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LOAN WORKOUTS – RESOLUTIONS FOR THE NEW YEAR

After two years of mainly “doom and gloom” in this industry, we are all looking forward to a new and hopefully, profitable New Year. However, for a substantial number of franchisees, a day of reckoning is at hand before they can hope to see a bright future. Unfortunately, there are still a lot of over-leveraged franchisees whose loans are under performing or about to go into either a technical or material default. Among this group of unfortunates, are many franchisees that were granted temporary fixes or reprieves by their lenders and / or franchisor. As most are now realizing, temporary fixes, such as interest relief, royalty relief and extended amortizations, are just that...temporary. Accordingly, many of these franchisees will have to consider their options between a true, structural workout or various forms of bankruptcy whether it be a Chapter 11 - Reorganization or even a dreaded Chapter 7 - Liquidation.

However, all is not lost, if you have good operations, a sound management team, a past history of good credit and ... if you act now! Thus, I have included a list of New Year’s “Resolutions, Goals and Objectives” that, if fulfilled, will greatly enhance your chances of having a good New Year and a profitable future.

1. Resolve to ACT NOW!

Pride, denial and delay come before the fall. Are you in or near technical or material default on any of your loan covenants? Have you experienced a steady drop in sales, lower profits or are you experiencing difficulty paying vendors? Do you lack detailed internal financial controls and reporting? If so, you need to address your situation immediately. It may be difficult to look at your company critically but delaying an honest appraisal of your operations will only insure the ultimate failure of a complete financial meltdown.

One of the primary reasons for the failure of a business is an owner’s inability or unwillingness to address serious problems early before they become unmanageable. It is difficult not to be emotionally over-involved and to look at your company’s potential or real problems on an honest, critical and

unbiased basis. This emotional involvement can create a tendency to blame others (i.e. franchisors, lenders, etc.) for our problems. Unfortunately, this approach usually doesn't play well with people who may have a critical and substantial involvement in your financial survival. Even if your unbiased analysis reflects that a franchisor or lender may have contributed to your problems, you can still address that issue at the appropriate time in your workout negotiations.

Do not expect your franchisor, vendors or lender to work with you, if you fail to take an analytical, professional approach. Delaying the problem will only make the situation worse. Franchisors and lenders don't want to play the "blame game", they want to know the true, factual cause of your problem and the solution(s) you propose to solve your problems.

2. Resolve to really know and understand what factors are key to your success or failure.

This sounds obvious, but some owners believe that they if they run really good operations, everything will work out. This approach is seen at all levels, large or small. Owners of large to mid-size operations may have focused their time and efforts on the "big picture", leaving the financial administration to office managers who may be ineffective, inexperienced or even untrustworthy. Smaller owners are truly stretched in their attempt to run operations and juggle sometimes complex financial matters along with all their other responsibilities. However, you must ask yourself, if you don't find a way to devote enough time and resources to knowing what is causing your financial problems, how much is it going to cost you later at a more critical time?

Are your employees, accountants or lawyers experienced in understanding and analyzing your financial statements? Have you educated and aligned them and yourself to achieve certain financial and operational goals? If not, your problem may lie within the company itself. Additionally, you should not just rely on your accounting firm or bookkeeper to report critical factors on a quarterly or annual basis. Finding a problem weeks or months later could be too late.

Accordingly, you should educate and re-emphasize to each of your employees what factors are important at each level. Your lenders and franchisor will be focused on important financial ratios such as debt coverage ratio, fixed charge coverage ratio, times interest earned and funded debt to EBITDA, not only on a consolidated basis, but also on a store level basis. Your key personnel should know and fully understand what factors into each of these calculations and why they are important to you and your lender. Create internal controls, reporting formats and information systems that will allow you to review and discuss these issues on a weekly basis. This weekly

report should give you all relevant liquidity ratios, activity ratios, debt ratios and profitability ratios related to your particular industry. Operational reports (ie. key indicators such as food or inventory costs, customer satisfaction indexes, delivery times, employee turn-over, etc.), marketing reports (ie. advertising responses / effectiveness, promotional response, demographic analysis, etc.) and any other industry-specific areas should be critically analyzed as well.

If you don't know the key success factors of your business, you won't be able to discover and resolve the underlying causes of your problems. As a result, you shouldn't expect a lender or franchisor to have any confidence in your ability to implement an effective workout plan.

3. Resolve to hire experienced professionals to develop and implement your workout plan.

If you are incurring a financial crisis, time is not your friend. The longer your financial predicament persists, the closer you get to bankruptcy. You have a business that requires your focus. Allow professionals who are efficient, knowledgeable, unbiased and experienced to focus on your workout. Some franchisees either think that they can't afford professionals or don't need them. Unless you or your employees are experienced in workouts, you cannot afford not to make this resolution. Lenders and franchisors are experienced in these matters because they deal with them on a regular basis. They also employ professionals such as their own in-house or outside legal counsel or their own finance division to advise them. Accordingly, they have heard every excuse or rationale for every default. As a result, you should not enter into serious discussions or negotiations without putting yourself on equal footing. Your outside professionals will give unbiased opinions and tell you the truth when employees might hesitate to tell the boss the "bad news" or may be too involved to clearly see the issues themselves. A wise old saying in legal circles states that, "An attorney who represents himself, has a fool for a client." Do not put yourself in this situation. Workouts will require specialized and detailed financial / legal / operational analysis and involve complex issues that will affect each of these disciplines. Unless your company already possesses unique experience in workouts, you should consider hiring workout specialists. Workout professionals keep abreast of the latest developments in their fields and constantly maintain and develop important outside relationships with new and existing lenders or portfolio managers. These workout specialists devote their careers to assisting companies who are in financial crisis on a full-time basis. Additionally, they can coordinate your accountants, your in-house financial managers (i.e. CFO, bookkeeper, etc.), key operational managers and legal counsel into a team that works in an efficient and coordinated manner towards resolving your financial issues. If there is no coordination between these divisions, you may incur unanticipated

excess expense from the confusion created by divergent and conflicting strategies. Company executives and employees should be aware that their position within the company is not threatened and that the presence of outside professionals will bring additional tools and resources to assist them through a difficult period. Accordingly, it is important to meet with your company beforehand and openly discuss the need for open communications, cooperation and common goals.

Furthermore, in order to prevent conflicting communications with lenders and franchisors, it is essential to appoint either your workout specialist or one of your executive officers or your attorney as your authorized negotiator. In addition, you should delegate roles, responsibilities and authorization to only a select and limited number of team members who understand how to work with and through your authorized negotiator. Your authorized negotiator should also understand that any critical, final or major decisions or commitments would have to be pre-approved by yourself or your executive team. You should also be aware that some lenders or franchisors might attempt to circumvent your designated negotiators by directly contacting and pressuring you into quick decisions in attempt to leverage your emotional involvement and personal relationship with them. Decisions made under this situation are usually not in your best interests. Accordingly, you should never allow anyone to undermine the credibility and authority of your designated negotiators through this approach. You should also avoid conversations that are outside of your expertise or in which there is pressure to make a critical decision without the input of your workout team. These are situations in which your interests are best served through your designated executives (i.e. CEO / CFO), your attorney or one of your workout professionals. Again, it cannot be emphasized enough that you should discuss and agree on who and how communications with lenders, creditors and franchisors should be handled within your team. If you do not maintain a consistent and defined line of authority and communication, it will invariably work against your interests.

4. Resolve to create and implement a cohesive workout strategy.

Assuming that your company and /or your workout professionals have completed a detailed analysis of all financial, operational and economic issues, you should now know what has gone wrong. Experience shows that the three main categories for failure will be either a bad business/industry/economic cycle, poor operations and / or financial mismanagement (i.e. over-leveraged loans, excess costs, fraud, poor accounting, etc.). Recognize that every division of your business whether operational, financial or legal will be affected by any decision or strategy implemented in the other categories. Therefore, each part of your company needs to be consulted and coordinated in the execution of any new decision or strategy.

Accordingly, constant communication and coordination should be maintained at all times during a workout. This communication and coordination between your company and your workout specialists should result in a solid, straightforward strategy and a cohesive framework for addressing your problems. This approach should also create the foundation for a detailed, process-oriented written strategy plan that can be efficiently and successfully implemented. This plan should pinpoint the results of your analysis by detailing the causations of your financial dilemma including all financial, operational and legal issues, the interim strategies for stabilizing the business and increasing cash flow and your proposed long-term solutions that would put the business on a stable and profitable foundation in the future. Furthermore, interim and ultimate goals to stabilize the business and weekly reporting formats should be developed and should reflect the progress towards achieving the established goals. These reports will allow key management personnel and workout professionals the ability to assess progress and the need for adjustments or modification. You should also include in this plan all the negotiation strategies and lines of authority for communicating with your lender and /or franchisor as previously discussed.

If this plan is properly drafted and communicated to your lender and franchisor, they will feel confident that this plan is not only fair to them but that it is the best and most permanent solution for your business. Anything less will only serve to fuel suspicion and uncertainty. This credibility gap will only prolong negotiations that will ultimately result in a unsatisfactory resolution for you.

5. Understand that your Lender and Franchisor prefer a Workout to a Bankruptcy.

Assets and / or collateral, in most cases, can lose value in a bankruptcy. Chapter 7 – Liquidation scenarios usually result in the franchise “going dark” in markets. In this situation, collateralized real estate values are usually materially impacted downward and diminution of the brand name and reputation can result in huge embarrassment and loss to a franchisor. Additionally debt and equity buyers become bottom-fishers looking to buy assets for “pennies on the dollar.” Even if a franchisor chooses to take back the market, they face daunting expenses in negotiating with local landlords and vendors, maintaining key personnel, shifting corporate resources to your franchise market and many other transition issues too numerous to mention in this article.

Similarly, lenders do not want to incur the additional legal and administration expenses and loss of control over their collateral due to the bankruptcy. Nonconsensual use of cash collateral, delays caused by the automatic stay, avoidable transfer and lender liability allegations involving potential loss or reduction of liens, unsecured creditor committee involvement

in or disruption to negotiations, non-accrual of interest (where lender is under-collateralized), loss of time value of money, erosion of value of the collateral and presence or lack of competing creditors or bidders can all be unattractive risks to lenders and Franchisors in the context of a bankruptcy.

However, bankruptcy is no picnic for the debtor either. Mandatory Financial reporting to creditor committees and the Office of the United States Trustee or an interim trustee, living under court supervision, accrual of legal and financial advisory expenses, divided focus between business and bankruptcy issues, employee morale / retention issues, loss of reputation and a tough credit/ financing environment are just a few of the hassles suffered in a bankruptcy context by a debtor. Furthermore, to exit bankruptcy usually requires the assumption of the franchise agreement that the debtor defaulted on prior to the bankruptcy. Assumption requires “prompt cure,” that is, to exit bankruptcy with the franchise intact, you will have to cure it in a timely manner either by agreement or by obtaining a court order determining what is “prompt” and what is required to “cure” the defaults. And, even while one is in bankruptcy, one must perform under the franchise agreement in order to prevent its termination after the filing date.

On the other hand, a workout can entail less expense for outside professionals, keeps the lenders and franchisors comfortable, allows more control over your destiny, take less attention from your business and can be resolved in a far shorter time than the average 6 – 24 months a bankruptcy reorganization can require.

Attempting an out of court restructuring gives franchisees the opportunity to try to consensually improve loan terms by reducing principle and interest expenses, to negotiate “cash outs” through refinancing, to construct equity restructuring terms that allow a franchisee to defer debt expenses while offering lenders an opportunity to be substantially repaid sometimes in the future – all the while holding the card of bankruptcy as a last resort. Thus, the ability to restructure debt and equity outside of bankruptcy can result in a fair, creative and efficient resolution of financial issues for everyone.

6. Resolve to clearly Follow-up and Fulfill your Commitments.

Many workout negotiations fail or are substantially impaired due to a simple lack of communication on the part of the franchisee. Delaying or hiding from your problems will only make things more difficult. Your relationship with your lender and franchisor is critical if you want them to trust you and to work with you. Avoiding tough conversations or even worse, making promises or commitments that you know will be difficult or impossible to deliver will only create distrust, anger and inflexibility with the very people who are critical to a successful workout. Get ahead of the crisis by communicating early that you are analyzing the situation and that you will

get back to them with a plan to resolve the issues. Lenders and franchisors are more likely to work with franchisees that take responsibility and are proactive than with someone who constantly breaks his promises, assigns blame and looks for excuses.

Upon the completion of the workout plan, you should present it to your lender and franchisor for their input and feedback. Once everyone is in agreement, the implementation of your approved strategy needs to begin immediately and you should provide your weekly update reports to your lender and franchisor.

You should never make a commitment if you are unsure that you can deliver. Over-promising and under-delivering will greatly reduce your chances of resolving tough issues with creditors who are being asked for concessions or new terms. The utilization and constant reassessment of your new reporting formats, should allow you to make an informed decision on any commitments you make. The information provided by these reporting formats should also greatly reduce any concern about your ability to fulfill those commitments. This process should give you the ability to convince your creditors that you have a solid, pragmatic solution for fulfilling your commitments and fair terms for implementing your workout plan. Conversely, it should provide leverage in resisting unreasonable demands.

Your professionalism in critically analyzing your problems, creating new reporting formats, implementing new strategies to stabilize and turnaround the business will only build your credibility and your creditors' confidence in you. Accordingly, a well-planned and negotiated workout not only will save your business, it will reduce costly and lengthy legal and administrative expenses while preserving valuable business relationships. It also ensures that you will have a Happy New Year and a profitable future.

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