When a mill or paper company is facing financial or operational distress, bankruptcy can be a viable option for preserving value, if handled correctly

Proper Bankruptcy Process Can Fuel Recapitalization for Paper Companies

By **MICHAEL L. NEWSOM**

Just as other areas in financial operations have become more efficient and effective over the years, so has the area of bankruptcy administration. Bankruptcy is now more than ever a viable option for the recapitalization and revitalization of struggling companies. Also, in cases where businesses are not fundamentally sound and cannot survive, bankruptcy fosters an organized and efficient means for the liquidation of assets. This is not to give the impression, however, that bankruptcy is win-win situation, but rather an honest endeavor to bring equity to creditors, employees, and company stakeholders alike.

Businesses that have untenable business models or obsolete products will have limited success in bankruptcy both in reorganization and in liquidation. The paper industry, however, has a different outlook. Being primarily a commodity based and mature business, the sustaining variables are generally volume, margin, and competition. So, even with inefficient production, paper mills can find success in niche markets given manageable fixed costs, and in particular a manageable interest burden. Furthermore, the liquidation value of paper mills can be quite high.

As is well known, paper machines installed in the 1960s or earlier continue to be bought and sold today. More valuable still can be the land. Paper mills are invariably located on waterfront property. When the mills were constructed, the property was likely remote, but today it is just as likely that it is in, or close to, urban areas that are prime for high-end development.

Another critical factor in industrial reorganization and liquidation is the environmental condition of the property. Relatively speaking, the paper industry is an environmentally clean industry, and many factors can be readily quantified to assess the liability.

If you are a strategic decision maker in a paper company you are probably asking, "So, what do I do if I fear a troubled financial future for my company?" In response, this article provides some information on the bankruptcy process, some strategic suggestions, and a short synopsis of an actual paper mill Chapter 11 liquidation at Durango Georgia Paper Co.

Waiting Too Long Depletes Value

By and large, companies wait far too long to declare bankruptcy. They deplete their working capital. They degrade their equipment by lack of maintenance. They alienate their customer base, and they make enemies of their suppliers. Needless to say, these conditions are not favorable to a successful outcome.

Durango Georgia Paper Co. as viewed along the North River

Another misfortune that might not be common knowledge is that the proper fiduciary responsibility might not be served. According to bankruptcy law, at the point that a business enters the "zone of insolvency," fiduciary responsibility is owed not to the shareholders but to the creditors. If management fails to observe this and act accordingly, they can be subject to severe penalties.

Bankruptcy administration is a sophisticated process. It takes a great deal of planning prior to the declaration. Specialists, both legal and financial, are needed to accomplish the many and varied tasks. Generally, debtor in possession (DIP) financing will be needed to sustain the estate, and well planned first-day orders are important to allow the contemporaneous needs of the organization to be met. In the best of scenarios, early planning can result in a financially restructured company that avoids bankruptcy. In the event that efforts to that end are not successful, bankruptcy can be used as a powerful forum for restructuring.

After bankruptcy declaration, virtually all agreements, contracts, and debts are on the table for renegotiation. More critical perhaps is that all causes of action and claims for immediate payment are put on hold. The immediately effective "automatic stay" provides companies with a breathing spell to manage the cash they have, raise money, and ward off creditors. The automatic stay is the salient feature in bankruptcy that allows value to be preserved.

So, is management just advised to plan for the preservation

of the enterprise and assets? No, they are legally obligated to plan ahead and recognize if insolvency is unavoidable. Getting legal help for this looming catastrophe may be a first thought, but getting financial assistance in industry-specific bankruptcy is also very important.

While this outside help may not be a planned budget item, it will be well worth it. The cliché comes to mind that, “If you think hiring an expert is expensive, try hiring someone who is not.” In the planning process, managers must come to grips with a new paradigm and acknowledge what was mentioned earlier in this article; bankruptcy is not a win-win prospect. It is a fairness process. It is important to understand the options and act with prudence.

Liquidation at Durango Georgia

Let’s review the actual bankruptcy liquidation of Durango Georgia Paper Co. in Saint Marys, Ga. Bridge Associates (Bridge), an interim management firm, was brought in later than it would have liked, but soon enough to preserve substantial value. Durango Georgia had been a company in distress from its origin. In 1999, it was created from the St. Marys, Ga., pulp mill part of the Gilman paper enterprise. The mill had been unprofitable prior to its purchase, but the situation worsened in 2001 and 2002 when paper prices could not cover rising production costs (Table 1).

As is common, management delayed pursuing bankruptcy as an option and some vendors actually filed the paperwork to put the company into “involuntary” bankruptcy. Unfortunately for the enterprise, the mill could not sustain production into bankruptcy and was shut down cold. Over the next 20 months, the debtor, without a financial advisor, was unable to restart or sell the mill. The best offer on the table was $7 million plus some contingent money for all of the assets.

The first act of Bridge was to convince the official committee of unsecured creditors not to consummate this $7 million deal. The firm’s thesis was that the intrinsic value of the land alone was worth well more than its present offer. Key to Bridge’s proposal was to convince them that the horror stories they heard about the environmental condition of the mill were completely false.

This representation of the environmental status was later proven true and will be true for most paper mills. The problem in coming to a conclusion on the environmental status is a familiar paradox. At the time the decision must be made, it must be made on faith, not comprehensive test data. The purchaser wants environmental data from testing. The seller, however, is opposed to doing any testing for fear that something bad might be found, the buyer will walk away, and the seller will have triggered a responsibility to engage in a clean up.

Bridge presented an analysis based on industry data, site data, geological data, and a great deal of plain “been there, done that” information. The presentation made sense, the creditors approved of it, and the process began.

TABLE 1.

Durango Georgia’s situation worsened in 2001 and 2002 when paper prices could not cover rising production costs.

Mill Revenue and Operating Profit ($000)			
Year	Net sales	Operating Profit	Producer Price Index*
2002	Bankruptcy filed		144.7
2001	$201,271	($13,133)	150.6
2000	$240,688	$9,520	149.8
1999	$242,142	($19,878)	141.8
1998	$243,554	($25,773)	145.4
1997	$250,668	($10,517)	143.9
1996	$274,687	($4,344)	149.4
1995	$296,457	$23,872	159.0
1994	$240,079	($17,752)	126.0
1993	$240,223	$6,535	123.8
1992	$243,074	$28,171	123.2

* U.S. Bureau of Labor Statistics, *Pulp & Paper.*

When Bridge took over, it had only enough cash to make two months of payroll for the company employees retained to manage the estate. The firm was also saddled with the self-imposed restriction it could not sell equipment that was critical to a restart of the mill. This posture was adopted because Bridge wanted to continue to market the site to restarters as well as to developers. The firm put the bankruptcy process to work and obtained funds sufficient to finance the activities through the time of the asset auction.

The firm also organized a national marketing program and conducted numerous tours of the facility led by experts in both environmental matters and paper manufacturing. From experience, Bridge knew that distressed property developers alone would not provide offers commensurate with the true value of this property. So, the goal was to educate mainstream developers about the site and its liabilities. Along the way, all types of interested parties and parties from various corners of the world were encountered. Bridge held a spirited auction and signed contracts totaling over $42 million.

In the end, losses to the creditors were minimized. Assets were not squandered. The local community was not condemned to have an environmental and aesthetic eyesore for some indeterminate time. The bankruptcy liquidation plan was executed to a level of success not initially thought possible. Could the results have been better? Yes, but only if the process was started earlier. In conclusion, value was preserved and the bankruptcy process worked to the advantage of the creditors and the community. **P&P**

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