THE INTERIM CHIEF FINANCIAL OFFICER

Profit Center or Cost Center?

THE ISSUE

A world-class Interim Chief Financial Officer[1] should be a profit center and generate verifiable cash savings several times in excess of any compensation. Why is this so? The easiest way to explain is through the telling of an actual story[2].

THE SITUATION

We were retained as Interim Chief Financial Officer for a high-tech manufacturer in early 2008. The former chief financial officer had just been terminated after several years of undistinguished service. While there were numerous reasons for the firing, the final straw was his inability to produce timely financial statements and complete the annual financial statement audit. For the next eight months we carried out the usual crisis clean up often found in these situations[3]. The three days a week in the office were more than enough time to right the ship financially and things were now humming along smoothly, with excess accounting department staff time to handle increasing work loads dictated by the rapidly growing revenue. By that point our work had been successful enough through cost streamlining initiatives and owner tax planning that our fees were fully covered. However, merely covering costs is not a win-win situation, especially when our guarantee is to save a multiple of costs. In November 2008, we quarterbacked a series of maneuverers that reduced fixed cash expenditures by nearly $1 million over less than four years and deferred any taxes on the gain for more than an additional four years. The client realized more than triple the costs of retaining our professional services while still enjoying all the other benefits of having access to a world-class chief financial officer. Here's how it worked:

THE BACKGROUND

Opportunities often come along in a company to score big. Unfortunately, due to inexperience and inattention frequently an owner fails to recognize adverse circumstances as a disguised financial opportunity. In 2006 my client merged his existing professional services company with the money-losing subsidiary of a Fortune 500 company. The idea was to vertically integrate professional services and manufacturing to increase existing workload and profit margins. The combined entity purchased the assets from the parent and gave an interest only balloon note for the entire purchase price. The note provided for annual interest payments over two years and a balloon; unfortunately, due

[1] Sometimes referred to as an outsourced, part-time, fractional, acting, or interim chief financial officer.

[2] Names changed to protect client confidentiality.

[3] See our other publications for details on these activities.

to the company doing much worse than originally anticipated, it defaulted on the note at the end of the first year when the first interest payment was due.

Prior to the asset purchase and sale, the Fortune 500 company was the owner of the property and leased the land and building to its wholly owned subsidiary. It subsequently sold the land and building and leased it back from the new owner. Therefore, there was a new property owner as Landlord, the Fortune 500 company as the Prime Tenant, and the wholly owned subsidiary as the Sub Tenant. The wholly owned subsidiary merged with my client and continued as the Sub Tenant. Rent from the Prime Tenant to the Landlord was approximately $42,000 per month. Rent from the Sub Tenant to the Prime Tenant was approximately $50,000 per month; therefore, the Prime Tenant was making money off the Sub Tenant at no risk since the lease was absolute triple-net. At the end of 2006, my client defaulted on the first annual interest payment and the noteholder sought to foreclose on the defaulted promissory note. Of course, no one wanted this result since the Fortune 500 noteholder didn't want the business back and my client couldn't afford to make the annual interest payment due to the unexpectedly low cash flow of the business at the time. So a compromise was reached: all defaults would be waived and the lease reinstated if my client made an additional $20,000 per month rent payment which would be credited against the promissory note balance thereby extinguishing the note in full over 66 months. So far, so good: my client gets out from under the default, doesn't have to make a major interest payment and balloon payment which it couldn't afford, all in return for $72,000 per month in rent. The Landlord is happy because it has a credit worthy Fortune 500 company as the Prime Tenant. And the Prime Tenant is happy because it has a Sub Tenant paying monthly rent substantially in excess of what it is paying the Landlord per month. Everyone is happy, and it appears that my client negotiated an excellent outcome to a particularly difficult situation, except that in November 2008, approximately eight months into the engagement, the Fortune 500 company Prime Tenant filed for Chapter 7 bankruptcy. With over a thousand retail locations, all landlords were thrown into disarray, with the bankrupt tenant prepared to reject most, if not all leases.

While the bankruptcy filing was well publicized, my client received the official bankruptcy notice in the mail with no fanfare and very little interest. He specifically told me not to bother with it and certainly not to send it to the attorneys because "they're too expensive." Fortunately, I decided that I had an ethical duty to carefully review the legal notices. The property had subsequently been resold to a local investor group consisting of several attorneys who were now the Landlord, and they contacted us wanting to know what our intent was for the future. Obviously, they were concerned that if the Prime Tenant rejected the lease, then the Sub Tenant could walk away as well, leaving the investor group with a vacant (unsubdividable) property and building which would cause

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a default under their mortgage. The timing of receipt of the bankruptcy notice and contact by the landlord was concerning; a review of the bankruptcy notices and included documentation was even more alarming.

Included with the bankruptcy notice was the usual list of leases to be rejected with no mention of our property. However, also included among the hundreds of pages was a motion to assign our sub-lease to ABC Acquisition Corp. for $1.00; that is, the Prime Tenant was petitioning the bankruptcy court to approve a pre-negotiated transfer of the prime lease with the Sub-Tenant to another company. This was quite curious because it was so out of the ordinary, with no description of the acquiring company, or its ownership. I quickly ran a search of the Secretary of State's office corporate records and found the company and the name of its incorporator, unfortunately without any listed mailing address. What was apparently a dead end was avoided by Googling her full name and remarkably finding a link to a wedding photo on Facebook which included several public pictures of her recent marriage and attending party with captioned names. In the attending party was a Miss Burger. Miss Burger had the same last name as last name of the general partner of the Landlord. Could it be that ABC Acquisition Corp. was affiliated with the Landlord and was attempting to take an assignment of the lease from the Prime Tenant at a bargain price in an attempt to preserve the Sub-Tenant's monthly rent payment of $72,000?

THE OPPORTUNITY

It was now time to bring in our attorneys. We petitioned the bankruptcy court to permit us to take an assignment of the prime lease and offered to pay $10,000 to the trustee, well in excess of the $1.00 stated in the motion. Based on borrowing costs and the net present value of cash potentially saved by eliminating the Prime Tenant, we were actually willing to go as high as $350,000 for the assignment. Needless to say, ABC Acquisition Corp. principals were not pleased by the objection to their motion and our counter motion and immediately contacted us. Not surprisingly, the contact came from the principal of the Landlord who admitted to the whole scheme. Of course, there was nothing illegal with the scheme, except that my client would have had to continue paying $72,000 per month in rent to the Landlord who had already been accepting $42,000 per month in rent from the now-bankrupt Prime Tenant. Therefore, the landlord would have been richer by $30,000 per month for doing nothing other than negotiating a back-room deal with a bankrupt debtor and filing a motion, and my client would have certainly been in no worse a situation, but could have been in a much better situation.

Based on the analysis we had up to $350,000 that we could spend to obtain the assignment. I negotiated a line of credit commitment with our main lender to have the funds available and instructed our attorneys to appear at the preliminary bankruptcy proceeding to negotiate an auction on the lease assignment.

THE RESULT

Working through the situation with the bankruptcy court proved to be both stressful and time consuming. After extensive discussions with the Landlord, it was determined that the Landlord was primarily concerned about losing the Sub Tenant and the certain subsequent default on its mortgage. Given that the building was a single-user facility not capable of multi-user retrofit and the local commercial real estate market depressed, the Landlord was very unlikely to find another tenant, creditworthy or not. Sensing the opportunity, we were able to obtain bankruptcy court approval and negotiated revised terms of the sub-lease as follows:

1. The original sub-lease had nearly four years left. The sub-lease was extended for an additional six years (10-year term) at the same absolute triple net monthly rental rate of $42,000 with no annual rent escalations and two-five year rights of refusal to lease and an option to purchase the property.

2. Monthly rental payment savings of $17,500 for 46 months over original lease term for a cash savings of $805,000.
3. No personal guarantees of the owners; only requirement to provide company annual financial statements.
4. Absolute right to assign the lease without Landlord consent.
5. Real estate taxes and Landlord insurance to be paid direct as opposed to escrow by Landlord.
6. No requirement for capital improvements to the building only maintenance repair and replacement.

In addition to the lease savings, my client also received the following financial statement benefits that positively affected its borrowing capabilities with its main lender:

1. The current liability portion of the original notes payable to the Seller was eliminated.
2. The long-term liability for deferred rent was eliminated.
3. The long-term liability of the original notes payable to the Seller was eliminated.
4. A non-operating gain was recognized that significantly increased shareholders' equity.

Lastly, and equally important, recent passed tax legislation supported by the newly elected Obama Administration and signed into law included a provision that permitted owners of pass-through entities to defer any recognized gains on debt forgiveness for a period of four years, with ratable recognition of the gain over the subsequent four years, effectively deferring income tax on the gain for eight years.

CONCLUSION

This is about as close as its gets to "having your cake and eating it too!" Not only did our client obtain world-class chief financial officer services over a 14 month period, the real estate, finance, and tax expertise employed resulted in not only no cost, but rather in substantial and verifiable monthly positive net cash flow to the company over an extended period of time. This positive outcome was the result of intimate knowledge of the business coupled with assembling a responsive and nimble legal and accounting team. In every interim chief financial officer engagement undertaken, these types of results have been consistently achieved for our clients.

DISCLAIMER

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