



What's Really Included in the Price of Your Burger?

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From Bertucci's to Joe's Crab Shack, these past few years have seen an influx of restaurant bankruptcy filings.

Even with great food, world-renowned chefs, and topnotch customer service, restaurants are still finding it difficult to stay in business due to varying factors, including high rents, heavy debt loads, and the rising cost of labor in some states. Whatever the reasons contributing to both in court and out-of-court restaurant restructurings, it's clear that restaurants often run businesses with tight margins and, as they say, "cash is king." Thus, for attorneys representing restaurant debtors, ensuring the debtor has enough cash on hand to successfully run the business is an important task.

A restaurant-debtor's focus on cash most often relates to its relationship with its senior secured pre-petition lender. Indeed, Section 363(c)(2) of the U.S. Bankruptcy Code prohibits a debtor in possession from using cash collateral of a secured party without the secured party's consent or approval by the bankruptcy court. With respect to the former, the process to obtain consent from a lender often involves lengthy negotiations between the parties. To obtain approval from the bankruptcy court, a debtor must show the secured party's interest in the cash collateral is 'adequately protected.'

This article explores the nuances in a restaurant bankruptcy case related to a debtor's use of 'cash collateral,' particularly with respect to 'floating liens' and the exception set forth in Section 552 of the bankruptcy code.

What is Cash Collateral?

Cash collateral is defined in the bankruptcy code as:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the *proceeds*, products, offspring,

rent, or profits of property...whether existing *before* or *after* the commencement of a case under this title.¹

Section 363 of the bankruptcy code also states that "a debtor-in-possession may not use, sell or lease cash collateral unless 1) each entity with an interest in the cash collateral consents to or 2) the court, after notice and hearing, authorizes the use of, cash collateral."²

Does the Secured Creditor Have an Interest in Post-Petition Property?

Section 552 of the bankruptcy code limits a secured creditor's interest in post-petition property of the estate.³ This section of the code is critical for debtors who grant security interests to lenders with 'after-acquired property' clauses, in which certain property acquired by a debtor going forward automatically becomes subject to the secured party's lien. This type of lien is often called a floating lien. Generally, after-acquired property in a bankruptcy proceeding, unless subject to an exception, is not subject to any lien, floating or otherwise, resulting from a pre-petition security agreement.⁴ One exception to this general rule is that if the debtor enters into a security agreement where the security interest extends to proceeds,

products, offspring, or profits of pre-petition property, the security interest extends to proceeds, products, offspring, or profits of the pre-petition property, even if those proceeds are acquired post-petition.⁵

In other words, for a pre-petition security agreement to attach to property acquired post-petition, a creditor must show that: 1) the security agreement extends to the after-acquired property upon which the creditor seeks the lien, and 2) the after-acquired property is proceeds, product[s], offspring, rents, or profits of pre-petition property subject to the lien.⁶

The first prong is usually dictated by the terms of the agreement, while the second prong is dictated by state law.⁷

How are Post-Petition Restaurant Revenues Treated?

A debtor in a restaurant case may find it has some leverage with respect to its proposed use of alleged cash collateral. Indeed, a restaurant-debtor may have a legitimate argument that post-petition revenue should not be deemed 'proceeds' of a senior secured lender's original collateral and, therefore, should not be subject to any post-petition lien. The court's decision would ultimately dictate who has a superior right to the asset—either the debtor or the secured party.

A 1988 restaurant case from the United States Bankruptcy Court for the Western District of Kentucky explored the concept of the term 'proceeds' in the context of restaurant revenues.⁸ In *In re Inman*, a secured creditor argued that the money received from the sale of fast food by the debtor constituted proceeds of the restaurant's inventory rather than after-acquired property of the debtor. In support of its argument, the secured creditor noted that fast-food restaurants simply provide food, and not service, to the customer, whereas upscale restaurants may be classified as service providers.⁹ Contrary to the position of

Contrary to the position of the secured party, the court held that the money obtained from the sale of the food was after-acquired property and did not constitute proceeds of inventory. It found that the restaurants were engaged primarily in the service industry, and that cash earned from operations was not a proceed from the sale of inventory.

the secured party, the court held that the money obtained from the sale of the food was after-acquired property and did *not* constitute proceeds of inventory. It found that the restaurants were engaged primarily in the service industry, and that cash earned from operations was not a proceed from the sale of inventory.¹⁰ Notably, the court reasoned that “the degree of service is not the significant factor for our consideration... the restaurant industry, in general, is a service-oriented industry.”¹¹ In sum, because the post-petition revenues were not deemed proceeds from the sale of pre-petition inventory, they could not be subject to the lender’s pre-petition lien on the debtors’ inventory.

Similarly, in *In re Timothy Dean Restaurant & Bar*,¹² the court found that the bank’s pre-petition security interest in a Chapter 7 debtor-restaurant’s inventory did *not* extend to accounts receivable generated post-petition. The court explained its decision, noting that the accounts receivable stemmed from services the debtor-restaurant provided post-petition by preparing and serving food, and the bank failed to produce any evidence demonstrating what portion of accounts at issue could be identified as proceeds of inventory on which it had a lien on the petition date.

Interestingly, *Inman* and *Timothy Dean* have even been cited favorably by

other cases that have not gone quite as far in protecting restaurant-debtors with respect to post-petition receivables.

In *In re Cafeteria Operators*, a bankruptcy court reviewed Massachusetts state law in order to determine whether revenues generated by a restaurant were ‘proceeds’ of pre-petition property in accordance with the exception outlined in Section 552 of the code, and thus subject to a blanket lien on the debtors’ real and personal property.¹³ The Massachusetts Uniform Commercial Code defines proceeds, in relevant part, as “(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; (B) whatever is collected on, or distributed on account of, collateral; (C) rights arising out of collateral.”¹⁴

The *Cafeteria Operators* court found that, although the Massachusetts definition of proceeds does not specifically include revenues generated by a service-oriented business such as a restaurant, an argument could be made that restaurant revenues are proceeds under Massachusetts commercial law because they are acquired “upon the sale of food and beverage inventory” and “arise out of the use of fixtures and equipment,” such as “stoves, ovens, warmers, tables, chairs, plates, forks and knives,” all of which are subject to a creditor’s pre-petition blanket lien.¹⁵ Massachusetts’ definition of proceeds stems from the Uni-

form Commercial Code, which is adopted by most states. Thus, in most states, post-petition revenue generated by a restaurant may be considered a proceed that is subject to a pre-petition lien on the debtors’ property.

Notably, the *Cafeteria Operators* court was unwilling to find that *all* post-petition revenue was subject to the bank’s blanket lien. The debtors’ CEO testified that the post-petition revenue generated by the debtors was “primarily derived from services provided by the Debtors,” and that the value of the food component used in each meal was less than one-third of the price charged for the final plate of food.¹⁶ The court spoke favorably of the *Inman* court’s assertion that post-petition revenues generated from the operation of the restaurants resulted, in large part, from the debtors providing a service to the customers.¹⁷ The *Cafeteria Operators* court recognized, however, that at least some of the cash generated by the restaurants was derived from the inventory, which was subject to a pre-petition lien.¹⁸ To balance these interests, the court held that the creditor would maintain its lien on the debtor’s cash, but only in an amount equal to the cost of the inventory used in each sale.¹⁹ In other words, in *Cafeteria Operators*, the bank had a lien on less than one-third of the proceeds of each plate in the restaurant.

The court found a more reasonable approach would be to conclude that, since a restaurant patron is paying for both the services provided and for the food itself, “the portion received in exchange for the inventory,” or in exchange for the food, constitutes proceeds of that inventory.

The court in *In the Matter of Strick Chex Columbus Two, LLC*²⁰ came to a nearly identical holding. In that case, the court restated and further explained that, although the debtor sold the inventory that was subject to the pre-petition lien, the court could not “conclude that *all* of the revenue brought in from food sales is proceeds of the food inventory.”²¹ The court restated that restaurants are service oriented, which makes them unlike grocery stores or other food wholesalers.²² The court also noted that, generally, revenue generated post-petition “as a result of a debtor’s labor” is not subject to any pre-petition interests.²³ The court also discussed the *Inman* opinion, commenting that its approach was somewhat extreme and that the opinion ignored the fact that the final product of the debtor’s labor is undoubtedly made up of the food and beverages subject to the pre-petition security interest.¹⁴ The court found a more reasonable approach would be to conclude that, since a restaurant patron is paying for both the services provided and for the food itself, “the portion received in exchange for the inventory,” or in exchange for the food, constitutes proceeds of that inventory.¹⁵

Conclusion

Most courts agree that post-petition restaurant revenues are not just a prod-

uct of inventory and equipment. Restaurants are, without question, service oriented, and the argument can be made that restaurant revenues are a product of the debtor’s post-petition labor and, thus, not subject to pre-petition liens. If an attorney handling a restaurant restructuring can show the debtor’s post-petition revenues are, at least in part, not subject to pre-petition liens, the attorney will give the debtor the freedom to use its cash without the requirement of consent of its creditor. ⚡

Endnotes

1. 11 U.S.C. § 363(a) (emphasis added); *see also In re Cafeteria Operators, L.P.*, 299 B.R. 400, 403 (Bankr. N.D. Tex. 2003).
2. 11 U.S.C. § 363(c)(2).
3. 11 U.S.C. § 552.
4. 11 U.S.C. § 552(a).
5. 11 U.S.C. § 552(b)(1).
6. *Cafeteria Operators*, 299 B.R. at 405.
7. *See id.* at 405-06.
8. *In Re Inman*, 95 B.R. 479 (Bankr. W.D. Ky. 1988).
9. *Id.* at 480-81.
10. *See id.*
11. *See id.*
12. 342 B.R. 1, 23 (Bankr. D. Col. 2006).
13. *Id.* at 406.
14. *Id.*; *see also* Mass. Gen. Laws ch.

- 106 § 9-102(a)(64).
15. *Id.*
16. *Cafeteria Operators*, 299 B.R. at 408.
17. *Id.*
18. *See id.* at 410 (“Restaurant revenues are primarily the fruit of the Debtors’ labor; however they do contain some component of proceeds of inventory.”).
19. *Id.*
20. *In the Matter of Strick Chex Columbus Two, LLC*, 542 B.R. 914 (Bankr. N.D. Ga. 2015).
21. *Id.* at 919.
22. *Id.*
23. *Id.* (quoting *Arkison v. Frontier Asset Mgmt., LLC (In re Skagit Pac. Corp.)*, 316 B.R. 330, 336 (B.A.P. 9th Cir. 2004)).
24. *Id.* (citing *Cafeteria Operators*, 299 B.R. at 409).
25. *Id.* at 919-20 (citing *Cafeteria Operators*, 299 B.R. at 409).