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Protecting Shareholder Value Through Strategic Use of Chapter 11 Bankruptcy

Many companies believe bankruptcy should only be considered as a final option. However, filing for Chapter 11 bankruptcy can sometimes be used as an effective strategy to protect a company and its stakeholders from further damages.

by Scott McDermott

Everyone knows the market environment in the ethanol industry has been challenging over the past 18 months. This cycle downturn is the latest of many downturns experienced in the ethanol industry and several companies have had to make the uncomfortable decision to file for bankruptcy. Unfortunately, too often companies seem to view bankruptcy in one bucket—as the end and as something that happens when the money runs out and all else is lost. This is Chapter 7 liquidation and, more often than not, it is triggered by a lack of proactive diagnosis and action. Things don't have to get that far. The fact is, the threat of or filing for Chapter 11 bankruptcy, when managed effectively and proactively, can represent a powerful tool to protect shareholder value and can provide precious time to realign the business to better fit the market environment.

Ethanol plants are facing margin pressure, but some plants are better positioned to endure the challenging environment than others. Some of the plants filing bankruptcy became insolvent because of hedging and speculating losses or because the plants never operated at designed capacity. Other plants that are struggling are undercapitalized or have contracts and cost structure that were established in a structurally higher market, which makes them higher cost and more susceptible to margin and cash flow pressure. The majority of these plants were built in the past three to four years. And many are now seeking to refinance, recapitalize and/or are filing for bankruptcy.

Firms may not control the realities of the market, but they do control how their firm responds. Preparing the company to manage through a challenging environment and the prospects of filing bankruptcy are the responsibility of the board and senior management. They are responsible for protecting the shareholder value of the firm. Boards and management must be sure to work closely together to understand risk and devise plans to maneuver the uncertain waters. Management is the “eyes and ears” and will be the first to see signs of increased risk. Management must communicate increased risk to the board, and the board must ask probing questions of management in order to identify potential issues early and have time to address issues and adjust.

The board has a fiduciary responsibility called “duty of care,” which obligates them to identify risks to the firm and make plans to manage those risks. Board members face personal liability if they are not actively engaged in assessing the risks to the business. “I did not know” may not be good enough to protect a board member from negligence.

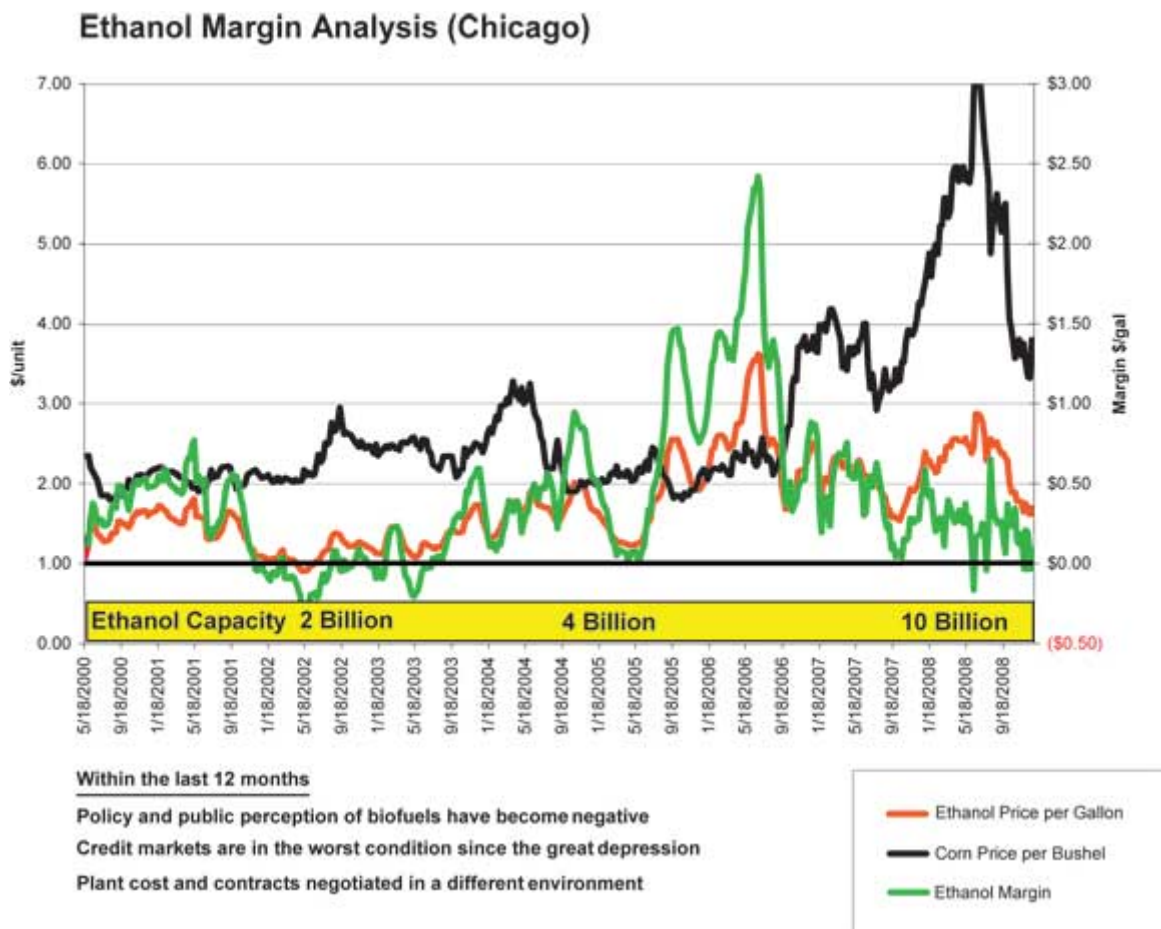
Some of the common failures of board members include the failure to act when action by the board is necessary, failure to provide proper management oversight, failure to manage risk, failure to attend board meetings and be prepared, and most important, failure to investigate further after learning of red flags in the business.

Directors have heightened duties when the company is facing a serious crisis. In this “zone of insolvency,” directors have a fiduciary duty to creditors as well as shareholders. There is no hard and fast rule for when these duties begin; however, if the board believes there is a strong likelihood that the company may be unable to pay its debts when they become due, the company should be considered to be in the zone. Companies enter the zone long before missing payments or declaring bankruptcy. This is why a board must consider how it would position the firm to maneuver through bankruptcy long before the situation is eminent and even though the firm may not actually go into bankruptcy. One of the biggest risks to shareholder value is not having a good understanding of the current and potential financial position of the firm, including not

understanding the firm's position with its creditors, being heavy-handed with creditors because the firm thinks it has power it does not have, or trying to work with creditors when it is too late.

Once a firm is in the zone, the board must be aware of additional duties, including avoiding taking riskier actions that have big payoffs and maximizing the value of assets for payment to creditors. Under the "absolute priority rule," secured and unsecured creditors' claims to the company's capital trump claims of shareholders. The board must be diligent in working with creditors to manage and negotiate through the prebankruptcy and bankruptcy process to protect shareholder value. This rule plays a major role in dictating how the board sets negotiating strategy.

When it comes to protecting shareholder value in the presence of the possibility of bankruptcy, the key ingredient is to proactively plan for the worst and hope for the best. One of the things boards and managers can do to improve the odds for success is to avoid denial. Being proactive and having a detailed understanding of the firm's position and the creditor's position is critical to setting strategies to protect shareholder value. This entails having a clear handle on the firm's financial position, having a detailed understanding of the terms of all major contracts, gathering a war team, and communicating thoughtfully and consistently with all stakeholders to educate, manage expectations and avoid misunderstandings.



One important factor that is often underestimated is the importance and power of communication. As part of the homework, it is critical for the firm to proactively manage communications with advice from its legal counsel. Planned communications with creditors, banks, shareholders and other stakeholders is critical to maneuvering through the Chapter 11 process to preserve shareholder value. This is where the board and management determine how to position the firm to get to the win-win position as much as possible.

Everyone involved has money at risk; and if the plant is forced into liquidation in a difficult environment, almost everyone loses everything except for the senior lender who is now banker and ethanol plant operator. Making sure everyone understands this reality is an important point of leverage for shareholders

because there is incentive for secured and unsecured parties to negotiate an equitable settlement to save their investment.

Management and boards should have a detailed understanding of the drivers of profitability, commodity market-to-market positions and risks, and operating costs for the plant.

Firms need to do their best to perform an honest assessment of how cost competitive they are to their peers. In the end, ethanol production is a commodity industry and understanding where each plant is on the cost curve is critical. Firms also need to have detailed pro-forma projections at weekly, monthly and annual intervals to understand their projected cash flow and risk to cash flow. This allows the board and management to have a clear and detailed understanding of their working capital position and risks to working capital. Even if a plant is not the lowest cost facility, in the current environment a well-capitalized plant with a good capital preservation strategy can endure in the end over a lower operating cost plant. Barring mistakes, all of these factors are key selling points to creditors and stakeholders and show that the board and management are up to the job of running a viable company.

Oftentimes, a project with a high probability for a successful restructuring that would strengthen the firm is derailed when a contract term "land mine" that puts the firm at risk is uncovered. Many of these land mines could have been diffused if the company had uncovered them early and put in place a plan to mitigate.

Managers and boards need to proactively get a detailed understanding of the key terms of the company's contracts and the counterparty's position in those contracts. Often people perceive these contracts as being zero sum games. One person has to lose for the other to win, but this is not always the case. Contracts may not have been made to be broken, but they are certainly made to be renegotiated in the current environment. Legal contracts and documentation are painful to work through; however, with the help of qualified legal council and a seasoned financial team, board and management members can understand their risks, mistakes, leverage and opportunities to position the company to preserve shareholder value.

The final point is to organize a turn-around team and have that team in place early, even if it is not a full-court press to maneuver through prebankruptcy. Remember, it will be war and the right team makes the difference between shareholders maintaining interest in their investment and losing everything. Key team capabilities include experienced executive board members and managers that can dedicate the time required, experienced bankruptcy legal counsel, experienced and sophisticated financial advisory support as well as other capabilities on a as-needed basis. Often management and boards try to maneuver through the process by themselves in order to save money, but mistakes in the prebankruptcy process can be devastating to investors. In the current environment, several of the plants that have tried to save money have lost 100 percent of their equity investment in the plant.

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