

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

IN RE:	§	
	§	
SCHLOTZSKY'S, INC.	§	CASE NO. 04-54504
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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
	§	
56TH AND 6TH, INC.	§	CASE NO. 04-54512
	§	
RAD ACQUISITION CORP.	§	CASE NO. 04-54513
	§	
SAN FELIPE, LLC,	§	CASE NO. 04-54514
	§	
Debtors.	§	CHAPTER 11
	§	(Motion for Joint Administration Pending)
	§	

**DEBTORS' EMERGENCY MOTION TO ESTABLISH PROCEDURES
FOR TREATMENT OF RECLAMATION CLAIMS**

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"), Schlotsky's Brand Products ("Brand Products"), DFW Restaurant Transfer Corp. ("DFW"), 56th and 6th, Inc. ("56th and 6th"), RAD Acquisition Corp. ("RAD"), San Felipe, LLC ("San Felipe") (collectively, "Schlotsky's" or the "Debtors"), files this

their Debtors' Emergency Motion to Establish Procedures for Treatment of Reclamation Claims (the "Motion"), and respectfully represent as follows:

I. JURISDICTION AND VENUE

1. This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. This Motion is a core proceeding under 28 U.S.C. §§ 157(b)(1) and 157(b)(2)(A). Venue is proper in this Court under 28 U.S.C. §§ 1408 and 1409. The statutory predicate for the relief sought in the Motion is 11 U.S.C. § 546(c).

II. BACKGROUND

2. 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.

3. 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.

4. 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.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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.

10. 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.

11. 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.

12. 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

Schlotszky'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.

13. 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 Schlotszky's restaurants in New York and Tennessee. 56th & 6th no longer has employees.

14. 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 Schlotszky's restaurant in Texas and has approximately twenty (20) employees.

III. RELIEF REQUESTED

15. The Debtors anticipate that they will receive numerous reclamation demands from suppliers and other creditors in the days following the Petition Date. By this Motion and pursuant to 11 U.S.C. § 546(c), the Debtors request that the Court establish the following guidelines and procedures for the treatment of timely-asserted reclamation claims against the Debtors:

- a. Any supplier or other creditor asserting a reclamation claim must assert its reclamation claim in compliance with the requirements of section 546(c) and applicable state law;

- b. Notwithstanding any reclamation demand that would require the Debtors to segregate the assets subject to the reclamation demand, the Debtors would be authorized to use, in the ordinary course of their business operations and without interruption, the goods, products, and raw materials provided by suppliers and other trade creditors that may be subject to reclamation claims;
- c. In lieu of physical reclamation, to the extent it is later determined by the Court that a particular supplier or other trade creditor has a valid reclamation claim, such creditor would be granted a claim with the same priority as an administrative expense claim under 11 U.S.C. § 503(b), subject to any prior-perfected security interests and only to the extent priority treatment for reclaiming creditors is authorized by the Bankruptcy Code and applicable law, as may be determined by further court order; and
- d. In any proceeding commenced to determine the validity or amount of any reclamation claim, the supplier or other trade creditor asserting the claim will bear the initial evidentiary burden of establishing the validity of its reclamation claim under section 546(c) and applicable state law by a preponderance of the evidence.

IV. ARGUMENTS AND AUTHORITIES

16. Section 546(c) of the Bankruptcy Code preserves, to a limited extent, a seller's right to reclamation under applicable state law.¹ In pertinent part, section 546(c) provides:

(c) Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547 and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but –

(1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods –

¹ In the case of credit sales, a seller's reclamation rights usually arise under U.C.C. § 2-702, as adopted by the particular state. In pertinent part, section 2-702 provides:

(2) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this subsection the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or intent to pay.

(3) The seller's right to reclaim under subsection (2) is subject to the rights of a buyer in ordinary course or other good faith purchaser under this Article (Section 2-403). Successful reclamation of goods excludes all other remedies with respect to them.

U.C.C. § 2-702 (2002). If the seller successfully establishes the required elements, it will be entitled to return of the subject goods, to the exclusion of any other available legal remedy with respect to those goods.

- (A) before 10 days after receipt of such goods by the debtor; or
- (B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor.

Section 546(c) is intended “to recognize, in part, the validity of section 2-702 of the Uniform Commercial Code.” *See* Notes of Committee on the Judiciary, Senate Report No. 95-989.

17. Section 546(c) is the exclusive reclamation remedy in bankruptcy. *See, e.g., Oakland Gin Co., Inc. v. Marlow (In re Julien Co.)*, 44 F.3d 426 (6th Cir. 1995); *Flav-O-Rich, Inc. v. Rawson Food Serv., Inc. (In re Rawson Food Serv., Inc.)*, 846 F.2d 1343 (11th Cir. 1988). Therefore, once a bankruptcy petition has been filed, a vendor may exercise its reclamation rights only if it has met the requirements outlined in section 546(c). If the vendor does not have reclamation rights under applicable nonbankruptcy law, then the rights and protections afforded in section 546(c) are unavailable. The vendor bears the burden of proving all elements of its reclamation rights by a preponderance of the evidence. *See Rawson Foods*, 846 F.2d 1343.

18. Notwithstanding a vendor’s proper perfection of its reclamation claim, bankruptcy courts have discretion under § 546(c) to deny a seller the ability to reclaim its goods. Specifically, that statute empowers the bankruptcy court to deny reclamation to a vendor only if the court (i) grants the vendor’s reclamation claim the same priority as an administrative expense claim under 11 U.S.C. § 503(b) or (ii) secures the reclamation claim with a lien. *See* 11 U.S.C. § 546(c)(2). That remedial discretion permits a bankruptcy court to fashion alternative relief to physical reclamation when the subject goods are needed to effectuate the contemplated reorganization. *See, e.g., Pester Ref. Co. v. Ethyl Corp. (In re Pester Ref. Co.)*, 964 F.2d 842 (8th Cir. 1992); *Eagle Indus. Truck Mfg., Inc. v. Cont’l Airlines, Inc. (In the Matter of Cont’l Airlines, Inc.)*, 125 B.R. 415 (Bankr. D. Del. 1991); *McCain Foods, Inc. v. Flagstaff Foodservice Corp.*, 14 B.R. 462 (Bankr. S.D.N.Y. 1981).

19. Because reorganization is the goal of a financially distressed but honest debtor, “Congress gave the court the latitude Section 546(c)(2) gives it to ensure that the debtor’s continued operation would not be adversely affected by the improvident grant to a seller of the right to retrieve its goods in the debtor’s possession.” *Flagstaff Foodservice*, 14 B.R. at 468. Consequently, “granting the relief of physical reclamation is discretionary.” *Cont’l Airlines*, 125 B.R. at 417. In deciding reclamation issues, “the court must weigh the debtor’s need for the goods in light of the [Bankruptcy] Code’s policy encouraging companies to reorganize against the seller’s right to physically reclaim the goods.” *Id.*

20. The Debtors believe that the requested procedures for resolving reclamation claims are necessary to prevent supply interruptions and severe and irreparable injury to their business operations at a time when customer loyalty and patronage is critical. The success and ultimate viability of the Debtor’s businesses depends on immediate utilization of the goods, products, and raw materials that may be the subject of reclamation claims. If suppliers or other trade creditors are allowed to reclaim certain assets or if the Debtors are required to segregate those assets, there could be disastrous interruptions in the Debtor’s business operations and the distribution of its products to customers. Furthermore, the disruption and adverse publicity that would result would threaten the Debtors’ customer bases and force an effective shut down of their business operations, which could severely impair, or possibly eliminate, any possibility for a successful reorganization.

21. The Debtors do not propose to resolve, in the context of this Motion, the issue of the extent a reclamation seller is entitled to an administrative expense claim or lien if physical reclamation is denied. The Debtors, however, reserve the right to raise such issue in the future.

WHEREFORE, the Debtors request that the Court enter an order (i) approving the procedures for the treatment of reclamation claims as set forth herein and (ii) granting to the Debtors such other legal and equitable 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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