The Hole Story: *Case Study of Bess Eaton's Bankruptcy* Sale

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For more than 50 years, New England residents had been getting their donuts and coffee at Bess Eaton, a chain of coffee and baked goods stores headquartered in Westerly, R.I. The business was owned by Louis Gencarelli, Sr. and had been started by his father, Angelo Gencarelli, Jr. in 1953. Over the years, Louis had grown the chain by acquiring real estate and leases at strip malls and freestanding locations. In 2002, 56 stores were in the chain, including many seasonal locations along the coast of Rhode Island and Connecticut, and a few stores in southeastern Massachusetts. Of the 56 stores, Louis and his son Paul owned 30 stores, which they leased to the company. The company was the seventh largest employer in Rhode Island, with more than 800 employees.

BESS EATON BITES OFF MORE THAN IT CAN CHEW

In 1996, Gencarelli had ambitiously completed construction of a 40,000-sq.-ft. bakery to bake donuts and other baked goods for the stores. The bakery was built to support continued expansion of the retail locations, as well as to provide baked goods to other retail stores.

Bess Eaton had achieved its peak earnings in 1999: on sales of $32.0 million it had net income of $214,600 and EBITDA of $2.7 million. However, since it did not service enough retail stores to cover its fixed overhead, the resulting excess capacity was responsible for the bakery incurring a net loss of $519,000. In 2000, the company's net income was $66,000 after bakery losses of an additional $1.1 million. Then in 2001, it incurred a net loss after taxes of $632,000, after bakery losses of $1.5 million.

In 2002, George Cioe, a local real estate developer, became CEO of Bess Eaton, while Gencarelli remained as chairman. Cioe received a 10-year management contract and in subsequent litigation, claimed that he was to have received 20% of the company's stock. Under Cioe's direction, the company was expected to grow by an additional five stores, expand and diversify so that some of its stores would compete with businesses such as Starbucks, and planned to increase annual revenues by $3 million.

IN A STICKY SITUATION

Instead, in 2002 the company closed nine locations and opened only three, leaving 50 stores. Its revenues remained level at $32.7 million that year. It also incurred additional SG&A expenses of $1.4 million in connection with Cioe's expansion plans. At the same time, the bakery lost $1.4 million and gross profit margin declined to 16.9% from 19.3% the previous year. As a result, in 2002 Bess Eaton lost $2.37 million and had an EBITDA of only $296,000. Then, in the first quarter of 2003, the company incurred an additional loss of $1.1 million, at which point Gencarelli fired Cioe.

For the fiscal year ended December 31, 2003, it incurred a net loss of $2.2 million, including a net loss from bakery operations of $1.4 million. In addition, Gencarelli sold two stores to generate cash for the business, leaving 48 stores. The company also closed its bakery operation and laid off dozens of its employees.

Cioe sued Gencarelli for wrongful termination. In addition, Cioe and certain other creditors claimed Louis Gencarelli and his son Paul, who was the company's CFO, had committed fraud, and sued them for alleged "systematic looting" of the company, mismanagement, and deception. They also threatened seeking appointment of a receiver under Rhode Island state Court to take over company operations.

NHB RISES TO THE OCCASION

In January 2004, NHB was hired as financial advisor to the company. NHB Principal Lee Goldberg led a case team whose initial assessment revealed that:

- The company had lost $5 million during the previous two years, and was within two weeks of not having sufficient cash to meet payroll.
- Trade payables were seriously past due, with many vendors insisting on payment of past-due balances and refusing to ship except on COD terms. To complicate matters, the company was unable to honor vendor promissory notes, many of which were past due and had been personally guaranteed by Gencarelli. The company's main coffee supplier had historically provided advances to cover seasonal cash shortfalls in the winter months, but was refusing to do so in the Current year. Many vendors displayed open hostility to Gencarelli and distrust in him to operate the business, with some disgruntled vendors threatening to put the company into state law receivership or an involuntary bankruptcy.
- Comparable store sales had declined by 20% versus the previous year. There had been inadequate investment in the stores during the past few years, and the company needed funding for overdue store maintenance, repairs, and upgrading.
- Gencarelli had negotiated for almost a year with Tim Hortons (the largest coffee and baked goods retail chain in Canada and a subsidiary of Wendy's International) and with several Dunkin' Donuts franchisees to buy the company, but had been unsuccessful in reaching an agreement.
- There was significant litigation against the company and the owner, including a lawsuit filed by the former CEO.

As financial advisor, NHB's first priority was to determine the extent of the company's negative cash flow. Once it was determined that the company had barely enough cash to cover payroll and pay critical suppliers on a current basis and was not able to service past-due payables and other cash needs, NHB contacted key vendors to seek their support pending formulation of a plan. Given the creditors' claims of Gencarelli's past broken promises and dishonored promissory notes, it was difficult to establish credibility and convince critical vendors to continue supplying the company. At the same time, it was important to maintain a viable business and overcome poor employee morale. This situation was exacerbated by the ongoing litigation from the former CEO and substantial negative Publicity in the local press.

It was clear that, without an immediate infusion of cash or an agreement from the vendors to stand still on past-due obligations and to continue shipping to the stores, the company could not survive on its own and would have to file for immediate bankruptcy and possible liquidation. Since Gencarelli had guaranteed certain corporate obligations, he would probably have to file for bankruptcy as well.

As of February 2004, the company had total secured and unsecured debt of $14.7 million and an estimated negative book value of $4.6 million. The estimated going concern value of the company's assets was determined by the NHB case team to be approximately $10 million, which if realized would have left a shortfall to pay creditors of over $4.7 million. Further, estimated liquidation value of the company's assets was determined to be only $5.3 million, which would have left a shortfall for creditors of more than $9.4 million.

RECIPE FOR SUCCESS

NHB immediately contacted Tim Hortons and Dunkin' Donuts, both of which were still interested in continuing acquisition discussions. In fact, the company and the owner had been about to sign an agreement to sell 15 stores to Dunkin' Donuts, followed by expected additional sales of stores over the ensuing 12 months.

NHB determined that the pending Dunkin' Donuts deal would not work due to the company's immediate cash needs. Even if the Dunkin' Donuts deal were consummated, the top 15 stores in volume and producing the greatest amount of cash flow would have been sold off with the proceeds used solely to pay bank debt. There would then have been insufficient cash proceeds from the sale to fund continuing operations, since the remaining stores would not have provided sufficient cash flow to cover corporate overhead. Thus, the value of the remaining assets would have been substantially reduced.

NHB then contacted Tim Hortons, which had 2,300 stores and a 70% market share in Canada, as well as 180 stores in the U.S. and plans to open 200 stores per year overall. Several representatives of Tim Hortons flew to Rhode Island within two days of NHB's phone call to discuss their interest in purchasing substantially the entire company. The company also engaged Allan M. Shine, Esq. of Winograd Shine & Zacks, a prominent Rhode Island bankruptcy firm, as its counsel.

Within three weeks of NHB contacting Tim Hortons, and with the collaboration of Shine, along with Joseph Ferrucci, Esq. representing Gencarelli, and Edwin Smith, Esq. of Bingham McCutcheon and Edward Bertozzi, Esq. of Edwards & Angell representing Tim Hortons, an asset purchase agreement for most of the business and store assets was successfully concluded. Tim Hortons agreed to pay $35.2 million, an amount which would pay all secured and unsecured creditors in full.

Wendy's International, a NYSE-listed company that owned Tim Hortons, insisted that the assets of Bess Eaton be purchased free and clear of any current or threatened litigation or other potential successor liabilities. It was naturally determined to proceed via a Section 363 sale under the Bankruptcy Code. The situation was complicated by the owner's personal ownership of the bulk of the store assets and his personal guarantees of certain corporate obligations. The company's planned Chapter 11 filing and sale would likely require his personal bankruptcy filing, and it would be necessary for him to guarantee any shortfall to the company's creditors out of any sale proceeds paid to him personally by Tim Hortons.

In order to obtain the cooperation of the company's trade creditors and lenders, NHB and Shine considered convening a meeting of the top creditors and lenders to explain the difficult cash situation, the expected liquidation value of the company if not sold as a going concern, and the need for their cooperation in allowing the company to continue as a viable going business. However, NHB recognized the substantial risk in convening such a meeting, since it could potentially result in an involuntary bankruptcy proceeding. It would fall to NHB and the company's counsel to persuade the creditors and lenders that cooperation was their best course.

While the negotiations were still continuing with Tim Hortons, NHB and the company's counsel planned a meeting of creditors and lenders. In order to gain their support for the plan to sell the business, Gencarelli first named NHB's Lee Goldberg as interim CEO, and asked him to take control of the company's daily operations, including negotiating with the trade creditors and all parties in interest.

NHB and the company's counsel then convened the meeting with the top creditors. At the meeting, counsel Allan Shine explained the overall current legal situation, and then Lee Goldberg provided a compelling PowerPoint presentation. Goldberg explained the company's position and recent history, the expected liquidation value of the company's assets, the ongoing negotiations for sale of the business at a price which would potentially pay the creditors in full, and the important fact that Gencarelli had put him in charge of running the company's operations, without his interference.

Primarily due to the credibility and track record of NHB and Goldberg, the creditors agreed to support the proposed plan to sell the business. They promised to support the company by standing still on past-due invoices while continuing to ship product to the stores. The creditors formed an informal Creditors Committee and engaged Harry Murphy, Esq. Of Hanify & King as counsel to represent them during the sale process.

Shortly after the creditors were organized, an asset purchase agreement was concluded with Tim Hortons. On the strength of the sale announcement to Tim Hortons and the support of the plan by the trade creditors and lenders, Goldberg was able to improve store sales and employee morale, and operate the business with a positive cash flow during the sale process.

Upon signing the asset purchase agreement, the company and Gencarelli then each filed for Chapter 11 bankruptcy on March 1, 2004, in the U.S. Bankruptcy Court in Rhode Island, along with a motion to pursue the planned asset sale. Pursuant to Section 363 of the Bankruptcy Code, an auction sale must be advertised to other prospective bidders, and the court supervises the final auction sale to the highest bidder. Tim Hortons was the "stalking horse" bidder, and would be compensated by a break-up fee for its time and effort in executing the asset purchase agreement if it were not ultimately the successful bidder.

The pending sale was duly advertised, Goldberg and his NHB case team managed the due diligence process, including preparing CD-ROMs containing 17,000 pages of data sent to 55 interested parties who had signed a confidentiality agreement. In addition to the business and store assets, the company's bakery and bakery equipment as well as its corporate offices were also included in the list of assets to be sold.

A SWEET DEAL

An auction sale was held in Bankruptcy Court on April 23, 2004, for both the Bess Eaton and Louis Gencarelli assets, only 54 days after the Chapter 11 filing. The Dunkin' Donuts franchisees, which had earlier negotiated to purchase some stores, and Dunkin' Donuts parent company, Allied Domecq, combined at the auction sale to compete against Tim Hortons' "stalking horse" bid.

Ultimately, Tim Hortons outbid Dunkin' Donuts by paying $41.6 million for the business and store assets (an increase of $6.4 million over the price in the asset purchase agreement), which included converting a five-year $3.5 million note to cash at closing. In addition, the bakery and bakery equipment were sold for $1.975 million, and the corporate office was sold for $1.13 million, with insurance recoveries and cash on hand adding another $1.5 million. *Total cash recovery for the creditors was in excess of $46 million.*

As a result of the hugely successful bankruptcy sale managed by NHB and Winograd Shine and Zacks, the following outcomes resulted to the benefit of creditors and other major stakeholders:

- *All* of the company's secured and unsecured creditors were paid in full, including postpetition interest paid at 6% through the date of payment, within five months of the Chapter 11 filing.
- Most of the 800 former Bess Eaton employees obtained jobs with Tim Hortons. Also, due to Tim Hortons' plans to expand and upgrade stores and go to 24-hour operation in many locations, many additional jobs were created.
- Tim Hortons now has a viable foothold in New England and has substantially increased its presence in the United States.
- All of the owner's personal creditors and mortgage holders, who had been owed a total of $20 million, were paid in full within five months of the Chapter 11 filing.
- The litigation against the owner and the company was settled, with the former CEO receiving $1.3 million in cash to settle his lawsuit.
- Louis Gencarelli, who had substantial corporate and personal obligations in default at the time of the Chapter 11 filing, realized in excess of $10 million in cash after payment of all his fees, taxes, personal and corporate liabilities.
- The bankruptcy sale process took only a few months from beginning to end.