Franchise Times®
www.franchisetimes.com The News and Information Source for Franchising February 2009

Difficult times require companies to think differently and use any financial and legal tool available to them in order to survive. Here is one possible solution.

GoodCo vs. BadCo

A tale of two companies, one owner

In these times there is a real need to think outside the box. My colleague, Andy Hall, and I have come up with a theoretical situation that involves completing a reorganization of a borderline insolvent restaurant company that may stave off a bankruptcy and give a remnant of the predecessor a reasonable chance to survive the current tough times.

As with any transaction, there are no guarantees this type of reorganization will equal our hopes. Nonetheless, many franchisees will find reorganizing outside of bankruptcy is the preferred approach, even if the company ends in bankruptcy despite our best efforts. This type of reorganization, which we call "GoodCo/BadCo," carries with it many risks, but at the end it has the potential of achieving similar results as a Chapter 11 bankruptcy with the client in somewhat more control.

A GoodCo/BadCo reorganization is best described with an example. Assume our company is an operator of fast-casual restaurants with 18 stores operated under one corporation. The company owns all of the assets, is the franchisee and tenant and is the borrower under secured credit facilities. Six of the stores are losing money and burdened by expensive and unforgiving leases. The other 12 stores are profitable and have favorable leases or landlords willing to work with the client to make the leases more favorable. The senior debt is secured by all of the assets of the company.

Working with the senior lender and the franchisor, the operating company transfers the assets strictly related to the profitable stores to a new entity—which, of course, we call GoodCo. The assets strictly related to the unprofitable stores are left with the company—naturally, BadCo. Similarly, the liabilities strictly related to the good stores are assigned to GoodCo and the liabilities strictly related to the bad stores remain with BadCo.

One key external component to making the transaction work is the backing of the senior lender. As the holder of a security interest in the company's assets, any transfer is subject to the senior lender's consent. The senior lender needs to agree to allow the assignment of a large portion of the senior debt from BadCo to GoodCo. This debt assignment and assumption is the currency used in the transaction—in exchange for the assets of the good stores, GoodCo assumes senior secured debt in an amount just greater than the fair market value of the transferred assets. The senior lender has an incentive to do this, primarily because the expected value of the senior lender's debt position with GoodCo post-transaction usually will exceed the senior lender's expected value from the bankruptcy of the original company.

Similarly, the consent of the franchisor is a second key external component, at least in situations where the franchise agreements cross-default or where there is a personal guarantee behind the franchise agreements. The franchisor will need to consent to the transaction and the franchisee group divided in two—in other words, there will no longer be any cross-default between the franchise agreements held by GoodCo and those held by BadCo. In addition, the franchisor will need to release any guarantors from the BadCo franchise agreement guarantees. It also would be helpful if the franchisor provided other assistance to both BadCo and GoodCo in the form of royalty deferrals or forgiveness. In our experience, franchisors are

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

initially hesitant to help but tend to warm to the idea when the failure of an entire enterprise with all franchised stores becomes a possibility.

The third external component, although not as important as the first two, is the landlords for the GoodCo locations. Most commercial leases include provisions for landlord consent to assignments. In these cases, the assignment of the leases for the performing restaurants from BadCo to GoodCo requires landlord buy-in to the reorganization. When faced with a tenant bankruptcy, most landlords would agree to an assignment to an entity that has a greater likelihood of long-term survival. Landlords in these situations may also be more amenable to some favorable lease modifications.

After the transaction is completed, GoodCo is a separate entity with 12 viable stores and a fighting chance for long-term survival and growth. BadCo, on the other hand, is the unprofitable remnant of our borderline insolvent restaurant company that, without major help, will end up dissolving or going through bankruptcy. Certainly, the creditors of BadCo will not be pleased and we would expect saber-rattling if not legal action. The biggest risks are (a) the reorganization getting unwound in a future legal or bankruptcy proceeding, (b) the imposition of successor liability on GoodCo for BadCo's debts and (c) a finding by a court that the officers and directors of the original company violated the fiduciary duties to creditors that the officers and directors became subject to once the original company entered the zone of insolvency. Nonetheless, if the right circumstances exist, as they did in the reorganization discussed above, these risks can be substantially minimized.

With regard to the circumstances that exist in our hypothetical above, we have come to the conclusion that the right circumstances are not necessarily a "perfect storm"—not every aspect of our hypothetical situation has to exist to make a GoodCo/BadCo reorganization a viable alternative for struggling multi-unit companies. With a willing franchisor and a willing lender, a similar reorganization or variation on the theme may be beneficial to a different company in different circumstances to promote its survival.

Tough times require a different way of thinking, like using legal and financial tools to gain an advantage or just to survive. No matter how tough things look; there are always techniques like GoodCo/BadCo that can be used. FT

Reprinted with the permission of Franchise Times, February 2009 © Franchise Times, 2808 Anthony Lane South, Mpls., MN 55418