

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF TEXAS
SAN ANTONIO DIVISION**

IN RE:	§	
SCHLOTZSKY'S, INC.	§	CASE NO. 04-54504
SCHLOTZSKY'S RESTAURANTS, INC.	§	CASE NO. 04-54506
SCHLOTZSKY'S REAL ESTATE, INC.	§	CASE NO. 04-54507
SCHLOTZSKY'S FRANCHISOR, LLC	§	CASE NO. 04-54508
SCHLOTZSKY'S FRANCHISE OPERATIONS, LLC	§	CASE NO. 04-54509
SCHLOTZSKY'S BRAND PRODUCTS, LLC	§	CASE NO. 04-54510
DFW RESTAURANT TRANSFER CORP.	§	CASE NO. 04-54511
56 TH AND 6 TH , INC.	§	CASE NO. 04-54512
RAD ACQUISITION CORP.	§	CASE NO. 04-54513
SAN FELIPE, LLC	§	CASE NO. 04-54514
	§	CHAPTER 11
	§	(Motion for Joint Administration Pending)

**DEBTORS' EMERGENCY MOTION FOR INTERIM AND FINAL ORDER
AUTHORIZING USE OF CASH COLLATERAL**

TO THE HONORABLE UNITED STATES BANKRUPTCY JUDGE:

Schlotsky's, Inc. ("SI"), Schlotsky's Restaurants, Inc. ("Restaurants"), Schlotsky's Real Estate, Inc. ("Real Estate"), Schlotsky's Franchisor, LLC ("Franchisor"), Schlotsky's Franchise Operations, LLC ("Franchise Operations"), and Schlotsky's Brand Products, LLC ("Brand Products"), DFW Restaurant Transfer Corp. ("DFW"), 56th and 6th, Inc. ("56th and 6th"), RAD Acquisition Corp., and San Felipe, LLC ("San Felipe") (collectively, "Schlotsky's" or the

“Debtors”), files this Debtors’ Emergency Motion for Interim and Final Order Authorizing Use of Cash Collateral (the “Motion”), and respectfully represent as follows:

I. JURISDICTION AND VENUE

1. The Court has jurisdiction over the subject matter of this Motion pursuant to 28 U.S.C. § 1334(b) and this matter is a core proceeding under 28 U.S.C. §§ 157(b)(1) and 157(b)(2)(A), (D), (G), and (M). Venue in this Court is proper under 28 U.S.C. §§ 1408 and 1409.

II. BACKGROUND

2. The Bankruptcy Cases. On August 3, 2004 (the “Petition Date”), the Debtors filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code (the “Bankruptcy Code”) in the United States Bankruptcy Court for the Western District of Texas, San Antonio Division.

3. Since the Petition Date, the Debtors have managed their affairs and conducted their businesses as debtors-in-possession, pursuant to sections 1107 and 1108 of the Bankruptcy Code. No trustee has been appointed in the Debtors’ Chapter 11 cases.

4. The Debtors’ Businesses. SI, through its wholly-owned subsidiaries, is a franchisor and operator of restaurants in the fast casual sector under the Schlotzsky’s brand. Schlotzsky’s restaurants offer a current menu of hot sandwiches and pizza served on their proprietary buns and crusts as well as wraps, chips, salads, soups, desserts and beverages.

5. As of August 2, 2004, the Schlotzsky’s system included 471 domestic franchised restaurants, twenty-one (21) company-owned restaurants (“Company Restaurants”) and twenty-one (21) international franchised restaurants located in thirty-six (36) states, the District of Columbia, and six (6) foreign countries.

6. In 2003, the Schlotzsky's system generated revenues of approximately \$56.2 million through two business segments: franchise operations and restaurant operations. The Franchise Operations segment is a key source of revenues for Schlotzsky's through royalties that Franchisor collects from its franchisees for the use of trademarks and operating systems and license fees that Brand Products receives from manufacturers and supply chain managers of Schlotzsky's brand products. Several brand products, including chips, cheeses and meats, are available for retail sale in grocery and other retail stores. The Restaurant Operations segment operates the Company Restaurants.

7. Schlotzsky's, Inc. SI is a Texas corporation with executive offices located at 203 Colorado Street, Suite 600, Austin, Texas 78701. SI is the parent corporation of Franchisor, Restaurants, Real Estate, Franchise Operations, DFW and RAD. SI has approximately one hundred nine (109) employees, including the corporate office staff and the restaurant managers of the Company Restaurants.

8. Schlotzsky's Franchisor, LLC. Franchisor is a Delaware limited liability company wholly owned by SI and is the parent company of Brand Products. Franchisor is the "Franchisor" or "Grantor" under all franchise agreements, area developer agreements and master license agreements, owns Schlotzsky's intellectual property, including the trademarks, and also licenses Brand Products the right to sublicense private label use of the Schlotzsky's brand. Franchisor has no employees.

9. Schlotzsky's Brand Products, LLC. Brand Products is a Delaware limited liability company wholly owned by Franchisor. Brand Products receives license fees from licensed third party manufacturers and supply chain managers based on their sales of

Schlotzsky's brand products to distributors who in turn sell to the Schlotzsky's restaurant system and to retail outlets. Brand Products has no employees.

10. Schlotzsky's Restaurants, Inc. Restaurants is a Texas corporation wholly-owned by SI and is the parent corporation of 56th and 6th. Restaurants operates the twenty-one (21) Company Restaurants. Fifteen (15) of these Company Restaurants are in Schlotzsky's long-term portfolio that Schlotzsky's intends to operate for the purposes of leadership of the franchise system and, in certain cases, to stimulate the redevelopment of certain markets. These stores also are used to demonstrate sales potential and key operating metrics, to build brand awareness, and to serve as laboratories for product development, concept refinement, product and process testing, and training. In addition, Schlotzsky's operates six (6) Company Restaurants that were developed for or acquired from franchisees and are expected to be operated until those stores are re-franchised or otherwise divested. Restaurants has approximately 625 employees.

11. Schlotzsky's Franchise Operations, LLC. Franchise Operations is a Delaware limited liability company wholly owned by SI. Franchise Operations is party to a management agreement pursuant to which it manages, services and administers certain assets owned by Franchisor, Brand Products, and two SI affiliates, Schlotzsky's N.A.M.F., Inc. and Schlotzsky's NAMF Funding, LLC, including all franchise agreements, area developer agreements and master license agreements, all Schlotzsky's intellectual property, including trademarks, and also all licensing by Brand Products of private label use of the Schlotzsky's brand. Franchise Operations has approximately 22 employees.

12. Schlotzsky's Real Estate, Inc. Real Estate is a Texas corporation wholly-owned by SI. Real Estate is party to a number of real estate mortgage and lease contracts and

documentation for the Company Restaurants that are operated by Restaurants. Real Estate has no employees.

13. DFW Restaurant Transfer Corp. DFW is a Texas corporation wholly-owned by SI. DFW serves as the Area Developer under certain Area Developer Agreements that were re-purchased by Schlotzsky's through DFW and holds certain real estate and equipment leases and contracts associated with several recently closed Company Restaurants in Georgia, Mississippi and Utah. Pursuant to these Area Developer Agreements, DFW performs certain ongoing services for franchisees in its area developer territories and receives a percentage of the gross sales from those franchisees. DFW has no employees.

14. RAD Acquisition Corp. RAD is a Texas corporation wholly-owned by SI. RAD serves as the Area Developer under certain Area Developer Agreements that were re-purchased by Schlotzsky's through RAD and holds certain real estate and equipment leases and contracts associated with recently closed Company Restaurants in Tennessee and New Mexico. Pursuant to these Area Developer Agreements, RAD performs certain ongoing services for franchisees in its area developer territories and receives a percentage of the gross sales from those franchisees. RAD has no employees.

15. 56th & 6th, Inc. 56th & 6th is a Texas corporation wholly-owned by Restaurants. 56th & 6th is party to certain Franchise Agreements and other agreements related to the operation of three now closed Schlotzsky's restaurants in New York and Tennessee. 56th & 6th no longer has employees.

16. San Felipe, LLC San Felipe is a Texas limited liability company that is owned 50% by SRI and 50% by a third party named Uptown Restaurants, Inc. Restaurants has sole right and authority to control the operations of San Felipe. As a Special Member, Uptown

Restaurants, Inc.'s sole right is to receive a Special Member Cash Distribution to be paid in monthly installments through September 2006. San Felipe, LLC operates one Schlotzsky's restaurant in Texas and has approximately twenty (20) employees.

III. RELIEF REQUESTED AND BASIS THEREFOR

17. The Debtors seek authority pursuant to §§ 105, 361, 363(c)(2) and (e) of the Bankruptcy Code and Rules 4001(b) and 9014 of the Federal Rules of Bankruptcy Procedures to use the alleged cash collateral of Commercial National Bank ("CNB"), NS Associates I, Ltd. ("NSA"), and Jeff and John Wooley ("Wooleys") (collectively, the "Franchisor Secured Creditors"). The Franchisor Secured Creditors claim liens in substantially all the assets of Franchisor which include the royalties paid by Schlotzsky's franchisees and the license fees from third parties who manufacture and sell private label products under the Schlotzsky's name (the "Franchisor Collateral"). Additionally, NSA claims first priority liens on, and security interests in, (a) all of SI's stock or membership interest and related rights in each of Franchisor and DFW and (b) substantially all of the assets of DFW (the "Additional NSA Collateral").

18. NSA's security interest in the Franchisor Collateral is subordinate to the security interest of CNB, and senior to the security interest of the Wooleys in the Franchisor Collateral.

19. The Debtors have an immediate need for use of cash collateral, as that term is defined in Section 363(a) of the Bankruptcy Code, in compliance with the budget attached hereto as **Exhibit "A."**

20. Absent the ability of the Debtors to use Cash Collateral, the Debtors will not be able to operate their businesses, and the Debtors, their creditors and estates will suffer irreparable harm as a result of the loss of the Debtors' going concern value. The use of Cash Collateral, subject to and within the limits imposed by the Budget, is necessary to prevent immediate and

irreparable harm to the Debtors' estates and this Interim Order provides solely for the use of Cash Collateral for these limited purposes.

21. In addition to the cash flows that constitute Franchisor Collateral and the Additional NSA Collateral, the Debtors have unencumbered cash flows from the restaurants owned and operated by Restaurants. These funds allow Restaurants to pay all of the direct expenses of operating the restaurants, including payroll. Restaurants also contributes funds to SI for corporate overhead expenses.

22. Franchisor has also contributed to meeting the Debtors' operating expenses by funding the expenses of Franchise Operations which, as indicated above, manages, services and administers the assets of Franchisor. Franchisor has also "upstreamed" funds to SI to cover the corporate overhead expenses allocable to the management, servicing and administration of the Franchisor assets and to maintain the viability of the franchise system.

23. The interests of the Franchisor Secured Creditors in the post-petition cash generated by the Franchisor Collateral (the "Cash Collateral") are adequately protected by granting to the Franchisor Secured Creditors post-petition replacement liens in the Franchisor Collateral and by the investment of the Cash Collateral to maintain the operation of the Schlotzsky's franchise system, without which, the value of the Franchisor Collateral would be severely diminished. Further, pursuant to the Budget, Franchisor plans to make the regularly scheduled monthly payment of \$190,000 due to CNB under its loan agreement. In connection with the entry of a Final Order, the Debtors anticipate making post-petition interest payments to NSA.

24. Section 363(c)(2) of the Bankruptcy Code provides that a debtor may not use, sell, or lease cash collateral unless: "(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 in accordance with the provisions of this section.” 11 U.S.C. § 363(c)(2).

25. The relief requested in this Motion is appropriate because the Debtors’ use of Cash Collateral is essential to preserve and maximize the value of the Debtors’ bankruptcy estates. Although the Debtors have considerable assets, they have limited unencumbered funds and are, therefore, dependent upon obtaining immediate Court approval for their use of Cash Collateral. In the absence of Court authority to use the Cash Collateral, serious and irreparable harm to the Debtors and their estates will occur and the value of the Debtors’ estates will be diminished. The use of Cash Collateral to support the Debtors’ franchise operations is essential to protecting the value of the Franchisor Collateral and inures, in the first instance, to the benefit of the Franchisor Secured Creditors.

26. The purpose of adequate protection under section 361 is to protect a secured creditor from diminution in the value of its interest in the collateral at issue during the period of the use of such collateral. *See United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd. (In re Timbers of Inwood Forest Associates, Ltd.)*, 793 F.2d 1380, 1389 (5th Cir. 1986) (adequate protection is intended to protect secured creditors from a decrease in value of its collateral); *Thomas Jefferson Const. Co., Inc. v. Martinez*, 1997 WL 375880, *2 (E.D. La. 1997) (adequate protection provisions of the Bankruptcy Code were intended to protect a secured creditor against a decrease in value of its collateral); *In re Ledgemere Land Corp.*, 116 B.R. 338, 343 (Bankr. D. Mass. 1990) (creditor should receive adequate protection only where there is a decrease in value of the collateral). Here, the Debtors are requesting authority to use Cash Collateral to protect the value of the Franchisor Collateral through maintaining franchise operations and protecting the Schlotsky’s brand.

27. Whether or not a creditor is adequately protected is determined on a case-by-case basis. *See In re Self*, 239 B.R. 877, 881 (Bankr. N.D. Tex. 1999) (determination of adequate protection is not an “exact science” rather, it requires a court to balance all relevant factors); *In re O’Connor*, 808 F.2d 1393, 1396 (10th Cir. 1987) (stating that the concept of adequate protection is a flexible one and that courts should determine whether it exists on a case-by-case basis); *In re JKJ Chevrolet, Inc.*, 190 B.R. 542, 545 (Bankr. E.D. Va. 1995) (stating that adequate protection is determined on a case-by-case basis).

28. Here, the Franchisor Secured Creditors are adequately protected because the value of the Franchisor Collateral is not decreasing. Once the Debtors have shown that the value of the collateral adequately protects the secured creditor, the collateral “may be used by the debtor for the general benefit of the estate and need not be devoted exclusively to the protection of the creditor or the collateral.” *In re Triplett*, 87 B.R. 25, 27 (Bankr. W.D. Tex. 1988). Without the ability to use the Cash Collateral, the Debtors and their creditors will suffer immediate and irreparable harm. *See e.g., In re Aqua Assocs.*, 123 B.R. 192, 195 (Bankr. E.D. Pa. 1991) (when determining whether adequate protection exists, the important question is whether the secured creditor’s interest is being unjustifiably jeopardized).

29. The Debtors request pursuant to Bankruptcy Rule 4001(b)(2) the allowance of use of the Cash Collateral on an interim basis until the Final Hearing is held on notice pursuant to § 363(b)(3) of the Bankruptcy Code and Bankruptcy Rule 4001(b)(3) and a Final Order is entered by this Court.

IV. NOTICE

30. Bankruptcy Rules 4001(b) and 4001(c) provide that a final hearing on a motion to use cash collateral pursuant to section 363 of the Bankruptcy Code may not be commenced

earlier than fifteen (15) days after the service of such motion. Upon request, however, the Court is authorized to conduct a preliminary expedited hearing on the motion and authorize the use of cash collateral to the extent necessary to avoid immediate and irreparable harm to a debtor's estate. Such relief is routinely granted in chapter 11 cases in this and other districts.

31. Notice of the hearing on the relief sought herein was provided by facsimile transmission or hand delivery to the Franchisor Secured Creditors asserting a security interest in the Debtors' assets as presently identified, the office of the United States Trustee for the Western District of Texas, **and the counsel for the Official Unsecured Creditors' Committee**, with first class mail notice provided to each of the Debtors' twenty largest unsecured creditors as presently identified, and other parties in interest. The Debtors submit that such notice is sufficient and adequate pursuant to Rules 2002, 4001, 9006, and 9014 of the Federal Rules of Bankruptcy Procedure and as required by §§ 102(1) and 363 of the Bankruptcy Code. The Debtors also believe that no further notice of, or hearing on, the relief sought in this Motion is necessary or required.

32. In light of the nature of the relief requested herein, the Debtors respectfully submit that the Court may enter the Interim Order granting the relief requested without further notice. Shortened notice, particularly of the interim relief requested herein, is appropriate given the urgent need to use the Cash Collateral. Such notice complies with § 102(1) of the Bankruptcy Code. A Final Hearing on the relief requested herein should be set upon at least fifteen (15) days notice as required by Rule 4001(b)(2) of the Federal Rules of Bankruptcy Procedure, consistent with a timetable to allow the Debtors operations to continue. The Debtors shall serve notice of this hearing upon all of the foregoing parties as well as (i) parties requesting notice under Rule 2002 of the Federal Rules of Bankruptcy Procedure; (ii) other secured

creditors and parties in interest identified as having an interest in the relief requested herein, if any; (iii) any appointed committees; and (iv) any other parties otherwise entitled to notice of the proceedings initiated herein.

WHEREFORE, the Debtors respectfully request that the Court enter an Order (i) granting this Motion in full and in all respects; and (ii) granting to the Debtors such other and further relief to which the Debtors may be justly entitled.

RESPECTFULLY SUBMITTED THIS 3RD DAY OF AUGUST, 2004.

HAYNES AND BOONE, LLP

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PROPOSED ATTORNEYS FOR THE DEBTORS
AND DEBTORS IN POSSESSION

Schlitzky's, Inc. and Subsidiaries
Cash Plan

	Entity	Description	Projected 6-Aug	Projected 13-Aug	Projected 20-Aug
	SRI	Restaurant Sales	425,000	425,000	425,000
	SI	Other	-	-	-
	Franchisor	Royalties	225,000	250,000	225,000
	Franchisor	Master Franchise Fee	-	-	-
	Franchisor	Brands License Fees	20,000	20,000	315,570
	SFO	NAMF Reimbursement	-	27,000	-
		San Felipe Funds	-	-	-
		Total Inflows	<u>670,000</u>	<u>722,000</u>	<u>965,570</u>
Payroll/Insurance	SI	Payroll and Health Insurance	30,000	226,000	20,000
Payroll	SRI	Payroll and Health Insurance	210,000	15,000	210,000
	SFO	Payroll	-	99,000	-
Notes Payable	Franchisor	Commerce National Bank Payment	-	190,000	-
Notes Payable	DFW	NS Associates	-	44,000	-
Notes Payable	Franchisor	JCW/JW monthly Payment	-	-	-
Notes Payable	SRI	GE Notes Payable	-	-	-
Notes Payable	SRI	State Bank NP	-	-	-
		Thomas Payment	-	-	-
Notes Payable	SRE	American Bank of Commerce	-	-	-
Notes Payable	SRI	Texas Coffee Traders	-	-	5,000
Rent	SI	203 Colorado Lease and Parking	-	-	-
Rent	SI	Trammell Crow - Corporate storage	-	-	-
Rent	SRI	Balcones Woods	-	-	-
Rent	SRI	Pearl, MS	-	-	-
Rent	SRI	Guadalupe	-	-	-
Rent	SRI	University - College Station	-	-	-
Rent	SRI	Littlefield	-	-	-
Rent	SRI	Southwood - College Station	-	-	-
Rent	SRI	Brodie Oaks	-	-	-
Rent	SRI	218 Lamar	-	-	-
Rent	SRI	218 Lamar	-	-	-
Rent	SRI	Northcross	-	-	-
Rent	SRI	Parmer	-	-	-
Rent	San Felipe	San Felipe	-	-	-
Property Taxes	SI/SRI	Texas County Property Tax Payment Plan	-	-	-
	SI/SRI	State Franchise Taxes	-	-	-
Sales Taxes	SRI	Expected June remittances	-	-	160,000
Vendor/Employee	SI/SRI/SFO	Employee Expense Reports/Utilities/Vendors	125,000	85,000	85,000
Franchisor	Franchisor	Independent Directors	-	-	-
	Franchisor	Commerce National Bank Legal Fees	25,000	-	-
Vendor	SI	Edi Cusheil	-	-	-
Vendor	SI	UCC Financial Advisor	-	-	-
Vendor	SI	Trinity	-	-	10,000
Vendor	SI	UCC	-	-	-
Vendor	SI	Haynes and Boone	-	-	-
Vendor	SI	Insurance	-	-	-
Vendor	SI	Opletree	4,000	-	-
Vendor	SUSFO	Legal - Franchise Issues	10,000	10,000	10,000
	Franchisor	NS Legal Fees	-	-	-
Vendor	SRI	Vistar - Food Supplier	-	45,000	110,000
Vendor	SRI	Labatt - Food Supplier	6,000	6,000	6,000
	SRI	Vistar Deposit	330,000	-	-
Vendor	SRI	Other Payables	-	15,000	15,000
		Voided Checks	-	-	-
		Outflows	<u>740,000</u>	<u>735,000</u>	<u>631,000</u>
		Net Change	<u>(70,000)</u>	<u>(13,000)</u>	<u>334,570</u>
		Ending Cash Balance	<u>299,000</u>	<u>286,000</u>	<u>620,570</u>

