Restaurant Chain Chapter 11s: Red Flags and Accounts Receivable Strategies, Pre- and Post-Filing, for the Credit Team

✧ *This occasional paper illustrates what suppliers can take away from recent restaurant chain Chapter 11s and red flags that may aid the suppliers with identifying insolvency risk.*

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Overview

The restaurant industry is experiencing a spike in Chapter 11 filings, including a number of high profile chains, due to an array of reasons. According to the Wall Street Journal, the restaurant industry in the US is failing to cope with an assortment of factors that are changing in the market and the environment around it. Some of these factors are: more employees telecommuting, lowest prices of groceries in decades, over expansion of store fronts paired with a fall in foot traffic during prime times, and consumer healthcare premiums becoming too much for many families to handle, causing discretionary spending to fall.

This increase in Chapter 11 asset sales coincides with a shift in financially-distressed restaurant chain bankruptcies. The traditional Chapter 11 exit strategy has been an operating or earn-out plan. Restaurant chain Roadhouse Holdings, Inc, which own Logan's Roadhouse restaurant chain, for example, is exiting Chapter 11 via an earn-out plan. Earn-out exit strategies are on the wane, however, and the modern approach of the financially-distressed restaurant chain is to sell its assets through Chapter 11. QSL of Medina, Inc. ("QSL"), Zio's Restaurant Company, LLC. ("Zios"), Buffets, LLC. ("Buffets"), Cosi Sandwich Bar, Inc. ("Cosi"), and Garden Fresh Restaurant Intermediate Holding, LLC., which owned Souplantaion, sold substantially all of their assets through Chapter 11.

Restaurant chains, however, are not being sold exclusively through bankruptcy. More financially-sound chains, such as Rita's, sold their assets through out-of-court transactions to private equity firms and national restaurant chains. The key difference for suppliers in the Chapter 11 asset sale versus the equity sale is that suppliers' open invoices will ride through on an equity sale.

Recent Restaurant Chapter 11 Filings		
Restaurant Chain	Date Files	Venue
QSL of Medina, Inc.	November 16, 2015	Ohio (N.D.)
Buffets, LLC*	March 7, 2016	Texas (W.D.)
Fired Up, Inc*	July 14, 2016	Texas (W.D.)
Roadhouse Holdings, Inc.	August 8, 2016	Delaware
Last Call Guarantor, LLC	August 10, 2016	Delaware
Zio's Restaurant Co., LLC	September 7, 2016	Texas (W.D.)
Cosi Sandwich Bar, Inc.	September 28, 2016	Massachusetts
Garden Fresh Restaurant Intermediate Holding, LLC	October 3, 2016	Delaware
Rita's Restaurant Corp.	October 4, 2016	Texas (W.D.)
Ignite Restaurant Group, Inc.	June 6, 2017	Texas (S.D.)

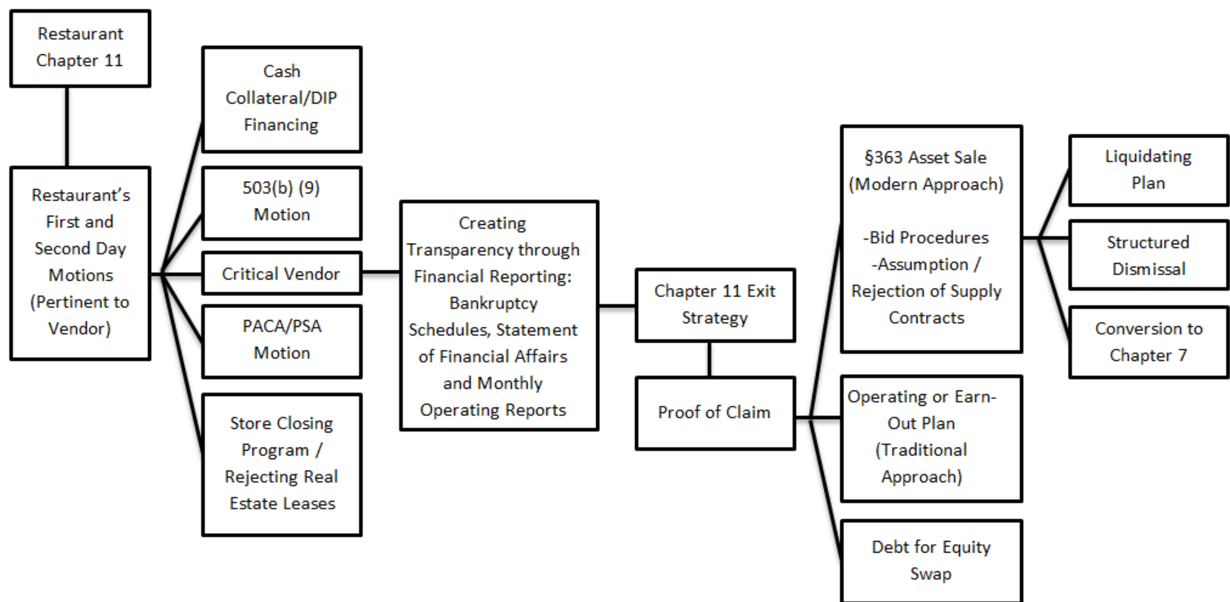
*Notes Chapter 22

Asset Sales through Chapter 11: The Modern Approach of Financially Distressed Restaurant Chains to Transfer Assets

Chapter 11 allows for the reorganization of the restaurant chain as it continues to operate. Management continues to run the business, even with the most popular exit strategy of selling all their assets. The automatic stay arises with the restaurant chain's filing, providing the breathing room to work through its financial shortfalls, while enjoining suppliers and other creditors from collecting on their pre-petition debts. A restaurant chain restructuring may involve not just the sale of assets, but assumption of rejection of certain contracts, including supplier contracts, and the rescheduling of pre-petition debts.

Chapter 11 Flow Chart for the Restaurant Chain

The trend towards a sale of assets as an exit strategy is compressing the timeframe for completion of key stages of the Chapter 11 process, from years to several months.



Stock Check: The Chapter 11 Restaurant Chain and Their Financial Condition

Chain	Founded	#Stores (excludes franchises)	Employees	Annual Revenues	Assets	Liabs
Large						
Garden Fresh	1978	123	5,500	$300M	$92.5M	$240M
Buffets	1983	150	9,000	$28.6M	$133M	$105M
Roadhouse	1991	234	18,964	$606M	$199.8M	$549M
Ignite	1991	137	7,000	$450.3M	$153.4M	$197.4M
Medium						
Last Call		80	4,700	$186.9M	$39.3M	$129.6M
Cosi	1996	72	1,100	$89.9M	$4.5M	$12M
Fired Up	1997	36	2,060	$86M	$6.7M	$23.3M
Small						
Rita’s	1985	17	745	$55M	Approx. $1M to $10M	Approx. $1M to 10M
Zio’s	1994	16	875	$38M	$2M	$1.7M
QSL	1974	12	948	$500K	$1.1M	$1.9M

Large Restaurant Chains

This category consists of Garden Fresh, Buffets, and Roadhouse, each of which operates over 100 restaurants across several states.

Garden Fresh dates to 1978 with stores in 15 states. At its Chapter 11 filing in October 2016, the chain listed $92.5 million in assets and $240 million in liabilities. The primary causes of the Chapter 11 filing include: declining sales experienced by the entire restaurant industry; cash flow pressure from cost increases related to workers’ compensation plans, coupled with increased collateral requirements to secure the plans; minimum wage increases at several restaurants with high employee benefit costs associated with health plans, and; increased annual store rents on properties sold by and leased back to Garden Fresh.

Buffets started in 1983 and operates in more than 25 states after several mergers. At the time of its third Chapter 11 filing in March 2016, Buffets listed $133 million in assets and $105 million in liabilities. The primary causes of the recent Chapter 11 filing were an $11.37 million judgment against Buffets, declining sales, and a number of underperforming restaurants.

Roadhouse dates to 1991 with operations in 23 states. At the time of its Chapter 11 filing in August 2016, Roadhouse listed $199.8 million in assets and $549 million in liabilities. The reasons for the Chapter 11 filing included poor sales due to the overall decline of the economy and increased competitiveness in the casual family dining sector, compounded by decreasing margins resulting from increases in commodities and labor.

Ignite dates to 1991 with operations in 32 states. At the time of its Chapter 11 filing in June 2017, Ignite listed approximately $153 million in assets and $197 million in liabilities. The main reason for this Chapter 11 was a net loss of approximately $46 million per year for the previous 3 fiscal years. This loss is attributable to factors such as the increase in operational costs and the decrease in disposable income for their consumers, which led to an overall decline in revenue.

Medium Restaurant Chains

This category consists of Last Call, Cosi, and Fired Up, each of which operates over 35 restaurants across several states not including franchise locations.

Last Call started in Texas and operated in 25 states. At the time of its second Chapter 11 filing in August 2016, Last Call listed $39.3 million in assets and $129.6 million in liabilities. The primary causes of the Chapter 11 were: an unsuccessful rebranding and remodeling program, including a new menu; information technology and the debtors' systems; increased labor costs and higher turnover resulting from moving all workers to part-time status to avoid providing health care coverage, and; the weak casual dining environment.

Cosi started in 1996 in New York with operations in the US, the United Arab Emirates and Costa Rica. At the time of its Chapter 11 filing in September 2016, Cosi listed $4.5 million in assets and $12 million in liabilities. The Chapter 11 was attributed to overall economic conditions within the fast-casual restaurant industry that impacted Cosi's sales and restaurant-level profits, as well as significant operating losses associated with certain locations, including payments to critical vendors and landlords.

Fired Up dates to 1997 and operates Johnny Carino's Italian restaurants in 6 states. At the time of its Chapter 11 filing in March 2016, Fired Up listed $6.7 million in assets and $23.3 million in liabilities. The primary cause of the Chapter 11 was the economy and negative change in the casual dining marketplace, making the first Chapter 11 projections overly optimistic.

Small Restaurant Chains

This category consists of Rita's, Zio's, and QSL, each of which operate fewer than 20 restaurants excluding franchise locations.

Rita's started in 1985 in Texas and operates in 9 states. The chain's statement of financial affairs filed in December 2016 listed total assets at $2 million and liabilities at $5.4 million. The primary causes of the Chapter 11 included: the overall weakness in the casual dining environment; pressures from the rapid growth of fast casual Mexican brands, in addition to the competitive intrusion of Mexican product offerings to the varied-menu bar and grill segment; struggle with rental rates, and; the increased costs of goods, services and labor.

Zio's started in 1994 in Oklahoma and operates in 6 states. As of its Chapter 11 filing in August 2016, Zio's listed $2 million in assets and $1.7 million in liabilities. The primary causes of the Chapter 11 were:_ the weakening casual dining environment; the economic fall-out from declining oil and gas prices, and; rising rents, commodity prices and labor.

QSL started in 1974 in Pennsylvania and operates in 16 states and Canada. At the time of its Chapter 11 filing in November 2015, QSL listed $1.1 million in assets and $1.9 million in liabilities. The primary cause of QSL's Chapter 11 was sensitivity to volatility in consumer discretionary spending, similar to other casual dining restaurant chains.

The Takeaway

An analysis of surveys and industry experts from late 2016 and early 2017 indicates the following factors facing the US restaurant industry:

- The number of total visits to restaurants will likely remain flat;
- Total spending on meals outside of the home is not expected to grow;
- Increased labor costs will continue to present a challenge;
- Fast-casual chains continue to add locations, increasing competition for flat or decreasing foot traffic;
- Grocery and convenience stores offering lower cost prepared meals benefit from lower wage and commodity costs;
- Historically large gap between CPI for food away from home and food at home

Some bright spots have appeared and may allow some restaurants to improve future results:

- Full-service restaurants may fare better if labor issues, price and quality are managed well;
- Independent restaurants do not appear to be suffering as much as chains;
- Delivery from casual restaurants may be an area for growth as evidenced by strong (10%+ same store sales by Domino's in early 2017) coupled with an expressed desire from consumers for a greater choice of such options;
- Chain closures and reduction in the number of locations by some operators could benefit the remaining restaurant participants

Keeping the Restaurant Chain's Doors Open:
Use of Cash, Debtor-in-Possession and Exit Financing

Profile of Restaurants (As of Their Petition Dates)					
Chain	Secured Debt	Pre-Petition Lender(s)	Cash Collateral	DIP Financing	DIP Lender(s)
Large					
Garden Fresh	$190.1 million	Apollo Investment Corp.; Cerberus Business Finance, LLC; Cortland Capital Market Services, LLC; Sun Capital Partners, Inc.	Yes	$4.5 million	BP Salad Holdings LP
Buffets	$48.7 million	Alamo CRG, LLC; All Jones, LLC; BPTX Holdings, LLC; Dayspring Operating, LLC; FMP SA Management Group LLC; Larrac Inv., LLC	Yes	$2 million	Alamo CRG LLC *Alamo Ovation, LLC owns Buffets Restaurant Holdings Inc.
Roadhouse	$407 million	JPMorgan Chase Bank, N.A.; exchange offer with Kelso & Company, L.P.; exchange offer with GSO Capital Partners, LP	Yes	$25 million	Carl Marks Management Company, LLC; Marblegate Asset Management, LLC; GSO Capital Partners LP; and Kelso & Company, L.P.
Ignite	$133 million	Credit Suisse AG as agent bank for the bank group lenders	Yes	N/A	N/A
Medium					
Last Call	$120.1 million	AIG; Blue Cross Blue Shield of Kansas; Cantor Fitzgerald & Co.; Fun Eats and Drinks, LLC; Hartford; Liberty Mutual; Zurich	Yes	$5.4 million	Fun Eats and Drink LLC ("FEAD")
Cosi	$7.5 million	Milfam II L.P.; AB Opportunity Fund LLC; AB Value Partners, L.P.	Yes	$4.1 million	Milfam II LP, AB Opportunity Fund LLC, AB Value Partners, L.P
Fired Up	$19 million	FRG Capital, LLC; Independent Bank of Waco; Prosperity Bank	Yes	N/A	N/A
Small					
Rita's	≥ $3 million	Lone Star State Bank of West Texas, Odessa	Yes	$750,000	All Jones, LLC
Zio's	No secured creditors	N/A	Yes	$500,000	Alamo CRG, LLC
QSL	$29,060	Scott's Buffalo Wings, Inc.	Yes	$2 Million	TravelCenters of America LLC

The majority of restaurant chains profiled utilized third party lenders to finance their pre-petition and post-petition operations. Third party lenders conditioned their financing on taking a security interest in the restaurant chain's assets, including its cash. To operate in the opening weeks of a Chapter 11 filing, the debtor must have access to cash to meet operating expenses. This can be accomplished through the restaurant chain's secured creditor consenting to the use of cash under an agreed upon budget, or by Bankruptcy Court approval over the secured creditor's objection. A restaurant chain cannot use cash collateral over the secured creditor's objections though, unless it demonstrates that the secured creditor's interest in the collateral is adequately protected.

If the restaurant chain's cash flow is insufficient to meet its budget, it may need short term borrowing in the form of debtor-in-possession (DIP) financing. A typical DIP financing arrangement involves an asset-based line that provides the restaurant chain with both immediate access to cash and a longer-term working capital line for the duration of the Chapter 11. DIP financing must be approved by the bankruptcy court. The lender, whether a party to a cash collateral stipulation or providing DIP financing, is entitled to at least a priority claim and, commonly, a super priority claim. The DIP lender has a security interest in the restaurant chain's pre-petition and post-petition assets. DIP lenders are now often crafting the restaurant chain's exit strategy in the opening days of the Chapter 11 by conditioning financing on a sale of substantially all of the assets by a certain date. Hence, suppliers selling post-petition need to consider the terms of the DIP financing.

As part of the restaurant chain's exit strategy from Chapter 11, whether through a sale of assets or an earn out plan, exit financing is proposed. Exit financing takes out a DIP facility and provides liquidity for effective date plan confirmation payments, as well as financing after exiting from Chapter 11. In the opening days of the Chapter 11, bankruptcy court approval of a restaurant chain's use of cash collateral or DIP financing is a key marker for suppliers. A supplier will commonly hold post-petition purchase orders requesting credit until the restaurant chain's access to cash has been resolved.

The Restaurant Chain's Treatment of the Supplier's Freshest Invoices: 503(b)(9) Claims

Section 503(b)(9) of the Bankruptcy Code provides the supplier with a priority claim for goods received by the restaurant chain within 20 days of the bankruptcy filing. The Bankruptcy Code requires that (b)(9) claims be paid not later than plan confirmation.

503(b)(9) Treatment				
Restaurant Chain	Amount of 503(b)(9) Debt	Early Pay (b)(9)Motion(Modern Approach)	Global Reclamation Procedures	Bar Date for (b)(9) Claims
Large				
Garden Fresh	$1.2M	X		
Buffets	$150K		X	
Roadhouse	$580K			X
Ignite	Unknown*			X
Medium				
Last Call	$950K		X	
Cosi	Unknown*			X
Fired Up	Unknown*			X
Small				
Rita's	Unknown*		X	
Zio's	Unknown*		X	
QSL	Approx. $450K to $650K for all administrative claims			X

**Amount Not Yet Established*

The 503(b)(9) Decision Tree

The modern trend is for the restaurant chain to request the bankruptcy court to allow early payment of (b)(9) claims in exchange for the (b)(9) claimants providing comparable credit terms for the duration of the Chapter 11. Because the food industry generally operates on shorter credit terms, the early pay (b)(9) motion may pay most of the restaurant chain's trade debt. The key for the early pay motion is: the restaurant chain's liquidity; the amount of (b)(9) claims, and; a lender's willingness to finance early payment of the (b)(9) claims. Alternatively, the restaurant chain may file a global (b)(9) procedures motion. With this motion, which generally does not provide for early payment of (b)(9) claims, the restaurant chain will seek to control the timing of the allowance of the (b)(9) claims and will likely seek to bar any (b)(9) claimant from filing a motion to compel payment. The restaurant chain may also choose to set a bar date for creditors to file claims, including (b)(9) claimants. The bar date usually does not provide for early payment of (b)(9) claims. Garden Fresh may be an exception.

Large Restaurant Chains

Garden Fresh estimated $1.17 million in (b)(9) claims. With its early pay (b)(9), Garden Fresh was authorized to immediately pay (b)(9) claims, provided that claimants agreed to credit terms and pricing equal to, or better than, those provided to Garden Fresh pre-petition. Penn Traffic filed a global (b)(9) procedures motion that provided for allowance, but not early payment. With Roadhouse, the court set a bar date, but did not authorize early payment of (b)(9) claims.

Medium Restaurant Chains

Last Call estimated $950,000 in (b)(9) claims. It filed a global (b)(9) procedures motion that provided for allowance, but not early payment. With Cosi and Fired Up, the courts set a bar date, but did not authorize early payment of (b)(9) claims.

Small Restaurant Chains

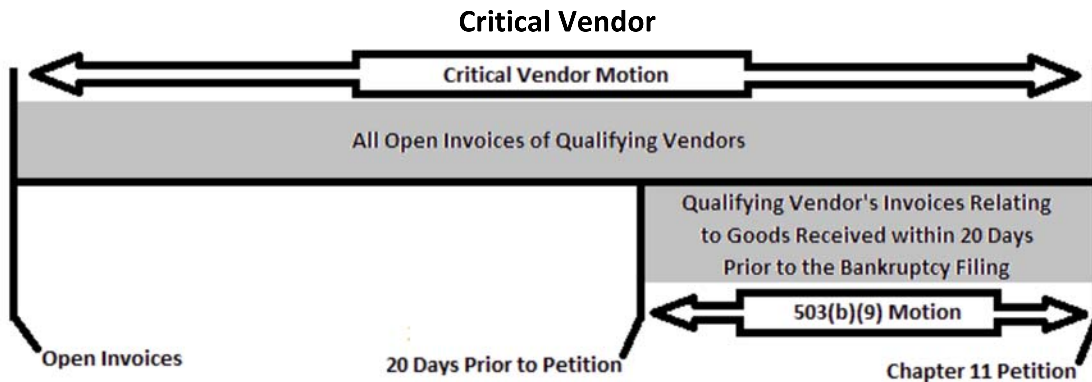
Rita's and Zio's filed global (b)(9) procedures motions that provided for allowance, but not early payment. In QSL's disclosure statement, the Debtor estimates $450,000 to $650,000 in total administrative claims. The court set a bar date, but did not authorize early payment of (b)(9) claims.

The Takeaway

The trend for restaurant chains is to set bar dates for (b)(9) claims. Where an early pay (b)(9) motion is filed, suppliers should give due consideration, as this motion may be the key to being paid, at least promptly, on pre-petition invoices. Payment of the (b)(9) claims may be at risk where a restaurant chain defers payment of allowed (b)(9) claims to confirmation of a plan, and the restaurant chain's exit strategy is a structured dismissal following a sale of assets. Likewise, (b)(9) claims may be at risk where the restaurant chain is operating at a loss during the Chapter 11 and may not have sufficient cash to pay (b)(9) claims in full at plan confirmation.

In evaluating whether to qualify for an early pay (b)(9) motion, the supplier should measure post-petition credit risk against the profit from these credit sales, amongst other factors to be discussed later. The supplier should appreciate that the early pay (b)(9) motion eliminates the payment risk of the (b)(9) claim. Note that with the restaurant chain's Chapter 11 filing, the Bankruptcy Code imposes financial disclosure and transparency requirements, which assist the supplier in evaluating the post-petition credit risk. Financial disclosure, even with a private restaurant chain, such as a 13-week budget, bankruptcy schedules and statement of financial affairs and monthly operating reports, can be used by the supplier to quantify post-petition credit risk.

Critical Vendor



Unlike the early pay (b)(9) motion, which covers only invoices relating to goods received within 20 days of the Chapter 11 filing, a critical vendor motion covers payment of all of a supplier's pre-petition invoices.

Several restaurant chains filed critical vendor motions. The court authorized Garden Fresh to pay those vendors Garden Fresh had identified as critical, setting a cap at $1.7 million. The court authorized Buffets to pay or otherwise satisfy all critical vendor claims up to the amount of 75% of the critical vendor's claim. With Roadhouse, the court authorized the restaurant chain to pay certain critical vendors not to exceed $950,000. The court authorized Last Call to pay certain pre-petition claims of certain critical vendors not to exceed $250,000. The court authorized QSL to pay critical vendors with a cap of $844,000. With Rita's and Zio's the courts authorized the restaurant chains to pay 100% of the critical vendor claims. Similarly, with Fired Up, the court authorized payment of 100% of certain critical vendor claims; however, the court ordered that any creditors who are also insiders could not be paid any sums owed as of the petition date. In all cases, payments to critical vendors were contingent on their agreeing to credit terms and pricing equal to, or better than, those provided pre-petition.

The Takeaway

While the critical vendor motion may provide for payment of all outstanding invoices, unlike the (b)(9) motion, it also requires the supplier to continue selling to the restaurant chain for the duration of the reorganization process and on terms equal to, or better than, those provided pre-petition. A successful reorganization is not guaranteed, and post-petition credit under a critical vendor motion is unsecured, so the supplier must assess the post-petition credit risk.

Special Treatment for Certain Suppliers: PACA and PSA Claims

Unpaid suppliers of perishable fruits and vegetables are given special protections under the federal Perishable Agricultural Commodities Act (PACA). Once a supplier delivers perishable agricultural goods to a restaurant chain, a trust is automatically created in the purchased goods, the accounts receivable from the sale of the goods, or the cash proceeds from the sale. PACA requires that the goods, accounts receivable and proceeds be held by the restaurant chain until all PACA suppliers have been paid. Title to the unpaid goods is not transferred to the restaurant chain until the supplier is paid. The PACA trust is superior to the secured claims of the restaurant chain's lenders.

Restaurant Chain	Amount of PACA/PSA Debt
Large	
Garden Fresh	$1.4M
Buffets	$901K
Roadhouse	$1.1M
Ignite	$500K
Medium	
Last Call	$400K
Cosi	$251.5K
Fired Up	$974K
Small	
Rita's	$200K
Zio's	$20K
QSL	$844K

Given the super priority of PACA claims, all of the restaurant chains were authorized to pay their PACA and PSA claims in the ordinary course of their operations.

The Takeaway

Once their claims had been approved, PACA and PSA claimants were paid in full, and in a timely fashion.

Store Closing Program

For Chapter 11 restaurant chains, one of the most common strategies to reduce overhead is a store closing program, through which the restaurant chain sells off unprofitable locations.

Where the restaurant chain owns the real property on which the unprofitable store operates, the restaurant chain will sell the property through a noticed motion. If, however, the restaurant chain leases the property, then it will move to reject the lease. By rejecting the lease, the restaurant chain is deemed in breach of contract and the landlord is entitled to a claim for damages. The Bankruptcy Code limits the landlord's claim to the greater of (i) one year's rent or (ii) 15% of the remaining lease, not to exceed three years.

All of the Chapter 11 restaurant chains examined in this article used a store closing program to close unprofitable locations.

A Supplier's Continued Sales to the Chapter 11 Restaurant Chain and the Buyer of Assets?

With its Chapter 11 filing, the restaurant chain places purchase orders with suppliers post-petition requesting terms. The Bankruptcy Code provides suppliers with priority for goods delivered post-petition on credit, should the restaurant chain default. During the opening weeks of the Chapter 11 where the restaurant chain is formulating its exit strategy, the supplier will look to the restaurant chain's authorization to use cash, DIP financing and early pay (b)(9) motion to determine whether to fulfill the purchase orders on terms.

Where the restaurant chain has made its Chapter 11 exit strategy election to sell its assets, the buyer of the restaurant chain's assets may seek trade relationships with the restaurant chain's suppliers. A supplier selling to the restaurant chain under a supply contract may find that the proposed buyer of assets wishes to assume their contract. Assumption of the supply contract provides for the payment of a supplier's pre-petition claim and releases the supplier from preference liability. If, conversely, the supplier is selling to the restaurant chain on an invoice-by-invoice basis, the supplier will not have its pre-petition claim paid directly by the buyer of assets. Instead, the claim will be paid pro-rata based on the available sale proceeds.

Chapter 11 Exit Strategy

Restaurant chains filing Chapter 11 have three exit strategies: sale of assets (modern approach), an earn-out strategy (traditional approach) or a debt-for-equity swap.

Chapter 11 Exit Strategy			
Restaurant Chain	Section 363	Earn-Out	Stock for Debt
Large			
Garden Fresh	X		
Buffets		X	
Roadhouse		X	
Ignite	X		
Medium			
Last Call	X		
Cosi	X		
Fired Up	X		
Small			
Rita's	X		
Zio's	X		
QSL	X		

Sale of Substantially All of the Assets

Section 363 of the Bankruptcy Code allows for the sale of the restaurant chain's assets outside the ordinary course of business. The sale of assets is a multi-step process. First, the restaurant chain attempts to lock up a stalking horse bidder. Then, the restaurant chain must file a bidding procedures motion, which provides: (1) the identity of the stalking horse bidder; (2) the purchase price; (3) the assets to be sold, and; (4) the terms for overbids of the stalking horse bid. The bidding procedures order is key to suppliers and a committee in creating value through an overbid. Next, the restaurant chain files a sale of assets motion, which provides for the auction procedures.

In the opening days of the Chapter 11, suppliers may move to act as a team through an official creditor committee. The committee's mission in a sale of assets strategy is to obtain the highest and best offer. The committee will want to ensure that the assets are fully marketed and advertised, as they do not participate in due diligence of the pre-petition marketing efforts (they are left out of the tent). The question is whether the trade can react quickly enough. The bankruptcy courts require more disclosure and more of a record to support the sale. The

committee needs to push back with a sale solely for the benefit of the secured creditor. The committee may try and use hold up value to extract value to unsecured creditors.

The stalking horse bid is often set at just above the amount of the restaurant chain's secured debt and estimated administrative claims. The stalking horse commonly conditions the offer on protections, such as the breakup fees and no shop provision. The stalking horse bidder is trying to chill bidding. If an early pay (b)(9) motion has not been filed, the bankruptcy courts may insist that (b)(9) claims be paid. A "tip" for nonpriority claims is often included. This is because secured creditors must consent to any stalking bid that is lower than the restaurant chain's secured debt. Given that the bid and secured debt are equal, unless the auction results in a significant overbid, there will not be a meaningful distribution for unsecured creditors. A court may authorize sales in which there are no sale proceeds distributed to unsecured creditors.

The timetable to complete a sale of assets continues to compress. The stalking horse and the restaurant chain may contend that the assets are akin to a melting ice cube and must be sold at the earliest opportunity as a going concern to capture the good will. The restaurant chain's post-petition budget will usually support this. If the restaurant chain is not able to attract a stalking horse, the sale may go to auction, or the secured creditor may credit bid its secured claim.

Once the bankruptcy sale is complete and the sale is approved by the court, the restaurant chain, usually in negotiation with a creditor's committee, may propose a plan of liquidation, structured dismissal of the Chapter 11 or conversion to Chapter 7. The liquidating plan governs the distribution of sale proceeds to creditors and establishes the liquidating trust and appointment of a trustee. In addition to overseeing the eventual distribution of proceeds, the trustee is often tasked with bringing preference actions against suppliers.

Large Restaurant Chains

The court entered a sale order approving solicitation of offers for sale of substantially all of Garden Fresh's assets. On January 9, 2017, the United States Bankruptcy Court approved the sale of substantially all the assets of Garden Fresh to Cerberus Capital Management L.P.

Ignite received a $50 million bid for purchase of substantially all of its assets from a private equity firm. Ignite will solicit additional bids, at a court-supervised auction, and close sale within 90 days.

Medium Restaurant Chains

Fun Eat and Drinks LLC acquired Last Call after winning an auction to acquire ownership out of bankruptcy with a bid of $26.8 million. Cosi's stalking horse bidder, Limab LLC, had the best bid at $6.8 million. However, the sale still needs court approval, and the hearing to consider approving the purchase of substantially all assets was continued to May 25, 2017. Fired Up sold 24 locations to Bluestone Holdings Group, LLC, the stalking horse bidder, for $7.89 million.

Small Restaurant Chains

QSL sold substantially all of its assets to TravelCenters, the stalking horse bidder, for $25 million. Likewise, Rita's and Zio's also sold substantially all of their assets.

The Takeaway

The trend for restaurant chains filing Chapter 11 is an early exit strategy of selling their assets as a going concern. This may be driven by a restaurant chain's inability to obtain long-term or exit financing. The stalking horse often conditions the purchase of the restaurant chain's assets through a Chapter 11 to obtain a bankruptcy court's buyer protections. This trend may also be driven by the private equity firms entering the US food service space.

Earn-Out Plan

Buffets LLC had planned on liquidating substantially all of its assets due to concerns of liquidity and financing the lengthy court proceedings; however, objections from the unsecured creditor's committee led to mediation, which in turn led to the adoption of the Joint Plan of Reorganization.

Roadhouse emerged from bankruptcy in November 2016. Roadhouse's earn-out plan was focused on cutting cost: (1) closing 34 restaurants and (2) renegotiating leases and contracts. This reduced its debt from approximately $400 million to just over $100 million. It also plans to implement menu, marketing, and training program changes.

The Takeaway

The restaurant chains pursuing an earn-out plan as an exit strategy closed stores, cut overhead and renegotiated their supply contracts and financing. Suppliers' pre-petition claims were paid over time.

Red Flags: Spotting Warning Signs of a Restaurant Chain's Insolvency

Is the supplier selling to an insolvent restaurant chain? This question requires substantial fact finding. The supplier should review from both a macro and micro perspective. Factors in both arenas dictate credit decisions. While larger national restaurant chains have weathered the recession, the environment has been tougher for regional restaurants. Regional restaurant chains have struggled to cope with: (1) the increasing grocery inventory featured by large-scale, low-cost operators (i.e. Wal-Mart and Target); (2) the fall of discretionary spending by consumers; (3) internal financial struggles; (4) over expansion coupled with a fall in foot traffic; (5) increase in telecommuting (lunch was once a large staple in revenue for this industry—

according to a market study by NPD Group Inc., in 2016, Americans made 433 million fewer lunchtime trips to restaurants. This drastic drop resulted in roughly $3.2 billion in lost business for restaurants); (6) new rivals, like Blue Apron, who do meal-kit home/work deliveries; (7) failure to adapt to generational and environmental changes, and; (8) increase in cost of living.

Visits to Locations

The emptiness of the location, especially in densely-populated areas, can signal trouble for the restaurant locations. If a location in a crowded area cannot attract customers, it is probable that other locations are also struggling to attract customers.

Key Restaurant Share Losses

Private or public, it is relatively easy to determine the competitive landscape for any given restaurant chain. Multiple agencies track the data and are found in industry news publications, analysts' reports and subscription services. Most suppliers subscribe to such publications that would be available to the credit team. Restaurant chains who are nimble at either raising the top line (sales) or quickly reducing expenses are the most likely to thrive, or at least survive.

Declining Same Store Sales

An attribute of restaurant share losses, data typically compares the dollar and unit sales of the restaurants that were in operation during the same period in the prior year. A restaurant chain may experience declining same restaurant sales in a specific geographic location as opposed to throughout its overall operating geography.

Changes in Lending Agreements

In recent years, despite frequent press regarding a challenging lending environment, many restaurant chains have renegotiated lending agreements with lengthened maturities and lower interest rates. Although the restaurant chain benefits from the reduced interest rate charges, the principal balance represents significant leverage that will remain unpaid longer – "Kicking the can down the road".

Frequent Covenant Violations and Amendments

In following a restaurant chain, it is important to "follow the money" and determine what information is available on the various debt obligations. Some privately held companies issue public debt, which requires financial disclosure. In addition, full lending information is available on public restaurant chains. Therefore, notification of lending covenant violations and the resulting amendments can be an indication of decreased operating performance.

Poor Restaurant Presentation

Oftentimes a restaurant chain will elect to forego capital expenditures as a means to maintain profits or avoid losses. Over time, that lack of investment shows in the individual store's presentation, as well as increased maintenance costs.

Departure of Select Senior Management

As in any risk assessment situation, experienced management is key to success. Turnover in the C-suite or in executive positions can be an indication of negative events. This information is usually available with larger restaurant chains, and may be available for more regional or smaller situations.

Changes in Communication Patterns with Supplier

Although there can be many reasons for a restaurant chain to change their manner of communication, typically if all is going well, there is no change.

Payment Issues and Terms Pushback Strategy

Returned checks are the result of cash flow issues. In a retailer situation, by the time a check is returned, the customer may be cash constrained. Insight into the restaurant chain's financing allows assessment much earlier in the relationship, which can allow the supplier to plan alternatives.

What if the restaurant chain's checks continue to clear, but payments are being made further outside terms? This may indicate a terms pushback program (TPS), where the restaurant chain ignores supplier-set trade terms and unilaterally extends these terms to better suit its operations and cash flow needs. Aside from the negative effects a TPS has on the supplier's DSO and cash flow, it can also spell trouble for the trade relationship going forward. Generally, there are two types of TPS, each with different implications for the trade relationship. First, the restaurant chain may be rolling out a formal terms pushback to all of its suppliers in an effort to extend its DPO and retain working capital. This form of TPS is usually not indicative of insolvency. Alternatively, the restaurant chain may be pursuing an *ad hoc* TPS, through which the cash-constrained restaurant chain singles out particular suppliers. In this latter setting, where the supplier is likely offering last-resort financing for the troubled restaurant chain, the TPS is a red flag. While a formal TPS is often preceded by a public announcement, the restaurant chain is less likely to draw attention to its *ad hoc* TPS efforts.

Industry Wide Data

Industry groups can provide insight into a restaurant chain's financial status. Have fellow suppliers experienced any recent payment issues with the restaurant chain customer? Has the restaurant chain approached other suppliers with TPS requests? While industry group comments

can help suppliers get a jump on a restaurant chain's insolvency, the credit team must be careful with the confidential information it obtains in industry group meetings, so as not to run afoul of antitrust laws.

Acting on the Red Flags: Strategies to Reduce Bankruptcy and Preference

Risk yet Still Make the Credit Sale

Once the supplier has identified potential red flags, that supplier must balance its desire for increased sales with its aversion to losses before choosing a course of action. What do the supplier's internal teams think will happen with the restaurant chain should they file bankruptcy?

Sales and marketing teams in a supplier's organization study restaurant saturation and competitive pressures. Many will have views as to the restaurant chain's ability to reorganize, be sold, or who a buyer of assets may be. Long before the situation is actionable, the credit team should work to assess the strengths and weaknesses in the supplier's relationship with the restaurant chain.

Although not fully answerable from the credit team's point of view, collaboration within the supplier's organization will facilitate a well-rounded view, which can be used as a basis for a business risk decision. Developing a course of action is dependent upon many factors, some of which focus on the industry and most of which focus on the supplier's relationship with the restaurant chain. Evaluation of the trade relationship must be realistic. For example, a supplier of goods to a restaurant chain has most likely paid a price (a "slotting fee") to have the goods stocked.

In evaluating concerns about a possible bankruptcy, the value of the slotting fees should be assessed. If the supplier stops shipping to the restaurant chain, and the restaurant chain survives Chapter 11, the supplier may have to pay slotting fees again to restock the goods, and the new slotting fees may be significantly higher.

Credit Enhancements, Distribution and Payment Alternatives

When worried about the insolvency risk of a restaurant chain, the supplier may backstop that risk with credit enhancements, distribution alternatives and/or alternative payment channels.

Large Restaurant Chains

1. Letter of Credit - A letter of credit is a promise by a bank, independent of any underlying supply contract, to pay the supplier when the restaurant chain defaults on the credit sale.

2. Credit Insurance - The supplier may purchase credit insurance to protect itself from the restaurant chain's insolvency, default or dispute. Under this arrangement, the supplier retains control of the accounts receivable, while the credit insurer covers a percentage of the insured invoices (as much as 90%).

Medium and Small Restaurant Chains

1. Certificate of Deposit - The restaurant chain's bank may issue a certificate of deposit in the supplier's name. Alternatively, the supplier may hold a customer's deposit to reduce the risk of nonpayment with the credit sale. The certificate of deposit is payable to the supplier upon demand, and renews for the length of the credit line.

2. Personal Guaranty - The supplier may make all future orders contingent on the restaurant chain's principal, personally guarantying past due debt and/or future credit sales.

3. Sale through Distributor - The supplier may consider selling its product indirectly through an intermediary, such as a national distributor, where balance sheet and credit risk demonstrate an ability to pay.

4. Drop Ship to Supplier-Controlled Warehouse - The vendor may consider limiting the product the debtor holds by shipping to a warehouse.

5. Credit Cards - The supplier may negotiate a credit card payment program with its restaurant chain customer. When the restaurant chain uses a credit card to pay the supplier's invoices, the supplier receives payment within terms, while the cardholder has an additional 30 days from the issuance of the first statement reflecting the transaction in which to pay the credit card company. In this way, the supplier may extend the delinquent restaurant chain's terms without sacrificing its own cash flow.

Chapter 11 Considerations

1. Keep Restaurant Chain within 20-day Terms - The supplier might suggest limiting sales to 20-day terms, so as to maximize those invoices that may qualify for (b)(9) priority should the restaurant chain file for bankruptcy protection. Is the supplier providing goods that are in high demand? If so, the restaurant chain may be more flexible when negotiating credit support. Are the goods supplied so specialized that the restaurant chain may find it difficult to replace the product on an expedited basis? That too increases the supplier's negotiating leverage.

2. Supply Contract - If selling beyond 20-day terms, the supplier may consider moving the trade relationship from PO-based to supply contract-based. If the supplier is already supplying goods under a formal supply contract, the supplier should negotiate with the restaurant chain and the buyer of assets to assume or accept the supply contract.

Assumption of the supply contract results in the supplier's pre-petition invoices being paid in full, as well as a preference release. The supplier will also have a trade relationship with the buyer of the restaurant chain's assets.

Should the restaurant chain file bankruptcy, they may accept or reject the supply contract. What opportunities does that present for the supplier? Are there points of leverage in the relationship that would influence the restaurant chain's decision to accept or reject the contract?

3. Forward Contract - Not all contracts are created equal. If a supplier is selling commodities to a restaurant chain on some specified future date, and at a fixed price, then that contract may qualify as a forward contract under the Bankruptcy Code. Where an ordinary supply contract must be assumed post-petition in order to immunize the preferential transfers made under that contract, the forward contract exempts any transfers made pursuant to the contract from preference liability.

4. Offset Credits - If the supplier is holding credits the restaurant chain accrued, the supplier may seek to offset its invoices to the balance owing.

5. Sell A/R - If its restaurant chain customer files for bankruptcy, the supplier may elect to sell its pre-petition claim. In this setting, third parties will offer to buy the claim at a discount. Once its claim is sold, the supplier is under no further obligation to sell the restaurant chain, unless the receivable is sold subject to recourse.

6. Preference Risk - All of the foregoing options notwithstanding, the supplier must be careful when reacting to a restaurant chain's financial red flags. While a tightening of terms, or a changing of payment methods, may help the supplier recoup past due in the run up to the Chapter 11 filing, these tactics may weaken the supplier's subjective ordinary course of business defense, should the Chapter 11 restaurant chain bring a preference suit against the supplier. The supplier may consider limiting its written demands and attempts to pressure the restaurant chain into paying, especially where such demands are made electronically (thus creating an audit trail).

Conclusion

The increase in telecommuters and individuals who work through their lunch has led to a steep decline in lunchtime traffic for restaurants—traffic that was crucial to their success in previous decades. Additionally, the introduction and subsequent rise of meal-kit delivery services has further strained the restaurant industry. Will this trend be the death knell for traditional restaurants, or will the implementation of technologies such as DoorDash and UberEats be enough to revitalize the industry?

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RESOURCES

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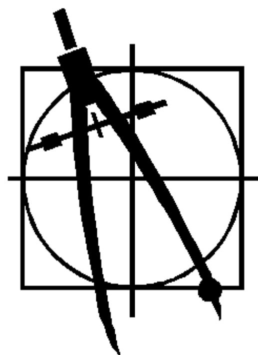
http://www.crfonline.org



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