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Bankruptcy Law

Stalking Profits

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To quote the Neil Sedaka song, "breaking up is hard to do." However, for the initial, or "stalking horse," bidder for bankruptcy estate assets, a breakup fee — the fee the stalking horse may receive when it is outbid at a bankruptcy court auction — can result in the stalking horse earning a profit even though it was outbid. Indeed, there are a number of advantages that an initial bidder can obtain over competing bidders in connection with the potential acquisition of assets from a bankruptcy estate.

Optimal Value

The sale of bankruptcy assets is governed by Section 363(b) of the federal Bankruptcy Code, Title 11 U.S.C. The section provides that a bankruptcy trustee, after notice and a hearing, may use, sell, or lease the property of the bankruptcy estate outside the ordinary course of business. A Chapter 11 debtor-in-possession ("DIP") has rights comparable

to those of a trustee. 11 U.S.C. Section 1107(a).

As Section 363(b) encompasses virtually any sale of assets that is outside the course of a debtor's normal business operations, the section is broad in scope. A Section 363(b) sale can be of a bankruptcy estate's personalty, realty or intangible property. By way of illustration, a bankruptcy court can authorize a Section 363(b) sale of a Chapter 11 DIP's ongoing business, land or intellectual property. The court can also approve a Chapter 7 trustee's sale of an individual debtor's home, the right to collect a royalty stream, or litigation claims that the estate holds against third-parties that exist independent of bankruptcy law.

"The court's obligation in Section 363(b) sales is to assure that optimal value is realized by the estate under the circumstances." *In re Lahijani*, 325 B.R. 282, 288 (9th Cir. B.A.P. 2005). To optimize sale value, bankruptcy courts often

require that an auction take place in open court, even though a Section 363(b) sale "may be by private sale or by public auction." Fed.R.Bankr.Proc. 6004(f)(1). "The auction procedure has developed over the years as an effective means for producing an arms' length fair value transaction." *In re Trans World Airlines Inc.*, 2001 Bankr. LEXIS 980, at *13 (Bankr. Del. 2001). When bankruptcy estate assets are to be auctioned in open court, the court will often approve the auction procedures first, at which time the auction will be set for a later date.

The Breakup Fee

Given the judiciary's preference for selling a bankruptcy estate's assets via an auction, a party interested in purchasing estate assets should consider the advantages of being the initial bidder at the auction — commonly referred to as the "stalking horse." Typically, counsel for the stalking horse and for the bankruptcy estate

representative (be it the trustee or DIP) will negotiate an asset purchase agreement (APA) that sets forth the proposed terms of a sale and auction bidding procedures, all of which are subject to court approval. An APA drafted by a stalking horse's experienced bankruptcy counsel will often include protective provisions such as a breakup fee, a minimum overbid, and terms relating to the timing of the proposed auction and the stalking horse's ability to withdraw its initial bid under certain circumstances.

A breakup fee is the fee that a stalking horse bidder receives from the bankruptcy estate when the stalking horse is outbid at the auction. Bankruptcy courts have generally approved breakup fees under Code Sections 363(b) and 105(a). The latter section provides, in pertinent part, that a bankruptcy court may "issue any order, process, or judgment that is necessary or appropriate to carry out the [Bankruptcy Code's] provisions."

Bankruptcy courts recognize that an initial bidder for estate assets will incur significant time and expense — often far greater than that which overbidders will incur — in without limitation negotiating, drafting the APA and performing due diligence with respect to the assets that are for sale. Therefore, "breakup fees and other strategies may be legitimately necessary to convince a 'white knight' bidder to enter the bidding by providing some form of compensation for the risks it is undertaking." *In re 995 Fifth Ave. Associates, L.P.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989). See also, *In*

re Hupp Indus. Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) ("without such fees, bidders would be reluctant to make an initial bid for fear that their first bid will be shopped around for a higher bid from another bidder who would capitalize on the initial bidder's (i.e. stalking horse's) due diligence").

Courts typically require that a breakup fee reasonably relate to, without limitation, the initial bidder's "risk, effort, and expenses..." *In re Integrated Resources Inc.*, 147 B.R. 650, 662 (S.D.N.Y. 1992). There is no bright-line rule as to what percentage of the initial bid constitutes a reasonable breakup fee. The breakup fee amount may vary depending on the type of assets that are for sale, the amount of the initial bid, and other factors. For instance, one bankruptcy court approved a maximum breakup fee of approximately 1.6 percent of the initial bid (based on a sale price of \$565 million), where an expert testified that the standard breakup fee in the industry was approximately 3.3 percent.

Integrated Resources, 147 B.R. at 662. In contrast, another court approved a breakup fee of \$8.2 million, which constituted approximately 5.7 percent of the initial \$141.9 million bid. *In re Financial News Network, Inc.*, 980 F. 2d 165, 167 (2d Cir. 1992).

As a practical matter, a breakup fee of 2 percent or 3 percent of the stalking horse's initial bankruptcy auction bid will often pass judicial muster. Thus in the context of negotiating a hypothetical APA with a \$10 million initial bid, counsel for the stalking horse might, for instance,

attempt to negotiate for the stalking horse to receive a \$275,000 or \$300,000 breakup fee in the event it is not the winning bidder at the auction. Such a breakup fee could meaningfully compensate the stalking horse for the time and expense it incurred.

Other Advantages

Another advantage for the stalking horse is that its counsel can negotiate an APA with a provision that the minimum auction overbid must exceed the initial bid by a particular agreed amount. Typically, bankruptcy courts will approve such minimum overbid provisions as long as they do not chill bidding. However, there is no set formula for determining whether a particular proposed minimum overbid will reduce competition. For instance, in the case of *In re Mama's Original Foods Inc.*, 234 B.R. 500, 505 (Bankr. C.D. Cal. 1999), the court held that where the initial bid was \$22,462.33, setting the minimum overbid at \$25,000 — 11.3 percent above the initial bid — was excessive and likely to chill bidding. The court determined that a minimum overbid of at least \$500 more than the initial bid — roughly two percent more — would be acceptable. On the other hand, in the case of *In re Wintex Inc.*, 158 B.R. 540, 543 (D. Mass. 1992), the court held that a 10 percent minimum overbid increase requirement constituted a "reasonable litmus test."

It might be advisable for the stalking horse's counsel to negotiate an APA where the minimum overbid only slightly

exceeds the sum of the initial bid plus the breakup fee. For instance, in proposing an APA with a \$10 million initial bid and a \$275,000 breakup fee, the stalking horse's counsel might negotiate for the minimum overbid to be set at \$10,300,000. If a third-party were to win the auction with a bid of \$10,300,000, the bankruptcy estate would receive \$10,025,000 and the stalking horse would receive \$275,000. Thus, even when factoring in the estate's payment of the breakup fee, the minimum overbid would still be more favorable to the estate than the initial bid; yet the court might deem the proposed minimum overbid amount as low enough to not chill competitive bidding.

Aside from negotiating a favorable breakup fee and minimum overbid provisions

in the APA, a stalking horse may seek the inclusion of other advantageous terms in the APA (subject to the trustee or DIP's agreement and court approval), including terms relating to the timing of the proposed auction, the amount of the stalking horse's deposit, and terms concerning whether and under what circumstances the deposit may be refundable. For instance, a stalking horse that is farther along in the due diligence process than other prospective bidders might attempt to negotiate an APA with an early proposed auction date.

Alternatively, if the stalking horse still needs to conduct substantial due diligence, the stalking horse can negotiate for a low deposit amount and include various contingencies in the APA wherein some or

all of the deposit might be refundable under certain circumstances. By way of illustration, if realty is for sale, the stalking horse might request that the APA include a provision that the stalking horse's deposit will be refundable prior to a date certain in the event that the property is found to have environmental problems.

In sum, one interested in buying a bankruptcy estate's assets can obtain various advantages by being the stalking horse bidder. These advantages may include a favorable breakup fee, establishment of a minimum overbid, and other protections. Therefore, it is important for the stalking horse to retain experienced bankruptcy counsel to negotiate the APA on its behalf.

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