

1-1-1989

Financial Failure In the Hospitality Industry

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Recommended Citation

Tavlin, Edward M.; Moncarz, Elisa S.; and Dumont, Deb (1989) "Financial Failure In the Hospitality Industry," *Hospitality Review*: Vol. 7 : Iss. 1 , Article 7.

Available at: <https://digitalcommons.fiu.edu/hospitalityreview/vol7/iss1/7>

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Abstract

The hospitality industry (especially the restaurant segment) has a historically high rate of financial failures. Yet, financial failure in the industry has not received the attention it deserves. In this article, the authors identify basic reasons underlying failed ideas while presenting a study of several hospitality chains that have experienced varying degrees of financial failure. The characteristics and pitfalls of these companies provide the necessary groundwork to explore major lessons to be learned which should aid hospitality management to avoid future business failures.

Keywords

Wendy's, Taco Viva, Ponderosa, Sambo's, Restaurant Industry, Edward M. Tavlin, Elisa S. Moncarz, Deb Dumont, Financial Failure in the Hospitality Industry, Chapter 7 Bankruptcy, Chapter 11 Bankruptcy, Turnaround Strategy, Reorganization, FIU

Financial Failure in the Hospitality Industry

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The hospitality industry (especially the restaurant segment) has a historically high rate of financial failures. Yet, financial failure in the industry has not received the attention it deserves. In this article, the authors identify basic reasons underlying failed ideas while presenting a study of several hospitality chains that have experienced varying degrees of financial failure. The characteristics and pitfalls of these companies provide the necessary groundwork to explore major lessons to be learned which should aid hospitality management to avoid future business failures.

Each year a significant number of hospitality firms close their doors. Generally, food service/restaurant companies experience a higher rate of failure than do lodging companies. Unfortunately, the statistics that are available can be somewhat misleading since they are composed of only those businesses that have filed for bankruptcy. The figures do not include businesses that have closed, but have been able to pay off their debts. Nor do they include companies that have been able to resolve their financial difficulties and continue in business.¹

In 1986 the failure rate per 10,000 listed concerns (Dun's Census of American Business) for eating and drinking places was 142. During the same period, the failure rate for the lodging industry was 65. In 1987 there was a slight decrease in the failure rate for both segments. Eating and drinking places experienced a failure of 91 per 10,000 listed concerns, while the failure rate for hotels was 62 per 10,000 listed concerns.²

Failure is defined by Webster as "the state of fact of being lacking or insufficient ('falling short')." Failure does not necessarily result in the dissolution of a business. In an economic sense, failure means that a firm's revenues do not cover costs. At the other extreme, there is insolvency in bankruptcy when the company's net worth is negative (i.e., liabilities exceed the appraised value of company's assets). In between there exists an entire range of possibilities which may be temporary and subject to remedy, but if not corrected, could lead to the dissolution of the business.

Table 1 summarizes the three basic types of financial or business failure.

Table 1
Types of Financial Failures

Term	Definition	Source
Economic Failure	Occurs when a company's costs exceed its revenues or that the internal rates or return on its investments are less than its cost of capital. ³	Arthur J. Keown John D. Martin William Petty David F. Scott <i>Basic Financial Management</i>
Technical Insolvency	Occurs when a business cannot pay its obligations. The book value of its assets may exceed its liabilities, indicating positive net worth, but the company does not have sufficient liquidity to pay its debts. The business may be able to escape total failure if it can convert some of its assets into cash within a reasonable time. ^{4,5}	Arthur J. Keown, et al. <i>Basic Financial Management</i> Lawrence J. Gitman <i>Principles of Managerial Finance</i>
Bankruptcy	Occurs when the company's liabilities are actually greater than the fair market valuation of its assets, indicating negative net worth. The firm is totally unable to meet its maturing obligations. This situation generally indicates that liquidation or dissolution rather than reorganization of the firm is necessary. ⁶	Arthur J. Keown, et al. <i>Basic Financial Management</i>

Just as there are various degrees of failure, there are also a number of remedies available to an organization in financial distress. These solutions may be applied voluntarily or involuntarily. Most voluntary remedies are applied by the business without court or trustee supervision of the settlement.

Table 2
Types of Voluntary/Involuntary Solutions To Financial Failures

Term	Definition	Source
Extension	A firm's creditors agree to postpone debt payments for a specified time period in order to mitigate the firm's problems. ⁷	Charles W. Haley Lawrence D. Schall <i>Introduction to Financial Management</i>
Composition	A firm's creditors agree to receive less than the amount originally owed to them. ⁸	Charles W. Haley Lawrence D. Schall <i>Introduction to Financial Management</i>

Term	Definition	Source
Quasi-reorganization	Occurs when a firm modifies its capital structure. This modification usually involves writing off a deficit against additional paid-in capital; reduction in the par value of the company's common stock; or write-down of overvalued assets. A quasi-reorganization permits a company to regain its position as a profitable business without the stigma associated with large deficits or continuous operating losses. ⁹	E. John Larsen A. M. Mosich <i>Intermediate Accounting</i>
Chapter 11 Bankruptcy Reform Act of 1978	This remedy is applied under court supervision. Usually the debtor remains in possession of and continues to operate the firm while working out a plan to settle the company's obligations. Chapter 11 permits these negotiations to be conducted directly among the debtor, creditors and stockholders. ¹⁰	Glenn G. Munn <i>Encyclopedia of Banking and Finance</i>
Chapter 7 Bankruptcy Reform Act of 1978	This is an involuntary solution. It is applied in situations where it has been determined that a fair, equitable, and feasible basis for reorganization does not exist. The business is liquidated or dissolved in an orderly manner. Any proceeds from the sale of the assets are distributed to creditors first. Any residual proceeds are then distributed to the shareholders. ^{11,12}	Lawrence J. Gitman <i>Principles of Managerial Finance</i> John D. Finnerty <i>Corporate Financial Analysis</i>

There are many reasons leading to business failures, particularly restaurant failures. Studies show that only 10 percent of all failures are directly attributable to acts of God, neglect, or dishonesty on the part of management or owners. Some reasons for failure include poor execution, ego of the founder, undercapitalization, non-diversification, abandonment of a successful concept, inadequate manager and/or employee training, poor upkeep of the property, too rapid expansion, inadequate internal controls, reliance on a gimmick theme, poor site selection, and inadequate market analysis.

We will now examine several different companies that have experienced varying degrees of financial failure.

Wendy's International, Inc.

Wendy's was recently rated number five in the *Nation's Restaurant News* Top 100 Chains ranked by system-wide sales. Annual system-wide sales as of August 1988 were \$3 billion. Wendy's was also ranked number five in this survey in the market share category. In the hamburger chain segment, Wendy's is currently ranked fourth in system-wide sales, third in number of units with 3,950, and eleventh in sales per unit.¹³

Wendy's concept is based on freshly-ground ("hot off the grill") hamburgers garnished with the customers' choice of toppings. Although it has been considered adult oriented, the company has increased its efforts to attract the "family" market.

In the past Wendy's was considered one of the best chain operators. Management would thoroughly study an idea before implementing it. Initially, things were kept simple. In order to keep capital costs down, Wendy's built smaller units and purposely planned to do most of its business through the drive-thru window. The company also made a conscious decision not to complicate the menu with a large variety of items. Hamburgers, fixed a number of ways, were the key to success. Additionally, during the early years, Wendy's was able to get greater productivity out of store crews than either McDonald's or Burger King. As a result of these basic philosophies, Wendy's was considered a success from the opening of its first store in 1969 through the end of 1984. However, in 1985, deviation from the basic concept and some basic business practices began to negatively affect the company's performance for the first time in 15 years.

In 1983, the company had a net income of \$55.2 million. The profit margin was 8 percent and Return on Equity (ROE) was 19 percent. Revenues increased to \$720 million, up 19 percent and system-wide sales increased to \$1.92 billion, up 18 percent. The company attributed its increased profitability to the opening of 95 additional (both foreign and domestic) company-owned units, increased real sales volume, and, to a lesser degree, increased prices. Several new menu items such as the bacon cheeseburger, an upgraded salad bar, and a "hot stuffed" baked potato helped stimulate sales. Additionally, the cost of sales decreased during the year as a result of increased operating efficiencies, lower beef prices, and a change in the product mix.

In 1984, net income increased to \$68.7 million. The profit margin remained steady at 8 percent, but ROE increased slightly to 20 percent. Revenues increased to \$944.7 million, up 31 percent, and system-wide sales increased to \$2.42 billion, up 26 percent. Again, the company attributed its success to the opening of additional company-owned units¹⁴, increased real sales volume, and an increase in prices. The unusual success of its "Where's the Beef?" TV commercials was also very important. The company introduced a new daypart (breakfast) and extended its hours of operation to include late night service. Breakfast was becoming the fastest growing daypart in the fast food segment at this time. The company also implemented computerized

cash registers which improved operating efficiency and cash controls. Management personnel and crew depth were also increased.

Several Factors Contributed To Financial Failure

In 1985, Wendy's net income was \$76.1 million and the highest level of earnings achieved in the company's 16-year history. Revenues were up to \$1.126 billion, an increase of 19 percent, and system-wide sales increased to \$2.69 billion, up 11 percent. During this year Wendy's opened 200 additional company-operated units. The profit margin and ROE both decreased slightly to 7 percent and 19 percent, respectively. This slight decline was attributed to the softness in the economy and lower discretionary spending by consumers. In addition, the breakfast program generated less than anticipated sales. Breakfast menu items were not finger foods, easily served and eaten on the go. Costs associated with the program (advertising, labor, etc.) also increased as a result of increased its use of couponing during this period to protect its market share and remain competitive. Coupon expenses increased to 1.7 percent of sales compared to .7 percent in 1984. Additionally, Wendy's introduced a "light" menu in response to the growing popularity of low-calorie and healthy foods.

In 1986, Wendy's sustained a net loss of \$4.9 million, the first in the company's history. The profit margin was less than 1 percent and ROE was negative. Revenues increased by 1 percent, totaling \$1.14 billion. System-wide sales increased to \$2.7 billion, up 2 percent. Management continued to blame softness in the restaurant industry for the poor results. The company also blamed increased competition for the erosion of sales related to some products and dayparts. In addition, Wendy's increased couponing in response to competition. Coupon expense increased to 2.6 percent of sales in 1986, as compared to 1.7 percent in 1985. Wendy's also took a \$51.8 million restaurant realignment charge (this include write-down of assets and estimated losses until the units were disposed of) for the disposition of 164 marginal or unprofitable company operated units. These units were to be franchised or closed. The company also repurchased 744,000 shares of its stock for \$9.9 million. During 1986, the company introduced Wendy's Big Classic which was designed to refocus attention on its primary product, the hamburger. Baked potatoes, breakfast, and salad bars had clouded its fundamental product.

In 1987, Wendy's earned a profit of \$4.5 million. The profit margin remained at less than 1 percent, but ROE increased slightly to 1 percent. Retail sales declined slightly during this year to \$987.7 million, down from \$1.036 billion in 1986, due to lower sales per unit. In addition, Wendy's introduced the "SuperBar" concept, an "all you can eat" hot and cold food bar featuring salad items, Mexican food items, and Italian pasta items. Food costs also increased as a result of this program. Additionally, implementation of the SuperBar requires a \$25 thousand per unit capital investment. Couponing also increased for the third straight year, costing the company 3.2 percent of sales in

1987, as compared to 2.6 percent in 1986. Wendy's implemented substantially all of its realignment program.

One of the primary reasons for this company's financial problems was deviation from the company's basic concept, freshly-ground burgers. Wendy's attempted to increase its market share by broadening the menu; in doing so, they began to lose touch with a successful formula. In most surveys the consumer generally rates Wendy's hamburgers better than the competition.

Another reason for the company's distress was its breakfast concept. In mid-1985 Wendy's tried to take advantage of the growing breakfast market by introducing a "cooked-to-order" breakfast menu. However, the company was misguided in its attempt. The menu that was developed was not finger food; it couldn't be eaten in the car or at the desk. Instead, the customer was forced to sit down in the restaurant and eat his meal with a fork and knife. The menu was also considered very expensive, labor intensive, and operationally slow.

The heavy use of couponing or discounting also affected Wendy's financial performance. Beginning in 1985, the company increased its reliance on coupons and discounts to stimulate sales, protect its market share, and respond to the use of coupons by competitors, McDonald's and Burger King. However, discounting did not stimulate sales to any measurable degree. Couponing rarely provides more than a short-term boost to revenues.

In spite of a declining financial position and a poor operating performance, Wendy's used funds of \$22.9 million in 1987 and \$19.9 million in 1986 for the payment of dividends. As a result of dividend payments and stock repurchases, Wendy's financial position weakened further.

Turnaround Strategies Implemented

Wendy's falls into the category of an economic failure, that is, failure to continue its great success.

Wendy's has implemented several strategies to turn its financial situation around, including returning to an emphasis on its primary product, the hamburger, with the introduction of Wendy's Big Classic. In addition, the company is currently testing smaller (2 oz.) and low-priced hamburgers and cheeseburgers in some markets. Its "Hamburger A" television commercials are helping refocus attention on Wendy's hamburgers.

In the first quarter of fiscal 1986, Wendy's decided to make breakfast an optional menu item. Most of the domestic company and franchise stores discontinued the program. Although Wendy's management indicated in its 1986 Annual Report that it was working on a number of breakfast variations, the immediate emphasis was on the hamburger.

Wendy's has also slowed the growth of its company-owned units which resulted in reduced capital spending. Rather than opening a large (100 +) number of restaurants each year, the company plans to

continue its emphasis on improving operations in existing units, and on completion of image enhancement programs, and also plans to reduce its ownership of stores. In the past, Wendy's maintained ownership of 36 percent of total units. Large scale development and international development will be handled primarily through franchising.

Another turnaround strategy implemented by the company was a reorganization at the corporate level eliminating over 400 positions in 1987. Several layers of management between the top levels and field operations were eliminated as well as other administrative programs that did not effectively support restaurant operations. The franchise area director's staff was increased to provide more one-on-one assistance to franchisees. Critical to future success, the franchise system is in disarray. Many failed and others are well behind in license payments. Decision-making has been decentralized somewhat and restaurant managers are being held more directly accountable for running their units. These changes should result in a reduction in Wendy's administrative and general expenses.

The SuperBar, another turnaround strategy, is designed to set the company apart from direct competition with McDonald's and Burger King. According to Wendy's officials, the SuperBar has broadened its customer base by attracting new customers, more families, and more dinner and weekend business. Recently, Wendy's announced plans to test the viability of adding Chinese food and pizza to the SuperBar to keep customer interest stimulated.¹⁵ The SuperBar is a high risk strategy, due to capital costs, but a needed gamble.

The turnaround strategies have begun to take hold and have resulted in a steady improvement in overall performance. For the second quarter of fiscal 1988, profits increased to \$9.6 million, nearly five times the profits for the same period in 1987.¹⁶

Wendy's Has Earnings Rebound

In the September 12, 1988, issue of *Nation's Restaurant News*, several financial analysts indicated they believe Wendy's is once again on its way to being a viable and successful company. According to Caroline Levy of Shearson Lehman Hutton, who changed her rating of Wendy's stock from "sell" to "accumulate," "the stock represents good value based on its potential earnings momentum."¹⁷ Her view reflects her confidence in the turnaround strategies implemented by Wendy's, which are supported by improving profit margins, finances, and some store sales. At company store levels operating margins have improved by 5 percent over the previous year due to better operational controls, a significant reduction in couponing, and lower food costs.

According to Becky Barfield of First Boston in New York, "the strong earnings rebound represents some recovery of sales and significant operating improvements. It appears that Wendy's earnings outlook is improving."¹⁸

Despite these positive opinions, some analysts remain cautious about the company's turnaround. There is concern that the SuperBars

are cannibalizing core menu sales since same store sales and real sales have only sustained moderate increases since their introduction. Some analysts estimate that the sale of non-SuperBar menu items has actually decreased by 20 percent since the introduction of this new item.

According to Jay Freedman of Kidder, Peabody and Co., there are two major obstacles in the way of a complete recovery by Wendy's. "First, the company's SuperBar remains unproven...the company must find ways to keep customers interested once the novelty wears off."¹⁹ The second obstacle pertains to Wendy's franchise system, which Freedman says remains weak; 18 percent of franchise royalties are still in arrears.

Most analysts are taking a "wait and see" attitude on Wendy's because, although the company is beginning to see some tangible results, progress is not yet strong enough to warrant a strong or attractive stock rating.²⁰ Wendy's stock is only nominally above its 1988 low for the year.

Victoria Station

Victoria Station is the next example of a restaurant company that has experienced financial problems. However, this company's financial difficulties were much more serious than the previous example.

Victoria Station was conceived as a medium-priced, limited menu (initially only six entrees were offered) restaurant featuring prime rib served in old railroad boxcars which functioned as the dining rooms. This theme, boxcars and old railroad memorabilia, was used for all the company's restaurants. The concept was designed to appeal to singles, couples, and families who were looking for good quality food at reasonable prices.²¹

The company opened its first restaurant in San Francisco, California, in April 1969. By the end of 1978, Victoria Station had 97 restaurants in operation. These restaurants were all company-owned since there were no franchises. In 1986, as a result of its various financial problems, Victoria Station had 39 restaurants in operation.

During its first decade the company was very successful. However, in 1980 the financial picture began to change.

Financial Failure Sets In

In both 1980 and 1981, Victoria Station suffered operating losses. However, in 1982 the company was able to achieve a small profit due to halted expansion, reorganization of management, and tightening cost controls. The profit margin was 1 percent and the return on equity was 3 percent. This proved to be the last profitable year for Victoria Station.²²

In 1983, the company suffered a loss of \$8 million. Both the profit margin and return on equity were negative. Sales declined from 1982 by \$11.6 million, resulting primarily from a decline in customer counts. Poor economic conditions were also blamed as well as an increase in expenses as Victoria Station attempted to reposition itself.²³ It is interesting to note that all our failure examples cite poor economic condi-

tions for the onset of their problems. Yet, in all cases there were successful competitors in those same markets.

In 1984, Victoria Station's loss was \$5.76 million. Again, both the profit margin and return on equity were negative. Sales also declined, but not at the same rate as the previous year. They decreased by \$7.5 million.²⁴

In 1985, the company's loss was \$5.25 million, and sales decreased by \$8.4 million.²⁵

In 1986, the worst year experienced by Victoria Station, the loss was \$35.42 million and sales decreased by \$19 million from the previous year. While there were other contributing factors, most of the losses over this five-year period were attributed to the sale of restaurants and a drop in customer counts. Losses in 1985 and 1986 were also attributed to the failure of "Bonkers," a gourmet hamburger restaurant. Victoria Station allocated funds from its dinner house market to develop this new concept and penetrate a new market segment.²⁶

One of the major reasons for this company's failure was too rapid growth. Victoria Station's unit expansion was undercapitalized as well. The company, like so many others, felt the pressure from Wall Street to keep growing and increasing earnings. Many of the sale and lease back arrangements the company entered into in order to finance its growth were more costly than its original investment in the properties. Another aspect affecting the company's growth was the fact that it did not franchise, thus it was highly leveraged and assumed all the risk should things go wrong.²⁷

Another major reason for the company's decline was the theme itself. Customers became bored with eating in a boxcar. Rather than being enjoyable or entertaining, the concept became tedious. Additionally, this theme or motif could not be adapted for other uses. There was nothing the company could do to it that would modify it to any degree. The boxcars were also expensive to buy, renovate, or maintain. Many of them had leaky roofs and lacked proper insulation, and to renovate one cost more than the renovation of an ordinary building.²⁸

Closely related to its inflexible theme was the fact that Victoria Station relied heavily on a single item—beef. Rising beef prices as well as a decrease in beef consumption by consumers contributed to the company's poor financial performance. While it tried to adapt to this change in consumer tastes, it made so many changes that Victoria Station lost its identity and unique positioning with the consumer.

In addition, there was no economy of scale with the way the restaurants were established. There were never more than five to six restaurants in any given market, thus supervisory costs and advertising expenses were very high.

One other major contributing factor to the company's distress was its attempt to expand into the gourmet burger market. In 1984, the company opened its first Bonkers Burger Bar & Grill. It quickly grossed \$2.6 million in sales. Soon after, Victoria Station opened five additional units. This concept failed rather quickly, however, because of the amount of competition in this very narrow market segment.²⁹

Victoria Station Files for Bankruptcy

Victoria Station falls on the scale as a total failure; in May 1986, the company filed for bankruptcy under Chapter 11. The reorganization plan called for a reduction in the number of restaurants to 45 Victoria Station units and two Bonkers restaurants.³⁰

Prior to filing for protection under Chapter 11, the company tried to implement a number of turnaround strategies.

In 1981, Terrance Collins, replacing Richard Bardley (one of the original founders) as the company's CEO, halted the company's expansion, reorganized management, tightened cost controls, and made several menu and price changes. He was able to cut administrative expenses by 30 percent and reduced food costs to below 40 percent.³¹ Collins left Victoria Station in 1982 following a dispute with the board over the company's future. He was replaced by Richard Niglio.³²

Under Niglio's guidance, Victoria Station attempted to reposition itself by updating and expanding its menu. New items included seafood, poultry, and pasta entrees, as well as appetizers and an expanded salad bar. He also directed changes in the restaurant decor and improved facility maintenance. Also during this period, the company began disposing of unprofitable restaurants.

In addition, Niglio was responsible for trying to increase the company's market share with the Bonkers concept. In 1984, the gourmet burger segment was considered by many to have real growth potential, while growth of the dinner house segment had begun to slow down.

Some expenses were also restructured in 1984, 1985, and 1986, including a write-down of assets held for sale, reclassification of current maturities to long term debt, reclassification a short term liabilities as pre-petition liabilities, and a reduction in notes receivables.³³

The company also exchanged some of both its common and preferred stock for a reduction in its long term debt and interest expense. Stock was also used to secure a \$5 million loan in 1984. Victoria Station discontinued dividend payments in 1981 to conform to the terms of one of its loan agreements.

In spite of these attempts at a turnaround, the company was unable to reverse its failure.

Current Situation

In December 1987, Lowell Farkas formed the Victoria Station Acquisition Corporation (VSAC), which purchased the Victoria Station trademark, 11 restaurants located in Boston, Miami, and New York for \$6.5 million, and assumed a \$1 million tax liability. The purchase agreement also required VSAC to turn over 10 percent of its stock to shareholders of the old Victoria Station stock. Additionally, another 10 percent of the common stock plus 1 million shares of preferred stock were to go to unsecured creditors of the old Victoria Station.³⁴

As of August 1988, VSAC was still privately held and no information about the company going public was available. However, Farkas is confident he can lead Victoria Station to a comeback.

Sambo's

Of all the companies reviewed here, Sambo's is considered the classic example of a successful company "gone bad." The company went from an organization of 1,117 restaurants in 1981 to a final sell-off of 175 units (after filing for Chapter 11 protection) in 1985.

Sambo's opened its first restaurant in 1957 with a concept of a low-priced pancake/coffee house. The target market was primarily blue-collar families and the concept was designed to be a mass appeal, value-oriented restaurant.³⁵

By 1963 the company had grown to 20 units which served approximately five million customers annually. During the six-year period Sambo's significantly outperformed its competition. No menu prices were raised; the average check was \$1.25, and prices were 15 percent below competitors. Simultaneously, Sambo's achieved a net profit-to-sales ratio of 18 percent. This success was attributed to high customer volume and fast customer turnover.³⁶

By 1969 the company had 92 restaurants in operation, serving 100,000 customers daily. In addition, the company went public. "The act of going public changed Sambo's entire complexion, putting it in the limelight and encouraging accelerated expansion."³⁷ On its first day of trading, the company's stock went from \$19/share to \$32/share. Sambo's became the "darling" of Wall Street during the mid-1970s.

By 1977 the company had 869 restaurants in operation and profits had increased to \$22.8 million.³⁸

The primary reason for Sambo's successful expansion during this period was a company profit sharing plan called "Fraction of the Action" (FDA). Under this plan a restaurant manager could purchase 20 percent ownership of his particular restaurant and in return for his investment could receive up to 20 percent of the restaurant's profits. This program served to instill an "entrepreneurial spirit" into the ranks of unit management. The program worked because the management team was interested and motivated to insure that quality and other operational controls were properly managed. Additionally, the FDA program helped provide capital to finance the company's aggressive expansion.³⁹

In 1976, however, initial warning signs began to appear that signaled future problems. One such signal was slower or flattening growth in unit sales, which increased by only 7 percent. This situation was further aggravated by the growing corporate bureaucracy. According to one source, "There were all sorts of management people giving and taking directions. As the corporation kept growing, they paid less and less attention to the restaurants."⁴⁰

Downfall Began in 1977

The company's ultimate downfall began in 1977. During that year the Securities and Exchange Commission (SEC) ruled that the FDA program was a security and had to be registered with the SEC. Additionally, the receipts from these investments could not be counted as

revenues, but had to be recorded on the balance sheet as a deposit (Sambo's had the option to buy back the managers' investment when they left the company.) The SEC gave the company two options if it wanted to retain the program.

- Restate all revenues and earnings for the eight-year period since Sambo's had gone public by converting the FDA purchases from revenues to deposits.
- Immediately vest all the participating managers, giving them permanent title to their 20 percent ownership.⁴¹

"Sambo's chose the latter alternative. It amended the program to offer only 1 percent interest for \$3,000 to new managers each year and tried to induce current managers to sell back their vested shares by offering as much as \$50,000 to buy back the 20 percent \$20,000 shares on which the managers had been making 20 percent of the annual pre-tax profits of their units."⁴²

On August 23, 1977, the company's board decided to abolish the program, giving two reasons for the decision. First, with expansion going at such a rapid pace, the board felt the program might become uncontrollable. Second, if Sambo's wanted to position itself to be purchased by another restaurant company, the FDA program would block the sale.⁴³

The managers considered this move a betrayal of their trust, and few believed that the SEC had actually forced the change. Managers began leaving the company in droves. Within six months of abolishing the program, 50 percent of the managers had quit. Beginning in 1978 average management turnover exceeded 100 percent. "The incentives, stability, and cohesiveness that had been built were destroyed."⁴⁴ The entrepreneurial manager was gone and unit controls were virtually non-existent.

"In April 1986 a \$7 million settlement was reached in a class action suit by Sambo's former shareholders for compensatory damages for alleged stock market losses following the August 23, 1977, modification of the Fraction of the Action Plan."⁴⁵

A second reason for the company's severe financial distress was that despite the fact the FDA program had been abolished and was considered the basis for the company's expansion, top management pushed an even more aggressive rate of expansion. Beginning in 1977, Sambo's expanded at a rate of well over 100 units per year.⁴⁶ Such expansion was beyond the capacity of its thin real estate and construction staff.

Another major drain on the company's finances was the number of lawsuits in which it found itself involved. In 1979, former managers of the company began filing suit against Sambo's claiming that the FDA program was a pyramid scheme that took the investment of the individual restaurant managers and put it in the pockets of top corporate management. The company was also hit with lawsuits from the NAACP and other civil rights groups which charged discrimination be-

cause of the negative connotation of the company's name which they felt was derived from the children's story *Little Black Sambo*.⁴⁷

As a result of the high management turnover, there was no continuity left in the company and no organization at the field level to maintain proper controls. Additionally, there was also a lack of proper internal controls at the individual unit level, one of which was poor money handling. Additionally, cleanliness and sanitation standards of the facilities began to seriously deteriorate.

Company Files for Bankruptcy in 1985

Sambo's is also considered a complete or total failure. In 1985 the company filed for bankruptcy under Chapter 11; however, it did try to implement some corrective actions.

In 1979, Daniel Shaughnessy became the CEO for Sambo's. Under his direction the company implemented the "Price Point" strategy which reduced the company's overhead at the corporate, field, and restaurant levels. From 1979 to 1981 Sambo's reduced its employees from 37,000 to 28,000.⁴⁸

Another change implemented under the "Price Point" strategy included elimination of the Senior Citizens Discount program, affecting the company's image with senior customers and senior stockholders. Sambo's also raised menu prices and implemented a menu pricing strategy based on several different meal combinations. However, both customers and restaurant staff were confused as to how this program actually worked. Meanwhile, the physical appearance of the restaurants continued to deteriorate.⁴⁹

Despite these and several other efforts, Sambo's was unable to recover from its financial distress, and in 1985 filed for complete liquidation of its assets.

Jerrico, Inc.

Jerrico's Long John Silver's Seafood Shoppes "had grabbed 50 percent of the seafood market by 1982 while experiencing a rise in earnings from \$1.1 million to \$20.9 million from 1972 to 1982, making it the 14th fastest growing U.S. corporation for that period."⁵⁰ It also became "the eighth largest fast-food chain in the country."⁵¹ But Long John Silver's reliance on codfish imported from Iceland and Canada resulted in less control over the price and size of the catch compared to smoother price changes in the burger market. Because the price of fish has risen so sharply, the company has been forced to raise its prices significantly or serve smaller portions. Thus the company has lost its price value base as compared to its major competitors, the fast food burger chains.

"From 1986 to 1987, Long John Silver's cod costs jumped 35 percent, to \$2.30 per pound. The increase forced menu prices up about 9 percent over the past two fiscal years and resulted in a customer backlash."⁵²

Recently, Jerrico announced its 1989 strategy, which includes

"testing a fast-food Italian concept and using, in addition to cod, a new species of whitefish to enhance its perceived value and rebuild customer counts."⁵³

Taco Viva

Taco Viva, another company that experienced success initially, but soon fell into the overexpansion trap, was considered a regional (Florida) type of company filling a specific niche, Mexican fast food. Until the company went public in 1982, growth was held at a gradual pace. However, once the company went public, expansion became more rapid. "Going public gave Taco Viva momentum to move from the local track to the fast track and J. Brian Foulke III (Taco Viva's founder) missed some warning signs of the train moving too fast."⁵⁴ The company's expansion was accelerated by leasing space in shopping malls in 10 states. "By the end of 1985 Taco Viva had 74 restaurants."⁵⁵

The expansion strategy implemented by Taco Viva was launched at a time of industry-wide problems, especially the saturation of the Mexican restaurant segment. This, coupled with declining management control of existing stores, resulted in Taco Viva's loss of \$1.7 million in 1986.

Also, the start up expenses associated with establishing units out of the area, combined with a fall off in unit sales within the state, contributed to Taco Viva's distress. Additionally, insufficient management combined with this too rapid growth also led to the company's financial difficulties.

Some analysts felt that Taco Viva should have expanded more slowly outside of Florida rather than opening units in four or five states in one year. An aborted buyout offer by W.R. Grace and Co. in 1985 weakened Taco Viva further, resulting in many managers abandoning the company.

Recently, the sale of Taco Viva to Vista Group of London was announced "in order to get cash infusion to remodel the interiors of restaurants that were built in the late 1970's and early 1980's."⁵⁶

Ponderosa

Ponderosa, also very successful during its early years in operation, was one of the earliest budget steak houses. The quality and atmosphere were somewhat less than traditional steak houses such as Steak and Ale. The atmosphere was very spartan and similar to eating at camp, long tables and family style seating. However, the consumer perceived the food was adequate for the price. Unfortunately, inflation caused a rise in beef prices which in turn forced the company to raise its menu prices. Customers began to object to paying \$6 for a chewy steak versus the former \$3 price. They also began to object to the atmosphere. One upmanship by the company's competition also contributed to its problems. Other similar concepts were able to offer more for the same price. The company's chairman of the board also may have contri-

buted to its problems. Rather than trying to improve the concept, he continually replaced his operating personnel who were often experienced food service managers while he himself was not. Ponderosa is no longer publicly held, having been taken private in a leveraged buy-out.

D'Lites of America

D'Lites had a unique concept—healthy fast food. Menu items were lower in calories than traditional fast food. Initially Wall Street loved them. Both the profit margins and differentiation from the Big Three chains (McDonald's, Burger King, and Wendy's) were there. They began selling franchises at a very fast pace; however, they ran into problems of execution. Customers wanted the hamburgers to be readily available rather than having to wait for them. Additionally, the Big Three were able to quickly expand into this niche with their salads, salad bars, plain baked potatoes, etc.

Nonetheless, the company continued the expansion of D'Lites "healthful fast food concept before it had been fully developed, i.e., who D'Lites was, what it was and how to market it."⁵⁷

One of D'Lites major pitfalls was its policy of buying back unsuccessful franchises, which put a severe drain on cash flows. As cash flows declined, D'Lites, which was heavily leveraged, found itself unable to meet its debt load. Accordingly, D'Lites of America became another classic example of a company that began with a most successful concept, but at the end of an eight-year period filed for bankruptcy due to its poor execution. It seems customers wanted tasty food and rapid service and did not count calories.

Pizza Time/Show-Biz Pizza

Pizza Time and Show-Biz Pizza were two companies that experienced financial difficulties primarily as a result of poor execution. They constantly battled over the originality of the concept, opening units next to each other in some markets. These companies experienced rapid initial individual success with their franchises. However, these individual successes evolved into vendettas of one operator against another. Additionally, the pizza was of poor quality and taste, as was the service. Another contributing factor to the financial problems was the expense associated with the video game machines which were a key part of the restaurants' concept. Some restaurants had a prohibition against teens being in the facility without their parents. Additionally, the home video game market grew rapidly and prices decreased accordingly. Thus it was no longer necessary to go to one of these restaurants to play video games; sales continued to decline.

Ryan's Family Steakhouses

Ryan's, with headquarters in Greenville, South Carolina, has been credited with being among those pioneering the giant food bars that have revitalized the family steakhouse segment.

After becoming a publicly-held company in 1982, "Ryan's became an immediate hit on Wall Street, as its dedicated following kept sales climbing. The 1985 introduction of the Megabar broadened the concept's appeal and kept sales rolling."⁵⁸ Wall Street's pressure on Ryan's resulted in the astonishing growth rates of 100 percent in 1986 and 50 percent in 1987. But, as a result of steakhouse rivals upgrading their salad bar selections and an overall core customer fatigue, "recent softness in sales suggests that Ryan's has not been able to sustain its appeal."⁵⁹ Accordingly, Ryan's has cut back expansion plans for the next two years.

Vicorp Corp

Vicorp, the highly successful operator of Village Inn Pancake Houses, undertook a very aggressive expansion program beginning in 1984. It included the acquisition of 59 Poppin Fresh Pie houses from Pillsbury, over 200 restaurants from bankrupt Sambo's, and all 72 restaurants in Ralston Purina's Continental Restaurant Systems. "These acquisitions transformed 'little Vicorp,' making the Company a very risky proposition since Gordon Miles (Vicorp's chairman) had mortgaged the company to the hilt."⁶⁰ The continued conversion of former Sambo's restaurants led to a \$1.04 million net loss in the first quarter of 1986; the company earned \$2.2 million in the first quarter of 1985. "The company said its loss stemmed from initial operating shortfalls in converted Sambo's and from the continuing expenses of the conversion program."⁶¹

Operating losses were cut to \$162,000 in the first quarter of 1988. "With the drawn-out, taxing conversion of its Sambo's near completion and some new top management"⁶² in place, Vicorp has been fighting to turn around its disappointing financial and operating performance of the last few years. In this regard, Vicorp sold the profitable specialty dinner house division for \$17.5 million in late 1987 and is stepping up marketing efforts to heighten its limited awareness in certain regions. Vicorp will increase emphasis on planning, selection, and development of human resources.⁶³

Some Lodging Firms Experience Financial Failure

While the companies reviewed in this article so far have been restaurants, there are a couple of hotel companies that should be mentioned as well.

Howard Johnson's Corp.

Howard Johnson's Corp., which by the end of World War II had the single best known name in the restaurant business in the United States, had the same reputation McDonald's has today, but was unable to hold that edge. This company's failure is attributed to the ego of Howard Johnson, Jr. He refused to pay attention to new trends, particularly the growth of the fast food industry. He didn't permit money to be spent for renovation and also refused to put cash back into the business.

In December 1979 Imperial Group PLC, a leading British conglomerate, paid \$630 million to acquire Howard Johnson's Corp. However, Imperial failed to accomplish its goal of straightening out Howard Johnson's and reversing a deteriorating trend that kept the company stagnant and unable to reach its full potential. In November 1985, Imperial sold Howard Johnson's chain, except for the Ground Round Division, to Marriott for \$300 million, including the assumption of \$138 million in debt. At the same time, Marriott sold the lodging properties and the franchise system to Prime Motor Inns.

La Quinta Motor Inns, Inc.

La Quinta Motor Inns is another example of a hotel company in financial distress. Strategically and successfully positioned between budget and luxury hotels, La Quinta increased its number of rooms by over 100 percent between 1975 and 1980, while achieving occupancies of 80 percent and 90 percent, well above industry averages. Return of Equity was over 20 percent.

But La Quinta was greatly affected by the 1982-1983 recession, "the most difficult time in its corporate history"⁶⁴ since the economic downturn spread to its major market area, the Southwest, as opposed to previous recessions.

However, the company has strong management and was able to quickly recognize what was happening to the economy in its market areas. La Quinta was over-committed to the oil belt, Texas, Oklahoma, and Louisiana. The economies in these states are or were very dependent on energy revenues. The company placed too many units in too small a geographic area so there was too rapid growth without geographic diversification.

Nonetheless, it is believed this company will be able to turn itself around and continue to grow, but at a much slower pace. La Quinta has adopted several financial strategies such as significantly cutting expenses while focusing development efforts on "expansion into a variety of geographic areas with diverse economies to eliminate the risks associated with dependence on any economic area."⁶⁵

Lessons Can Be Learned

As can be seen from our discussion of what contributed to the failure, whether partial or total, of the hospitality companies presented here, there are a number of factors involved. We need to take note or become aware of these factors in order to avoid making the same mistakes in the future. To summarize the factors contributing to financial failures, the following is a list of reasons for hospitality company failures.

There is a common theme or thread that runs throughout all the companies presented here, a lack of execution of company management which was manifested through lack of responsiveness to change, inadequate manager and/or employee training, or failure to execute the company's concept properly; all of these companies experienced this problem to some degree.

Ego of the founder or chairman is another factor. Both Ponderosa Steak House and Howard Johnson's Corp. experienced this problem. The ego of the founder or CEO prevented these companies from adapting to changes in their markets.

Undercapitalization and, closely related to it, overexpansion, are additional reasons that contribute to a company's financial distress. Undercapitalization primarily affects individual hospitality operations; Benihana's and its Big Splash concept is a good example of this factor. If you spend too much on an individual unit, as they did, you can never hope to make a return on the investment. Any time a company builds a new type unit or introduces a new concept, it must try to ensure that any capital expenses involved can be retrieved and some sort of return on investment obtained.

Large companies have also experienced this problem as a result of expanding too quickly before the concept is solidified. Examples include D'Lites, Victoria Station, and Taco Viva.

Another contributing factor to a company's financial failure is non-diversification in the marketplace. The best example of this situation has been La Quinta Motor Inns. Because operations were concentrated in such a small geographic area, the Southwestern United States, when the economies were "bust" in these areas, so did La Quinta's financial situation. Because they were so concentrated in the oil belt states and heavily dependent on oil revenues, when oil prices dropped, so did La Quinta's occupancies.

Abandonment of a successful concept is an additional factor contributing to financial failures. Wendy's is the prime example of a company experiencing problems as a result of this factor. In its attempt to attract a larger or broader share of the market, Wendy's moved away from a concept based strictly on burgers by expanding the menu to include baked potatoes, salads, chicken, and breakfast items, none of which helped to broaden its appeal with consumers, but did result in increased operating expenses.

Seeking growth and assuming profits will follow is another reason some hospitality companies end up with financial problems. Taco Viva is an example of what can happen in this situation. Just because an idea works in one community doesn't mean it will work everywhere. Taco Viva continued to expand its operation despite the fact sales in existing units had begun to drop off. Potential investors in the hospitality industry should be skeptical of a company's financial projections. There is no such thing as a negative financial projection. Cash flows are always positive because that is what the potential investor wants to see. Financial projections often are simply the hopes and dreams of a management based upon limited experience and results. The company's past performance or history is what the investor needs to look at.

A lack of inadequate internal controls can also contribute to a company's failure. This factor is actually an example of poor management execution. Sambo's is one of the best examples of this situation. After the company's Fraction of the Action program was discontinued and

managers left in droves, internal controls within the individual units began to dissolve. Cleanliness and sanitation problems became significant, as did improper cash handling. To make matters worse, there was no training program in existence to assist the replacement managers in developing or maintaining good internal controls.

Some companies have experienced financial problems as a result of poor upkeep. In other words, the company refuses to allocate funds for renovation or general upgrade of the facilities or property. Howard Johnson's is one example. Howard Johnson, Jr. refused to put capital back into the business; thus, facilities began to deteriorate, giving consumers the impression they were no longer the quality operation they once were.

A company's success may also decline as a result of reliance on a gimmick or a theme that goes stale. Victoria Station is the best example of a company whose failure can be blamed primarily on a successful theme going stale. Serving prime rib in old railroad boxcars was initially successful, but people tired of eating in them and tastes shifted away from beef to chicken, fish, and other "lighter" alternatives. Unfortunately Victoria Station was unable to adapt to these changes.

Table 3 summarizes the lessons to be learned by the hospitality industry pursuant to the problems experienced by these companies.

Table 3
Lessons To Be Learned

Company	Major Problem Areas	Lessons To Be Learned
Wendy's	Deviation from proved concept Breakfast concept Overexpansion Discounts/coupons	When a concept works and is accepted by consumers the company should expand on it rather than move away from it. New concepts should be thoroughly tested prior to store-wide implementation. Again, growth/expansion must be controlled. Discounts should be used sparingly.
Victoria Station	Stale theme Overexpansion Change in consumer tastes Confusion over new concept Expansion into highly competitive market	Must be careful that the concept is flexible and can be adapted to change in the market. Growth/expansion must be controlled. New concepts or changes to existing concept should be thoroughly tested prior to implementation.

Company	Major Problem Areas	Lessons To Be Learned
Sambo's	High management turnover. Poor management execution Overexpansion	Top management must ensure a management training program exists and is valid. Management must concentrate on existing operations in addition to the new. Growth/expansion must be controlled.
Jerrico, Inc.	Rise in food costs (imported codfish)	Don't rely on limited sources of supply.
Taco Viva	Overexpansion Market saturation of the concept Poor management execution	Growth/expansion must be controlled, particularly in new market areas. Must be able to find a way to position themselves from competition. Management must focus attention on existing units as well as on new units.
Ponderosa	Rise in food costs Competition Ego of the CEO	Price increases should be accompanied with an increased perception of value which in turn makes you more competitive. Top management must be sensitive to economic changes.
D'Lites of America	Concept not fully developed Buyback of unsuccessful franchises. Poor management execution	Concept must be fully tested prior to full scale expansion. Growth must be controlled with management oversight. Management must focus on proper internal control procedures.
Pizza Time/ Show Biz Pizza	Poor management execution Management infighting Lack of customer service Gimmick theme	Management must focus on proper internal control procedures, such as product quality, customer satisfaction, wants/ desires of target market. Top management must instill a sense of teamwork throughout the company.
Ryan's Family Steakhouses	Wall Street pressure to maintain sales growth	Growth in units/sales must be reasonable and consistently achievable. Constant analysis of competition. Be able to adapt to changes in market.
Vicorp Corporation	Too ambitious an expansion program	Solvency is extremely important. Growth and acquisitions must be well managed to ensure the company stays financially healthy.

Company	Major Problem Areas	Lessons To Be Learned
Howard Johnson's Corporation	Ego of founder Failure to invest in a growing business	Companies must continue to invest in their existing operations to capitalize on an outstanding operation.
La Quinta Motor Inns, Inc	Non-diversification Poor economic environment	Companies should not concentrate on one geographic area, but should pursue growth in diverse economic areas.

It is hoped the hospitality industry can learn and is learning from the examples of failure cited here. In order to become or remain successful, hospitality companies need to refocus their efforts away from uncontrolled operation and its associated problems. It is equally important to be aware of the factors leading to the failure process in order to recognize the warning signals.

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