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RESTAURANT BANKRUPTCIES –
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RESTAURANT REVENUES AS CASH COLLATERAL

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A. Cash Collateral Generally

Section 363 of the Bankruptcy Code governs the estate's use of cash collateral. A debtor in possession ("DIP") may not use cash collateral unless either "(A) each entity that has an interest in such cash collateral consents; or (B) the court, after notice and a hearing, authorizes such use, sale, or lease . . . ." 11 U.S.C. § 363(c)(2). Unless the DIP obtains consent or a court order, it "shall segregate and account for any cash collateral in the trustee's possession, custody, or control." 11 U.S.C. § 363(c)(4). To authorize use over the secured party's dissent, the Bankruptcy Code directs "the court, with or without a hearing, [to] prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest." 11 U.S.C. § 363(e). The court must thus "prohibit or condition" a debtor's use of cash collateral based upon whether the debtor has adequately protected a creditor's interest in such cash collateral.

Cash collateral is defined 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, rents, or profits of property . . . whether existing *before* or *after* the commencement of a case under this title." 11 U.S.C. § 363(a) (emphasis added).

Additionally, Section 552 of the Bankruptcy Code generally limits a secured creditor's interest in post-petition property of the estate. *See* 11 U.S.C. § 552. Section 552 provides, in relevant part:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

11 U.S.C. § 552(a). Thus, under § 552 of the Bankruptcy Code, post-petition property acquired by the debtor's estate, such as revenues generated from operations, is not subject to any liens resulting from pre-petition security agreements.

There are two exceptions to this general rule. The first applies to "proceeds" of collateral under Section 552(b)(1) of the Bankruptcy Code. 11 U.S.C. § 552(b)(1). That section of the Bankruptcy Code provides that if a security interest in property extends to proceeds, products, offspring, or profits of property, then the security interest is effective against the proceeds, products, offspring, or profits of such property acquired post-petition "to the extent provided by such security agreement and by applicable non[-]bankruptcy law." 11 U.S.C. § 552(b)(1).

The second exception generally applies to rents generated by real property collateral under Section 552(b)(2) of the Bankruptcy Code. 11 U.S.C. § 552(b)(1). Section 552(b)(2) of provides:

> [I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as *rents* of such property or the fees, *charges, accounts,* or *other payments* for the *use* or *occupancy* of *rooms* and *other public facilities* in *hotels, motels* or *other lodging properties,* then such security interest extends to such rents and such fees, charges accounts or other payments acquired by the estate after the commencement of the case to the extent provided in such Security Agreement.

11 U.S.C. § 552(b)(2) (emphasis added).

Thus, for a pre-petition security agreement to attach to after-acquired property, a creditor must show the following: (i) the security agreement extends to the after-acquired property upon which the creditor seeks the lien, and (ii) the after-acquired property is proceeds, product, offspring, rents, or profits of pre-petition property subject to the lien. The express terms of the security agreement generally govern the first prong, while state law generally governs the second prong. *In re Timothy Dean Restaurant & Bar*, 342 B.R. 1, 24 (Bankr. D. D.C. 2006).

Under the Bankruptcy Code, the secured lender has the burden of proof on the issue of validity, priority and/or extent of its lien on the property. 11 U.S.C. § 363(o). In turn, the DIP has the burden of proof on the issue of adequate protection. *Id.*

Finally, even if the secured lender carries its burden under § 363(o), Section 552(b) of the Bankruptcy Code "grants the court broad equitable powers in determining the extent of the security interest Creditor may be allowed to maintain postpetition." *In re Cafeteria Operators, L.P.*, 299 B.R. 400, 409 (Bankr. N.D. Tex. 2003); *see also Wolters Vill., Ltd. v. Village Props., Ltd. (In re Village Props., Ltd.),* 723 F.2d 441, 443 (5th Cir. 1984), *cert. denied,* 466 U.S. 974 (1984). "This 'equities of the case' provision is intended to prevent secured creditors from receiving windfalls and to allow bankruptcy courts broad discretion in balancing the interests of secured creditors against the general policy of the Bankruptcy Code, which favors giving debtors a 'fresh start.'" *Id.* The equity exception of § 552 is to "cover cases where an expenditure of the estate's funds increases the value of the collateral.... [A]s an example the situation where raw materials are converted into inventory at the expense of the estate (which would thus deplete the fund available for the general unsecured creditors)." *Id.* Thus, notwithstanding a showing a valid security interest in post-petition cash collateral, the court can limit the secured lender's rights in post-petition collateral to promote bankruptcy policy. *Id.* ("To grant Bank Group a blanket lien on all of [restaurant-]Debtors' cash generated post-petition would represent a windfall to Bank Group, in the face of Debtors' utilization of estate resources, *i.e.* the services of their employees, to increase the value of Bank Group's collateral, and would unfairly deplete the funds available for general unsecured creditors.").

B. *Restaurant Revenues Cases*

Despite the number of operating restaurants in the United States and their inherently risky prospects for success, relatively few cases analyze cash collateral issues in the restaurant context. The few cases that do address the issue generally focus on revenues derived from the sale of inventory and the UCC definition of "proceeds". *See Timothy Dean Restaurant & Bar*, 342 B.R. at 24; *Cafeteria Operators,* 299 B.R. at 408; *In re Inman,* 95 B.R. 479, 481 (Bankr. W.D. Ky. 1988).

The Uniform Commercial Code, adopted by most states, 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; or (C) rights arising out of collateral." U.C.C. § 9-102(a)(64). Courts have uniformly held that revenues strictly arising out of the performance of a personal service do not fall under the definition of "proceeds" and would not constitute cash collateral. *See, e.g., Cafeteria Operators,* 299 B.R. at 404-05 (citing cases).

Based on this analysis, restaurant cases generally hold that restaurant revenues are, at least in part, derived from the performance of services (*i.e*, the preparation and service of food), and only the portion of revenues generated by the sale of inventory constitutes proceeds. *See, e.g., Timothy Dean Restaurant & Bar*, 342 B.R. at 24 (holding that revenue generated from the sale of only food and beverage (such as from a vending machine) is undoubtedly cash collateral, but customers of a restaurant pay a premium for having a chef prepare a meal and that premium is not proceeds); *Cafeteria Operators,* 299 B.R. at 408 (revenues generated from services are not proceeds, but the portion of revenues acquired as a result of the disposition of food and beverage inventory is proceeds); *cf. Inman,* 95 B.R. at 481 (all revenues generated by a restaurant are derived from services; therefore, none of the revenues are proceeds).

The general restaurant revenue analysis is well-summarized by *Cafeteria Operators*:

> This Court agrees with the court in *Inman* that the restaurant industry is a service-oriented industry and that "the cost of preparing food for human consumption is passed on to the consumer." *Inman,* 95 B.R. at 481. If consumers were solely purchasing the food component, they would look to the local grocery store, for example, to make such a purchase. Clearly, restaurant customers are paying some premium to have the food prepared prior to consumption and served to them. Similarly, third-parties purchasing pre-prepared foods from Debtors' distribution center are paying a premium for the privilege of having food delivered that is already prepared rather than in its natural state.
>
> The Court disagrees with the result reached by the *Inman* court, however, that *none* of the revenues generated by a restaurant are proceeds of inventory. In this case, the Bank Group has a security interest in the Debtors' food and beverage inventory. The

> inventory is being disposed of on a daily basis. Thus, under Massachusetts law, that portion of the revenues acquired as a result of the disposition of the food and beverage inventory constitutes proceeds of such inventory. Under § 363(a), only that portion of the revenues, then, constitutes the Bank Group's cash collateral.
>
> This holding balances the outcome of the hotel revenues cases and the restaurant cases. The hotel cases involve use of real property without real diminishment to the facility, except over a long period of time. Yet, the rents generated thereby are typically cash collateral since they are generated primarily from the use of the real property. The restaurant cases, particularly *Inman,* focus on the fact that the restaurant industry is service-based, yet do not account for the utilization of the secured lender's collateral. In a restaurant, the food and beverages that make up the final product of the restaurant undoubtedly are used up in the process. The reasoned approach, then, is to grant a limited interest in post-petition revenues to secured lenders.

Cafeteria Operators, 299 B.R. at 409; *see also Timothy Dean Restaurant & Bar*, 342 B.R. at 24 n. 32 ("Without a doubt, patrons of a first-class restaurant are paying for the preparation of their meal by a first-class chef.").

Accordingly, to the extent courts have thoughtfully analyzed the issue, they have generally concluded that only the portion of restaurant revenues attributed to the disposition of inventory constitutes the secured lenders' cash collateral.

C. *Cash Collateral Derived From The Use Of Good Will, Tradenames, Recipes, and Other General Intangibles*

A possible approach to restaurant revenue analysis that does not appear to have been explored in a reported case is whether a portion of revenues generated from the operation of a restaurant constitutes proceeds from the use of that restaurant's good will, tradenames, recipes, or other general intangibles. Patrons of a restaurant do not come to a restaurant only because of the inventory and the services, but also because of the good will associated with a tradename or the trademarked recipes. If the tradename, recipes, good will, or other general intangibles are subject to a creditor's prepetition lien, revenues generated from the post-petition use of those general intangibles might constitute "proceeds" within the meaning the U.C.C.

A plain reading of U.C.C. § 9-102(a)(64)(B) and (C) appears to support this approach. Subsections (B) and (C) of U.C.C. § 9-102(a)(64) defines proceeds broadly to include "(B) whatever *is collected on*, or distributed on account of, collateral; or (C) *rights arising out* of collateral." U.C.C. § 9-102(a)(64) (emphasis added). Subsections (B) and (C) were added to the Revised Article 9, in part, as an express rejection of cases that held that stock dividends were not proceeds of stock collateral. *See* U.C.C. § 9-102(a)(64) cmt. 13(a). Nevertheless, its plain meaning could be read broad enough to include revenues "collected on or distributed on account

of" or generated from "rights arising out of" the use of general intangibles. Unfortunately, no cases have interpreted U.C.C. § 9-102(a)(64)(B) and (C) in this manner.[1]

A few cases that touch on the issue do not lend support to this approach. Some of the analysis in the restaurant revenue cases, however, hint at how a court might approach this argument. In *Cafeteria Operators*, the court not only analyzed whether revenue generated from the sale of inventory and the performance of services constituted proceeds, the court also examined whether revenues arising out of "the *use* of fixtures and equipment, *i.e.* stoves, ovens, warmers, tables, chairs, plates, forks and knives" constitutes proceeds under the U.C.C. *Cafeteria Operators,* 299 B.R. at 407 (emphasis added). After concluding that revenues generated from the services preformed were not proceeds, the court noted:

> However, the security interest of the Bank Group is broad and includes the Debtor's pre-petition inventory of food and beverages and other related assets and also extends to Debtors' fixtures and equipment. The only asset converted to cash, though, is the food and beverage inventory. The Debtor's fixtures, *i.e.* the tables, chairs, plates, etc., are not converted to cash. The fixtures remain after the customer has left. The same is true of the equipment, for example the ovens, refrigerators, etc. The revenues generated from the use of fixtures and equipment in the present case does not constitute proceeds under Massachusetts law. *Therefore, the cash allegedly generated by Debtors' use of the fixtures and/or equipment in its business does not equate to proceeds of the fixtures and/or equipment.* Bank Group, at best, may be entitled to adequate protection from any diminution in value of the fixtures and equipment by virtue of their use . . . .

Id. at 408 (emphasis added). This language would tend to weaken the argument that revenues generated from the use of general intangibles constitute proceeds. After all, if revenues generated from the use of fixtures and equipment do not constitute proceeds, why would revenues generated from the use of other collateral, such as general intangibles, constitute proceeds?[2]

Two cases that are somewhat relevant to a secured lender's claim to proceeds derived from the use of a general intangibles do not appear to support the argument. *See In re Las Vegas Monorail Co*, 429 B.R. 317 (Bankr. D. Nev. 2010); *In re Lady Madonna Indus., Inc.*, 99 B.R. 536 (S.D.N.Y. 1989).

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1 Revenue generated from the disposition of a general intangible would constitute proceeds under Subsection (A) of U.C.C. § 9-102(a)(64). Apportioning a gross selling price among the various assets (which might include unencumbered assets) presents myriad issues.

2 The court appears to base its reasoning solely on the fact that the equipment and fixtures were not converted to cash. In other words, the court used a traditional disposition analysis under Subsection (A) of 9-102(a)(64) and does not appear to have considered whether revenues generated from the use of equipment and fixtures would qualify as proceeds under the broader meanings expressed in Subsections (B) and (C) of 9-102(a)(64).

In *Las Vegas Monorail*, the debtor operated a monorail that served several hotels on the Las Vegas strip under an agreement with the city. *Las Vegas Monorail*, 429 B.R. at 318. The secured lender had a lien on the "contract rights" arising from the franchise agreement. *Id.* at 333. After the debtor filed bankruptcy, the secured lender argued that all the debtor's pre- and post-petition cash constituted part of its collateral. *Id.* The secured lender asserted that "since [the debtor] could not run the monorail or collect fares without the Franchise Agreement, all fares must be 'collected on, or distributed on account of' the Franchise Agreement, . . . or must be 'rights arising out of the collateral'" under U.C.C. § 9-102(a)(64)(B) and (C). *Id.* The court disagreed and found that the debtor granted a security interest in certain "contract rights" contained within the franchise agreement, "but not all the entitlements and privileges represented by the agreement." *Id.* at 335. Distinguishing the only case relied upon by the secured creditor, the court incredulously noted that "If fruits and products from the use of collateral were treated as proceeds, every creditor with a security interest in equipment would have a security interest in all items produced from the equipment as well as revenues earned by the equipment." *Id.* at 334. The court also noted that "If the [secure creditor] were correct, its interpretation would make every single dollar that [the debtor] generates proceeds, thus rendering the remaining grants of security interests in [the security agreement] superfluous." *Id.* at 335. The court also analogized the secured lender's argument to FCC license cases, and essentially raised the point that, under the secured creditor's reasoning, a lender with a lien on NBC's FCC license, for example, would have a lien on every dollar of revenue generated by NBC because NBC cannot operate without the FCC license. *Id.* at 336. Rejecting these notions, the court found that the secured lender did not have a lien in the cash generated by the debtor's operations. *Id.*

In *Lady Madonna*, a debtor was in the business of manufacturing and selling maternity wear and baby clothing bearing unique trademarks and tradenames. *Lady Madonna Indus., Inc.*, 99 B.R. at 538. The secured lender had a lien in "all accounts receivable, contract rights, equipment, and farm products, and any . . . general intangibles relating thereto or arising therefrom." *Id.* When the debtor filed for Chapter 7 protection, the trustee sold the trademarks. *Id.* The secured lender then sought distribution of the proceeds from the sale. *Id.* The secured lender argued that the trademarks related to the debtor's accounts receivable and contract rights subject to its security interest since all of the debtor's accounts receivable arose from the sale of Lady Madonna and Baby Madonna branded garments. *Id.* at 540. The secured lender also asserted that "the price of the garments, and therefore the amount of the accounts receivable and contract rights that the debtors were able to amass by contracting to make and making such sales, depended on the value of these names and good will established by the franchisees who traded under such names." *Id.* The district court agreed with the bankruptcy court in its finding that the secured lender's argument "is nothing more than a statement that the accounts receivable might arise in part from the trademarks and tradenames, as well as the debtors' inventory, franchise contracts, manufacturing contracts and skills of their employees", which was not supported by the security agreement. *Id.* at 541. Therefore, the district court found that the secured lender did not have a lien in the trademark proceeds. *Id.*

Since *Las Vegas Monorail* and *Lady Madonna*, additional cases have arrived at the same conclusion. For example, in *1st Source Bank v. Wilson Bank & Trust*, a secured creditor argued that its security interest in the debtor's "tractors and/or trailers, accounts, and in the proceeds

from the agree-upon collateral," included the accounts receivables, because those accounts receivables were "proceeds." *1st Source Bank v. Wilson Bank & Trust*, 735 F.3d 500, 502 (6th Cir. 2013). The court disagreed, reasoning that "in order for rights to 'arise out of collateral' [such that they would be considered proceeds], they must have been obtained as a result of some loss or disposition of the party's interest in that collateral, not simply its use." *Id.* at 50; *see also In re Gamma Center, Inc.*, 489 B.R. 688, 696 (Bankr. N.D. Ohio 2013) (holding that accounts receivable or funds collected as the result of using equipment collateral do not constitute proceeds).

Additionally, *In re Premier Golf Props., LP*, 477 B.R. 767 (B.A.P. 9th Cir. 2012), the bank was granted a blanket security interest in of a golf club's real and personal property, including, but not limited to, all contract rights, general intangibles, and the proceeds thereof. *Premier Golf*, 477 B.R. at 770. The golf club filed chapter 11 bankruptcy but continued to operate its business as a debtor-in-possession. *Id.* The bank filed a motion to prohibit the golf club from using cash collateral. *Id.* The golf club argued that the post-petition income from the sale of golf memberships, green fees, cart rentals, the sale of balls for the driving range, and food and beverage service was not the proceeds, profits, or products of the bank's collateral. *Id.* The bank responded by claiming that at least the post-petition green fees and driving range fees were proceeds of the bank's interest in the golf club's personal property collateral, specifically its interest in general intangibles. *Id.* at 771, 775. The court applied UCC § 9-102(a)(64) to determine what constitutes proceeds under Bankruptcy Code § 522(b). *Id.* at 775. The court held that the green fees and driving range fees were not proceeds generated from the bank's collateral, and that the revenue was not derived from the bank's security interest in general intangibles. *Id.* at 776. They reasoned that revenue generated by the operation of a debtor's business, post-petition, is not considered proceeds if such revenue constitutes compensation for goods and services rendered by the debtor in its everyday business performance. *Id.* at 76-77. They also reasoned that revenue generated post-petition solely as a result of a debtor's labor is not proceeds of a creditor's pre-petition interest. *Id.* The court focused on whether the revenue was the proceeds from a license or proceeds from payment intangibles. *Id.* The court did not analyze whether the revenues constituted proceeds of the golf club's good will, trade name, or other general intangibles.

However, although cases such as *Las Vegas Monorail*, *Lady Madonna*, *1st Source Bank*, and *Premier Golf Props* are somewhat informative in this discussion, they could be distinguishable from a restaurant operation.

D. Conclusion

Almost beyond question, the secured lender to a restaurant has an interest in some portion of the cash generated from post petition operators. The scope of that interest, however, is subject to serious and material debate. At some point, the lender's interest in general intangibles will enter the discussion. Because the cases have focused on the connection between the reason patrons frequent the restaurant and the lender's lien, that discussion may evolve to include the lender's interest in site control and in the Franchise Agreement.