Securing Your Tomorrow®

UCC Filings and the Foodservice, Beverage, and Hospitality Industries

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The restaurant, beverage and hospitality industries are massive. The National Restaurant Association projected that commercial restaurant services sales would reach $783 billion by the end of 2016, which is about 4% of the U.S. gross domestic product.

With a flooded market, there is variety, but there is also significant risk.

If you are supplying goods, equipment or services to the foodservice, beverage or hospitality industries, you are faced with a unique set of challenges when extending credit. The most common challenge? The high rate of company failure.

So how can you, the creditor, reduce your risk in extending credit? UCC filings!

In this article, you will learn the basics of UCC filings, the important role UCC filings play in the foodservice/beverage/hospitality industries, which UCC filing is right for you and what steps to take in the event your customer defaults and/or sells the business when you have a UCC in place.

The Restaurant-Risk is Real --Beverage and Hospitality are No Exception

As mentioned above, the most common challenge for creditors in the foodservice, beverage and hospitality industries is the rate at which their customers' companies fail.

> "Most restaurants fail quickly, and the seeds of their failure are planted before the restaurant even opens." -- Christine Letchinger, professor at Chicago's Kendall College.

In The Anatomy of Restaurant Failure: Dead Man Walking, author Christine Letchinger cited studies that estimate 60% of restaurants fail within their first three years.

> "Various studies estimate that among the 60% of operations that fail within the first three years, 44% failed the first year, 33% within the second year, and 23% in the third year."

Why do companies in these industries fail? Per Statistic Brain, 46% of start-ups fail due to "incompetence," which includes emotional pricing, lack of planning, and inexperience with record keeping and financing. Coming in at 30% is "unbalanced experience or lack of managerial experience," which includes inadequate borrowing practices and poor credit granting practices. Rounding out the reasons for failure is the "lack of experiences in line of goods or services" at 11% and "neglect, fraud, disaster" at 1%.

Statistic Brain also notes that grocery stores and restaurants are included with the businesses that have the worst rate of success after the fifth year.

In an article for Nation's Restaurant News, author Jonathan Maze said restaurant bankruptcies aren't uncommon and should come as no surprise.

> "restaurants file for credit protection every year. They are capital-intensive businesses operating in a saturated industry that caters to a fickle consumer. They frequently borrow money to expand. And they lease spaces for their restaurants. Thus, when sales fall, bankruptcies can often follow… the wave of bankruptcies is largely due to a decline in sales at restaurant chains that is particularly harmful to companies that are already walking a balance-sheet tightrope."

"...60% of restaurants fail within their first three years."

In the fall of 2016, one source reported that restaurant bonds had moved to 4th position on Standard & Poor's Distress Ratio list, right behind brick & mortar retailers. Several major restaurant chains filed for bankruptcy in 2016 including Rita Restaurant Corp., Restaurant Acquisitions, Logan's Roadhouse, Fox & Hound (2nd time), HomeTown Buffet (for the 3rd time!) and Quaker Steak & Lube.

In a report on the Restaurant Performance Index from the National Restaurant Association, only 39% of restaurant owners expect sales growth in 6 months' time. Some experts believe the restaurant industry is an early predictor of the overall economy -- if restaurants are down, other facets of the economy will soon follow.

Of course, restaurants aren't the only entities filing for bankruptcy; grocery store chains such as Fairway Group Holdings Corp. and The Great Atlantic & Pacific Tea Company, Inc. (a two-time bankruptcy candidate) have filed. As have other retailers such as Sports Authority, Golfsmith and American Apparel.

Your Risk Reduction Tool: UCCs

Article 9 of the Uniform Commercial Code (UCC) provides an opportunity for trade creditors to collateralize or "secure" their goods and/or accounts receivable by leveraging the personal property assets of their customer. Properly perfected security interests via UCCs will mitigate *(though not eliminate)* risk.

Jerry Bailey, Education & Sales Manager at NCS, speaks to creation of Article 9:

> "Article 9 created a system where we establish priority of creditor's claims in the event we must dismantle a business because it fails. It also created a system where we would have a public registration of these encumbrances against a business and potential lenders could go and search against a business and see how many encumbrances were against that business and the nature of those encumbrances."

UCCs are a form of consensual security, which means your customer must grant you the security interest.

As you may know, a properly perfected security interest is comprised of two parts: one part Security Agreement and one part Financing Statement. The Security Agreement is the portion that creates and grants the security interest and the Financing Statement creates the public record of the security interest.

"Article 9 created a system where we establish priority of creditor's claims in the event we must dismantle a business because it fails."

The key pieces of information that must appear in your Security Agreement include proper identification of your customer including their address, a clear collateral description, the granting clause, and a reference to governing law. Plus, it is critical the document be properly dated and that you ensure the signors of the document have the authority to sign the agreement. As a best practice, you should obtain a copy of your customer's Articles of Incorporation, as they will correctly identify your customer and confirm the state in which the entity is registered.

The Financing Statement must be recorded with the Secretary of State in the state in which your customer's business is registered (see -- Articles of Incorporation are important). As an example, your customer may be a registered entity in Delaware, with their actual place of business in Ohio. The Financing Statement should be filed in Delaware, because that is where the entity is registered.

Financing Statements are in place for 5 years and, at the end of 4.5 years, you have a six-month window to continue your filing for a new five-year period.

The Role of UCCs & Which Type is Best for Your Business

The risk of failure is prevalent in the food, beverage and hospitality industries. Creditors actively and aggressively implement UCC filings for security. Creditors often include security language within their credit applications and establish standard business practices by always obtaining a signed Security Agreement, because UCCs work.

UCCs are a basic risk mitigation tool; they are a low-cost solution, requiring nothing more than a signature from the customer.

Blanket Filing
A Blanket Filing is a security interest in all assets of your customer on a non-priority basis, eliminating potential conflict with your customer's primary lender. *(Think of it as a blanket that lays down over all customer assets.)*

The priority or payout in a bankruptcy is determined by the filing date (first in time, first in right). For example, if ABC Co. files the first UCC and XYZ Co. files the second UCC, ABC Co. will be paid first and XYZ Co. will be paid second.

Blanket filings are popular among those supplying to restaurants, as they are most commonly used in situations when your customer "consumes" or otherwise does not stock your goods.

Creditor priority is based on first in time, first in right.

Here's an example of a new restaurateur whose creditors secured via Blanket Filings, and the fate of his secured & unsecured creditors in a Chapter 7 bankruptcy.

Chef Charles is going to start a restaurant. He's worked in the restaurant industry his entire working life and thinks, "OK, I'm pretty good at this. I know how to run a restaurant, and how to make foods that are delicious and attractive, plus I can create an environment where people will want to dine."

Chef Charles creates his business plan and determines he needs start-up capital, so he goes to the bank with his business plan and a request for $20,000. The bank reviews his plan and decides to lend the $20,000 to Chef Charles, and the bank perfects their security interest.

Chef Charles is ready to start. Various vendors will solicit Chef Charles regarding different materials and services he may need, and each vendor that successfully sells their goods to Chef Charles will need to decide whether they are going to sell on open credit terms, via credit card or cash in advance. If the vendor decides to sell on open terms, the vendor will need to further decide whether they will sell on a secured or unsecured basis.

Chef Charles has selected his vendors. Of his numerous vendors, four of them have taken a security interest and filed a UCC.

- Secured Creditor 1: $10,000
- Secured Creditor 2: $10,000
- Secured Creditor 3: $5,000
- Secured Creditor 4: $10,000

We'll assume the remaining vendors have opted to sell on unsecured open terms.

Business is underway! At any given time, Chef Charles has $61,000 in assets.

Unfortunately, 3 years later Chef Charles becomes a statistic when his business fails and he files for Chapter 7 bankruptcy protection.

What happens to his creditors? It's simple. Chef Charles's assets will be liquidated and creditors will be paid by priority. Creditor priority is based on first in time, first in right.

Here are the Basics
The bankruptcy trustee is going to liquidate Chef Charles' $61,000 in assets and begin paying his creditors.

The bank was the first party to lend and take a secured interest, so they will be the first paid, then the other vendors who filed UCCs will be paid in the order in which they secured their interest.

Total Assets	**$61,000.00**
Bank is paid	($20,000.00)
Secured Creditor 1 is paid	($10,000.00)
Secured Creditor 2 is paid	($10,000.00)
Secured Creditor 3 is paid	($5,000.00)
Secured Creditor 4 is paid	($10,000.00)
Total Available for Unsecured Creditors	$6,000.00

Once the secured creditors have been paid, there is $6,000 remaining, and that $6,000 will be disbursed on a pro-rata basis to all general unsecured creditors.

In this case, Chef Charles has 100 unsecured creditors that were each owed $1,000. Each of these creditors will receive $60 (based on the pro-rata disbursement) or 6 cents on the dollar.

Purchase Money Security Interest Filing: Inventory or Equipment
A Purchase Money Security Interest (PMSI) filing provides the same benefits as the blanket filing with the addition of priority of repossession of specific identifiable goods, primarily inventory or equipment that your company would provide.

The determination of whether your goods are inventory or equipment depends on what your customer is doing with the goods you provide.

If you sell goods to your customer and your customer intends to resell them to other entities, then your goods would be considered inventory. Within the food, beverage & hospitality industries, we don't often see creditors using inventory filings.

Why? Well, frequently these goods are perishable and you don't want them back.

> **PMSI in Inventory:** "Securing collateral that is defined as inventory 9-102(48) -- "Inventory" means goods, other than farm products, which: (A) are leased by a person as lessor; (B) are held by a person for sale or lease or to be furnished under a contract of service; (C) are furnished by a person under a contract of service; or (D) consist of raw materials, work in process, or materials used or consumed in a business."

PMSI in Equipment filings are much more common in the food, beverage & hospitality industries.

> **PMSI in Equipment:** "Securing collateral that is defined as equipment 9-102(33) -- "Equipment" means goods other than inventory, farm products, or consumer goods. The "equipment" is used in the course of the debtor's business -- it is not stocked."

Creditors who would benefit from a PMSI in Equipment would supply items like copy machines, beverage dispensing machines, flatware, ice machines, stoves/hoods and walk-in coolers; equipment your debtor would keep, use in their ordinary course of business and not re-sell. These are items that you could potentially repossess because there is a resale value to you.

(Note, as we'll discuss shortly, if you are supplying equipment, it could be deemed a fixture, which warrants a different type of UCC filing.)

Let's go back to the example of the same bankrupt restaurateur, except, this time, we have six secured creditors. One of his creditors is secured via a PMSI Filing, 5 creditors are secured via Blanket filings, and the remaining creditors are unsecured.

> The creditor secured via a PMSI filing has sold a piece of equipment which has been placed in Chef Charles' restaurant. The original price of the equipment was $10,000, and, over time, Chef Charles has retained possession of the equipment and paid $5,000 towards the balance, leaving a balance of $5,000 due to his creditor.
>
> Just as in the previous example, the bankruptcy trustee is going to liquidate Chef Charles' $61,000 in assets and begin paying his creditors.
>
> Except this time, the creditor with the PMSI filing will go in first and repossess their piece of equipment. Then the total asset value is reduced from $61,000 to $56,000. Now, payment priority goes first in time, first in right.

Total Assets	**$61,000.00**
Creditor with PMSI Filing Repossesses Equipment	($5,000.00)
New Asset Balance	**$56,000.00**
Bank is paid	($20,000.00)
Secured Creditor 1 is paid	($10,000.00)
Secured Creditor 2 is paid	($10,000.00)
Secured Creditor 3 is paid	($5,000.00)
Secured Creditor 4 is paid	($10,000.00)
Total Available for Unsecured Creditors	$1,000.00

Once the secured creditors have been paid, there is $1,000 remaining, and that $1,000 will be disbursed on a pro-rata basis to all general unsecured creditors.

Because the creditor secured their equipment through a PMSI filing, they took priority over the various Blanket filers.

Fixture Filings
As I mentioned above, there are circumstances where a fixture filing may be more appropriate than an equipment filing. To take it one step further, there may even be occasions where securing mechanic's lien rights would be better than a fixture filing.

In the food, beverage and hospitality industries, fixtures could include ranges, ovens, coolers, sinks, dishwashers, hotel headboards and external signage. Notice the overlap? How can a cooler be a piece of equipment and a fixture? Based on the definition under Article 9, a fixture is anything that is "so related to a particular property."

> **What are fixtures?** Fixtures are "goods that have become so related to particular real property that an interest in them arises under real property law". -- Article 9-102(41)
>
> **What is a fixture filing?** A fixture filing is "the filing of a financing statement covering goods that are or are to become fixtures and satisfying Section 9-502(a) and (b). The term includes the filing of a financing statement covering goods of a transmitting utility which are or are to become fixtures."
> -- Article 9-102(40)

The key is "so related," which indicates the item isn't permanent, but is still physically attached to the real property. You will likely notice a theme here: fixtures are secured to the building or premises, but can be removed if necessary (if their removal won't impact the structural soundness of the building or property).

Let's go back and look at the example of headboards and external signage. Headboards are often affixed to the wall, but could be removed without compromising the physical integrity of the hotel (i.e. a removed support beam would compromise the hotel, but simply changing out a headboard that is secured to the wall won't make the building tumble to the ground). Similarly, the signs you see outside the hotel, identifying it as a Holiday Inn or Marriott, are attached to the building, but not permanent (the same could be said for signs identifying restaurants).

If we look closer at the differentiation of a cooler being a piece of equipment versus a fixture, the answer is gray at best. *Wait, what?* If the equipment is affixed to the floor or walls, yet is still removable, it could be considered a fixture.

For example, a cooler that has been bolted to the wall and secured to the floor, like a walk-in cooler, would likely be a fixture. Whereas, a display cooler that holds soda, (those that you often see in grocery stores at the checkout line), can easily be moved as needed.

Here's another example from NCS' Jerry Bailey: "If it's a restaurant and I put a copier in that business, that business could still run if the copier was removed. They could still run the restaurant, so, in that case, it's not a fixture. If it's a restaurant and I put a stove in there and I take the stove out, the restaurant can't continue to cook food, so if the restaurant can't continue to cook the food, then the stove is very much a fixture."

Although a fixture filing is still a UCC filing, it is recorded in the real property records, which then turns the security interest into a mortgage or lien against the actual property where the fixture is or will be located.

This makes fixture filings immensely beneficial for creditors, in the event their customer tries to sell their business, because the filing clouds the title of the property. This encumbrance alerts potential buyers/sellers that you need to be paid before the filing will be removed from the property – essentially, the filing keeps the property from transferring from one party to another, until the debt is satisfied.

Now, briefly back to the idea that you could also benefit from securing mechanic's lien rights. There are situations where the piece of equipment is considered an improvement to the building, therefore eliminating the fixture filing.

As an example, one of our clients furnishes exhaust hoods, exhaust fans, heaters and other various pieces of equipment for commercial kitchen ventilation systems. Independently, a single piece of equipment, such as an exhaust hood, could be classified as a fixture (because it is affixed to the property). However, if this same piece of equipment is deemed an "improvement to the real property," rights can be secured via the state mechanic's lien statute.

Mechanic's lien statute has its own set of gray-area-challenges, but one important difference to keep in mind is that mechanic's liens are not consensual. Meaning, your customer does not have to sign an agreement permitting you to file a mechanic's lien, unlike the Security Agreement required for UCC filings. If you supply items that rest on the fine line of "fixture" or "improvement to real property" you may want to consider securing your mechanic's lien rights.

Of course, one could argue that a new walk-in cooler is an improvement to a real property (i.e. mechanic's lien) or that a ventilation hood is merely affixed & therefore removable (i.e. a fixture filing), which means that determining whether something is or isn't an improvement to a building will likely require a legal opinion.

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Consignment Filings - Scan-Based Trading
There are two type of consignment:

- "Sale or Return": where goods are delivered to the consignee primarily for retail purposes. In this type of consignment, title passes to the consignee upon delivery, but the consignee remains contractually obligated to return any unused goods.
- "True Consignment": where the goods are delivered to be primarily used by the consignee, but the consignor retains title to the goods. The consignee may either be pulling goods from stock on an as needed basis, or might be testing out goods on a trial basis to determine the necessity of the goods.

How does a true consignment work? The consignor/owner retains title to the delivered goods, while the consignee/recipient holds and attempts to sell the goods. If/When those goods are sold, the owner's security attaches to the proceeds of the sale. If the consignee is unable to sell the goods, they can simply return the goods to the owner.

This falls right into scan-based trading. Grocery stores are a great example of scan-based trading. A creditor provides a grocery store with an inventory of goods. Until those goods are scanned at the counter, the title to those goods remains with the creditor. Once the goods have been scanned/sold, the creditor records the sale and the sold goods leave the inventory.

But, to maintain title to those goods, you must perfect a security interest via a UCC filing. NCS' Jerry Bailey comments on how Article 9 changed consignment sales.

> "Article 9 changed consignments and it basically said, 'Look, that stuff belongs to you, you and your debtor both know that, but nobody else does because there's no public registration, and that's not right.' They call these secret liens because the goods belong to you, but nobody else knows that.
>
> Potential lenders should be able to do a search and see what's there and who it belongs to. So, they said, 'From now on if you're selling under consignment, there should be a public registration.'
>
> There had been instances where banks came in to a business, saw all the inventory and decided they would factor this inventory into their risk analysis and lend based on the inclusion of that inventory. Unfortunately, they didn't realize that of the $1 million worth of inventory they looked at, $300,000 of it was consigned goods and belonged to creditors, so it shouldn't have been factored into the lending."

"...if you're selling under consignment, there should be a public registration."

How the UCC Can Protect You if Your Customer Sells Their Business

The buying and selling of businesses is a common and frequent transaction. Fortunately, UCC filings can act like a security system.

Let's say your customer sells their restaurant; often, there is language within the sale of the business that relieves the buyer of any responsibility from the previous business owner's debt. Ultimately, erasing debt linked to the business becomes a condition of the sale of the business.

Enter your filed & perfected UCC …

> Your UCC filing acts as a lien on the business, therefore, before title passes from one party to another, the lien should be acknowledged and either settled or renegotiated. Check out this success story.
>
> "USF has a long-time customer with several restaurants. The customer is a high-volume account with annual sales exceeding $2M. The credit worthiness of the customer remains unknown as the division does not have financials, only their payment history.
>
> The Credit Team pursued UCC's on all locations to help mitigate risk last year. We were notified that the customer was selling a location which, at the time, had an AR in the mid six figures, all of which was past due. After their attorney did their due diligence, they noticed a lien on the business which prompted a call from the seller inquiring about the UCC. Around the same time, the attorney reached out and asked what was needed to lift the lien. The answer was simple, a lump sum check for the entire balance of $154,000. The sale took place and our Credit Manager was contacted by the attorney who had the check in hand for the full amount. Had we not had the UCC filing in place, we would not have received this payment and very likely, only cents on the dollar.
>
> The end result was a very good month for the division from a performance perspective based on this recovery. This success paid for the cost of filing previous UCC's and future UCC filings for years to come. This was definitely a win when looking at the cost benefit/ROI for securing our receivables with the UCC process and utilizing the services of NCS." – Division Credit Manager, US Foods

Your Customer's Default & Your UCC Filing

Any time your customer has defaulted on payments, it is strongly recommended you take immediate action to recover the funds; the longer an account remains unpaid, the harder it becomes to collect. A great, and relatively inexpensive, first step is to send a Demand Letter. A demand letter is a demand served upon your debtor, advising that legal action may be taken if payment is not received within a specified time frame.

In the event the demand letter does not prompt payment, you may need to proceed with further legal action. Your next course of action is dictated by the type of UCC you filed.

Did you file a PMSI UCC?
If your customer has defaulted on payment(s) and you have filed a PMSI, you need to determine whether you would like your equipment/inventory back.

- If you do not want your goods back, you can place your claim with an attorney to file suit. By filing suit, you may receive Judgment, which allows you to garnish accounts and/or attach to assets.
- If you do want your goods back, and your customer has the goods, you have the right to repossess **without disturbing the peace.**

If you are unable to peacefully repossess the inventory/equipment, you could take legal action by filing a temporary restraining order or by filing suit against your debtor.

Did you file a Blanket UCC?
If your customer has defaulted on payment(s) and you have filed a Blanket UCC, you could place the outstanding debt with a collection agency or file suit against your debtor.

Has your customer filed bankruptcy? *Keep in mind, the bankruptcy court freezes all debtor assets.*

- If your customer filed Chapter 7: File your secured proof of claim, regardless of whether you filed either a PMSI or Blanket UCC.
- If your customer filed Chapter 11:
  - o PMSI UCC: If you would like your goods back and your goods are at your customer's location, contact the Trustee to repossess. If the Trustee is uncooperative, you may need to take additional legal action.
  - o Blanket Filing: File a secured proof of claim and monitor for distribution.

Secured Creditor Success

"Do secured creditors really get paid?" Yes, secured creditors do get paid -- although every bankruptcy exit plan is different. Here are a few bankruptcy cases, which demonstrate the immense benefit of being a secured creditor rather than an unsecured creditor.

- In the Hostess Brands Inc. bankruptcy, secured creditors received 100% of their claims, while unsecured creditors received 0%.
- In the Buffets, LLC bankruptcy, secured creditors received 100% of their claims and unsecured creditors received 5% of their claims.
- In the Uno Pizzeria & Grill bankruptcy, secured creditors received 100% of their claim and unsecured creditors received 13% of their claims.
- In the Quaker Steak & Lube bankruptcy, secured creditors are to receive 100% of their claims and unsecured creditors are to receive 60% of their claims. (At the time this article was written, the organization plan for this bankruptcy was nearing final approval.)

Disclaimer: In larger Chapter 11 re-organizations the secured creditor may receive stock options or another form of payment instead of money. The information presented here illustrates that secured creditors are in the best possible position to get paid. However, this assessment does not guarantee a payout in future bankruptcies.

"Do secured creditors really get paid?" Yes, secured creditors do get paid.

UCCs at Work: More Than Risk Reduction

With 60% of restaurants failing in the first three years, and little surviving beyond five years, are you willing to take the risk of losing money? If you are not securing your rights through UCC filings, you are taking an unnecessary risk and allowing your company to be competitively disadvantaged.

UCC filing is more than reducing risk; it's about the opportunity to expand your market and increase sales, by providing you with the security needed to sell to marginal accounts and to increase existing clients' credit lines.

To Learn more:

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