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Corporate governance, strategy and corporations law

The case of Jack in the Box Inc.

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Abstract *The US restaurant industry and the food-service industry have undergone tremendous changes during the last decade owing to demographic changes, changes in the family structure, the increase in the number of working women and senior citizens, advances in technology (inventory management, customer order processing, accounting/financial systems, etc.), availability of financing, changes in the real estate industry (location, negotiation with malls, relationships with developers, etc.), intense competition, the growth in the types and number of marketing channels (including the Internet), increasing number of drive-through customers, employee training requirements, changes in labor laws, the rate of implementation of technology, changes in food sourcing/purchasing, the growth of the franchising business model, and increasing regulation. These factors have combined to shape the strategic, legal, economic and operational considerations that executives and decision makers should thoroughly understand. This article discusses the issues and challenges facing one company in these two industries and how management and banks have reacted, and then explains strategies for the future. Also discussed are relevant considerations for financial sponsors and companies. Most data and analysis are as of April 2000.*

Introduction

Jack in the Box (JBX) operates and franchises fast food restaurants in located primarily in the western and southern USA. It had annual revenues of about $1.5 billion, and about 39,000 employees. Its headquarters is in San Diego, California. JBX's operations raises several strategy and leadership issues. JBX offers a diverse menu that appeals to a wide cross-section of customers in the 18-34 age range. The menu items include traditional hamburgers, Mexican food, specialty sandwiches, finger food and the value-priced menu items for price conscious customers. JBX's offerings enable it to attract a wider customer base, and to differentiate itself from other chains. Between 1995-2000, JBX achieved the following:

- initiated improvements in food preparation and service;
- improved training and retention of employees;
- installed new menu boards and an electronic order confirmation system for drive-through customers which account for over 63 percent of JBX's revenues; and
- standardized specifications for food preparation, maintenance, conduct and appearance of employees.

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The restaurant industry and the fast food sector are highly competitive, and are affected by changes in customer tastes and preferences, location, demographic trends, pedestrian and motor traffic, consumer income, family structure, quality of food service and value of food service. JBX competes directly with companies that are substantially larger in size and scope, and have better access to capital. The fast food segment is poised to grow as more customers allocate more of their spending to fast food. Customers presently spend over 52 percent (up from 43 percent four years ago) of their total food expenses on fast food, thus, such expenses may not be considered discretionary, and should not be evaluated on the basis of disposable income, but are indicative of a new pattern of lifestyle – the status of the California and Texas economies are much less relevant to JBX's growth. The advent of the Internet will make it easier and faster for customers to order fast food, particularly for JBX's drive-through customers who account for over 63 percent of JBX's revenues. The growth of the number of working-age persons with two or more jobs, entertainment overload, relatively high divorce rates, growth of double income families, and increased female participation in the workforce, will increase revenues of fast food chains. Same store average sales for competing restaurants increased by about 9.0 percent in fiscal year 1999 owing to increases in both the number of transactions and the average check amount per transaction. JBX's gross revenues increased by 23 percent in fiscal year 1999, and its same store sales have maintained an annual growth rate of about 7 percent over the last few years.

Challenges

JBX faces numerous challenges as it strives to adapt to changes in the industry – these issues span a broad range of areas such as human resources management, regulatory compliance, capital structure, marketing, cost structure, competition, inventory management, real estate finance and development, international expansion and corporate strategy.

However, several trends are transforming the restaurant sector, some of which will improve credit quality and profitability:

- information systems will improve real time control of operations, financial management, inventory management and storage of products;
- the increasing popularity of franchising will stabilize operations – failing franchise stores are turned over to franchisors rather than being closed; and franchisors can often provide lease guarantees;
- changes in demographics and consumer behavior favor restaurants;
- although most firms have negative working capital, industry debt levels are relatively low;
- increased advertising for name recognition, brand image and product differentiation;

- increasing use of leasing as opposed to ownership of restaurant buildings/spaces;
- regional consolidation, and international expansion by some chains;
- better recruitment and training of franchisees and staff;
- segments: full-service, quickserve or “fast food”, away-from-home managed institutions for schools and hospitals, and other food businesses such as hotels, and catering;
- franchising is integral to the industry, but there is overabundance of supply in some markets;
- casual dining restaurants has had higher growth than the rest of the industry;
- finding qualified labor at reasonable prices remains a problem;
- supermarkets and convenience stores are increasing competition by offering “ready meals”;
- advertising partnerships, customer complaint resolution, faster payment transactions, and reduction of credit card fraud and transaction fees are important for profitability.

Creation of brand image and name recognition

JBX uses a combination of TV and radio ads, in-store visuals and varied menu, to create a brand image that targets a wide variety of customers, and is the best means to reach its target audience – adults in general and 18-34 year old males in particular. To date, JBX’s mascot “Jack” has been used to define the company’s image and has raised customer awareness of the brand, and association to the “variety” concept. JBX is focusing on maintaining a strong brand image, targeting an attractive demographic segment, and providing excellent service. However, JBX’s marketing has not been sufficient to define its brand and to substantially differentiate itself from others.

Key managers did not have employment agreements

JBX has a strong team of experienced management that has focused on improving quality and brand image, reducing costs and expanding operations. A significant number of its senior managers have worked at JBX for over 18 years, and have held senior management positions at competing firm such as Wendy’s. JBX’s insiders own about 21 percent of its common stock. JBX’s operations are dependent on the continued employment of key managers (Robert Nugent, President and CEO, Charles Duddles, CFO and CAO, and Kenneth Williams, EVP), none of whom had employment agreements as of April 2000. This factor obviously affects management’s motivation and security.

Intense competition

The $310+ billion US restaurant industry and its $60+ billion fast food segment are highly competitive and are very sensitive to increases in labor costs and food prices (Standard & Poors Restaurant Industry Report; Standard & Poors Retail Industry Report; trade journals). Although the fast-food segment is dominated by a few firms such as Macdonald's and Burger King, JBX's varied menu attracts a wider range of customers and thus ensures stronger competitive positioning. JBX has a 2.65 percent market share of this segment. JBX's competitors include Advantica Restaurant, McDonald's, Burger King, Wendy's, Tricon, Applebees International, and Taco Cabana. Although competition is based on location, perceived quality and service, JBX has added the new dimensions of variety, value, and quality drive-through service and access, all of which are unique competitive advantages. Companies such as Burger King, McDonald's and Wendy's have variously used discounting and promotions to increase the number of customer visits, but this has affected their profit margins. JBX responded by:

- using a three-tiered marketing strategy that stresses low-priced value items (including items priced at below $1.00), and adult-oriented sandwiches and hamburgers, and non-traditional items such as Chicken Teriyaki Bowl, the Philly Cheese Steak, Chili Cheese Curl Fries and the Oreo Cookie Shake; and
- reducing operating costs.

Hamburgers accounted for about 25 percent of JBX's revenues. The hamburger segment is dominated by MacDonald's, Wendy's and Burger King, which account for over 72 percent of market share. As of April 2000, JBX was a medium-to-small participant in the fast-food sector, with only 1,597 units in the USA, compared to Macdonald's which had more than 12,000 units, Burger King which has more than 12,000 units and Wendy's which has more than 5,500 units worldwide (as of April 2000). While the restaurant industry is highly fragmented and has been experiencing low growth, the fast food sector is characterized by high fixed costs (real estate, equipment and some labor costs), and slightly higher growth rates.

Diversification and vertical integration – timing and scope

In addition to restaurants sales and food service, JBX is positioned to earn more revenues from distribution of raw materials (dairy and bakery items) and plastic disposables to its franchisees and to other food chains, through JBX's existing warehouses and distribution system. This represents a kind of vertical integration for JBX. JBX's distribution system did not contribute much to cash flow during 1996-2000 owing to initial startup costs and the traditional low margins from food distribution businesses. The implementation of an Internet-based distribution/order system and consummation of long-term distribution agreements (with food processors and food service companies) will further reduce costs, improve profits, expand JBX's market coverage, and form the foundation for acquisitions of restaurant and food distribution companies (Markides, 1995; Lee and O'Connor, 2003; Baker, 1992).

Location, international expansion and development costs

Appropriate location is now more important than ever, and fast-food chains are seeking out unusual sites such as hospitals, gas stations and airports, and are trying "dual branding" (combining operations with other fast-food chains at the same sites).

The typical site selection criteria applied by restaurant chains for a free-standing site (ground-lease) are as follows:

- more than 25,000 sq. ft of land;
- located at a corner, and or at a traffic light, on a major road, and near demand generators;
- high traffic counts of at least 25,000 cars per day;
- "mixed use", "commercial" or "residential" zoning; and where feasible, land with multiple uses;
- favorable Phase-I environmental tests, and no history of environmental problems;
- 15-20 year ground-leases, with four five-year renewal options; and 10 percent-15 percent rent increments every five years or CPI-linked rent increments every five years;
- annual sales of more than $200 per square foot at existing restaurants in the secondary trade area;
- median annual household income of more than $18,000 in the secondary trade area. Average annual household disposable income greater than $6,000 in the Secondary Trade Area; and
- combined "lunch-time population" and "dinner-time population" of more than 50,000 people in the secondary trade area.

Domestic trends have compelled US chains to seek growth abroad; where around 2000, the number of restaurant units was growing at an average annual rate of 7.5 percent compared to about 1.7 percent in the USA. JBX seems positioned to expand internationally, particularly in Latin America, Canada and Europe, in terms of menu, experienced management, and steady cash flow. However, JBX needs to resolve its balance sheet problems (insolvency and asset mismatch) in order to be able to raise capital and to gain credibility among future joint venture partners. JBX is developing its own Mexican food brand which it will offer along with other JBX products. Such international growth can be achieved through acquisitions, or by internal growth. JBX has the financial resources and steady cash flow for such expansions.

- Acquisitions provide the fastest means and perhaps the cheapest (depending on acquisition price) of market entry – for example, Wendy's acquired Tim Horton's of Canada in order to expand its menu offerings. JBX can acquire national and regional foreign restaurant chains with similar operating styles, in order to expand its menu offerings, eliminate costs associated with building a brand, renting/developing space and hiring/training employees.
- The second alternative is for JBX to form joint ventures with local restaurant chains, and/or to franchise its brand in order to reduce upfront investment, to obtain local knowledge, and to conform to local standards and tastes.
- The third and most capital-intensive alternative is for JBX to build its own operations from scratch – leasing space as opposed to development, centralizing purchasing, hiring from competitors where possible, developing a local menu in addition to its traditional food offerings. Other US chains have developed substantial operations in Asia, Europe and Latin America.

As of fiscal year end in October 1999, JBX had 1,597 restaurants, of which 1,191 are owned and the rest franchised, and JBX had annual revenues of about $1.5 billion. JBX has been opening new restaurants at the average rate of 110 restaurants per year, and plans to open over 120 restaurants in each of the next few years – an annual growth of 10 percent. The company intends to continue opening sites at non-traditional areas such as near convenience stores and gas stations, in order to increase market penetration. JBX intends to open new restaurants in other states (in the south-eastern USA, Colorado, Nevada, Missouri) apart from California and Texas, which presently account for over 65 percent of JBX's revenues. In the first quarter of fiscal year 2000, JBX opened restaurants in Nashville, Baton Rouge and Charlotte, and intends to open at least 30 restaurants in the south-eastern US fiscal year 2000. Recent data have shown that JBX has not achieved adequate market penetration, and thus, there is room for more growth of units within and outside California. In 1998-1999 Macdonald's had one restaurant per about 22,000 persons, and JBX has substantially lower market penetration.

Although JBX has been developing its restaurants at an average cost of $1.5 million per restaurant, in the future, the company intends to lease sites at an average cost of $300,000-400,000, thus reducing its capital requirements while increasing financial flexibility (Manning *et al.*, 1999; Joroff *et al.*, 1993; Peters, 2001; Rabianski *et al.*, 2001; Riell, 2000; Roulac, 2001; Suri and Monroe, 2003).

Domestic growth through franchising

JBX can grow much faster by franchising its restaurants in many more states than by its present strategy of building restaurants and then entering into sale-leaseback transactions. Franchising will yield fixed franchisee fees of at least $50,000 per restaurant (as of April 2000) in addition to 5 percent of franchised restaurant revenues. JBX's relatively high franchise fees (other fast-food chains charge $30,000-$40,000 and 2-5 percent of sales), are justified by its concept and brand image, but JBX may have to change its fee structure to attract franchisees. As of April 2000, JBX owned and operated about 80 percent of its restaurants, unlike its competitors, who operate only about 30 percent of their restaurants. The recruitment of franchisees will greatly increase JBX's revenue growth rate, distribution fees, franchise fees and geographical diversification – this process will be facilitated by existing pool of well-trained JBX staff. Franchising will enable JBX to increase its brand recognition without having to bear the full cost of such expansion (Dant and Kaufman, 2003; Gibler *et al.*, 2002).

Working capital deficits

JBX, like many companies in the restaurant sector, operates with negative working capital. This is primarily attributable to its accrued payable and liabilities, which will likely be reduced if JBX leases more units, chooses the right locations, reduces its construction activity, changes its mix of debt, improves the management of its inventory, and increases its franchising efforts.

Quality problems

There have been incidents of food poisoning at restaurants owned or operated by JBX, notably in 1993 and 1999. In October 1999, JBX reported one such incident at its Virginia restaurant – 40 people were ill. However, JBX has almost overcome the resultant negative publicity arising from the 1993 incident by hiring dietary and food service staff (David Cheno), improving its food service operations and making the public aware of its efforts. JBX's "farm-to-fork" food safety and quality assurance programs and its "Hazard analysis and critical control points" (HACCP) system for managing food quality, are recognized and lauded by the industry and regulators like the United States Department of Agriculture and the Food and Drug Administration. JBX will need to emphasize quality more, in all its operations and performance measurement systems – in food storage and handling, food preparation, sanitation and service.

Organizational structure, employee retention and performance bonus plan

JBX's organizational structure had too many layers of management. JBX's performance bonus system is not available to ordinary employees, and this reduces their motivation. JBX's performance bonus plan emphasized profits only without emphasizing non-financial measures such as quality, customer satisfaction, regulatory compliance, human resources management, etc. Like most restaurant chains, JBX had relatively high employee turnover rates. The cost of employee turnover ranges from $7,000 to $40,000 per employee depending on their years of service, rank, job functions, location, time to replace the employee, advertising costs, interview and administrative costs, and the amount invested in training the employee. JBX needs to create and implement an effective employee retention and incentive compensation plan that is tied to both financial and non-financial performance measures.

Regulatory and environmental issues
JBX is subject to the federal Americans With Disabilities laws, Fair Labor Standards Act, environmental laws relating to discharge of waste, and various state labor and environmental laws. JBX's operations must comply with the US Food and Drug Administration, US Department of Agriculture and US Occupational Safety and Health Administration standards, in addition to regular inspections by state and local agencies. Furthermore, JBX will be affected by congressional proposals to increase the minimum wage, and to require employers to provide health insurance to employees, all of which, if passed into law, will increase JBX's operating costs. These regulations impose substantial compliance costs (and may lead to penalties for any violations) and JBX needs to integrate compliance measures into its quality programs, performance measurement systems, reward systems, training and information systems.

High leverage and insolvency
As of April 2000, JBX was highly leveraged and insolvent, and this reduced its ability to respond to the changing business environment, because debt covenants impose limitations on borrowing, capital expenses, and asset sales. Any new debt or refinancing of the bank credit facility will probably be done at much higher interest rates. JBX needs cash in order to grow at a faster rate into states in the south-eastern USA and north-western USA (Table I).

When the present value of minimum payments required by JBX's operating leases are added as liabilities and capital assets, JBX's risk increases substantially.

JBX's EBITDA interest coverage is lower than industry, sector and S&P averages. There was not much interest tax shields to be obtained by increasing debt.

JBX's $175 million credit facility expires in 2003, and at the present rate of growth, JBX's free cash flows are actually declining at a significant rate. Any new debt or refinancing of the bank credit facility will be done at much higher interest rates. JBX needs cash, if it intends to grow at a faster rate, into states in the south-eastern USA and north-western USA.

Litigation
JBX is exposed to litigation from customers, franchisees, government regulators and employees for various reasons such as compliance with laws

JBX risk profile	JBX	Sector	Industry	S&P
Current ratio	0.501	1.77	0.7	1.61
LT-debt/equity (book value)	1.39	1.06	0.61	0.59
Total debt/equity (bookvalue)	1.4	1.23	0.69	0.87
Interest coverage	5.3	4.57	8.23	10.69
Total assets/total debt	2.19	–	–	–
Tangible assets/LTD	1.85	–	–	–
Adj. total assets/total debt (1)	0.87	–	–	–
Adj. tangible assets/LTD (1)	0.74	–	–	–
Adj. total debt/equity (1)	4.36	–	–	–
Beta	0.85	1	0.77	1
EBITDA/tnterest	7.05	–	–	–
Debt/equity market value	0.39	–	–	–
Alpha (Merrill Lynch 12/99 est.)	1.42	–	–	–
Asset turnover	1.93	0.97	1.04	1.04
Inventory turnover	56.07	11.88	48.61	9.18

Source: Most data was obtained from Multex MarketGuide, MSN-MoneyCentral and Investorguide.com
Note: Debt includes present value of Operating Leases estimated at $570 million.
Data as of April 2000

Table I.

relating to physical access for disabled persons, unfair business practices, violation of the California corporations code, fraud, breach of fiduciary duty, and breach of a third party beneficiary contract (relating to performance of JBX's franchise agreements), wrongful termination of distribution licenses, and unfair competition, customer service, and its relations with franchisees. JBX needs to develop a comprehensive strategy for dispute resolution. Given the substantial impact of litigation news on customer traffic, use of the arbitral forum, appropriate disclosure and disclaimers on products, and adequate signage will reduce the impact of disputes on JBX's profitability.

Food and labor costs; inventory management

JBX is exposed to changes in food costs, shortages, and delays in delivery, and has to coordinate frequent deliveries and storage of fresh produce. Shortages or interruptions in the supply of fresh produce caused by adverse weather conditions or other conditions could adversely affect the availability, quality and cost of food ingredients. Thus, JBX needs to improve and coordinate its purchasing, storage, demand management, order processing, and information systems in order to reduce food waste and inventory. The prices of raw materials have remained steady, are not likely to increase substantially in the next few years, and cheaper supplies of meat and dairy products from Latin America may lower costs. However, increases in labor costs can be passed on to the customer. In 1999, JBX implemented its "assembled-to-order" ("ATO") programs, in order to greatly reduce inventory costs and food waste while ensuring that customers are served fresher meals.

Increases in labor costs, scarcity of potential reliable employees (usually aged between 18-24) and high employee turnover rates affect JBX's operations. Employee turnover is particularly problematic because JBX invests resources to recruit, process, train and develop employees. Labor prices have remained stable, but proposals to increase the minimum wage may affect labor costs. Although JBX's employees were not union members (as of April 2000), unionization of JBX's employees may increase salary and benefits expenses, and probably increase JBX's fixed costs.

Cost structure – high fixed costs

JBX has relatively very high fixed costs. Such fixed costs consists of real estate-related interest payments, real estate lease payments, employee-related costs, administrative expenses and inventory management costs. Reduction/elimination of JBX's construction activity, use of "leased" employees, and implementation of more efficient inventory management systems, implementation of customer order processing systems, and changes in the structure of leases (i.e. increasing the percentage of rent that is overage rent, using partial pass-through leases, etc.) will greatly reduce JBX's fixed costs.

In order to increase its flexibility and ability to relocate poorly performing stores without incurring substantial expenses, JBX should include assignment and subletting clauses in its retail leases.

Internal controls, accounting and disclosure

JBX had relatively very lax internal controls and its accounting/finance systems were inadequate. Furthermore, JBX's disclosures in its financial statements have been substandard and insufficient. JBX's annual reports and financial statements for 1999 and 1998 contain numerous factual and accounting errors, some of which are described as follows:

(1) In fiscal year 1999 JBX changed its estimates related to insurance costs. This change in estimates yielded savings of about $18 million, and a reduction of accrued liabilities. JBX did not disclose the reasons and the basis for the change in estimates.

(2) JBX builds restaurants on leased land. Normally, JBX should depreciate such buildings using either the life of the ground-lease or the useful life of the asset, whichever is shorter. But JBX's ground-leases are about 20 years, and contain renewal options, while the buildings have useful lives of 33-50 years. Often, the buildings built by JBX revert to the land-lessor on termination of the ground-leases – for such cases, JBX has not made any disclosure about assumptions related to residual values of these buildings, which could be substantial. JBX has not clearly disclosed issues related to how it depreciates the buildings built on leased land. If

JBX depreciates the building over only the original lease term (as opposed to original lease term plus renewal terms), the buildings are being depreciated faster than they should be.

(3) "Trading area rights" are amounts allocated under purchase accounting to reflect the value of operating existing restaurants in their trading areas. At present, JBX retires these rights when restaurants are sold or franchised. JBX has not disclosed its accounting treatment of these rights when the value of the rights actually increase. If these rights are assets, which are exchanged for cash or receivables as part of the purchase price when restaurants are sold or franchised, then should JBX's reduction of these rights not be matched by increases in cash or receivables? The rights recorded on JBX's balance sheets arose from restaurants purchased from franchisees.

(4) JBX did not make adequate disclosures about the marketing fund to which JBX and all franchisees contribute money. JBX's balance sheet did not disclose the exact amounts of capital lease assets. It appears that JBX is not disclosing in its Income Statements, the interest component of its capital/operating leases, and may be categorizing such interest expense as operating expenses.

(5) JBX has not made adequate disclosures about its sale-leaseback transactions, i.e. assumptions or actual data about residual values, gains and losses upon sale, actual number of sale-leaseback transactions in each fiscal year, imputed interest, taxation, etc.

(6) JBX's SEC filings did not disclose JBX's breaches of indenture provisions. Alternatively, JBX's SEC filings did not include any express certifications by independent law firms that JBX complied with terms of the debt indentures.

(7) JBX's restaurant sales are mostly to individuals who occasionally pay by credit card. JBX did not disclose:

- whether its restaurant food sales are reported at gross amounts or net of discounts due to credit card companies (if any);
- the accounting treatment of product discounts and promotions; and
- the nature and method of obtaining allowances for un-collectible sales (accounts recievables).

(8) JBX did not provide adequate disclosure regarding its retained earnings deficit and net operating loss carryforwards.

(9) Typically, for each franchised restaurant, JBX has options to purchase the restaurant. If at signing of the franchise agreement, it is probable that JBX will actually buy the restaurant, JBX should not recognize the initial franchise fees as revenues, but they should be reported as a liability, that reduces JBX's total investment in the restaurant.

(10) JBX did not disclose specific outstanding commitments arising from franchise agreements, and did not report franchise fees and franchise royalties separately. JBX did not disclose the revenue recognition method for its distribution agreements – revenues should be recognized only after receipt of the purchase orders, and delivery of goods.

(11) JBX's most recent annual report states that it operates in a "single segment" – see SFAS #131, *Disclosures About Segments of an Enterprise and Related Information*. In reality, JBX's hamburger sales, Mexican food sales and distribution businesses are distinct segments which should be reported as such.

(12) There may be fraud in, and there was inadequate disclosure (in JBX's Financial Statements) of JBX's dealings with the CRC-I and CRC-II partnerships (CRC), two independent Massachussetts real estate partnerships. The terms of deal are as follows:

- in January 1994, JBX sold "estate-for-years" interests in 76 restaurants to CRC (interests expire in 2028), but JBX retained residual fee interests in all 76 restaurants; an "estate-for-years" is the legal term for an interest in property for a specified period of time, after which the property reverts to its owner;
- the acquisition of these properties was funded by CRC's issuance of about $70 million of senior secured notes (the "CRC notes", which were secured by the restaurants), to a special purpose entity (FM 1993A Corp.), which in turn issued notes to other investors in order to fund the purchase of the CRC notes; the CRC and FM 1993A Corp. entities were all special purpose entities created solely for this transaction; some the underlying restaurants were fully functioning, while some (for CRC II) were either under construction or were yet to be built;
- the CRC notes were cross-collateralized and additional security included the assignment of leases, non-recourse guarantees by CRC, and JBX's residual interest in the restaurants;
- concurrent with the purchase of the estate-for-years, CRC leased the restaurants back to JBX under a Triple-Net Master-Lease (triple net clause covers utilities, taxes, insurance and maintainance) with an initial term of ten years (expiring in 2003), and options to renew for terms totaling 35 years ("CRC I Lease" and "CRC II Lease"); JBX was required to make semi-annual lease payments of $3.413 million (the "basic rent") and additional semiannual payments of $747,000 to a sinking fund for a future offer to repurchase 50 percent of the estates-for years before their maturity, and additional semi-annual payments of $25,000 for administrative costs;

- in 2003, JBX is also required to make a "special rent" payment equal to the difference between $23 million and the balance in the sinking fund account as of January 2003;
- JBX can sub-lease the restaurants to others for a term that does not exceed the current terms of the leases, and can assign its rights in the leases provided that there is no default and the assignment does not release JBX from its obligations;
- between 1 April 2003 and 1 October 2003, JBX must offer to re-acquire the estates-for-years interests in 50 percent of the 76 restaurants at a price which, together with the prior sinking fund payments, is sufficient to retire 50 percent of the senior secured notes; and by the beginning of year-ten (2003), the outstanding balance of the notes must be reduced to $35 million or less, and CRC is required to make an additional principal payment equal to the difference between $35 million and the balance in the sinking fund (this additional payment is required to be covered by JBX's "special rent" payment, and JBX's year-nine offer to repurchase 50 percent of the estate-for-years interests);
- JBX has an option to purchase 50 percent of the estates-for-years interests at the beginning of year-ten (2003), at a price equal to the fair market value of such interests, provided that it must not be less than 12/35ths of the termination value (termination value is each property's allocated portion of the applicable CRC I or CRC II original note balance) of such leased properties; JBX also has option to repurchase the interests on the last day of the initial lease term or on the last day of each subsequent five-year renewal term or extended term;
- if CRC rejects JBX's 2003 repurchase offer, JBX may purchase the restaurants at less than fair market value, or cause CRC to fund the remaining principal payments of the note; if in 2003 CRC retains its estate-for-years interest in the properties, JBX has options to extend its leases for total terms of up to 35 years at the same rental rate, after which the ownership of the properties will revert to JBX;
- the lease terms contain default provisions (and remedies); JBX has the right of first refusal and option rights to purchase the estates-for-years interests if CRC receives offers to sell the interests;
- the indenture of the senior secured notes issued by FM 1993A, limits its ability to conduct other business, to incur additional debt, or permit additional liens, or transfer more that 49 percent of its shareholder interests, or to merge or consolidate with or into another entity; and
- the net proceeds received by JBX from the sale of the estate-for-years interests was $66.428 million (from CRC's perspective, $70 million face

amount of debt less $1,092 million bond discount and $2.48 million of fees and issuance expenses), and was used for acquisition and construction of restaurants; CRC reflected JBX's financing lease obligations as a 9.75 percent notes receivable.

(13) The CRC I and CRC II notes payable to FM 1993A Corp., have face values of $30.2 million and $39.8 million respectively; thus interest income and interest expense to FM 1993A and CRC, inclusive of $200,000 of OID amortization will be $2.9 million and $3.9 million for CRC-I and CRC-II respectively. The lease is a capital lease because it contains a mandatory purchase offer clause, the collectibility of payments is reasonably assured, the lease transfers ownership of the underlying interest to JBX (via the 2003 mandatory purchase offer), the lease is triple-net, and the lease term (35 years) is equal to, or more than 75 percent of the economic life of the interests – the initial lease term is for ten years (expires in 2003) but JBX has several five-year renewal options for a total lease term of 35 years. See FASB #s 13 & 98, and Rule 90-15 of the SEC's Emerging Issues Task Force. JBX may have intended to create a "synthetic lease" but the completed transaction does not meet the criteria for "synthetic leases" because the leases were capital leases and are reported on JBX's balance sheet, the CRC special purpose vehicles do not appear to have made an equity investment equal to 3 percent or more of the purchase price of the estates-for-years interests, and JBX is required to make an offer to repurchase the estates-for-years interest in 2003, JBX does not have any lease termination options, sale-leaseback accounting treatment is applicable to the restaurants that were not yet built or under construction at the initiation of the transaction, JBX owned most of the underlying restaurants before the transaction, and the transaction involves sale-leaseback elements. Clearly, the transaction has elements of fraud or unfair terms. JBX was obligated to make lease payments on restaurants that had not yet been built or were under construction (those covered in CRC-II transactions), and thus lost substantial revenues. CRC used JBX's residual interest as security for the loans – this can be deemed as error or over-collateralization (or the term that makes the transaction a secured loan), because the loan was to finance only the estate-for-years, and JBX was supposedly an independent entity in a supposedly arm's-length transaction. In order for the transaction to have been at arm's-length and fair, JBX should not have been required to offer to re-purchase the estates-for-years interests, none of JBX's employees should work on the boards of directors of CRC or FM 1993A, and the $70 million loan should not have been collaterliazed by JBX's residual fee interest. JBX apparently sold the estates-for-years at a low rate, because the present value of JBX's minimum semi-annual lease payments for the first ten years at a 9.75 percent annual rate is $45.083 million (beginning of period payments), and the present value of the administrative

expenses for the first ten years is $330,000 – the sum of these two present values is $45.41 million, and is much greater than the portion of the $66.428 million purchase price that is attributable to the first ten years of the estates-for-years (approximately $3.2 million semiannually, or a present value of $42.27 million). The future value of the 20 semi-annual $747,000 payments at a 6.50 percent interest rate is $21.25 million, and JBX probably will need to make a special rent payment of about $1.75-2 million. The initial purchase price of the "estate-for-years" interest, paid for in 1994 to JBX by CRC, is similar to a lump-sum payment of the present value of a series of capital lease payments, and to a secured loan – CRC and FM 1993A are special purpose entities, and do not have any employees or operations, and a JBX officer serves as a board member of FM 1993A Corp. By buying the estate-for-years interests, CRC was exposed to risks and benefits of ownership and should normally deduct depreciation, but since CRC leased the assets back to JBX via triple-net capital leases, JBX retains depreciation benefits. At expiration of the estate-for-years interest in 2028, ownership of all 76 restaurants should revert to JBX, without any further payments by JBX. Thus, any offer by JBX to re-purchase the restaurants in 1/2003 and 11/2003, may represent attempts to illegally siphon money out of JBX if JBX pays a substantially high price. In its most recent annual report and Form 10K, JBX reported the 76 restaurants in its financial statements as an asset, and as a financing lease liability ($68.587 million as of October 1999). The correct accounting treatment for JBX is either:

- the present value of the lease payments are recorded as a liability in the balance sheet; the present value of JBX's residual fee interest is recorded as a long-term asset (the present value of JBX's residual fee interest is the present value of the year-2028 depreciated cost of the restaurants); the price of the estate-for-years is recorded as a capital asset and amortized over the 35-year term of the estate-for-years; upon reversion to JBX, only the then depreciated cost of the restaurants is recorded as an asset; the difference between the present value of JBX's financing lease payments, and the initial purchase price of the estates-for-years is recorded as a gain or loss on sale, and any gain is amortized over the lease term, and if there is no gain or loss then the lease is a financing lease; or
- record the price of the estates-for-years and the present value of JBX's residual fee interest as assets, and record the 70 million note as a liability, and deduct interest payments and depreciation. The transaction was effectively a loan, and a sham transaction that was done most probably to circumvent prior debt convenants.

(14) JBX did not make adequate disclosures about its commodity hedging activities – such disclosure should include annual notional amounts of

hedges, unrealized gains/losses, types of commodities hedged and qualitative discussion of risks, etc.

(15) JBX's disclosure does not comment on the quality and strength of "guarantees" by its subsidiaries. At issuance, JBX's senior sub notes had priority over all other claims except the bank debt. In the event of liquidation, holders are assured of a reasonable return of capital, and holders will participate in any restructuring. While the bonds are unsecured, they are guaranteed by JBX's current and future subsidiaries. However, such guarantees are subordinated to senior debt of the subsidiaries. The guarantees are "joint and several".

(16) JBX's 2000 high ROE ratios were misleading because JBX is highly leveraged and uses substantial leasing – during 1996-2001, the stock market did not reward JBX's growth with its existing capital structure. In this instance, return on invested capital is a better measure of performance. Furthermore, there appears to be substantial correlation among changes in prices of restaurant stocks, such that it is more difficult for any single stock to perform well when the sector or industry group is declining (in terms of price). There is not much correlation between high-yield bonds and equities, or treasuries or restaurant stocks. As of 10 March 2000, the 26-week and 52-week total returns for JBX's common stock were −9.3 percent and −12.1 percent respectively. JBX's bond offers a substantial yield advantage and potential capital appreciation, and the bond market is more likely to factor in JBX's best quality (stable and substantial operating cash flow) and any improvements in credit quality. The senior sub notes are likely to benefit most from continued growth in JBX's operating cash flows, which will improve coverage ratios, and JBX's ability to grow internally.

(17) JBX's bank credit facility was amended on 17 September 1999 by agreement, such that JBX was not required to file UCC financing statements or fixture filings after JBX changed its name to Jack-in-the-Box. Since this UCC filing requirement was eliminated by agreement between JBX, the bank and the agents, the net effect is that the bank credit facility was unsecured, and JBX's 8-3/8 percent '08 bonds ranked pari-passu with the bank credit facility in terms of liquidation preference. Furthermore, the 17 September 1999 amendment (to the credit facility) decreased the amount of sale-leaseback transactions that JBX could consummate to $85 million, $100 million, $125 million, $120 million and $120 million for the fiscal years ending in 1999, 2000, 2001, 2002 and 2003. JBX did not disclose the exact amount of sale-leaseback transactions that it entered into during fiscal year 1999.

JBX violated its bond indentures and loan covenants and was insolvent (as of March 2000)

JBX violated several terms of its loan covenants and bond indentures and was insolvent as of February 2000 (LoPucki, 1993; Triantis and LoPucki, 1994; Triantis, 1993; Langevoort, 1998, 2002; Jack in the Box Inc.'s Financial Statements and reports filed with the US Securities and Exchange Commission, and accessible via the Internet at www.sec.gov; Foster, 1980; Mella-Barral, 1999; Patel, 1999/2000; Schmitz *et al.*, 1998; Andrade and Kaplan, 1998; Cripe, 2003; Lipton, 2002; LoPucki, 1982; Luehrman and Hirt, 1983; Triantis, 1996). Management and auditors did not disclose this issue in its quarterly or annual reports and financial statements. JBX's banks also did not take any action, presumably because they wanted to maintain the relationship, JBX did not need immediate substantial amounts of capital and the cost of restructuring/bankruptcy procedures would have been onerous.

(1) Under the terms of the bond indenture for JBX's 8-3/8 percent '08 debt, JBX's EBITDA interest coverage should not exceed 2.25:1, and JBX's outstanding "indebtedness" was capped at $185 million. "Indebtedness" as defined in the bond indenture includes JBX's bank credit facility ($86 million used as of October 1999; $175 million total), JBX's capital leases (present value of $16 million as of October 1999), JBX's 8-3/8 percent '08 bonds ($124.8 million as of October 1999), certain JBX current liabilities which have to be repaid within six months of the purchase of goods or services (includes $15.5 million of advertising, $7.09 million of interest, $13.8 million of capital improvements and possibly $24.14 million of "other" liabilities), obligations arising from leases between JBX and CRC-I/CRC-II partnerships (financing leases which amounted to over $68.5 million as of October 1999), and JBX's secured notes ($7 million on October 1999). Thus, JBX technically breached the terms of its bond indenture, and defaulted.

(2) As of February 2000, JBX had violated the terms of the bond indenture which requires that the total capitalized lease obligations incurred with sale of property in sale-leaseback transactions should not exceed $15 million. As of October 1999, the present value of JBX's capital lease obligations exceeded $16.8 million, and the present value of its financing lease obligations exceeded $68 million.

(3) Although JBX's bond indenture prohibits any stock buy-back, JBX's board of directors approved a ten million dollar stock repurchase program (1999-2000), which violated indenture terms.

(4) The bond indenture prevents JBX from issuing any debt that is subordinated to the 8-3/8 percent '08 bonds, unless such new debt ranks pari-passu with the 8-3/8 percent '08 debt. This term greatly limits JBX's

financial flexibility. Furthermore, JBX cannot incur any liens unless such liens are secured on an equal basis as the 8-3/8 percent '08 bonds.

(5) The bond indenture limits JBX's ability to merge or sell assets, because the indenture requires that certain debt be retired at premia to face value, upon any asset sale or merger or change in control.

Relatively cheap equity market valuation

As of February 2000-March 2000, JBX's common stock was trading at \$18.50-20.3 per share which was at the low end of its 52-week trading range. Based on traditional ratios, and on a relative-value basis, JBX's stock was cheap compared to its sector. Some of JBX's ratios are misleading because JBX is highly leveraged and uses substantial leasing. JBX's relatively low stock market value may account for its recent implementation of a \$10 million common-stock buy-back program. JBX had approximately 41,105,434 shares of common stock outstanding (Figure 1).

The above-mentioned valuation method is used here only because it is the most common method among finance professionals (although it is not the most accurate or most relevant method) – newer valuation methods such as the "economic value added" model are gaining more acceptance in finance functions. The implied annual growth rate for JBX's free cash flows ("FCF") is 11-12 percent – implied from market FCF multiples and a 14-17 percent weighted average cost of capital. However, JBX's free cash flows have been declining owing to increased construction, and so an estimated growth rate of 5-6 percent is appropriate assuming JBX reduces its construction activities. The "Price/FCF (A)" valuation assumes that JBX continues operations in the present mode, and keeps building restaurants and entering into sale-leaseback transactions. The "price/FCF (B)" valuation assumes that JBX leases most of its restaurants in the future, and reduces or eliminates its new-construction activity, and thus saves about \$70 million of capital expenditures annually, which results in a stabilized annual FCF of about \$93.5 million – this is a very optimistic scenario. The "DCF – low, Scenario A" valuation assumes that initial year 2000 FCF of \$23.2 million grows annually at a 5 percent rate, and the discount rate is 14 percent, and JBX continues to build restaurants and enter into sale-leaseback transactions. The "DCF – low, scenario B" valuation assumes a 17 percent discount rate and a 5 percent annual growth rate, and that year 2000 FCF is \$23.2 million, and year 2001 FCF is \$92.5 million and, FCF increases at a 5 percent annual rate thereafter. The "DCF – high" valuation assumes a 14 percent discount rate and a 6 percent annual growth rate, and that FCF is about \$23.5 million in 2000, and that JBX reduces construction activity (and saves about \$70 million annually, which increases FCF) such that FCF is about \$92.5 million in 2001, and grows at an annual rate of 5-6 percent thereafter. For the price/cash-flow and price/FCF and DCF

JBX – October 1999 Data	JBX	Sector	Industry	S&P
Price/BV	3.29	4.24	8.28	11.17
Price/Tangible BV	4.76	4.3	11.02	14.34
Price/Cash flow	6.3	14.82	23.99	29.1
Price/Free-Cash-Flow	52.5	44	60	48.72
Sales Growth Rate (5yr)	6.70%	26.74%	12.13%	19.75%
Beta	0.9	1	0.77	1
Dividend Yield	0.00%	0.73%	1.82%	1.71%
Payout Ratio	0.00%	15.25%	10.29%	23.63%
ROE	43.34%	10.82%	19.68%	24.16%
ROIC	14.03%	3.42%	11.47%	15.11%

Data was obtained from Multex Marketguide's and Investorguide.com's websites

October 1999 Data (In $ millions)			
Total assets	833.6	WACC range (%)	14-17%
Tangible Assets	704.5	FCF Growth Rate	5-6%
Total Debt	380.5	Terminal Cap Rate	13.00%
Total Liabilities	615.8	Entry Cap Rate	15%
EBITDA	195.5	Working Capital	(131.7)
Unfunded Pension Liability	23.0	Cash	10.9
FCF – 1999 Actual	22.5	Stabilized FCF	92.5

Adjusted Net Asset Value Of JBX	Book Amount	Disc. Or Premium	Adjusted Value
Acct. Receivables	9.156	-30.0%	6.4
Inventory	20.159	-50.0%	10.1
Prepaid Expenses	15.4	0.0%	15.4
Assets Held For Sale	41.6	20.0%	49.9
PV of Operating Leases	570	PV	570.0
Land (Cost)	89.35	20.0%	107.2
Buildings (Cost)	379.6	20.0%	455.5
Restaur. & Other Equip. (Cost)	334.6	20.0%	401.5
Construction In Progress	55.16	10.0%	60.7
PV Tax shield from other assets	56	PV	8.4
Trading Area Rights	79	0.0%	79.0
Adjusted Total Assets			1764.1
Acct. Payable	-44.18	0.0%	(44.2)
Accrued Liabilitites	-183.151	0.0%	(183.2)
Long Term Debt	-303.5	0.0%	(303.5)
Other Long Term Liabilities	-75.27	0.0%	(75.3)
PV Of Operating Leases	-570	PV	(570.0)
Unfunded Pension Obligation	-23	0.0%	(23.0)
Adjusted Total Liabilties			(1199.1)
Adjusted Net Asset Value			565.0

JBX Valuation Summary	Amount	Multiple	Less Obliga-tions	Value/Share
Price/BV	217.8	2.7	(414.4)	4.2
P/Free Cash Flow (A)	23.2	32.0	(414.4)	8.0
P/Free Cash Flow (B)	83.3	35.0	(414.4)	60.9
P/(NI+Depr.+Amort)	122.3	11.0	(414.4)	22.6
DCF – (low, scenario A)	265.6	--	(414.4)	(3.6)
DCF – (low, scenario B)	951.3	--	(414.4)	13.1
DCF – (high)	1229.4	--	(414.4)	19.8
Adj. Net Asset Value	565.0	--	--	13.7
Average Value Per Share				17.3
# of Shares (millions)				41.1

1. Cash Flow is assumed to be = Net Income + Depreciation + Amortiz.
2. PV of tax sheilds from amortization of lease acquisition costs and "other" assets, assumes a 5% discount rate, a 40-year period and a 35% tax rate.
3. Present Value of operating leases was calculated by applying a conservative multiple (6) to the $95 million annual lease payments
4. Certain assets are assumed to be sold at a 20% premium above Initial cost. A/R and Inventory are assumed sold at a 10% discount
5. DCF was for a three year period, and includes a terminal value, calculated with a terminal cap rate of 13% (less 5-6% growth rate)
6. "P/FCF (B)" assumes increased FCF from reduced construction.

Source: Arnold and James (2000); Thompson (2000)

Figure 1.

valuations, the debt, cash, and un-funded pension liabilities are deducted from total enterprise value to obtain the value of equity.

JBX's 8-3/8 percent '08 senior surbordinated notes (principal amount was $125 million) were issued in the semi-public Rule 144A market, but now trade in public markets, and were rated B1 by Moody's and B+ by S&P (note that S&P assigned JBX an issuer rating of BB) (Table II).

JBX's bonds were issued on 8 April 1998 at 99.832 percent, and are callable after 15 April 2003 (initially at $104.188, and then at a declining premia to face value), and mature on 15 April 2008. The bonds are presently trading at a price of 90-91 percent (Salomon Smith Barney, 10 March 2000), with a yield of about 10.02 percent, which represents a spread of 345bp over eight-year treasuries. Comparable restaurant bonds are trading at an average spread of 330bp and comparable B and BB bonds of other industries are trading at an average spread of 300bp over treasuries. It is likely that JBX's spread will contract as its cash flow improves. An alternative valuation method is to use a probability

JBX bond comparisons	Bond rating	Coupon rate (%)	Maturity	Bond price	YTM (%)	Equivalent treasury yield (%)	Spread over treasuries
JBX	B1/B+	8.38	4/08	91	10.02	6.57	345
Tricon	Ba1/BB	7.65	5/08	94.317	9.86	6.57	329.13
Perkins	B1/BB	10.13	12/07	98	10.50	6.57	393.2
HMH Properties	Ba2/BB	7.85	8/08	86.25	10.37	6.57	380
Echostar	B	9.38	2/09	98	9.71	6.40	331
American Standard	BB −	7.35	2/08	91.5	8.90	6.57	233

Notes: Bond prices and yields for Wendy's, Tricon, Perkins and Darden are Merrill Lynch quotes (10 March 2000)
Bond prices and yields for HMH Properties and Tenet were obtained from the *Wall Street Journal* (10 March 2000)

Table II.

weighted default and recovery analysis to price the bond. However, adequate data are not available for that type of pricing.

Cyclicality/seasonality

JBX's sales are seasonal and peak during summer months. JBX needs to improve its marketing, site selection strategies, and financing strategy in order to eliminate the effects of cyclicality/seasonlaity. This may require:

- locating stores in non-traditional sites such as hospitals, office complexes, airports, bus stations, and interstate train stations;
- Internet ads to increase brand awareness; and
- promotions targeted at specific age groups, families, office workers, etc.

Financial strategy and related issues

Lease vs. own; and operating lease vs. capital lease decisions; and development risk

JBX is subject to various risks associated with development and franchising of restaurants. (Joroff *et al.*, 1993). These include land acquisition, site selection, availability of suitable sites, delays in construction, obtaining financing, environmental hazards, obtaining building permits, zoning issues, changes in government regulations, financial stability of franchisees, and the ability of franchises to operate restaurants in line with JBX's policies and procedures. JBX is exposed to substantial development risk because JBX presently develops sites and buildings with its own capital, and then enters into sale-leaseback transactions to sell these assets. JBX also builds restaurants on leased land, after which the land lessor may or may not reimburse JBX for the property. All such construction activities requires substantial cash and human capital, which diverts JBX's resources from improving existing restaurants

– JBX's October 1999 balance sheet shows about $41 million in "assets held for sale" and about $51 million in "construction-in-progress" assets. MacDonald's and Wendy's build some of their restaurants, but at much lower costs ($1-1.15 million per restaurant compared to $1.3-1.5 million for each restaurant that JBX builds).

As of April 2000, JBX owned about 14.5 percent of the land and about 41 percent of the buildings that it uses for its restaurants; and about 26.3 percent of JBX-owned buildings were on leased land, and 14.5 percent of JBX's buildings were on JBX-owned land. About 54 percent of JBX's restaurants were located in leased land/buildings. Thus, JBX leases most of the properties that it uses. Ownership involves high capital requirements, and potential high debt levels in a cash-based and highly competitive industry. The upside of ownership is in buying properties at low prices, and the appreciation in the value of the real estate or land, and the depreciation tax shields (and possibly interest tax shields) provided by such ownership. Thus, the advantages of ownership greatly depend on location, and in an era where fast-food chains are actively seeking out unusual sites in order to maximize market penetration, it is unlikely that real estate appreciation will occur at such sites. On the contrary, leasing involves substantially lower capital requirements, can replicate the depreciation benefits of ownership (use of capital leases), provides the company with more financial flexibility and operational flexibility in terms of relocating under-performing units, but creates exposure to lease termination and increased rental rates. Leasing allows JBX to grow faster by eliminating capital requirements and delays associated with new construction and acquisitions. In the future, about 97 percent of JBX's lease payments (as lessee) will be for operating leases. Most of JBX's leases have four five-year renewal clauses exercisable at JBX's option, and JBX's rental payments include base rent plus contingent rental payments of 2-10 percent of the restaurant's gross sales. More importantly, JBX uses mostly operating leases for the properties that it leases – this choice has substantial implications for costs, cash flows and asset base. Use of capital leases allows the lessee to carry the assets on its balance sheet (thus increasing total assets, and reducing ROA), to record the present value of minimum lease payments as long-term debt (thus increasing debt/equity ratios and reducing perceived financial stability), and to use depreciation tax shields associated which such property. With operating leases, the assets and the associated liabilities are not reported on the lessee's (JBX's) balance sheet, lessee does not depreciate the property, and the lessee (JBX) merely expenses lease payments. It should be noted that use of capital leases is best when the asset has shorter useful life, and is being depreciated faster than its normal usage. JBX also leases some restaurants to franchises and others, and uses mostly operating leases (over 95 percent of its leases), and to a lesser extent, sales-type leases. JBX has been building restaurants at an average cost of $1.5 million per restaurant (cash costs for leasing is about $300,000-400,000 per restaurant), but such development activities actually erode shareholder value because JBX does not sell the restaurants at any substantial profit (other revenues were $2.3 million in 1999), and such construction uses capital that could be invested more profitably in other ventures. Note that increased construction activity has reduced JBX's free cash flow between 1996-2000 (JBX's free cash flows were $22.5 million, $37.5 million and $60.8 million in 1999, 1998 and 1997 respectively, net of interest tax shields). JBX can contract with developers for construction of built-to-suit restaurants (Baker, 1992; Benjamin *et al.*, 2000; Carn *et al.*, 1999; Dale-Johnson, 2002; Gibler *et al.*, 2002; Gibson and Barkham, 2001; Graff, 2001; Horn, 2000).

Furthermore, JBX can enter into sale-leaseback transactions to free capital for expansion. JBX and other restaurant chains are likely to focus on some lease terms:

- ability to sublet or assign the lease;
- limitation of lease termination costs;
- purchase options in lease agreements; and
- increasing the proportion of rent that is overage rent (i.e. reduced base rents).

Complex and problematic capital structure; illegal stock rights?

JBX had a complex and problematic capital structure which did not appear to be appropriate to key characteristics of its operations – seasonal and cyclical business, labor-intensive, location-sensitive, perishable inventory, relatively high fixed costs (labor, leases and construction) and low receivables. JBX used substantial amounts of long-term debt (leases, loans and bonds), and the durations and liquidity of its liabilities did not match the durations and liquidity of its assets.

In July 1996, JBX granted stock-purchase rights to its then common-stock shareholders, for purchase of shares of voting participating preferred stock and or common stock. These rights presently trade together with JBX's common stock as a unit. The rights will separate from JBX's common stock and become exercisable only on the occurrence of any of the following events:

- ten days after an announcement that an entity (other than JBX or certain related parties) owns 20 percent or more, of JBX's common stock or securities convertible or exchangeable into 20 percent or more of JBX's common stock;
- ten days after announcement of any tender offer or exchange offer for 20 percent or more, of JBX's common stock;
- the first day after the announcement of acquisition of 20 percent or more of JBX's common stock, on which JBX is acquired in a merger or combination, in which JBX is not the surviving entity, or in which JBX's outstanding common stock is exchanged for stock or assets of another

entity, or on which 50 percent or more of JBX's assets or earning power are sold (other than in transactions in the ordinary course of business).

The rights are not available to investors who buy newly issued shares of JBX common stock. These rights expire in July 2006, unless redeemed or exchanged earlier, or unless the rights are separated from the common stock on occurrence of certain events as described, in which case, the right will expire ten years from the date of separation from the common stock. Each right entitles the holder to purchase one-hundredth of a share of Series A Junior Participating Non-Redeemable Cumulative Preferred Stock, $0.01 par value, at a price of $40 per share. In the event of liquidation, each one-hundredth share of preferred stock will receive the greater of $0.01 or one hundred times the aggregate amount to be distributed per share of common stock. Each share of preferred stock has one hundred votes – each one-hundredth share of preferred stock technically has one vote. In the event of a merger or consolidation, each share of preferred stock will receive one hundred times the amount distributed per share of common stock, and the preferred stock has anti-dilution provisions. Prior to the separation of the rights from JBX's common stock, JBX has the option to substitute for all or any portion of the preferred stock that otherwise would be issued on exercise of the rights, cash, assets or other assets having the same aggregate value as the such shares of preferred stock. The participating preferred stock pays dividends equal to the greater of $1.00 per annum, or one hundred times any dividends paid to common-stock shareholders. The participating preferred stock holders as a group, can elect one person to JBX's board of directors. If JBX does not pay preferred stock dividends for six consecutive quarters, the participating preferred stock holders as a group can elect an additional director to JBX's board of directors. The participating preferred stock is not redeemable, but JBX can repurchase them in the open market. Furthermore, each right entitles the holder to purchase at an initial exercise price of $40, shares of common stock with a market value equal to two times the exercise price. These rights are an anti-takeover measure. If exercised, the rights will provide additional capital, at a very low cost, but will dilute JBX's common stock, and reduce the probability that JBX will pay regular dividends to common-stock holders. By exercising the rights, existing shareholders can continue to dictate firm policy and possibly jeopardize interests of future common-stock shareholders. This raises the issue of whether existing shareholders will have greater rights than future shareholders who own the same class of securities.

Improved balance sheet, lower interest expense, and potential for recapitalization – a basis for growth by acquisition or expansion of operations

JBX reduced its interest expense and long-term debt during 1996-1999. However, the often unpredictable nature of restaurant sales demand and the perishable nature of the product, requires less stringent financing terms. JBX can recapitalize its current liabilities and long-term liabilities to better match its assets (and refinance its bank loans that mature in 2003) in order to provide flexibility for growth. Most of JBX's liabilities are fixed-rate liabilities, except for the bank credit facility. JBX can issue convertible preferred stock and make concerted efforts to reduce its accrued liabilities.

During 1996-2000, JBX produced substantial cash flow, that has grown steadily (over 6.5 percent annually) owing to improved efficiency, increased number of restaurants, stretching of payables, and tax shields provided by substantial depreciation and interest expense. JBX has funded normal operations and expansion from its operating cash flow.

Hidden and undervalued assets

JBX has hidden and undervalued assets that can be monetized to provide capital for expansion:

- JBX built many restaurants which it recorded in its balance sheets at depreciated cost, while real estate values have generally been trending upwards nationwide. The market values of these buildings are most probably higher than their carrying values – and JBX can realize such values by entering in to sale-leaseback type transactions, or by consummating more contracts with franchisees who can buy such assets, or by a spin-off of its real estate assets.
- JBX presently had over $50 million of construction-in-progress assets, and about $41 million in "assets held for sale" which are reported at cost, but which are most probably worth more than their book values (data are as of March 2000).
- Similarly, JBX's restaurant equipment are owned, and are depreciated over 3-30 years on a straight-line basis – most probably, the equipment is being depreciated faster than actual use, and probably has higher salvage values. JBX can realize value by sale-leaseback of such equipment. JBX's real estate and equipment secured some of its borrowings.
- JBX presently owns about $78 million worth of "trading area rights" recorded as intangible assets, which represent the value of the rights to operate existing restaurants within their specific trading areas. These rights are presently undervalued because JBX operates about 80 percent of its restaurants. The values of these rights are likely to increase as more restaurants are franchised, and as JBX increases market penetration and brand recognition.
- Owing to prior year losses, JBX has tax loss carry-forwards which provide tax shields.
- Leasehold interests: JBX leases most of its properties. If JBX's rents are below market value, or JBX's leases are renewable at below-market rental rates, then JBX has substantial leasehold interests that are not being taxed, but greatly reduce its fixed costs.

Investment considerations (as of April 2000)

JBX's capital structure presents investors with the opportunity to own its common stock or its 8-3/8 percent 2008 high-yield-bonds. The following are summary analysis and investment considerations:

(1) The senior subordinated notes are best positioned to gain from the restructuring – reduction of debt and interest payments either from the issuance of equity securities or reduction of debt. Restaurant share prices have been relatively under-valued over the last 12 months, and are likely to remain so, owing to intense competition in the industry, high-leverage, negative working capital balances, and perceived sensitivity to disposable income, labor costs, food costs, and seasonality; and because restaurant sector and industry ROE and ROIC and total returns have been consistently lower than S&P and market averages. Unlike many competitors, JBX does not pay any dividend (as of March, 2000, the average dividend was 0.75 percent for the industry and 1.82 percent for the sector, and 1.71 percent for the S&P, and industry dividends have been growing at an annual rate of 8.16 percent). JBX's sales growth rate is lower than sector and industry averages, but its ROIC (11.4 percent) and ROA (9.57 percent) were higher than sector and industry averages. Although JBX's return on equity has been relatively very high (43 percent, 63 percent and 51 percent in 1999, 1998 and 1997 respectively), the stock market has not reflected such earning power in JBX's stock price. JBX's high ROE ratios are misleading because JBX is highly leveraged and uses substantial leasing – the stock market is not rewarding JBX's growth with its present capital structure. In this instance, return on invested capital is a better measure of performance. Furthermore, there appears to be substantial correlation among changes in prices of restaurant stocks, such that it is more difficult for any single stock to perform well when the sector or industry group is declining (in terms of price). There is not much correlation between high-yield bonds and equities, or treasuries or restaurant stocks. As of 10 March 2003, the 26-week and 52-week total returns for JBX's common stock were – 9.3 percent and – 12.1 percent respectively. JBX's bond offers a substantial yield advantage and potential capital appreciation, and the bond market is more likely to factor in JBX's best quality (stable and substantial operating cash flow) and any improvements in credit quality. The senior sub notes are likely to benefit most from continued growth in JBX's operating cash flows, which will improve coverage ratios, and JBX's ability to grow internally.

(2) At issuance, JBX's senior sub notes had priority over all other claims except the bank debt. In the event of liquidation, holders are assured of a reasonable return of capital, and holders will participate in any restructuring. While the bonds are unsecured, they are guaranteed by

JBX's current and future subsidiaries. However, such guarantees are subordinated to senior debt of the subsidiaries. The guarantees are "joint and several". Asset coverage (total tangible assets/total debt) was 0.74 as of 3 October 1999.

(3) JBX's bank credit facility was amended on 17 September 1999, by agreement, such that JBX was not required to file UCC financing statements or fixture filings after JBX changed its name to Jack in the Box. Since this UCC filing requirement was eliminated by agreement between JBX, the bank and the agents, the net effect is that the bank credit facility is unsecured, and JBX's 8-3/8 percent '08 bonds now rank pari-passu with the bank credit facility in terms of liquidation preference. Furthermore, the 17 September 1999 amendment (to the credit facility) decreased the amount of sale-leaseback transactions that JBX can consummate to $85 million, $100 million, $125 million, $120 million and $120 million for the fiscal years ending in 1999, 2000, 2001, 2002 and 2003. JBX did not disclose the exact amount of sale-leaseback transactions that it entered into during fiscal year 1999.

(4) JBX's common stock, and restaurant sector shares have substantially high volatilities, and are cheap compared to only the fast-food sector, but not restaurant industry or S&P valuations. JBX has unique risk factors and unsystematic risk (discussed in this paper), such that JBX's bonds provide a safer and less volatile medium to participate in JBX's growth, while reducing risk. JBX's Beta is 0.90, and so JBX's common stock has substantial market risk and is sensitive to changes in the general level of market prices, while JBX's returns are much less than the market index – thus, investors can take less risk and earn more by buying the market index instead of JBX's common stock. Thus, much of JBX's performance can be attributed to its unsystematic risk – for which the bond is a better investment vehicle. On an absolute basis (Beta, standard deviation, volatility), the market risk of JBX's common stock is higher than that of JBX's bond (which has higher returns and better risk/return ratio). During 1980-1997, the annual returns for high-yield bonds and the S&P index were 14.35 percent and 17.89 percent respectively, and their volatilities were 9.19 percent and 17.24 percent respectively (DLJ, Ibbotson Assocs, etc.).

(5) JBX's planned expansions and any resulting and substantial increases in cash flow and brand image, will occur around 2003-2006, as JBX diversifies into other states and internationally. Thus, any substantial growth in JBX's stock price will follow such trends.

(6) As of April 2000, the US Treasury yield curve was in an unusual state. The 10 March 2000 US Treasury debt rates were 5.60 percent, 5.8 percent, 6.54 percent, 6.61 percent, 6.40 percent and 6.15 percent for

three-month treasury bills, six-month treasury bills, and two-year, five-year, ten-year and 30-year US Treasury bonds respectively. There is some aberration in the relationship between the two-year and ten-year treasury debt sectors. JBX's 8-3/8 percent '08 bond can be a possible component in a bond trade that bets that the US Treasury yield curve will revert to its normal relationships as per liquidity premium theories. This strategy will involve buying JBX bonds and shorting ten-year and two-year Treasury bonds (with a greater percentage of the short position in the ten-year treasuries).

(7) On a relative value basis, JBX's bonds are presently under-valued at current prices of 90-91 percent (as of March 2000). Their intrinsic value is in the 95-96 percent range.

(8) The senior subordinated notes are fulcrum-type securities in any restructuring of JBX's liabilities.

(9) JBX's bonds have a high probability of upgrades in ratings (and a corresponding increase in bond price) because:

- data and prior studies have shown strong positive correlation between stock Beta and bond ratings, and JBX's Beta is 0.90, which is about the same for companies rated A by Moodys, and the Beta for B-Baa companies are 1.024-1.258;
- JBX has consistently produced substantial operating cash flow which has been increasing over the last five years, and its free cash flow will grow faster if it reduces construction activity;
- JBX has a good concept, and potential for substantial growth in international markets; and
- variations (standard deviation) in JBX's sales and operating cash flows have been relatively low.

(10) Given the recent long period of growth of the US economy, and signs of a slow-down of economic growth in the USA, JBX's debt offers more protection for investing in a highly leveraged company in an uncertain and increasingly weaker economy.

(11) JBX's 8-3/8 percent '08 bonds are callable at any time after 15 April 2003, at an initial call price of $104.188 (and declining thereafter), and the yield-to-call is about 11.935 percent, which is quite attractive. More importantly, JBX has the option of redeeming these bonds before 15 April 2001 at a price of 108.375 percent, with the proceeds of one or more sales of JBX's capital stock. This cash redemption is limited to 35 percent of the amount of bonds, such that at any time after redemption, $81.15 million of the bonds should be outstanding. If the cash redemption occurred on 15 April 2001, at the April 2000 price of $91, the yield-to-redemption is 17.84 percent – this yield will be higher if the

bonds are redeemed earlier. JBX had good reasons to issue equity securities before 15 January2001 and use the proceeds to retire its 8-3/8 percent '08 bonds for the following reasons:

- JBX's EBITDA interest coverage was and is lower than industry, sector and S&P averages. There is not much interest tax shields to be obtained by increasing debt;
- JBX's $175 million credit facility expires in 2003, and at the present rate of growth, JBX's free cash flows are actually declining at a significant rate. Any new debt or refinancing of the bank credit facility will be done at much higher interest rates. JBX needs cash, if it intends to grow at a faster rate, into states in the south-eastern USA and north-western USA.
- Under the terms of the bond indenture for the 8-3/8 percent '08 debt, JBX's EBITDA interest coverage should not exceed 2.25:1, and JBX's outstanding "indebtedness" cannot exceed $185 million. "Indebtedness" as defined in the bond indenture includes JBX's bank credit facility ($86 million used as of October 1999, $175 million total), JBX's capital leases (present value of $16 million as of October 1999), JBX's 8-3/8 percent '08 bonds ($124.8 million as of October 1999), certain JBX current liabilities which have to be repaid within six months of the purchase of goods or services (includes $15.5 million of advertising, $7.09 million of interest, $13.8 million of capital improvements and possibly $24.14 million of "other" liabilities), obligations arising from leases between JBX and CRC-I/CRC-II partnerships (financing leases which amounted to over $68.5 million as of October 1999), and JBX's secured notes ($7 million on October 1999). Thus, JBX has technically breached the terms of its bond indenture, and has defaulted.
- JBX violated the terms of the bond indenture which requires that the total capitalized lease obligations incurred with sale of property in sale-leaseback transactions should not exceed $15 million. As of October 1999, the present value of JBX's capital lease obligations exceeded $16.8 million, and the present value of its financing lease obligations exceeded $68 million. As discussed, JBX regularly builds restaurants, and enters into sale-leaseback transactions pursuant to capital and operating leases. In its Form 10K and Annual Report, JBX did not disclose the exact amount of capital leases arising from such sale-leaseback transactions. It appears that almost all of JBX's $16 million capital leases arose from sale-leaseback transactions.
- Although JBX's bond indenture prohibits any stock buy-back, JBX's board of directors approved a $10 million stock (around 1999/2000) repurchase program, which violates indenture terms.

- The bond indenture prevents JBX from issuing any debt that is subordinated to the 8-3/8 percent ’08 bonds, unless such new debt ranks pari-passu with the 8-3/8 percent ’08 debt. This term greatly limits JBX’s financial flexibility. Furthermore, JBX cannot incur any liens unless such liens are secured on an equal basis as the 8-3/8 percent ’08 bonds.
- The bond indenture limits JBX’s ability to merge or sell assets, because the indenture requires that certain debt be retired at premia to face value, upon any asset sale or merger or change in control.

Corporate governance and policy issues

Legality of anti-takeover measures

JBX’s capital structure raises the issue of the legality of its stock-purchase rights, which are an anti-takeover measure, particularly when such measures favor certain groups of shareholders of a class of equity securities. The rights are contingent on, and are exercisable only on the occurrence of certain events. The rights are not related to any specific offering of securities or payment for services, or stock-splits. If exercised, the rights will dilute JBX’s common stock. By exercising the rights, existing shareholders can continue to dictate firm policy and possibly jeopardize interests of future common-stock shareholders. Thus, existing shareholders will have greater rights than future shareholders who own the same class of securities, for no justifiable reason (Lipton, 2002; Arlen, 2002; Romano, 1992; Garvey and Hanka, 1998).

Uniformity of partnership and LLC laws and fraudulent conveyance laws

The CRC-related issues and JBX’s situation illustrates the need for uniformity of partnership and LLC laws, and fraudulent conveyance laws in different states.

US Securities and Exchange Commission’s approval processes

Although JBX’s transactions resulted in fraudulent conveyance, the US Securities and Exchange Commission approved its filings. The SEC review processes for transactions that involve debt offerings in restructuring and mergers, should be changed. The SEC should require explicit and actionable certification (apart from comfort letters and similar compliance documents) from CPAs, management and law firms on pre-transaction and post-transaction solvency (Defond and Jiambalvo, 1994; Geiger, 2002; Hodder *et al.*, 2001; Hope, 2003; Langevoort, 1998; Schmitz *et al.*, 1998).

Disclosure laws, conflicts of interest and failure of auditing standards

There are often conflicts of interest in corporate transactions, particularly when buy-out funds and special situations funds are participants, and or when a management group decides to consolidate an industry or sector. In many of such instances, the present disclosure laws and transaction processing procedures have not adequately identified such conflicts of interest, and have not reduced "self-dealing" and unwarranted gains by perpetrators (Geiger, 2002; Chen and Church, 1992; Defond and Jiambalvo, 1994; Bernstein, 1998).

It appears that opinions issued by accounting firms are not adequate to protect investors, and in many cases, derogatory going concern opinions are issued late, many quarters after the company has significantly deteriorated. Accounting firms have an inherent incentive to delay the reporting of negative financial information about clients. Thus, there should be additional reporting mechanisms to protect investors. In the case of publicly traded bonds, the role of the bond trustee should be mandatorily expanded to include periodic certifications that the issuer is solvent, and such reports should be made mandatory SEC filings. The second issue is whether bond indentures should contain specific language about bondholders' recourse if the issuer is deemed insolvent – bank loans and private debt often contain such terms and conditions.

Furthermore, it is clear that the present auditing standards are insufficient to prevent fraud and misstatements in financial statements. Auditors have a very strong incentive not to issue derogatory reports, particularly where, as in this case, the clients are large companies that pay substantial fees. The auditing standards need to be strengthened and special procedures should be developed for large highly leveraged transactions and complex M&A transactions completed during the period being audited. The revised auditing standards should include actionable transaction-specific certifications by auditors, with emphasis on solvency, conflicts of interest, and tax compliance (Defond and Jiambalvo, 1994).

Accounting: current costs versus historical costs

JBX illustrates why current costs should be used more often in financial statements, and shows why its necessary to:

- include more disclosure about current costs in financial statements and related footnotes; and
- replace historical costs in balance sheets with current costs for certain assets and liabilities such as long-term assets and intangibles.

Most financial statements of services companies and technology companies do not contain adequate disclosure about 'human capital' and intellectual capital, even though these constitute the major assets of such companies (Defond and Jiambalvo, 1994).

The failure of US corporations laws (bankruptcy laws (chapter 11 and chapter 7), UCC Article 9 and debtor/creditor laws

JBX illustrates the failure of corporations laws in defining, monitoring and recording transactions, in addition to enforcing the laws. JBX raises the issue of whether to include “anticipatory laws” in bankruptcy codes and UCC laws. The rationale for such “anticipatory laws” are that:

- in many instances, financial distress can be drastic; and
- interested parties need to have mechanisms to intervene in troubled companies before the crisis reaches the bankruptcy and or liquidation stage.

Under most interpretations, current US corporate bankruptcy laws and UCC laws are at best, passive. There should be “triggers” and special proceedings that confer instant jurisdiction on the bankruptcy courts and federal courts to monitor transactions, determine solvency and enforce the laws. Such jurisdiction and proceedings will be different from standard bankruptcy proceedings (chapter 11 and chapter 7). Such triggers may include going concern opinions, transactions that involve a certain level of leverage, provisions for shareholder derivative actions, three to four years of reporting negative shareholder equity, etc. (Adler, 1994; LoPucki, 1982; Andrade and Kaplan, 1998; Franks *et al*., 1996; Bergstrom *et al*., 2001; Bernstein, 1998; Chatterjee *et al*., 1996; Chen and Church, 1992; Duberstein, 1993; Hillinger and Hillinger, 2001; Mella-Barral, 1999; Schmitz *et al*., 1998; UK Department of Trade And Industries, 1999; Zinneker, 1999).

The US UCC Article Nine was extensively revised in the late 1990s. However, Article Nine is also passive in terms of identifying and dealing with potential insolvency and financial distress. Article Nine is probably the best system with which to monitor secured transactions because it covers a wide range of transactions, involves filings and lien searches, and can be naturally extended to define rights and obligations when insolvency is likely.

Protection of rights of minority equity investors

JBX illustrates the need to protect the rights of minority investors, particularly in large transactions. At present, minority investors have three main forms of recourse for objecting to proposed transactions: shareholder derivative lawsuits, proxy solicitations and requests for shareholder voting on specific issues. Under current US laws, management and the board of directors have the right not to present specific issues for voting or discussion at shareholders’ meetings. Proxy solicitations are expensive and time consuming. Shareholder derivative lawsuits can also be time consuming, even when expedited processes such as declaratory judgment actions are used. There needs to be speedy and efficient mechanisms for shareholders to object to specific types of transactions that will impair their wealth or amount to fraudulent transfers. Such mechanisms could be implemented through special proceedings in ordinary courts, and bankruptcy courts (Bernstein, 1998; Sauer, 2002; Schmitz *et al*., 1998; Cripe, 2003).

Role of banks and financial intermediaries in corporate governance and financings

The analysis of JBX raises the issue of the role of banks in corporate governance and management in companies. Typically, banks provide the largest proportion of financial capital for companies in most industries, but earn capped returns that are often lower than returns to equity investors. However, banks typically do not have any say in day-to-day management or deliberations of the boards of directors, unless the company is in financial distress or bankruptcy proceedings. To complicate matters, executive compensation systems often provide incentives for managers to make decisions that are not in the best interest of banks. These issues result in principal-agency and moral hazard problems (Fama and Jensen, 1983; Bainbridge, 2001; Barnden, 2002; Macey and Miller, 1997; Triantis and Daniel, 1995; Amihud *et al.*, 1999). In Germany and Japan, banks have a more active role in corporate governance, but this has had substantial impact on both economies and on the structure of ownership.

Furthermore, in financings, banks and financial intermediaries have typically acted as lenders and advisors. These intermediaries perform a due diligence function and financing function. As illustrated by the JBX case, their passive "due diligence" role is not sufficient in ensuring the proper financing and operation of businesses. This is partly attributable to:

- the "sunk cost" effect;
- bankers' incentives to maintain client relationships;
- the way that banks are compensated for making loans; and
- over-reliance on external auditors' reports.

Regulatory approvals for loans in highly leveraged transactions

There should be a system of reporting loan inquiries by companies. The capital requirements rules are clearly insufficient as a risk mitigation or risk reduction mechanism. There should be a clear distinction between risk mitigation and risk reduction. Most risk reduction efforts in banks are in the form of credit analysis and due diligence. Capital requirements rules are a risk mitigation mechanism but are insufficient to prevent fraudulent transfers and improper loans. There should be additional rules that expressly state standards for loan origination and for reporting financial distress. There should be required regulatory approvals for highly leveraged transactions that involve loans that exceed specified amounts (Bernstein, 1998; Baird, 1991; Arlen, 2002).

Role of boards of directors, directors' liability and revision of the business judgment rule

The rules and expectations about directors' fiduciary duties and obligations should be revised – the "business judgment" rule and the "prudent man" rule.

In their present form, the "business judgment" rule and the "prudent man" rule are essentially "abstention doctrines" in courts and provide excessive protection to boards of directors for reckless and negligent misconduct. In courts, most judges will not review the substantive merits of lawsuits against boards of directors unless the plaintiff presents materials that rebut the presumption of good faith that is implicit in the business judgment rule (Bainbridge, 2001; Simpson, 1998; Lin, 1998; Cripe, 2003).

Some boards of directors are essentially serving as rubber stamps for management decisions, without performing substantial over-sight functions. How much control and responsibility should boards of directors statutorily have over the planning and execution of M&A, and major recapitalizations and the implementation of internal audit recommendations? Should there be more statutory definitions of matters that should be put to a vote of shareholders and those that should be decided by the boards of directors? (Geiger, 2002; Schmitz *et al.*, 1998).

Role of labor unions

Corporate transactions by service companies present labor union issues and pension fund issues, because such transactions involve often negotiations with, and concessions by unions (Hopt, 1994; Schmitz *et al.*, 1998). Labor unions can increase or reduce operating costs and competitiveness. Should the unions be statutorily represented on boards of directors and allocated a share of votes in M&A approval processes (FTC reviews, voting by shareholders, etc.)? In the case of under-funded pension plans, should unions have more statutory recourse? Should merging entities be statutorily required to file a plan to restore under-funded pension plans as a condition for approval of proposed mergers? Should cash proceeds of debt offerings, equity offerings and M&A be first applied to reduce under-funded pension plans before shareholders and the company get any funds ? How much discretion should management have in the use of excess pension fund assets? How much input should unions have in corporate strategy, executive compensation and general management?

Antitrust regulation

Many national and regional restaurant chains have stores in the same locations (Saltzman *et al.*, 1999; Poole *et al.*, 2003; Wrigley, 2001; Burt and Sparks, 2001). This raises the issue of determining the existence of antitrust violations. Typical measures of antitrust would include percentage of total restaurant sales in a metropolitan statistical area, percentage of total eateries in a town/city, percentage of total restaurant square footage in a town/city, etc. One key issue is whether ownership or leasing of physical stores increases the likelihood that a merger/acquisition will be deemed anti-competitive – if ownership is deemed to increase the probability of anti-competitive sanctions, then restaurants chains will be more likely to lease stores (Seiler *et al.*, 2001;

Roulac, 2001). Ownership sometimes involves the same or similar legal filings as long-term leases because major leases are sometimes recorded at municipal offices. Mortgages secured by certain leases are also recorded. In the case of capital leases, lessors often have the same economic rights and risks as owners. There are major differences in the accounting treatment of capital leases and operating leases, which should affect the level of antitrust liability in mergers/acquisitions. However, a retailer's ownership of a retail store generally indicates a longer-term commitment to a geographical market, compared to leasing (Poole *et al.*, 2003; Wrigley, 2001; Burt and Sparks, 2001; Williams, 2003). Thus, traditional measures of restaurant industry concentration such as retail chain floor space (relative to population) and store sales volume are becoming irrelevant (Myron *et al.*, 1997; Rubinfeld and Baker, 1999).

Conclusion

The foregoing discussion illustrates the need for greater emphasis on disclosure and corporate accountability, because they are the foundation for public trust in systems of private and public enterprise. Legal considerations and real estate analysis are now more relevant in the execution of corporate strategy and corporate transactions, which require thorough review and understanding of the entity's capital structure and obligations, within the context of its strategy and business activities.

The US restaurant industry and food service industry have undergone substantial changes during the last decade, which have created legal/regulatory, human resources, strategy and governance problems. Management and board of directors' ability to discern and respond to these changes remains crucial to firm performance.

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