MERGERS & ACQUISITIONS

Stalking horse bid protections: is it getting harder to have your cake and eat it, too?

BY CHRISTOPHER D. JOHNSON

Bid protections, such as break-up fees, have become commonplace in mergers and acquisitions both in and out of the bankruptcy process. In bankruptcy, the use of bid protections requires approval of the bankruptcy court and is subject to the scrutiny and objections of the United States Trustee, creditors of the debtor and other stakeholders in the case. While there are differences among the various federal appellate circuits as to the circumstances under which bid protections may be appropriate, bankruptcy courts in all circuits are subjecting bid procedures to increased scrutiny. Those seeking bid protections in bankruptcy should be ready to demonstrate to the bankruptcy court and all interested parties – before any auction or sale – the necessity and benefit of the proposed protections to the debtor's bankruptcy estate.

In many instances, a prospective purchaser's preferred acquisition strategy for purchasing the assets of a target company is through the bankruptcy process, either by a sale under Bankruptcy Code section 363 or as part of a plan of reorganisation. The reward for subjecting the transaction to the scrutiny of the bankruptcy court: a bankruptcy court order conveying the assets of the debtor free and clear of all liens, claims, encumbrances, and interests.

Given the broad scope and effect of that relief, a bankruptcy court's blessing on such a transaction is not bestowed lightly. The transaction terms must be disclosed to the creditor body, the debtor must reasonably endeavor to solicit competing offers, the sale will be subject to higher and better offers as determined through an auction, and ultimately, the bankruptcy court must approve the transaction.

In order to ensure that it is in the best position to bid on the debtor's assets, the prospective purchaser may agree to serve as a "stalking horse bidder" by making the initial bid for the debtor's assets. In other cases, the debtor may have to induce the prospective purchaser into making the initial bid through the use of bid protections.

The debtor has dual motives in entering into a transaction with a stalking horse bidder: first, the debtor seeks to ensure that it will have at least one prospective purchaser for its assets, and second, the debtor believes that the presence of the stalking horse bidder will encourage additional parties to bid for the debtor's assets. Of course, it is the latter of these motives that gives concern to the stalking horse bidder.

Perhaps more significantly, the stalking horse bidder incurs real (and potentially great) expenses conducting due diligence, negotiating with the debtor, and preparing the transaction documents long before the bankruptcy court considers the contemplated transaction. Because these activities usually take place prior to obtaining bankruptcy court approval of the sale or even the sale procedures, the stalking horse bidder risks not only losing out on the transaction to a subsequent bidder, but losing this "pre-bid" investment of time and money as well.

The bankruptcy court must decide whether the benefits of having a stalking horse bidder outweigh the potential detriment caused by the bid protections.

Therefore, the stalking horse bidder will usually seek bid protections, including a break–up fee, over bid requirements, exclusivity provisions, window shop provisions, topping fees, "last look" procedures, and/or deposit requirements, to compensate it for due diligence costs and transaction costs incurred, as well as missed opportunity costs in the event it is not the successful bidder. These bid protections are often negotiated between the debtor and the stalking horse bidder before the filing of the bankruptcy petition and, in any event, will be submitted to the bankruptcy court for approval as part of the motion to approve the sale of assets.

Bankruptcy courts recognise that bid protections may enhance the sale process by providing protection or compensation to the stalking horse bidder for the risks it is undertaking by making the first bid. However, break-up fees and other bid protections create an uneven playing field for other potential bidders, so the bankruptcy court must decide whether the benefits of having a stalking horse bidder outweigh the potential detriment caused by the bid protections.

Early decisions by bankruptcy courts considering approval of bid protections applied the "business

judgment rule", the same test applied to such transactions in a non-bankruptcy context. The business judgment rule effectively involves a presumption that, in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. Applying this rule in the section 363 sale context, the bankruptcy court considers: (1) whether the relationship of the debtor and purchaser is marked by self-dealing or manipulation; (2) whether the bid protections hamper, rather than encourage, bidding; and (3) whether the bid protections, particularly the amount of the break-up fee, are reasonable in relation to the proposed purchase price. The business judgment rule is a very debtor – friendly standard, as bankruptcy courts will typically not substitute their own business judgment for that of the debtor's managers. The business judgment rule is still the test applied in many jurisdictions.

Other courts have rejected the business judgment rule, finding that a section 363 sale is not a transaction conducted in the ordinary course of business, and that the business judgment of the debtor should not be solely relied upon. These courts have subjected section 363 sales to a higher standard intended to test whether the proposed bid protections are in the "best interests" of the estate, creditors, and equity interest holders alike. Under this "best interests" standard, the bankruptcy court more carefully scrutinises proposed bid protections to ensure the debtor's estate is not unduly burdened and that the relative rights of all parties in interest are protected. Reported cases applying the best interest standard indicate that the approval of bid protections is more difficult than under the business judgment rule.

In 1999, a major decision by the US Court of Appeals for the Third Circuit in the case of *In re O'Brien Environment Energy, Inc*. rejected the business judgment rule, and implicitly the best interests standard, and held that a break-up fee would only be appropriate if it could qualify as an administrative expense within the meaning of Bankruptcy Code section 503(b), i.e., that the proponent must demonstrate that the break-up fee was among the actual, necessary costs and expenses of preserving the estate. While the only bid protection sought in *O'Brien* was a break-up fee, the Third Circuit panel's analysis would apply to other bid protections as well.

The decision in *O'Brien* may be distinguishable from the typical motion to approve bid protections relating to a section 363 sale. *O'Brien* involved a post-auction request for a break-up fee sought by a disappointed bidder. However, since the *O'Brien* court expressly rejected a common law basis for allowance of bid protections, it is highly questionable whether the court would have applied a different standard to a pre-auction request for bid protections.

Prospective purchasers seeking bid protections in order to become stalking horse bidders should seek approval of bid protections prior to the marketing and auction process.

The *O'Brien* decision, coupled with a more recent unreported decision arising from the *Pillowtex* case in Delaware, demonstrate the need for stalking horse bidders to seek approval of bid protections prior to the marketing and auction process. In *Pillowtex*, the debtor and the creditors' committee filed a motion to approve bid procedures prior to selection of a stalking horse bidder. In the motion, the debtor and committee sought authority to solicit and select a stalking horse bidder, and provide that stalking horse with certain bid protections. The bankruptcy court denied the motion, holding that bid protections are only proper when the stalking horse's bid is part of the marketing process, not when the bid protections are sought in order to induce a stalking horse to make a bid.

Regardless of the court, prospective purchasers seeking bid protections in order to become stalking horse bidders should seek approval of bid protections prior to the marketing and auction process, present their bid at the time such approval is sought, and, with the support of the debtor, be prepared to demonstrate to the court the necessity and benefit to the debtor and its creditors of the proposed bid protections. ■

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