Franchise Times®

www.franchisetimes.com The News and Information Source for Franchising March 2008

Restructuring debt is a better option than bankruptcy, but there are several steps to consider for it to be successful.

Dennis Monroe

Dennis L. Monroe is a partner and the chairman of Krass Monroe, P.A., a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation.

Dennis can be reached at (952) 885-5999

Redoing debt

Steps in a successful restructure

Last month's column dealt with getting ready for a downturn. Much of the column discussed appropriate steps to take to minimize issues if, for some reason, the franchise business has to go through a restructure. Some of the key discussion points from last month's column dealt with unproductive assets, getting a corporate structure in place that protects personal assets, minimizing issues as to guaranties, and making sure there is a complete knowledge of the business structure and legal and financial constraints so appropriate steps can be taken.

This month's column discusses the steps in a successful restructure. One of the reasons for this topic is that filing bankruptcy is seldom the appropriate course of action for an overleveraged franchisee situation. A bankruptcy will extinguish debt, but in many cases, will also extinguish the ability of the franchisee to move the business forward.

Even though most restructure situations are not adversarial, there are still a number of competing interests that must be addressed. A successful restructure takes into account the following:

- A revised, restructured debt that allows adequate cash flow to service the restructured debt;
- Necessary capital expenditures to maintain or improve the assets or units;
- Purchase money financing to allow for future improvements;
- A systematic paydown of overdue current liabilities (specifically accounts payable);
- The accumulation of a liquidity reserve;
- Incentive plans to retain key employees and keep them engaged throughout the restructure and post-restructure process;
- Closing of under-performing stores; and
- Providing for a buyout or restructure of onerous or above-market leases.

Normally, the restructured loan provides for a "waterfalls" approach where cash is paid to various obligations in the order determined by the senior lender, franchisor and franchisee. The waterfalls approach may have the following priority payment list: (i) all operating expenses; (ii) back royalties owed to the franchisor; (iii) restructured senior debt; (iv) required capital expenditure reserves; (v) liquidity reserves; and (vi) other debt. This is by no means a fixed approach, but these are some of the considerations.

In most cases the senior debt facilities are rewritten down to a serviceable level. The lenders take into account an overall debt service level that will result in a workable fixed charge coverage ratio. The written down portion of the senior debt is usually converted to a non-accruing obligation or a preferred equity interest in the company. Sometimes we refer to this position as a "hope note."

All successful restructures involve an active franchisor. Franchisors may help in creating necessary liquidity and resolving potentially large back royalties and advertising fee obligations. A franchisor may provide for installment payments of the back debt payments or a deferral of some of the required capital expenditures and a no-fee extension of the franchise agreement.

Landlords also play a key part in economically distressed situations. In many cases dealing with landlords is the most difficult part of a restructure because the landlords have control of sites and, thus, the ultimate trump card (which, in many cases, supersedes the senior lender and the franchisor interest). Therefore, landlords must be approached with a realistic plan that provides for an effective, restructured, long-term lease.

We mentioned negotiations with landlords, franchisors, debt holders, and suppliers. All of these negotiations need to be resolved compatibly for a restructure to work. Sometimes, restructures are only done to buy time and that the inevitable failure of the business seems to be predetermined because the restructure does not allow for an accurate baseline of success but envisions a significant up-turn in business. This overly optimistic approach, while expedient, is not the solution. In most cases, a realistic restructure assumes a flat or slightly down economic performance on which to build eventual success.

The key element for a successful restructure is to make sure all aspects of the business and financial condition are considered and that the company coming out of the restructure has a chance to succeed. The plan should be prepared and implemented by experienced advisors who know your industry and are able to see beyond today's challenges and know what's possible. FT