REDACTED], 2009 at [REDACTED]:[REDACTED].m. (Arizona time) before the Honorable George B. Nielsen, Jr., United States Bankruptcy Judge, at the United States Bankruptcy Court, 203 North 1st Avenue, Phoenix, Arizona 85004. The Bankruptcy Court may adjourn the Confirmation Hearing from time to time without further notice except for an announcement of the adjournment date made at the Confirmation Hearing. The Bankruptcy Court has ordered that any objections to confirmation of the Plan be filed with the Clerk of the Bankruptcy Court and served so that they are actually received on or before **July 31**, 2009, at 5:00 p.m. (Arizona time) by:

Counsel to the Debtor:
SQUIRE, SANDERS & DEMPSEY L.L.P.
Two Renaissance Square
40 North Central Avenue, Suite 2700
Phoenix, Arizona 85004
Attn: Jordan A. Kroop, Esq.
Bradley A. Cosman, Esq.
Telephone: (602) 528-400

The United States Trustee:
OFFICE OF THE U.S. TRUSTEE
203 North 1st Avenue
Phoenix, Arizona 85004
Attn: Larry Watson, Esq.
Telephone: (602) 682-2600

THE DEBTOR BELIEVES THAT THE PLAN PROVIDES THE BEST RECOVERIES POSSIBLE FOR THE HOLDERS OF CLAIMS AGAINST THE DEBTOR. THE DEBTOR STRONGLY RECOMMENDS THAT YOU VOTE TO ACCEPT THE PLAN AND SUPPORT CONFIRMATION OF THE PLAN.

II. BACKGROUND REGARDING THE DEBTOR

A. Overview of Business Operations

The Debtor designs, manufactures and markets proprietary, high-performance hearing aids for use with mild, moderate and severe hearing impairments. The Debtor has historically sold its hearing aids through a shopping mall-based retail platform. The first retail locations were opened in February 2007. At its peak in October 2008, the Debtor had 29 stores across the United States with an additional location under construction. Before the Petition Date the Debtor closed twelve underperforming stores, combined its warehouse and corporate offices into one location in Phoenix and elected not to complete or open one unfinished store. During the Chapter 11 Case the Debtor closed an additional eleven mall-based stores. The Debtor opened ten new, smaller non-mall-based stores in six markets previously served by the Debtor and exited one market altogether.

The Debtor established a business model that the Debtor's management believed provided it with several competitive advantages over traditional hearing aid providers, including: (i) competing on price by providing a direct-to-consumer supply channel, reducing the average cost per pair of hearing aids from \$5,000 to \$7,000 per pair to approximately \$3,000 per pair; (ii) providing a technologically superior product, particularly in the areas of eliminating undesired noise and extending battery life, enhancing directionality, eliminating feedback, and enhancing voice quality; and (iii) reducing the number of visits to audiologists required to adjust the hearing aid by providing audiologists on-site at the Debtor's retail locations. While the Debtor executed on several aspects of this model, the shopping mall-based concept has not provided the direct-to-consumer advantages that the Debtor anticipated.

The Debtor utilizes a mix of internally-developed technology created by the Debtor's engineers and licensed technology developed by Acoustic Technologies, Inc. ("Acoustic"), an entity founded by Samuel Thomasson, the Debtor's founder and chief executive officer. The Debtor designs its products and utilizes contract manufacturers for the assembly, testing and packaging of its products.

The Debtor holds or has applied for 17 patents and has the exclusive rights within the hearing aid industry for the use of 41 patents (either issued or pending) held by Acoustic. The license between Acoustic and the Debtor (the "Acoustic License") provides the Debtor with an exclusive, perpetual, global, assignable (to distribution) and transferable (on the sale of the Debtor) license within the hearing aid industry for the use of Acoustic's intellectual property and technology. The intellectual property and technology provided under the Acoustic License is integral to the features that make the Debtor's product superior to that of its competitors. In consideration for the Acoustic License, the Debtor issued a significant number of shares of the Debtor to the shareholders of Acoustic, paid a one-time cash license fee of \$1 million, and paid certain other consulting fees associated with transitioning the acoustic technology. There are no royalties or other ongoing financial obligations under the Acoustic License.

As of the date of this Disclosure Statement, the Debtor had approximately 78 employees. None of the Debtor's employees is subject to a collective bargaining agreement.

B. Selected Financial Information for The Debtor

Appendix 3 contains financial information pertaining to the Debtor, in the form of income statements for fiscal years ending June 30, 2007 and June 30, 2008, a balance sheet as of the Effective Date of the Plan (assumed for purposes of the balance sheet as September 1, 2009), and projected income statements for fiscal years 2009 and 2010 (the “Projections”). As indicated in the documents contained in Appendix 3, for the fiscal years ending June 30, 2007 and June 30, 2008, the Debtor generated net revenues of approximately \$1.8 million and \$12.3 million, respectively, and an operating loss of approximately \$23.17 million and \$31.25 million, respectively. For the period between July 1, 2008 and January 31, 2009, the Debtor generated net revenues of approximately \$9.58 million and an operating loss of approximately \$15.53 million.

C. Prepetition Debt

Until January 2009, the Debtor had not incurred significant secured debt and had previously issued two series of convertible unsecured notes to accredited investors through private placements, including: (i) \$3,685,000 aggregate principal amount of 10% Series B Convertible Notes due 2009 and (ii) \$11,937,870 aggregate principal amount of 10% Series C Convertible Notes due 2009 (together, the “Convertible Notes”). Interest on the Convertible Notes is payable at maturity.

In November 2008, certain additional holders of Series C Convertible Notes received a security agreement from the Debtor, purporting to secure an additional \$525,000 aggregate principal of notes under that series (the “Secured Series C Notes”). The Debtor believes that holders of the Secured Series C Notes either failed to perfect any security interest they might hold in property of the Debtor’s Estate or that any such security interests are avoidable under various provisions of the Bankruptcy Code.

From December 2008 through February 2009, the Debtor issued a series of 10% Secured Convertible Notes to accredited investors (the “Secured Lenders”) through private placements in the aggregate principal amount of approximately \$4.5 million (the “Secured Notes”). Interest on the Secured Notes compounds quarterly and is payable at maturity. The Debtor believes that holders of approximately \$1.2 million of the Secured Debt either failed to perfect any security interest they might hold in property of the Debtor’s Estate or that any such security interests are avoidable under various provisions of the Bankruptcy Code.

D. Prepetition Capital Structure

The Debtor is a privately held Delaware corporation with its principal place of business in Phoenix, Arizona. The Debtor has issued four series of stock to accredited investors, including: (i) 46,435,662 issued shares of Series A Preferred Stock; (ii) 46,901,210 issued shares of Series B Preferred Stock; (iii) 59,649,052 issued shares of Class A Common Stock and 8,130,838 issued shares of Class B Common Stock. The holders of the Series A Preferred Stock, Series B Preferred Stock and Class Common A Stock hold 100% of the voting interest in the company.

E. Events Precipitating the Chapter 11 Case

Between February of 2007 and October of 2008, the Debtor rapidly expanded the number of mall-based stores from two to twenty-nine. The Debtor funded this growth principally through the issuance of its various equity securities, the Convertible Notes, the Secured Series C Notes and the Secured Notes. The funds raised through both equity and debt financing, however, proved insufficient to fund the Debtor's growth strategy and operating losses. As a result, the Debtor was left with insufficient cash to meet its existing obligations and numerous underperforming stores and burdensome leases. During the Chapter 11 Case, the Debtor has implemented a strategy to evolve from an entirely mall-based model to a model that combines a few mall-based locations with smaller community locations.

The Debtor has historically relied extensively on private placements of its equity securities to both obtain the Acoustic License and fund its expansion and operations. As a result, the Debtor has an unduly complicated capital structure, particularly in light of the size of the Debtor's business, that has and will continue to present an obstacle to future efforts to obtain capital.

III. SIGNIFICANT EVENTS IN CHAPTER 11 CASE

A. Continuation of Business; Automatic Stay

The Chapter 11 Case was assigned to the Honorable George B. Nielsen, Jr., United States Bankruptcy Judge for the District of Arizona. Since the Petition Date, the Debtor has continued to operate its business and manage its properties as debtor-in-possession under Bankruptcy Code §§ 1107(a) and 1108. No trustee has been appointed in the Chapter 11 Case.

An Official Committee of Unsecured Creditors was appointed in the Chapter 11 Case on April 16, 2009. The members of the Committee are: (i) Robert Clements; (ii) Group 7 Design, Inc.; (iii) JWT Specialized Communications, Inc.; (iv) Simon Property Group, Inc.; and (v) Steve Walczak.

An immediate effect of the filing of the Debtor's bankruptcy petition was the imposition of the automatic stay under Bankruptcy Code § 362 that, with limited exceptions, enjoined the commencement or continuation of all collection efforts by creditors, the enforcement of liens against property of the Debtor, and the commencement or continuation of litigation against the Debtor. This relief provided the Debtor with the "breathing room" necessary to assess and reorganize its business. The automatic stay remains in effect, unless modified by the Bankruptcy Court, until consummation of the Plan.

B. "First Day" and Administrative Orders

At the beginning of the Chapter 11 Case, the Bankruptcy Court entered several orders that the Debtor requested for purposes of maintaining ongoing business operations and to ensure that the Chapter 11 filings would not disrupt those operations. These orders, among other things, authorized the Debtor to pay certain prepetition claims and granted other relief necessary to facilitate the Debtor's transition between prepetition and postpetition business operations. The orders authorized, among other things:

- the retention of the Squire, Sanders & Dempsey L.L.P., as restructuring counsel to the Debtor;
- the maintenance of the Debtor's bank accounts and operation of its cash management system substantially as that system existed before the Petition Date and the continued use of existing business forms;
- the continuation of utility services during the Chapter 11 Case;
- approval of the DIP Facility (further described below);
- approval of the payment of certain pre-petition claims of essential vendors, up to an aggregate amount of \$600,000;
- rejection of leases for underperforming stores, the Debtor's former corporate offices and a store that was never opened; and
- the payment of employees' accrued prepetition wages and obligations associated with the Debtor's employee benefits plans.

C. The DIP Facility

On April 29, 2009, the Bankruptcy Court entered an order approving the DIP Facility (the "DIP Financing Order"). The DIP Facility was provided to the Debtor by Michael Stewart, Derwood Chase and certain affiliated entities designated by Derwood Chase (as defined in the Plan, the "DIP Lenders"). The DIP Lenders hold a majority of the Secured Debt.

Under the DIP Facility, the DIP Lenders provided the Debtor with \$1 million in post-petition financing to allow the Debtor to continue its business operations and authorized the Debtor's use of the Debtor's cash, which is subject to the pre-petition security interest of the Secured Lenders. The Debtor's obligations under the DIP Facility are secured by (i) a priming lien on substantially all of the Debtor's assets with priority over the Secured Debt, subject only to certain allowed liens, (ii) a first priority lien on all of the Debtor's unencumbered pre-petition assets, excluding causes of action arising under Chapter 5 of the Bankruptcy Code and (iii) a first priority lien on all other pre-petition and post-petition assets of the Debtor, subject only to certain allowed liens. The obligations under the DIP Facility are also entitled to a so-called "super priority" administrative claim under Bankruptcy Code § 364(c)(1).

In consideration for the DIP Lenders' provision of the DIP Facility, the Debtor acknowledged that (i) the Debtor was indebted to the DIP Lenders as a subset of all holders of the Secured Debt without defense, counterclaim or offset in the amount of approximately \$3.3 million, plus accrued and unpaid interest thereon and fees, expenses and other obligations incurred in connection with the Secured Debt; (ii) that the Secured Debt obligations of the Debtor to the DIP Lenders constituted legal, valid and binding obligations of the Debtor, enforceable in accordance with their terms; (iii) that no portion of the Secured Debt obligations of the Debtors to the DIP Lenders are subject to avoidance, recharacterization, recovery or subordination under the Bankruptcy Code or non-bankruptcy law; (iv) that the Debtor did not

have, and released on behalf of itself but not the Estate, any claims, counterclaims, causes of action, defenses or setoff rights against the DIP Lenders or their affiliates and (v) that all liens provided to the DIP Lenders to secure the Secured Debt held by the DIP Lenders were valid, binding, perfected and enforceable first priority liens on substantially all of the Debtor's assets, not subject to avoidance, recharacterization or subordination pursuant to the Bankruptcy Code or nonbankruptcy law and subject to only the priming lien of the DIP Lenders and certain allowed liens.

The Debtor anticipates that the credit provided under the DIP Facility will be insufficient to fund the Debtor's operations through the Effective Date and that additional post-petition financing will be necessary. The Debtor has engaged the DIP Lenders in discussion regarding the provision of additional financing under the DIP Facility.

D. Other Significant Events During the Chapter 11 Case

In addition to the first day motion to reject leases on twelve underperforming stores, the Debtor's former corporate headquarters and a store that was never completed or opened, during the Chapter 11 Case, the Debtor filed motions to reject leases for an additional eleven mall-based stores. The Debtor entered into leases for ten smaller community stores in six markets and elected to exit one market altogether.

IV. DESCRIPTION OF THE PLAN

A. Introduction

This section provides a summary of the Plan's structure, classification, treatment, and implementation. Although the statements contained in this Disclosure Statement include summaries of the provisions contained in the Plan and in documents referred to in the Plan, this Disclosure Statement does not purport to be a precise or complete statement of all the terms and provisions of the Plan or documents referred to in the Plan. Refer to the Plan and its exhibits for a complete statement of all the Plan's terms.

The Plan itself and the documents it refers to will control the treatment of holders of Claims against, and Equity Interests in, the Debtor under the Plan and will, on the Effective Date, be binding on all parties-in-interest, including holders of Claims against, and Equity Interests in, the Debtor and Reorganized Zounds.

B. Summary of Claims Process, Bar Date, and Professional Fees

The Bankruptcy Court entered an order (the "Bar Date Order") setting July 3, 2009 as the deadline for filing proofs of claim against the Debtor (the "Bar Date"), except for the claims of Governmental Units, which must be filed by September 26, 2009 under Bankruptcy Code § 502(b)(9). The Bar Date excludes certain Claims, including Administrative Claims (except claims entitled to priority under Bankruptcy Code § 503(b)(9), which are subject to the Bar Date), Professional Fee Claims and Claims based on the rejection of executory contracts and unexpired leases following entry of the Bar Date Order, as to which the bar date is controlled by provisions of the Plan and orders of the Bankruptcy Court authorizing the rejection of contracts or leases. The Debtor's Counsel provided notice of the Bar Date by mailing to each person listed in the

Schedules a notice of the Bar Date, a copy of the Bar Date Order, and a proof of claim form. In addition, the Debtor published notice of the Bar Date in the national edition of *USA Today*.

All Administrative Claims, Professional Fee Claims and Rejection Claims must be filed on or before the date that is the first Business Day that is 30 days after the Confirmation Date.

C. Classification and Treatment of Claims and Equity Interests, Generally

Bankruptcy Code § 1122 requires that a plan of reorganization classify the claims of a debtor's creditors and the interest of its equity holders. The Bankruptcy Code also provides that, except for certain claims classified for administrative convenience, a plan of reorganization may place a claim of a creditor or an interest of an equity holder in a particular class only if the claim or interest is substantially similar to the other claims or interests of that class. The Bankruptcy Code also requires that a plan of reorganization provide the same treatment for each claim or interest of a particular class unless the holder of a particular claim or interest agrees to a less favorable treatment of its claim or interest.

The Debtor believes that it has classified all Claims and Equity Interests in compliance with the requirements of the Bankruptcy Code. If a holder of a Claim or Equity Interest challenges the Plan's classification of Claims or Equity Interests and the Bankruptcy Court finds that a different classification is required for the Plan to be confirmed, the Debtor, to the extent permitted by the Bankruptcy Court, intends to modify the classifications of Claims or Equity Interests under the Plan to provide for whatever classification might be required by the Bankruptcy Court for confirmation. Except if a modification of classification adversely affects the treatment of a holder of a Claim or Equity Interest, acceptance of the Plan by any holder of a Claim or Equity Interest will be deemed to be a consent to the Plan's treatment of the holder of a Claim or Equity Interest regardless of the class as to which that holder ultimately is deemed to be a member.

D. Treatment of Unclassified Claims

As provided in Bankruptcy Code § 1123(a)(1), Administrative Claims, Preserved Ordinary Course Administrative Claims and Priority Tax Claims are not classified for purposes of voting on, or receiving distributions under, the Plan. Holders of Administrative Claims, Preserved Ordinary Course Administrative Claims and Priority Tax Claims are not entitled to vote on the Plan but, rather, are treated separately in accordance with Sections 2.02, 2.03 and 2.04 of the Plan and under Bankruptcy Code § 1129(a)(9)(A).

1. Allowed Administrative Claims

An Administrative Claim is a Claim for any cost or expense of administration of the Chapter 11 Case Allowed under Bankruptcy Code §§ 503(b), 507(b) or 546(c)(2) and entitled to priority under Bankruptcy Code § 507(a)(1), including: (a) fees payable under 28 U.S.C. § 1930; (b) actual and necessary costs and expenses incurred in the ordinary course of the Debtor's business; (c) actual and necessary costs and expenses of preserving the Estate or administering the Chapter 11 Case; and (d) all Professional Fee Claims to the extent Allowed by Final Order under Bankruptcy Code §§ 330, 331, or 503.

The Debtor estimates that, assuming an Effective Date of September 1, 2009, unpaid Allowed Administrative Claims will total approximately \$796,500, comprising:

<u>Administrative Claim</u>	<u>Estimated Amt.</u>
Jennings, Strouss & Salmon, P.L.C. – Counsel to the Committee	\$ 150,000
Squire, Sanders & Dempsey L.L.P. – Counsel to Debtor	\$ 400,000
Administrative Rent on Rejected Leases	\$ 190,200
Claims Under Bankruptcy Code § 503(b)(9)	\$ 56,300
TOTAL	<u>\$ 796,500</u>

2. *Preserved Ordinary Course Administrative Claims*

These are generally Claims for liabilities incurred by the Debtor in the ordinary course of business during the Chapter 11 Case relating to the purchase, lease, or use of goods and services, including services provided by the Debtor’s employees.

3. *Priority Tax Claims*

These are Claims of a Governmental Unit for taxes entitled to priority under Bankruptcy Code § 507(a)(8).

4. *Professional Fees*

Claims for Professional Fees are Claims of Professionals, including an entity (a) employed in the Chapter 11 Case in accordance with an order of the Bankruptcy Court under Bankruptcy Code §§ 327, 328, 363, or 1103 and to be compensated for services under Bankruptcy Code §§ 327, 328, 329, 330, and 331 or order of the Bankruptcy Court; or (b) for whom compensation and reimbursement has been Allowed by a Final Order under Bankruptcy Code § 503(b).

5. *Treatment.*

(i) Allowed Administrative Claims. Each Allowed Administrative Claim (other than a Preserved Ordinary Course Administrative Claim or Professional Fee Claim) will be paid in full in Cash (or otherwise satisfied in accordance with its terms) on the latest of: (a) the Effective Date, or as soon after that date as practicable; (b) any date the Bankruptcy Court may fix, or as soon after that date as practicable; (c) 30 days after the Claim is Allowed; and (d) any date on which the holder of the Claim and the Debtor or Reorganized Zounds agree.

(ii) Preserved Ordinary Course Administrative Claims. Each Allowed Preserved Ordinary Course Administrative Claim will be paid in full in Cash at Reorganized Zounds’s election either: (a) in accordance with the terms and conditions under which the Claim arose; or (b) in the ordinary course of Reorganized Zounds’s business. Payments will be made without further action by the holder of the Preserved Ordinary Course Administrative Claim.

(iii) Allowed Priority Tax Claims. Any Allowed Priority Tax Claim will be paid in full in Cash on the later of the Effective Date (or as soon after that date as practicable) and 30 days after the Claim is Allowed, but the Debtor or Reorganized Zounds may elect to pay any Allowed Priority Tax Claim through regular installment payments in Cash of a total value, as of the Effective Date, equal to the Allowed amount of the Claim, over a period ending not later than five years after the Petition Date, and in a manner not less favorable than the most favored General Unsecured Claim provided for by the Plan. If the Debtor or Reorganized Zounds so elect, the installment payments will be made in equal quarterly installments of principal plus interest at the rate imposed under applicable non-bankruptcy law after the Effective Date. The first payment will be made on the latest of: (a) the Effective Date, or as soon after that date as practicable; (b) 30 days after the Claim is Allowed, or as soon after than date as practicable; and (c) another date on which the holder of the Claim and the Debtor or Reorganized Zounds agree. Reorganized Zounds retains the right to prepay any Allowed Priority Tax Claim, or any remaining balance of such a Claim, in full or in part, at any time on or after the Effective Date without premium or penalty.

(iv) Professional Fee Claims. Each Allowed Professional Fee Claim will be paid in full in Cash: (a) no later than three days after the Professional Fee Claim is Allowed; (b) on any other terms the holder of an Allowed Professional Fee Claim and the Debtor or Reorganized Zounds may agree; or (c) in accordance with the terms of any applicable administrative procedures order entered by the Bankruptcy Court. Each Person seeking an award by the Bankruptcy Court of Professional Fees must file with the Bankruptcy Court and serve on Reorganized Zounds its final application for allowance of compensation for services rendered and reimbursement of expenses incurred through the Confirmation Date by the Professional Fee Bar Date.

All claims of Professionals for services rendered or expenses incurred after the Confirmation Date in connection with the Chapter 11 Case and the Plan including those relating to consummation of the Plan, any appeal of the Confirmation Order, the preparation, filing, and review of Professional Fee Claims, the prosecution of Avoidance Actions and Preserved Litigation Claims, and the resolution of Disputed Claims, will be paid by Reorganized Zounds on receipt of an invoice, or on other terms on which Reorganized Zounds and the Professional agree, without the need for further Bankruptcy Court authorization or entry of a Final Order. Reorganized Zounds has ten days after receiving a Professional's invoice to object to any item contained in that invoice. If Reorganized Zounds and any Professional cannot agree on the amount of post-Confirmation Date fees and expenses to be paid to the Professional, the Bankruptcy Court will determine that amount.

(v) Claims of DIP Lenders. On the Effective Date, all the Debtor's obligations to the DIP Lenders under the DIP Facility and the DIP Loan Documents will be fully and finally satisfied with proceeds of the Exit Financing Facility.

E. Treatment of Classified Claims and Interests

In accordance with Bankruptcy Code § 1123(a)(1), set forth below is a designation of classes of Claims against, and Equity Interests in, the Debtor (except the unclassified Claims receiving the treatment described in Section IV.D above). A Claim or Equity Interest is placed in

a particular Class for the purpose of receiving distributions in accordance with the Plan only to the extent that a Claim or Equity Interest has not been paid, released, or otherwise settled before the Effective Date. The treatment of classified Claims and Equity Interests and the provisions governing distributions on account of Allowed Claims and Allowed Equity Interests is set forth in Articles 3 and 4 of the Plan. You should refer to the Plan itself for the complete provisions governing the treatment of your particular Claim or Equity Interest.

1. *Class 1 (Priority Claims)*

Class 1 consists of all Priority Claims other than Priority Tax Claims. Class 1 is unimpaired by the Plan. All holders of Allowed Priority Claims are deemed to have accepted the Plan and will not be solicited to vote on the Plan.

Each holder of an Allowed Priority Claim other than a Priority Tax Claim will receive Cash in an amount equal to its Allowed Priority Claim on the later of: (i) the Effective Date, or as soon after that date as practicable; and (ii) 30 days after the Priority Claim is Allowed; unless, before the later of these two dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date.

As of the assumed Effective Date of the Plan, the Debtor estimates that Allowed Priority Claims will total approximately \$250,000.

2. *Class 2 (Secured Tax Claims)*

Class 2 consists of all Secured Tax Claims. Each holder of a Secured Tax Claim is considered to be in its own separate subclass within Class 2, and each subclass is deemed to be a separate Class for purposes of the Plan. Class 2 is unimpaired by the Plan. All holders of Allowed Secured Tax Claims are deemed to have accepted the Plan and will not be solicited to vote on the Plan.

Each holder of an Allowed Secured Tax Claim will receive Cash in an amount equal to its Allowed Secured Tax Claim on the latest of: (i) the Effective Date, or as soon after that date as practicable; (ii) any date the Bankruptcy Court may fix, or as soon after that date as practicable; (iii) 30 days after the Secured Tax Claim is Allowed; and (iv) the date on which the Secured Tax Claim is scheduled to be paid in the ordinary course of business under applicable law or regulation; unless, before the latest of the above dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date. Each holder of an Allowed Secured Tax Claim retains all Liens on applicable property of the Estate arising under applicable law until that holder's Allowed Secured Tax Claim is paid in full under Section 3.02.b of the Plan. If any portion of any Allowed Secured Tax Claim is not paid in accordance with Section 3.02.b of the Plan and Reorganized Zounds does not make that payment within ten days after notice of non-payment is received from the holder of the Claim, the holder may proceed with applicable state law remedies for collection of all amounts owing but not paid in accordance with this Section 3.02.b of the Plan.

The Debtor is unaware of any significant Secured Tax Claims that will remain unpaid as of the assumed Effective Date of the Plan.

3. *Class 3 (Miscellaneous Secured Claims)*

Class 3 consists of all Secured Claims other than the Secured Tax Claims in Class 2 and the Secured Notes Claims in Class 4. Each holder of a Miscellaneous Secured Claim is considered to be in its own separate subclass within Class 3, and each such subclass is deemed to be a separate Class for purposes of the Plan. Class 3 is unimpaired by the Plan. All holders of Allowed Miscellaneous Secured Claims are deemed to have accepted the Plan and will not be solicited to vote on the Plan.

Each holder of an Allowed Miscellaneous Secured Claim will receive Cash in an amount equal to its Allowed Miscellaneous Secured Claim on the latest of: (i) the Effective Date, or as soon after that date as practicable; (ii) any date the Bankruptcy Court may fix, or as soon after that date as practicable; (iii) 30 days after the Miscellaneous Secured Claim is Allowed; and (iv) the date on which the Miscellaneous Secured Claim is scheduled to be paid in the ordinary course of business under applicable law or regulation; unless, before the latest of the above dates, the holder of the Claim and Reorganized Zounds agree in writing to a different date. Each holder of an Allowed Miscellaneous Secured Claim retains all Liens on applicable property of the Estate arising under applicable law until that holder's Allowed Miscellaneous Secured Claim is paid in full under Section 3.03.b of the Plan. If any portion of any Allowed Miscellaneous Secured Claim is not paid in accordance with Section 3.03.b of the Plan and Reorganized Zounds does not make that payment within ten days after notice of non-payment is received from the holder of the Claim, the holder may proceed with applicable state law remedies for collection of all amounts owing but not paid in accordance with Section 3.03.b of the Plan.

The Debtor is unaware of any significant Miscellaneous Secured Claims that will remain unpaid as of the assumed Effective Date of the Plan.

4. *Class 4 (Secured Notes Claims)*

Class 4 consists of all Secured Notes Claims—*i.e.*, all Notes Claims with a corresponding Lien on Collateral. Each holder of a Secured Notes Claim is considered to be in its own separate subclass within Class 4, and each such subclass is deemed to be a separate Class for purposes of the Plan. Class 4 is impaired by the Plan. All holders of Allowed Secured Notes Claims are entitled to vote and will be solicited to vote on the Plan.

(i) Election of Treatment. Each holder of a Disputed Secured Notes Claim may elect on a Ballot to be treated as a Settled Notes Claim in Class 5. If a holder of a Disputed Secured Notes Claim does not so elect, it will be treated as a Disputed Claim in Class 4, subject to an Avoidance Action brought against that holder either before or after the Effective Date. If the holder of a Disputed Secured Notes Claim does not elect to be the holder of a Settled Notes Claim and that holder's Lien is avoided, the Disputed Secured Notes Claim will become a Disputed Unsecured Claim entitled only to the treatment accorded to Allowed Claims in Class 6. If the holder of a Disputed Secured Notes Claim does not elect to be the holder of a Settled Notes Claim but prevails in any Avoidance Action such that the holder's Lien is not avoided, that holder will have an Allowed Secured Notes Claim and will receive the treatment accorded to Allowed Secured Notes Claims in Class 4. All holders of Disputed Secured Notes Claims are

identified in attached **Appendix 5** to this Disclosure Statement and each such holder has been provided the form of Ballot provided to holders of Disputed Secured Notes Claims.

(ii) Nature of Distributions. Each holder of an Allowed Secured Notes Claim will receive a Pro Rata portion of 100% of the New Common Stock, subject to dilution by: (A) 5% by the New Common Stock issued to holders of Settled Notes Claims in Class 5; (B) any stock authorized and issued under any incentive plan or similar program for members of Reorganized Zounds' senior management as the board of directors of Reorganized Zounds may approve after the Effective Date; and (C) any future stock offerings as the board of directors of Reorganized Zounds may approve after the Effective Date in accordance with the Reorganized Certificate.

(iii) Timing of Distributions. Reorganized Zounds will issue shares of New Common Stock to holders of Allowed Secured Notes Claims, beginning on the later of (A) the Effective Date, or as soon after that date as practicable and (B) 30 days after the Secured Notes Claim is Allowed.

(iv) Entitlement to Distributions. Only holders of Allowed Secured Notes Claims as of the Distribution Record Date will be entitled to receive distributions under the Plan.

As of the Effective Date, all Debt Securities, and all agreements, instruments, and other documents evidencing the Debt Securities and the rights of the holders of Debt Securities, will be automatically canceled and extinguished (all without further action by any Person) and all obligations of any Person, including the Debtor, under such instruments and agreements will be deemed fully and finally discharged.

The Debtor believes that Allowed Secured Notes Claims will total approximately \$3.3 million and that Disputed Secured Notes Claims total approximately \$1.725 million.

5. *Class 5 (Settled Notes Claims)*

Class 5 consists of all Settled Notes Claims. Class 5 is impaired by the Plan. All holders of Settled Notes Claims are entitled to vote and will be solicited to vote on the Plan.

(i) Nature of Distributions. Each holder of a Settled Notes Claim will receive, in full and final satisfaction of its Allowed Unsecured Notes Claim a Pro Rata portion of 5% of the New Common Stock, subject to dilution by any shares issued under a stock incentive plan or similar program for members of Reorganized Zounds's senior management and any future stock offerings, each as the board of directors of Reorganized Zounds may approve after the Effective Date in accordance with the Reorganized Certificate.

(ii) Timing of Distributions. Reorganized Zounds will issue shares of New Common Stock to holders of Settled Notes Claims beginning on the later of (A) the Effective Date, or as soon after that date as practicable and (B) 30 days after the Unsecured Notes Claim is Allowed.

(iii) Entitlement to Distributions. Only holders of Settled Notes Claims as of the Distribution Record Date will be entitled to receive distributions under the Plan.

As of the Effective Date, all Debt Securities, and all agreements, instruments, and other documents evidencing the Debt Securities and the rights of the holders of Debt Securities, will be automatically canceled and extinguished (all without further action by any Person) and all obligations of any Person, including the Debtor, under such instruments and agreements will be deemed fully and finally discharged.

Assuming that all holders of all Disputed Secured Notes Claims elect to have their Claims treated as Settled Notes Claims, the Debtor estimates that Settled Notes Claims will total approximately \$1.725 million.

6. *Class 6 (Unsecured Claims)*

Class 6 consists of all General Unsecured Claims, all Unsecured Notes Claims, and all Rejection Claims. Class 6 is impaired by the Plan. All holders of Allowed Unsecured Claims are entitled to vote and will be solicited to vote on the Plan.

(i) Nature of Distributions. Each holder of an Allowed Unsecured Claim will receive, in full and final satisfaction of its Allowed Unsecured Claim a Pro Rata portion of the beneficial interests in the Unsecured Creditor Trust, which will be vested with the Avoidance Actions and will be the payee under the Unsecured Creditor Note.

(ii) Timing of Distributions. Reorganized Zounds will (subject to the provisions of Section 4.08.b of the Plan) begin making distributions on account of the Avoidance Actions and the Unsecured Creditor Note to the Unsecured Creditor Trust beginning on the Effective Date.

As of the Effective Date, all Debt Securities, and all agreements, instruments, and other documents evidencing the Debt Securities and the rights of the holders of Debt Securities, will be automatically canceled and extinguished (all without further action by any Person) and all obligations of any Person, including the Debtor, under such instruments and agreements will be deemed fully and finally discharged.

Assuming that all holders of all Disputed Secured Notes Claims elect to have their Claims treated as Settled Notes Claims, the Debtor estimates that Unsecured Claims total approximately \$26,000,000. But because the Bar Date will occur after the date of this Disclosure Statement and the Debtor may reject additional leases, the final amount of General Unsecured Claims may significantly exceed the amount estimated by the Debtor in this Disclosure Statement.

7. *Class 7 (Securities Claims)*

Class 7 consists of all Securities Claims not including Notes Claims. Class 7 is impaired by the Plan. All holders of Securities Claims are deemed to reject the Plan and will not be solicited to vote on the Plan.

Under Bankruptcy Code § 510(b), each Securities Claim is mandatorily subordinated to all other Claims. Accordingly, the holders of Securities Claims will not receive or retain any rights, property, or distributions on account of their Securities Claims under the Plan.

8. *Class 8 (Equity Interests)*

Class 8 consists of all Equity Interests. Class 8 is impaired by the Plan. All holders of Equity Interests are deemed to reject the Plan and will not be solicited to vote on the Plan.

As of the Effective Date, all Equity Interests will be canceled and extinguished without further action under any applicable agreement, law, regulation, order, or rule. The holders of Equity Interests will not receive or retain any rights, property, or distributions on account of their Equity Interests under the Plan.

V. IMPLEMENTATION OF THE PLAN

A. Plan Funding

1. *Effective Date Payments.*

Funds needed to make Cash payments on the Effective Date on account of Allowed Administrative Claims, Allowed Priority Tax Claims, Allowed Priority Claims, Allowed Miscellaneous Secured Claims, and Allowed Secured Tax Claims under the Plan will come from the Gross Assets and borrowing under the Exit Financing Facility.

2. *Exit Financing Facility*

On or before the Effective Date, the Debtor or Reorganized Zounds will execute the Exit Financing Documents, which must have been approved in either the Confirmation Order or by a separate Final Order of the Bankruptcy Court. The Exit Financing Facility, among other things, will be effective on the Effective Date, be a senior secured facility, and contain terms in form and substance acceptable to the Debtor.

B. Issuance of Securities

Reorganized Zounds will issue for distribution under the Plan the New Common Stock.

(i) Authorization. The Reorganized Certificate authorizes the issuance of 50,000,000 shares of New Common Stock and 5,000,000 shares of preferred stock. On the Effective Date, or as soon after as practicable, Reorganized Zounds will issue approximately 10,000,000 shares of such New Common Stock on account of Allowed Secured Notes Claims and Allowed Settled Notes Claims, which will represent 100% of the then-outstanding equity in Reorganized Zounds, subject to dilution by authorized shares of New Common Stock issued under any stock incentive plan or similar program for members of Reorganized Zounds's senior management as the board of directors of Reorganized Zounds may approve after the Effective Date. All shares of New Common Stock to be issued under the Plan will, at issuance, be duly authorized, validly issued, fully paid, and non-assessable.

(ii) Par Value. The New Common Stock will have a par value of \$0.0001 per share.

(iii) Rights. The New Common Stock will have those rights with respect to dividends, liquidation, voting, and other matters set forth in the Reorganized Certificate and as provided under applicable law including the right to one vote per share.

(iv) Section 1145 Exemption. In accordance with Bankruptcy Code § 1145, the issuance of the New Common Stock under the Plan is exempt from the registration requirements of Section 5 of the Securities Act and any state or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker dealer in such securities and is deemed to be a public offer of such securities.

C. Certificate of Incorporation and By-Laws.

As of the Effective Date and without any further action by the shareholders or directors of the Debtor or Reorganized Zounds, the Debtor's certificate of incorporation and by-laws will be amended and restated substantially in the forms of the Reorganized Certificate and the Reorganized By-Laws. The Reorganized Certificate and the Reorganized By-Laws will prohibit (to the extent required by Bankruptcy Code § 1123(a) and (b)) the issuance of non-voting equity securities. After the Effective Date, Reorganized Zounds may amend its certificate of incorporation and by-laws as permitted by applicable law.

D. Directors and Officers of Reorganized Zounds

The initial board of directors of Reorganized Zounds as of the Effective Date will comprise five directors: Michael Stewart (Chair); Gordon Marchand; Samuel Thomasson; and two individuals designated by Michael Stewart and Derwood Chase by no later than ten days before the Confirmation Hearing. The initial officers of Reorganized Zounds as of the Effective Date will be the same individuals then occupying officer positions immediately before the Effective Date. Reorganized Zounds will provide all its directors and officers with indemnification rights and a D&O Policy, and will compensate its directors and officers, in accordance with practices customary for entities of its type.

E. Unsecured Creditor Trust.

On the Effective Date, the Unsecured Creditor Trust will be formed, the proceeds of the Avoidance Actions will vest in the Unsecured Creditor Trust, the Unsecured Creditor Note will be made payable to the Unsecured Creditor Trust, and the Unsecured Creditor Trustee will begin serving for the benefit of all holders of Allowed Claims in Class 6, which will become the beneficiaries of the Unsecured Creditor Trust.

(i) Unsecured Creditor Trustee. The Unsecured Creditor Trustee may make distributions to the beneficiaries of the Unsecured Creditor Trust strictly in accordance with the terms of the Plan and must use his best efforts to liquidate all trust assets, make timely distributions, and not unduly prolong the existence of the Unsecured Creditor Trust.

(ii) Disputed Claims. The Unsecured Creditor Trustee must manage distributions from proceeds of the Avoidance Actions and the Unsecured Creditor Note so as to reserve sufficient Cash to make appropriate distribution on account of any Disputed Unsecured Claim that would have been entitled to distribution if that Disputed Unsecured Claim were an

Allowed Unsecured Claim on the Effective Date in the Maximum Amount. If and when any Disputed Unsecured Claim becomes an Allowed Unsecured Claim, Cash from Avoidance Action proceeds and payments under the Unsecured Creditor Note sufficient to make appropriate distribution under the Plan on account of that Claim will be made from such reserves. If a Disputed Unsecured Claim becomes a Disallowed Unsecured Claim, all reserved distributions attributable to that Disputed Unsecured Claim will become available for Pro Rata distribution to all Allowed Unsecured Claims as beneficiaries of the Unsecured Creditor Trust.

VI. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

A. Assumption and Rejection of Contracts and Leases

All executory contracts and unexpired leases set forth on the schedule of assumed executory contracts and unexpired leases filed with the Bankruptcy Court as part of Exhibit D to the Plan will be deemed assumed by Reorganized Zounds or assumed and assigned (as indicated on Exhibit D to the Plan) as of the Effective Date, except for any executory contract or unexpired lease: (i) that has been rejected in accordance with a Final Order entered before the Confirmation Date; or (ii) as to which a motion to reject has been filed with the Bankruptcy Court before the Confirmation Date.

All executory contracts and unexpired leases either (i) set forth on the schedule of rejected executory contracts and unexpired leases filed with the Bankruptcy Court as part of Exhibit D to the Plan or (ii) existing but not listed on Exhibit D to the Plan will be deemed rejected as of the Effective Date, except for any executory contract or unexpired lease that has been assumed or rejected in accordance with a Final Order entered on or before the Confirmation Date.

Entry of the Confirmation Order constitutes: (a) the approval under Bankruptcy Code § 365 of the assumption or assumption and assignment of the executory contracts and unexpired leases assumed or assumed and assigned under the Plan or otherwise during the Chapter 11 Case; and (b) the approval under Bankruptcy Code § 365 of the rejection of the executory contracts and unexpired leases rejected under the Plan or otherwise during the Chapter 11 Case. Notwithstanding anything contained in Section 5.02 of the Plan to the contrary, the Debtor retains the right to add or change the treatment (assumed or rejected) of any executory contract or unexpired lease on Exhibit D to the Plan, thus changing the treatment of the contract or lease under the Plan, at any time within 30 days after the Effective Date.

B. Cure of Defaults

On the Effective Date or as soon after that date as practicable, Reorganized Zounds will Cure any defaults under any executory contract or unexpired lease assumed or assumed and assigned under the Plan. Reorganized Zounds will not, and need not as a condition to assuming or assuming and assigning any executory contract or unexpired lease under the Plan, Cure any default that need not be cured in accordance with Bankruptcy Code § 365(b).

C. Rejection Damages Bar Date

All Rejection Claims arising from the rejection of any executory contract or unexpired lease under the Plan are required to be filed with the Bankruptcy Court no later than the Rejection Claims Bar Date. Any such Claim not filed within that time will be forever barred. With respect to any executory contract or unexpired lease rejected by the Debtor before the Confirmation Date, the deadline for filing a Rejection Claim remains the deadline set forth in the order of the Bankruptcy Court authorizing that rejection. If such an order did not contain such a deadline, the deadline for filing a Rejection Claim arising from that rejection is the Rejection Claims Bar Date.

D. Indemnification Obligations

Any obligation of the Debtor to indemnify any Person serving as a fiduciary of any employee benefit plan or employee benefit program of the Debtor, under charter, by-laws, contract, or applicable state law is deemed to be an executory contract and assumed by Reorganized Zounds as of the Confirmation Date (but subject to the occurrence of the Effective Date). Any obligation of the Debtor to indemnify, reimburse, or limit the liability of any Person, including but not limited to any officer or director of the Debtor, or any agent, professional, financial advisor, or underwriter of any securities issued by the Debtor related to any acts or omissions occurring before the Petition Date is rejected and canceled under the Plan as of the Confirmation Date (but subject to the occurrence of the Effective Date), and any Claim resulting from this rejection and cancellation in favor of any Person must be filed no later than 60 days after the Confirmation Date. Notwithstanding any of the foregoing, nothing contained in the Plan affects, impairs, or prejudices the rights of any Person covered by any applicable D&O Policy with respect to any such policy. Moreover, Reorganized Zounds will maintain in force for three years following the Effective Date appropriate D&O Policies covering pre-Effective Date directors and officers of the Debtor and containing substantially the same provisions and limits of coverage as the policies that were in force on the Petition Date. Reorganized Zounds will be responsible for paying the deductible or retention amounts under the D&O Policies for that three-year period.

E. Benefit Plans

1. Generally

On the Effective Date, all Benefit Plans will be either assumed or rejected and terminated as of the Confirmation Date as indicated on Exhibit D to the Plan, if not earlier terminated or assumed by the Debtor before the Confirmation Date. Any such terminations will be completed according to the terms and conditions of each Benefit Plan and effected in conformity with all statutory and regulatory requirements including any applicable notice provisions. Any undistributed, vested benefits of the terminated Benefit Plans will be distributed to the participants as provided by statute, the applicable regulations, and the Benefit Plans' provisions.

2. Regulatory Approvals

In order to ensure that the Benefit Plans' terminations comply with the terms of the Benefit Plans, applicable statutes, and regulations, the Debtor will obtain any necessary

approvals of the relevant regulatory agencies, such as the Pension Benefit Guaranty Corporation, the IRS, and the U.S. Department of Labor, in respect of such terminations. The Bankruptcy Court will retain jurisdiction to hear and determine any disputes relating to the termination of any Benefit Plans.

3. *Retirees*

If any Claim of a retiree against the Debtor gives the Debtor an indemnification claim under an agreement between the Debtor and any Person, the Debtor will, if necessary or appropriate, assign the indemnification claim to the retiree. Notwithstanding anything in Section 5.06 of the Plan or elsewhere in the Plan to the contrary, Reorganized Zounds will continue to honor all obligations of the Debtor owed to any retiree under any Benefit Plan as of the Confirmation Date solely to the extent, and for the duration of the period, the Debtor is contractually or legally obligated to provide those benefits, subject to any rights of the Debtor or Reorganized Zounds under applicable law.

VII. DESCRIPTION OF OTHER PROVISIONS OF THE PLAN

A. Vesting of Assets

Except as provided in the Plan, the Confirmation Order, or the Plan Documents, all property of the Estate will vest in Reorganized Zounds on the Effective Date free and clear of all Liens and Claims of all kinds existing before the Effective Date. From and after the Effective Date, Reorganized Zounds may operate its business and may use, acquire, and dispose of property free of any restrictions of the Bankruptcy Code, including the employment of, and payment to, Professionals except as otherwise provided in the Plan or the Confirmation Order.

B. Discharge

Except as provided in the Plan or the Confirmation Order, the rights granted under the Plan and the treatment of Claims and Equity Interests under the Plan are in exchange for and in complete satisfaction, discharge, and release of, all Claims including any interest accrued on General Unsecured Claims from the Petition Date. Except as provided in the Plan or the Confirmation Order, confirmation of the Plan discharges the Debtor and Reorganized Zounds from all Claims or other debts that arose before the Confirmation Date, and all debts of the kind specified in Bankruptcy Code §§ 502(g), 502(h) or 502(i), whether or not: (a) a proof of claim based on such debt is filed or deemed filed under Bankruptcy Code § 501; (b) a Claim based on such debt is Allowed under Bankruptcy Code § 502; or (c) the holder of a Claim based on such debt has accepted the Plan. Without limiting the foregoing, the discharge granted under the Plan is granted to the fullest extent allowed under Bankruptcy Code §§ 1141(a), 1141(b), 1141(c), and 1141(d)(1).

C. Injunction

Except as provided in the Plan or the Confirmation Order, as of the Confirmation Date, all entities that have held, currently hold, or may hold a Claim or other debt or liability that is unclassified by the Plan or that is classified by Article 3 of the Plan or that is subject to a distribution under the Plan, or an Equity Interest or other right of an equity security holder that is

subject to a distribution under the Plan are permanently enjoined from taking any of the following actions on account of any such Claims, debts, liabilities, Equity Related Claims, or Equity Interests or rights: (a) commencing or continuing in any manner any action or other proceeding against any property to be distributed under the Plan; (b) enforcing, attaching, collecting, or recovering in any manner any judgment, award, decree, or order against any property to be distributed under the Plan; (c) creating, perfecting, or enforcing any Lien or encumbrance against any property to be distributed under the Plan; and (d) commencing or continuing any action, in any manner, in any place, that does not comply with or is inconsistent with the provisions of the Plan or the Bankruptcy Code. Nothing in Section 10.03 or elsewhere in the Plan is to be construed or is to have the effect of extinguishing, prohibiting, or otherwise limiting, the right of any holder of a Claim to assert a right to setoff or recoupment arising in connection with that Claim as part of the resolution and treatment of that Claim under the Plan. Nothing in Section 10.03 or elsewhere in the Plan is to be construed or is to have the effect of extinguishing, prohibiting, or otherwise limiting, the right of the Estate (through Reorganized Zounds as its representative or otherwise) or Reorganized Zounds to assert and prevail on any Avoidance Action or Preserved Litigation Claim. Nothing in Section 10.03 or elsewhere in the Plan enjoins or otherwise precludes (or may be construed to enjoin or otherwise preclude) any party in interest from enforcing the terms of the Plan and the Confirmation Order.

D. Exculpation

None of the Debtor, Reorganized Zounds, any Committee, or any of their respective members, officers, directors, employees, advisors, professionals, or agents have or will incur any liability to any holder of a Claim or Equity Interest for any act or omission in connection with, related to, or arising out of, the Chapter 11 Case, the pursuit of confirmation of the Plan, the consummation of the Plan, or the administration of the Plan or the property to be distributed under the Plan, except for willful misconduct or gross negligence, and, in all respects, the Debtor, Reorganized Zounds, any Committee, and each of their respective members, officers, directors, employees, advisors, professionals, and agents are entitled to rely on the advice of counsel with respect to their duties and responsibilities under the Plan.

E. Preserved Litigation Claims and Disputed Claims Resolution

Notwithstanding anything to the contrary in the Plan, any non-Debtor party to a Preserved Litigation Claim or a Disputed Claim that has obtained or obtains relief from the automatic stay or from the injunction provisions contained in Section 10.03 of the Plan to pursue resolution of their Claim in a forum other than the Bankruptcy Court will not be deemed to have violated any provision of the Plan by seeking a resolution as to Allowance, Disallowance, or amount of the Claim in the other forum, but the classification and distributions on account of the Claim, once liquidated and Allowed or Disallowed, remain solely and exclusively subject to the Bankruptcy Court's continuing jurisdiction under Article 11 of the Plan and the terms and conditions of the Plan.

F. Preservation of Insurance

The discharge and release from Claims as provided in the Plan, except as necessary to be consistent with the Plan, do not diminish or impair the enforceability of any insurance policy that may cover Claims against the Debtor or any other Person.

G. Retention of Jurisdiction After the Effective Date

Notwithstanding the entry of the Confirmation Order and the occurrence of the Effective Date, the Bankruptcy Court will retain as much jurisdiction over the Chapter 11 Cases after the Effective Date as legally permissible including jurisdiction to:

- a. Allow, disallow, determine, liquidate, classify, estimate, or establish the amount, priority, or secured or unsecured status of any Claim, and resolve any request for payment of any Administrative Claim and any objection to the Allowance or priority of any Claim;
- b. Grant or deny any applications for allowance of compensation or reimbursement of expenses authorized under the Bankruptcy Code or the Plan;
- c. Resolve any matters related to the assumption, assumption and assignment, or rejection of any executory contract or unexpired lease to which the Debtor is a party and to hear, determine and, if necessary, liquidate any Claims arising from, or Cure related to, assumption or rejection;
- d. Ensure that distributions required under the Plan are accomplished in accordance with the Plan;
- e. Decide or resolve any motions, adversary proceedings, contested matters, and any other matters and grant or deny any applications or motions involving the Debtor that may be pending on the Effective Date;
- f. Enter any necessary or appropriate orders to implement or consummate the Plan's provisions and all contracts, instruments, releases, and other agreements or documents created in connection with the Plan or the Disclosure Statement;
- g. Resolve any cases, controversies, suits, or disputes that may arise in connection with the consummation, interpretation, or enforcement of the Plan, or any Person's obligations incurred in connection with the Plan;
- h. Hear and determine any motion or application to modify the Plan before or after the Effective Date under Bankruptcy Code § 1127

or modify the Disclosure Statement or any contract, instrument, release, or other agreement or document issued, entered into, filed, or delivered in connection with the Plan or the Disclosure Statement; or hear or determine any motion or application to remedy any defect or omission or reconcile any inconsistency in any Bankruptcy Court order, the Plan, the Disclosure Statement, or any contract, instrument, release, or other agreement or document issued, entered into, filed or delivered in connection with the Plan or the Disclosure Statement, in such manner as may be necessary or appropriate to consummate the Plan, to the extent authorized by the Bankruptcy Code;

- i. Issue injunctions, enter and implement other orders, or take any other necessary or appropriate actions to restrain any entity's interference with consummation or enforcement of the Plan;
- j. Enter and implement any necessary or appropriate orders if the Confirmation Order is for any reason modified, stayed, reversed, revoked, or vacated;
- k. Determine any other matters that may arise in connection with or related to the Plan, the Disclosure Statement, the Confirmation Order, or any contract, instrument, release, or other agreement or document issued, entered into, filed, or delivered in connection with the Plan, the Disclosure Statement or the Confirmation Order;
- l. Issue a final decree and enter an order closing the Chapter 11 Case; and
- m. Adjudicate the Disputed Claims, the Avoidance Actions, and the Preserved Litigation Claims and any other cause of action or claims of the Debtor or the Estate.

VIII. ACCEPTANCE AND CONFIRMATION OF THE PLAN

A. Acceptance of the Plan

As a condition to confirmation, the Bankruptcy Code requires that each Class of impaired Claims and Equity Interests accept the Plan, except under certain circumstances. Bankruptcy Code § 1126(c) defines acceptance of a plan by a class of impaired Claims as acceptance by holders of at least two-thirds in dollar amount and more than one-half in number of Claims in that Class, but for that purpose counts only those who actually vote to accept or to reject the Plan. Under Bankruptcy Code § 1126(d), a Class of Equity Interests has accepted the Plan if holders of such Equity Interests holding at least two-thirds in amount actually voting have voted to accept the Plan. Bankruptcy Code § 1126(f) deems a Class of Claims or Equity Interests to have accepted the Plan without voting if that Class is unimpaired under the definition in Bankruptcy Code § 1124. Classes 1, 2, and 3 under the Plan are unimpaired and, therefore, are deemed to accept the Plan. Classes 4, 5 and 6 are impaired under the Plan and, therefore, will be solicited to

vote on the Plan. Classes 6 and 7 under the Plan are impaired but will receive or retain no property under the Plan and, therefore, are deemed to reject the Plan without voting.

B. Feasibility of the Plan

To confirm the Plan, the Bankruptcy Court must find that confirmation of the Plan is not likely to be followed by the need for further financial reorganization of the Debtor. This requirement is imposed by Bankruptcy Code § 1129(a)(11) and is referred to as the “feasibility” requirement. The Debtor believes that it will be able to perform timely all obligations described in the Plan and, therefore, that the Plan is feasible.

To demonstrate the feasibility of the Plan, the Debtor refers to the Effective Date Balance Sheet included in **Appendix 3**. This balance sheet demonstrates that the Debtor will have sufficient Cash on hand as of the Effective Date to make, on the Effective Date, all payments required to be made on the Effective Date, and sufficient Cash on hand to satisfy all obligations under the Plan to all Creditors in all Classes. Accordingly, the Debtor believes that the Plan satisfies the feasibility requirement of Bankruptcy Code § 1129(a)(11). The Debtor cautions that no representations can be made as to the accuracy of the Effective Date Balance Sheet or as to Reorganized Zounds’ ability to achieve the projected results. Certain of the assumptions on which the Effective Date Balance Sheet are based are subject to uncertainties outside the Debtor’s control. Some assumptions inevitably will not materialize, and events and circumstances occurring after the date on which the Effective Date Balance Sheet was prepared may be different from those assumed or may be unanticipated, and may adversely affect the Debtor’s financial results. Therefore, the actual results can be expected to vary from the projected results and the variations may be material and adverse.

The Effective Date Balance Sheet was not prepared with a view toward compliance with the guidelines established by the American Institute of Certified Public Accountants, the practices recognized to be in accordance with generally accepted accounting principles, or the rules and regulations of the Securities and Exchange Commission regarding projections. Furthermore, the Effective Date Balance Sheet has not been audited by the Debtor’s independent accountants. Although presented with numerical specificity, the Effective Date Balance Sheet is based on a variety of assumptions, some of which in the past have not been achieved and which may not be realized in the future, and are subject to significant business, economic and competitive uncertainties and contingencies, and many of which are beyond the Debtor’s control. Consequently, the Effective Date Balance Sheet should not be regarded as a representation or warranty by the Debtor or any other Person, that projections will be realized. Actual results may vary materially from those presented.

C. Best Interests Test

1. Explanation

Even if a plan is accepted by each class of holders of claims, the Bankruptcy Code requires a bankruptcy court to determine that the plan is in the “best interests” of all holders of claims and interests that are impaired by the plan and that have not accepted the plan. The “best interests” test, as set forth in Bankruptcy Code § 1129(a)(7), requires a bankruptcy court to find

either that: (i) all members of an impaired class of claims or interests have accepted the plan; or (ii) the plan will provide a member who has not accepted the plan with a recovery of property of a value, as of the effective date of the plan, that is not less than the amount that such holder would recover if the debtor was liquidated under Chapter 7 of the Bankruptcy Code.

To calculate the probable distribution to members of each impaired class of holders of claims and interests if the debtor were liquidated under Chapter 7, a bankruptcy court must first determine the aggregate dollar amount that would be generated from the debtor's assets if its Chapter 11 case were converted to a Chapter 7 case under the Bankruptcy Code. This "liquidation value" would consist primarily of the proceeds from a forced sale of the debtor's assets by a Chapter 7 trustee.

The amount of liquidation value available to unsecured creditors would be reduced by: (1) the claims of any secured creditors to the extent of the value of their collateral; and (2) the costs and expenses of liquidation, as well as by other administrative expenses and costs of both the Chapter 7 case and the Chapter 11 case. As a general matter, a liquidation under Chapter 7 will not affect the rights of letter of credit beneficiaries, including certain sureties who posted bonds that the Debtor purchased for various business, litigation, and other reasons. Costs of liquidation under Chapter 7 of the Bankruptcy Code would include the compensation of a trustee, as well as of counsel and other professionals retained by the trustee, asset disposition expenses, all unpaid expenses incurred by the debtor in its bankruptcy case (such as compensation of attorneys, financial advisors, and restructuring consultants) that are allowed in the Chapter 7 case, litigation costs, and claims arising from the operations of the debtor during the pendency of the bankruptcy case. The liquidation itself would trigger certain priority payments that otherwise would be due in the ordinary course of business. Those priority claims would be paid in full from the liquidation proceeds before the balance would be made available to pay general unsecured claims or to make any distribution in respect of equity interests. The liquidation also would prompt the rejection of a large number of executory contracts and unexpired leases and thereby create a significantly higher number of unsecured claims.

Once the court ascertains the recoveries in liquidation of secured creditors and priority claimants, it must determine the probable distribution to general unsecured creditors and equity security holders from the remaining available proceeds in liquidation. If the probable distribution has a value greater than the distributions to be received by such creditors and equity security holders under a debtor's plan, then the plan is not in the best interests of creditors and equity security holders.

2. *Application to the Liquidation Analysis*

A liquidation analysis prepared with respect to the Debtor is attached as **Appendix 4** to this Disclosure Statement. The Debtor believes that any liquidation analysis is speculative. For example, the liquidation analysis necessarily contains an estimate of the amount of Claims that will ultimately become Allowed Claims. In preparing the liquidation analysis, the Debtor has projected the amount of Allowed Claims based on a review of its scheduled and filed proofs of claim. No order or finding has been entered by the Bankruptcy Court estimating or otherwise fixing the amount of Claims at the projected amounts of Allowed Claims set forth in the liquidation analysis. In preparing the liquidation analysis, the Debtor has projected a range for

the amount of Allowed Claims with the low end of the range the lowest reasonable amount of Claims and the high end of the range the highest reasonable amount of the Claims, thus allowing assessment of the most likely range of Chapter 7 liquidation dividends to the holders of the Allowed Claims. The estimate of the amount of Allowed Claims set forth in the liquidation analysis should not be relied on for any other purpose, including, without limitation, any determination of the value of any distribution to be made on account of Allowed Claims and Allowed Interests under the Plan.

Notwithstanding the difficulties in quantifying recoveries to creditors with precision, the Debtor believes that, taking into account the liquidation analysis, the Plan meets the “best interests” test of Bankruptcy Code § 1129(a)(7). The Debtor believes that each member of each Class will receive at least as much under the Plan as it would in a liquidation in a hypothetical Chapter 7 case. Creditors will receive a better recovery through the distributions contemplated by the Plan because the continued operation of the Debtor and the retention of the going-concern value of the Debtor’s assets under the Plan, rather than a forced liquidation of those assets, will allow the realization of more value for the Debtor’s creditors, owing principally to the greatly reduced value of assets in a liquidation context and to the increased costs attending a Chapter 7 liquidation, including statutory Chapter 7 trustee fees and trustee’s counsel fees, to name only a few additional expenses not present under the Plan. Indeed, the Debtor believes that holders of Claims in Classes 5 and 6 would realize no recovery if the Debtor’s assets were liquidated under Chapter 7.

D. Confirmation Over the Dissent of Non-Approving Classes

If the Plan is not accepted by all impaired Classes of Allowed Claims, the Plan may still be confirmed by the Bankruptcy Court under section 1129(b) of the Bankruptcy Code if: (a) the Plan has been accepted by at least one Impaired Class of Claims and (b) the Bankruptcy Court determines, among other things, that the Plan “does not discriminate unfairly” and is “fair and equitable” with respect to each non-accepting impaired Class (the “Cramdown Provisions”). If the Plan is not accepted by all impaired Classes of Allowed Claims or Equity Interests, the Debtor reserves the right to ask the Bankruptcy Court to confirm the Plan under the Cramdown Provisions.

The condition that a plan be “fair and equitable” with respect to a rejecting class of secured claims includes the requirements that (a) the holders of such secured claims retain the liens securing such claims to the extent of the allowed amount of the claims, whether the property subject to the liens is retained by the debtor or transferred to another entity under the plan, and (b) each holder of a secured claim in the class receives deferred cash payments totaling at least the allowed amount of such claim with a present value, as of the effective date of the plan, at least equivalent to the value of the secured claimant’s interest in the debtor’s property subject to the liens.

The condition that a plan be “fair and equitable” with respect to a rejecting class of unsecured claims includes the requirement that either (a) such class receive or retain under the plan property of a value as of the effective date of the plan equal to the allowed amount of such claim or (b) if the class does not receive such amount, no class junior to the non-accepting class will receive a distribution under the plan.

The condition that a plan be “fair and equitable” with respect to a rejecting class of interests includes the requirements that either (a) the plan provides that each holder of an interest in such class receive or retain under the plan, on account of such interest, property of a value, as of the effective date of the plan, equal to the greater of (i) the allowed amount of any fixed liquidation preference to which such holder is entitled, (ii) any fixed redemption price to which such holder is entitled, or (iii) the value of such interest, or (b) if the class does not receive such amount, no class of interests junior to the rejecting class will receive a distribution under the plan.

IX. CERTAIN FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN

A. Introduction

A summary description of certain United States federal income tax consequences of the Plan follows. This description is for informational purposes only and, owing to a lack of definitive judicial or administrative authority or interpretation, substantial uncertainties exist with respect to various tax consequences of the Plan discussed below. This disclosure describes only the principal United States federal income tax consequences of the Plan to the Debtor and to holders of Claims and Equity Interests. No opinion of counsel has been sought or obtained with respect to any tax consequences of the Plan. No rulings or determinations of the IRS or any other tax authorities have been sought or obtained with respect to any tax consequences of the Plan, and the discussion below is not binding on the IRS or other authorities. No representations are being made to the Debtor or any holder of a Claim or Equity Interest regarding the particular tax consequences of the confirmation and consummation of the Plan. No assurance can be given that the IRS would not assert, or that a court would not sustain, a different position from any discussed here.

The following discussion of United States federal income tax consequences is based on the Internal Revenue Code of 1986, as amended, Treasury Regulations, judicial authorities, published positions of the IRS and other applicable authorities, all as in effect on the date of this document and all of which are subject to change or differing interpretations (possibly with retroactive effect).

The following discussion does not address foreign, state, or local tax consequences of the Plan, nor does it purport to address the United States federal income tax consequences of the Plan to special classes of taxpayers (e.g., banks and certain other financial institutions, insurance companies, tax-exempt organizations, governmental entities, persons that are, or hold their Claims through, pass-through entities, persons whose functional currency is not the United States dollar, foreign persons, dealers in securities or foreign currency, employees of a Debtor, persons who received their Claims by exercising an employee stock option or otherwise as compensation, and persons holding Claims that are a hedge against, or that are hedged against, currency risk or that are part of a straddle, constructive sale, or conversion transaction). Furthermore, the following discussion does not address United States federal taxes other than income taxes.

Holders of Claims and Equity Interests are strongly urged to consult their own tax advisor regarding the United States federal, state, local, and foreign tax consequences of the transactions described in this Disclosure Statement and in the Plan.

B. United States Federal Income Tax Consequences to the Debtor

Under the Plan, the Debtor's outstanding indebtedness will be satisfied in exchange for either Cash, New Common Stock or beneficial interests in the Unsecured Creditor Trust. The satisfaction of a debt obligation for an amount of cash less than the "adjusted issue price" of the debt obligation generally gives rise to cancellation of indebtedness ("COD") income to the debtor.

The debtor does not, however, recognize COD income if the debt discharge occurs in a Title 11 bankruptcy case. Instead, the debtor reduces its tax attributes to the extent of its COD income in the following order: (a) net operating losses ("NOLs") and NOL carryforwards; (b) general business credit carryforwards; (c) minimum tax credit carryforwards; (d) capital loss carryforwards; (e) the tax basis of the Debtor's depreciable and nondepreciable assets (but not below the amount of its liabilities immediately after the discharge); and (f) foreign tax credit carryforwards.

A debtor may elect to alter the preceding order of attribute reduction and, instead, first reduce the tax basis of its depreciable assets. The Debtor does not recognize any COD income that exceeds the amount of available tax attributes, and such excess COD income has no other United States federal income tax effect.

Because the Debtor's outstanding indebtedness will be satisfied in exchange for Cash, New Common Stock and beneficial interests in the Creditor Trust, the amount of COD income, and accordingly the amount of tax attributes required to be reduced, may be significant. To the extent permitted for federal income tax purposes, the Debtor intends to deduct the respective amounts it pays in Cash and under the Plan.

C. Federal Income Tax Consequences to Creditors

The following discusses certain United States federal income tax consequences of the transactions contemplated by the Plan to Creditors that are "United States holders," as defined below. The United States federal income tax consequences of the transactions contemplated by the Plan to Creditors (including the character, timing and amount of income, gain or loss recognized) will depend on, among other things: (1) whether the Claim and the consideration received in respect of it are "securities" for federal income tax purposes; (2) the manner in which a Creditor acquired a Claim; (3) the length of time the Claim has been held; (4) whether the Claim was acquired at a discount; (5) whether the Creditor has taken a bad debt deduction with respect to the Claim (or any portion of it) in the current tax year or any prior tax year; (6) whether the Creditor has previously included in its taxable income accrued but unpaid interest with respect to the Claim; (7) the holder's method of tax accounting; and (8) whether the Claim is an installment obligation for federal income tax purposes. Creditors, therefore, should consult their own tax advisors regarding the particular tax consequences to them of the transactions contemplated by the Plan.

For purposes of the following discussion, a "United States holder" is a Creditor that is: (1) a citizen or individual resident of the United States; (2) a partnership or corporation created or organized in the United States or under the laws of the United States, a political subdivision of

the United States, or a State of the United States; (3) an estate whose income is subject to United States federal income taxation regardless of its source; or (4) a trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States fiduciaries have the authority to control all substantial decisions of the trust, or (ii) the trust was in existence on August 20, 1996, and properly elected to be treated as a United States person.

1. *Sale or Exchange of Claims*

Under the Plan, Creditors will receive Cash, New Common Stock or beneficial interests in the Unsecured Creditor Trust in exchange for their Claims. A Creditor who receives Cash in exchange for its Claim under the Plan will generally recognize gain or loss for United States federal income tax purposes in an amount equal to the difference between the amount of Cash and New Common Stock received and the Creditor's adjusted tax basis in its Claim. The character of the gain or loss as capital gain or loss or as ordinary income or loss will be determined by a number of factors, including the nature of the Claim as held by the Creditor, whether the Claim constitutes a capital asset in the hands of the Creditor, whether the Claim was purchased at a discount, whether any amount received in respect of a Claim constitutes accrued interest, and whether and to what extent the Creditor has previously claimed a bad debt deduction with respect to its Claim. A Creditor who recognizes a loss on a transaction conducted under the Plan may be entitled to a bad debt deduction, either in the taxable year of the Effective Date or a prior taxable year.

2. *Accrued Interest*

Under the Plan, Cash may be distributed or deemed distributed to certain Creditors with respect to their Claims for accrued interest. Holders of Claims for accrued interest that previously have not included such accrued interest in taxable income will be required to recognize ordinary income equal to the amount of Cash received with respect to such Claims for accrued interest. Holders of Claims for accrued interest that have included such accrued interest in taxable income generally may take an ordinary deduction to the extent that such Claim is not fully satisfied under the Plan (after allocating the distribution between principal and accrued interest), even if the underlying Claim is held as a capital asset. The adjusted tax basis of any Cash received in exchange for a Claim for accrued interest will equal the amount of Cash on the Effective Date, and the holding period for the property will begin on the day after the Effective Date. It is not clear the extent to which consideration that may be distributed under the Plan will be allocable to interest. Creditors are advised to consult their own tax advisors to determine the amount, if any, of consideration received under the Plan that is allocable to interest.

3. *Market Discount*

In general, a debt obligation, other than one with a fixed maturity of one year or less, that is acquired by a holder in the secondary market (or, in certain circumstances, on original issuance) is a "market discount bond" as to that holder if the obligation's stated redemption price at maturity (or, in the case of a debt obligation having original issue discount, the revised issue price) exceeds the holder's adjusted tax basis in the debt obligation immediately after its acquisition. However, a debt obligation will not be a "market discount bond" if such excess is

less than a statutory de minimis amount. To the extent that a Creditor has not previously included market discount in its taxable income, gain recognized by a Creditor with respect to a “market discount bond” will generally be treated as ordinary interest income to the extent of the market discount accrued on such bond during the Creditor’s period of ownership. A holder of a market discount bond that is required to defer deduction of all or a portion of the interest on indebtedness incurred or maintained to acquire or carry the bond may be allowed to deduct such interest, in whole or in part, on the disposition of such bond.

4. *Other Claimholders*

If a Creditor reaches an agreement with the Debtor to have its Claim satisfied, settled, released, exchanged, or otherwise discharged in a manner other than as described in the Plan, that Creditor should consult with its own tax advisors regarding the tax consequences of that satisfaction, settlement, release, exchange, or discharge.

5. *Tax Consequences Associated with Unsecured Creditor Trust*

If the Unsecured Creditor Trust is operated in accordance with the guidelines set forth in the Plan, it will be a “grantor trust” under the Internal Revenue Code. For federal income tax purposes, the holders of the Allowed Claims in Class 6 will be treated as the grantors, owners and beneficiaries of the Trust. (The holders of the Allowed Claims in Class 6 will be referred to as the “Beneficiaries” in the remainder of this discussion regarding the federal income tax consequences of the Plan).

For federal income tax purposes, on the Effective Date, the Debtor will be deemed to transfer to the Beneficiaries, the trust assets followed by a deemed transfer of such assets by the Beneficiaries to the Unsecured Creditor Trust. Each holder of an Allowed Claim in Class 6 will be treated as receiving its Pro Rata share of the Trust Assets on the transfer of the Trusts Assets to the Unsecured Creditor Trust.

Each Beneficiary may be permitted to recognize a loss (or may be required to recognize gain) on the deemed transfer of the Trust Assets by the Debtor to the Beneficiaries. Each Beneficiary’s loss (or gain) will equal the difference between (i) the adjusted tax basis such Beneficiary had in its Allowed Claim, and (ii) the fair market value of such Beneficiary’s Pro Rata share of the Trust Assets on the Effective Date. The fair market value of any Avoidance Actions or other Causes of Action will be determined by the Unsecured Creditor Trustee and will be binding on the Beneficiaries, but will not be binding on the IRS. Depending upon the manner in which the Allowed Claim arose, such loss (or gain) may either be capital or ordinary in nature. Due to limitations set forth in the Internal Revenue Code, a Beneficiary who recognizes a capital loss as a result of the deemed transfer to it of its Pro Rata share of the Trust Assets may not be able to utilize such capital loss in the taxable year it arises or possibly ever.

Although many Beneficiaries will not be required to recognize gain/income as a result of the deemed transfer to them of Pro Rata shares of the Trust Assets, certain situations may exist which will require a Beneficiary to do so. For example, if a Beneficiary’s Allowed Claim relates to a transaction pursuant to which the Beneficiary is required to recognize gain upon payment (for example, an installment sale), the Beneficiary may be required to recognize gain as a result of the deemed transfer to it of its Pro Rata share of the Trust Assets. Also, if (1) a Beneficiary previously took a deduction or loss relating to the partial or entire worthlessness of its Allowed

Claim, and (2) the fair market value of such Beneficiary's Pro Rata share of the Trust Assets exceeds its remaining adjusted tax basis, if any, in its Allowed Claim, such Beneficiary will be required to recognize gain/income. There are also numerous other reasons why a Beneficiary may be required to recognize gain/income as a result of the deemed transfer to it of its Pro Rata share of the Trust Assets. Therefore, each Beneficiary should consult its own tax advisor to determine if such Beneficiary will be required to recognize gain/income as a result of the deemed transfer.

Each Beneficiary's adjusted tax basis in its Pro Rata share of the Trust Assets will equal the fair market value of such Pro Rata share on the Effective Date. Because the assets of a grantor trust are deemed to be owned by the grantors, the Beneficiaries will not be required to recognize income or gain upon its deemed contribution of the Trust Assets to the Unsecured Creditor Trust.

Grantor trusts are generally ignored for federal income tax purposes. Accordingly, the grantors (in this case, the Beneficiaries) of a grantor trust are treated as directly owning shares of the assets of the trust and are required to include in its taxable income its proportionate share of the trust's gains, losses, income, deductions and credits (without regard to the timing of distributions from the trust). For example, each holder of an Allowed Claim in Class 6 will be required to report, as ordinary income, its Pro Rata share of any interest the Trust earns. Each holder of an Allowed Claim in Class 6 will also be required to recognize gain or loss when the Unsecured Creditor Trustee settles each Avoidance Action or other cause of action if such holder's adjusted tax basis in its Pro Rata share of the Avoidance Action or other cause of action is different than its Pro Rata share of the amount actually received by the Unsecured Creditor Trust for such Avoidance Action or cause of action. Such gain or loss will be a capital gain or loss and may be short term or long term depending upon the date such Avoidance Action or cause of action is settled. The holding period for such Avoidance Action or cause of action will begin when the assets are placed in the Trust, and will end when each Avoidance Action or cause of action is finally settled. Due to limitations set forth in the Internal Revenue Code, a holder of an Allowed Claim in Class 6 who recognizes a capital loss, may not be able to utilize such capital loss in the taxable year it arises or possibly ever. Each year the Unsecured Creditor Trust is in existence, each holder of an Allowed Claim in Class 6 will receive from the Unsecured Creditor Trust a statement, a copy of which will be filed with the IRS, informing such holder of the amount of income, gains, losses, deductions and credits such holder recognized from its share of the assets of the Unsecured Creditor Trust.

Because each holder of an Allowed Claim in Class 6 should have been reporting on its federal income tax returns its proportionate share of the Trust's income, gain, losses, deductions and credits each taxable year, the actual cash distribution by the Trust to each such holder should not be a taxable event.

6. *Information Reporting and Backup Withholding*

Certain payments, including payments in respect of accrued interest or market discount, are generally subject to information reporting by the payor to the IRS. These reportable payments do not include those that give rise to gain or loss on the exchange of a Claim. Moreover, such reportable payments are subject to backup withholding under certain circumstances. A United States holder may be subject to backup withholding at rate of 28% with respect to certain distributions or payments of accrued interest, market discount, or similar items

pursuant to the Plan, unless the holder (a) comes within certain exempt categories (which generally include corporations) and, when required, demonstrates this fact or (b) provides a correct United States taxpayer identification number and certifies under penalty of perjury that the holder is a U.S. person, the taxpayer identification number is correct, and that the holder is not subject to backup withholding because of a failure to report all dividend and interest income. Payments that give rise to gain or loss on the exchange of a Claim are not subject to backup withholding.

Backup withholding is not an additional tax. Amounts subject to backup withholding are credited against a holder's United States federal income tax liability, and a holder may obtain a refund of any excess backup withholding by filing an appropriate claim for refund with the IRS.

D. Importance of Obtaining Professional Tax Assistance

The foregoing discussion is intended only as a summary of certain United States federal income tax consequences of the Plan and is not a substitute for careful tax planning with a tax professional. The above discussion is for informational purposes only and is not tax advice. The tax consequences are in many cases uncertain and may vary depending on a Creditor's particular circumstances. Accordingly, Creditors are strongly urged to consult their tax advisors about the United States federal, state and local and applicable foreign income and other tax consequences of the Plan, including with respect to tax reporting and record keeping requirements.

IRS Circular 230 Notice: To comply with U.S. treasury regulations, be advised that any U.S. federal tax advice included in this communication (and it is not intended that any such advice be given in this Disclosure Statement) is not intended or written to be used, and cannot be used, to avoid any U.S. federal tax penalties or to promote, market, or recommend to another party any transaction or matter.

X. RISK FACTORS

A. Generally

The restructuring of the Debtor involves a degree of risk, and this Disclosure Statement and certain of its Exhibits contain forward-looking statements that involve risks and uncertainty. Reorganized Zounds' actual results could differ materially from those anticipated in such forward-looking statements as a result of a variety of factors, including those set forth in the following risk factors and elsewhere in this Disclosure Statement. **Holders of Claims and Equity Interests should consider carefully the following factors in addition to the other information contained in this Disclosure Statement.**

B. Dependence on Key Personnel

Reorganized Zounds' post-Effective Date operations depend to a great extent on the efforts of its officers and other key personnel. There can be no assurance that Reorganized Zounds will be successful in attracting and retaining such personnel, or that it will not incur increased costs in order to do so. Reorganized Zounds' failure to attract additional qualified employees or to retain the services of key personnel could have a material adverse effect on Reorganized Zounds' business, financial condition, and results of operations.

C. Competition

The markets in which the Debtor's products compete are extremely competitive. The principal competitive factors in the hearing aid market are quality, service, and price. The Debtor competes with several entities that are substantially larger, with longer operating histories, deeper market penetration and broader name recognition. While there can be no assurances that Reorganized Zounds will continue to remain competitive in these or other areas, the Debtor believes that through its pricing, product quality, re-focused store format and modified marketing efforts, Reorganized Zounds will be able to expand its market share.

D. Risks Association with New Common Stock

1. *Reorganized Zounds May Not Be Able to Achieve Its Projected Financial Results.* Reorganized Zounds may not be able to meet their projected financial results or achieve the revenue or cash flow that Reorganized Zounds has assumed in projecting its future business prospects. If Reorganized Zounds does not achieve these projected revenue or cash flow levels, Reorganized Zounds may lack sufficient liquidity to continue operations as planned after the Effective Date. The Projections represent management's view based on currently known facts and hypothetical assumptions about their future operations. The Projections do not, however, guarantee the future performance of Reorganized Zounds.

2. *The Plan Exchanges Senior Securities for Junior Securities.* If the Plan is confirmed and Consummated, Holders of Allowed Secured Notes Claims in Class 4 and Allowed Settled Notes Claims in Class 5 will receive, in part, shares of New Common Stock. Thus, in agreeing to the Plan, certain of such Holders will be consenting to the exchange of their interests in senior debt, which has, among other things, a stated interest rate, maturity date and a liquidation preference over equity securities, for shares of New Common Stock, which will be subordinate to all future Claims against Reorganized Zounds.

3. *A Liquid Trading Market for the New Common Stock Will Not Exist.* The New Common Stock will not be listed on a national exchange and will not be registered under the Securities Act, by reason of certain exemptions from the registration provisions of the Securities Act. The New Common Stock will be "restricted securities" under applicable U.S. federal and state securities laws and, under these laws, must be held indefinitely unless they are registered with the Securities and Exchange Commission and qualified by state authorities, or an exemption from such registration and qualification requirements is available. Reorganized Zounds will have no obligation to register or qualify the New Common Stock for resale. If an exemption from registration or qualification is available, it may be conditioned on various requirements including, but not limited to, the time and manner of sale, the holding period for the New Common Stock and on requirements relating to Reorganized Zounds which Reorganized Zounds is under no obligation and may not be able to satisfy.

4. *There Will Be No Market Data for the Value of the New Common Stock Following the Effective Date.* As privately-held securities that are not listed on a national exchange and with restrictions on transferability, the New Common Stock will not be publicly traded and there will be no market data for the value of the New Common Stock.

5. *Significant Holders.* Following Consummation of the Plan certain Holders of Allowed Secured Notes Claims in Class 4 will hold a majority of the New Common Stock and may be in a position to control the outcome of actions requiring shareholder approval, including election of directors.

6. *The Debtor's Financial Projections are Subject to Inherent Uncertainty Due to the Numerous Assumptions on Which They Are Based.* The Projections provided in **Appendix 3** are based on numerous assumptions including: timely Confirmation and Consummation under the terms of the Plan; the anticipated future performance of Reorganized Zounds; pricing for the Debtor's products; fluctuations in materials costs and general business and economic conditions and other matters, many of which are beyond the control of Reorganized Zounds and some or all of which may not materialize. In addition, unanticipated events and circumstances occurring subsequent to the date that the Disclosure Statement is approved by the Bankruptcy Court may affect the actual financial results of Reorganized Zounds' operations. These variations may be material and may adversely affect the ability of Reorganized Zounds to make payments with respect to indebtedness following Consummation. Because the actual results achieved throughout the periods covered by the Projections may vary from the projected results, the Projections should not be relied on as an assurance of the actual results that will occur.

Except with respect to the Projections and except as otherwise specifically and expressly stated, the Disclosure Statement does not reflect any events that may occur after the date of the Disclosure Statement. Such events may have a material impact on the information contained in the Disclosure Statement. Neither the Debtor nor Reorganized Zounds intend to update the Projections. The Projections, therefore, will not reflect the impact of any subsequent events not already accounted for in the assumptions underlying the Projections.

7. *The Actual Amount of Allowed Claims May Differ from the Estimated Claims and Adversely Affect the Percentage Recovery of Claims.* The estimated Claims set forth in the Disclosure Statement are based on various assumptions, and the actual amount of Allowed Claims may significantly differ from the estimates. Should one or more of the underlying assumptions ultimately prove to be incorrect, the actual amount of Allowed Claims may vary from the estimated Claims contained in the Disclosure Statement. Such differences may materially and adversely affect, among other things: (a) the percentage recoveries to Holders of Allowed Claims under the Plan; (b) Reorganized Zounds's ability to consummate the Plan; (c) the Projections; and (d) Reorganized Zounds's need to raise additional debt or equity financing.

8. *Reorganized Zounds Does Not Expect to Pay Cash Dividends on the New Common Stock for the Foreseeable Future.* Due to the existence of the secured obligations under the Exit Financing Facility and restrictions contained in the Exit Financing Documents, Reorganized Zounds will be unable to pay dividends on account of the New Common Stock for the foreseeable future.

E. Reorganization Factors

1. Financial Considerations

As with any plan of reorganization or other financial transaction, there are certain risk factors that must be considered. All risk factors cannot be anticipated, some events will develop in ways that were not foreseen, and many or all of the assumptions that have been used in connection with this Disclosure Statement and the Plan will not be realized exactly as assumed. Some or all of such variations may be material. While efforts have been made to be reasonable in this regard, there can be no assurance that subsequent events will bear out the analyses set forth in this Disclosure Statement. Holders of Claims and Equity Interests should be aware of some of the principal risks associated with the contemplated reorganization:

- a. There is a risk that one of more of the required conditions or obligations under the Plan will not occur, be satisfied or waived, as the case may be, resulting in the inability to confirm the Plan.
- b. The total amount of all Claims filed in the Chapter 11 Case may materially exceed the estimated amounts of Allowed Claims assumed in the development of the Plan and in the valuation estimates provided above. The actual amount of all Allowed Claims in any Class may differ significantly from the estimates provided in this Disclosure Statement. The amount and timing of the distributions that will ultimately be received by any particular holder of an Allowed Claim or Allowed Equity Interest in any Class may be materially and adversely affected if the estimates are exceeded as to any Class.
- c. Uncertainties may adversely affect Reorganized Zounds's future operations including acts of God or similar circumstances. Many of these factors will be substantially beyond Reorganized Zounds's control, and a change in any factor or combination of factors could have a material adverse effect on Reorganized Zounds' financial condition, cash flows, and results of operations.

2. Risk of Non-Confirmation of the Plan

Although the Debtor believes that the Plan will satisfy all requirements necessary for Confirmation by the Bankruptcy Court, there can be no assurance that the Bankruptcy Court will reach the same conclusion. There can also be no assurance that modifications of the Plan will not be required for Confirmation, that such negotiations would not adversely affect the holders of Allowed Claims and Equity Interests, or that such modifications would not necessitate solicitation or re-solicitation of votes.

XI. ALTERNATIVES TO THE PLAN

The Debtor believes that the Plan affords holders of Claims and Equity Interests the greatest realization on the Debtor's assets and, therefore, is in the best interests of those holders.

If the Plan is not confirmed, however, the theoretical alternatives include: (a) continuation of the pending Chapter 11 Case but without any immediately available financing; (b) an alternative plan or plans of reorganization; or (c) liquidation of the Debtor under Chapter 7 of the Bankruptcy Code.

A. Continuation of the Chapter 11 Cases

Because the Debtor's operations are not likely to change materially, continuing the Chapter 11 Case would only increase the amount of Administrative Claims against the Estate without any corresponding financing seemingly available. Since the Plan provides a means of satisfying all Claims with a blend of Cash, New Common Stock and beneficial interests in the Unsecured Creditor Trust, continuing the Chapter 11 Case would serve no purpose other than increasing costs to the Estate and reducing recoveries to holders of Class 6 General Unsecured Claims.

B. Alternative Plans of Reorganization

If the Plan is not confirmed, the Debtor, or, after the expiration of the Debtor's exclusive period in which to propose and solicit a reorganization plan, any other party in interest in the Chapter 11 Case, could propose a different plan or plans. Those plans might involve either a reorganization and continuation of the Debtor's business, or some other form of orderly liquidation of the Debtor's assets, or a combination of both.

C. Liquidation Under Chapter 7

If no plan is confirmed, the Debtor's Chapter 11 Case may be converted to a case under Chapter 7 of the Bankruptcy Code. In a Chapter 7 case, a trustee or trustees would be appointed to liquidate the assets of the Debtor. It is impossible to predict precisely how the proceeds of the liquidation would be distributed to the respective holders of Claims against or Equity Interests in the Debtor. The Debtor believes, however, that holders of Claims and Equity Interests would lose substantial value if the Debtor were forced to liquidate under Chapter 7 because the Debtor's inventory and other valuable assets would bring a significantly reduced value in a liquidation context (as opposed to a going concern context) and additional administrative expenses involved in the appointment of a trustee or trustees and attorneys, accountants and other professionals to assist those trustees would cause a substantial diminution in the value of the Estate. The assets available for distribution to holders of Claims and Equity Interest would be reduced by those additional expenses.

XII. CONCLUSION

A. Hearing on and Objections to Confirmation

1. *Confirmation Hearing*

The hearing on confirmation of the Plan has been scheduled for [REDACTED] at [REDACTED]:[REDACTED].m. (Arizona time). The hearing may be adjourned from time to time by announcing the adjournment in open court, all without further notice to parties in interest, and the Plan may be modified by

the Debtor under Bankruptcy Code § 1127 before, during, or as a result of that hearing, without further notice to parties in interest.

2. *Deadline for Objections to Confirmation*

The time by which any objections to confirmation of the Plan must be filed with the Bankruptcy Court and received by the parties listed in the Confirmation Hearing Notice has been set for **July 31**, 2009 at 5:00 p.m. (Arizona time).

B. Recommendation

The Plan provides for an equitable distribution to Creditors and the continuation of the Debtor's business for the benefit of all Creditors and the Debtor's customers, suppliers, and employees. The Debtor believes that any alternative to confirmation of the Plan, such as Chapter 7 liquidation or attempts by another party in interest to file a plan, could result in significant delays, litigation, and costs. For these reasons, the Debtor urges you to vote to accept the Plan and to support Confirmation of the Plan.

Dated: June 3, 2009

Respectfully submitted,

SQUIRE, SANDERS & DEMPSEY L.L.P.

ZOUNDS, INC.

Debtor-In-Possession

By: /s/ Jordan A. Kroop

By: /s/ Samuel Thomasson

Jordan A. Kroop

Samuel Thomasson

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Counsel for Debtor-In-Possession

Appendix 1
Plan of Reorganization

Appendix 2
Order Approving Disclosure Statement

Appendix 3
Selected Financial Information

[To come]

Appendix 4
Liquidation Analysis

Zounds, Inc.
Liquidation Analysis

<u>Proceeds</u>		<u>Liquidation Value</u>	
Cash and Cash Equivalents		\$ 318,953	
Inventory		300,000	
Property, Plant & Equipment		250,000	
Intangible Assets, Net		1,000,000	
LT Assets - Deposits		10,000	
<u>Restricted Cash</u>		<u>300,000</u>	
Gross Proceeds for Distribution		<u>\$ 2,178,953</u>	
<u>Distributions</u>	<u>Allowed Claim</u>	<u>Distribution</u>	<u>Recovery %</u>
First Priority Priming DIP Loan	\$ 1,000,000	\$ 1,000,000	100.00%
Net Proceeds After DIP Loan		<u>\$ 1,178,953</u>	
Chapter 11 Professional Fee Carveout	475,000	475,000	100.00%
Net Proceeds After Carveout		<u>\$ 703,953</u>	
Allowed Secured Claims	5,101,500	703,953	13.80%
Net Proceeds After Secured Claims		<u>\$ -</u>	
Chapter 11 Administrative Claims	25,000		
Chapter 7 Administrative Claims	65,369		
Total Administrative Claims	<u>90,369</u>	-	0.00%
Net Proceeds After Admin Claims		<u>\$ -</u>	
<u>Unsecured Claims</u>			
Unsecured Priority Claims	250,000		
General Unsecured Claims	25,485,113		
Total Unsecured Claims	<u>\$ 25,735,113</u>	<u>\$ -</u>	0.00%

Appendix 5

Disputed Secured Noteholders

[To Come]