

Bankruptcy Auctions

Balancing Finality with Value to the Estate

By Steven B. Smith and Monica M. Lawrence

Bankruptcy practitioners are all well aware that one of the key fundamental principles underlying any bankruptcy case is the maximization of estate value for the benefit of each of a debtor's creditor constituents. Debtors will often attempt to achieve such value maximization through a sale of its assets. But what happens to the sale process — usually conducted pursuant to very strict, court approved bidding procedures and protections — if another bidder rides its white horse into the limelight after the 11th hour expressing its willingness and ability to pay more for the assets? Unless and until this issue is resolved by the United States Supreme Court, the answer may very well depend upon which bankruptcy court is overseeing the sale process in question. This article highlights the tension courts face between recognizing the finality of a sale and reopening a sale process if potentially greater value for the creditors exists, and compares how bankruptcy courts in the Southern District of New York and in Delaware have addressed the issue.

THE AUCTION PROCESS

As noted above, the sale of a debtor's assets in a Chapter 11 case will often occur through an auction process typically governed by court approved bidding procedures. Bidding procedures — which are designed to attract serious prospective purchasers — will typically will require such purchasers to, among other things, submit an irrevocable offer at an

amount above the stalking horse price, submit a form asset purchase agreement (or at least the terms of such agreement), submit evidence of the purchaser's financial wherewithal, and pay a good-faith deposit. In addition, bidding procedures could also contain certain protections for a "stalking-horse" bidder (if there is one), such as a "break-up" fee. If there is a "stalking-horse" bidder, the debtor and the stalking-horse bidder will usually negotiate the terms of the initial bid, memorialize those terms in a signed asset purchase agreement (APA), and may also negotiate the terms of the overbid process. The debtor will at that point seek court approval of the APA and the overbid process.

Notwithstanding the availability of bid protections, the goal of a bankruptcy sale is to secure the highest and best bid, and therefore, a court will only approve proposed bid protections after concluding that they encourage — and do not chill — bidding. Importantly, once the court approves the bidding procedures and form of the stalking-horse bidder's APA, the debtor will usually serve notice of the APA and the deadlines for the submission of any overbids. Thereafter, the debtor will need to determine whether any timely submitted bids are "qualifying" bids (*i.e.*, have complied with all the bidding procedures). If a debtor receives more than one qualified bid, then an auction is usually scheduled to allow the qualified bidders to submit additional bids.

After an auction takes place, a debtor will typically confer with its advisers and, in some cases, a representative from the official creditors' committee, to determine which bid constitutes the highest and best offer. Once that determination is made, the debtor will ask the court at a hearing to approve the sale to the successful bidder.

DIFFERENT APPROACHES

At times, courts have found that the best interests of creditors are served by reopening an auction because doing so may generate additional value for creditors. This is either because an existing bidder has determined to offer greater value than the highest and best offer previously selected by the debtor; or, perhaps a new bidder, who specifically waited for the selection of the highest and best offer while ignoring all bidding procedures, emerges to offer greater value. In either scenario, the reopening of an auction, and the resulting additional value generated, inures to the benefit of all creditors, but conflicts with another goal in the sale context, namely, finality and certainty for the prospective purchaser.

Generally speaking, courts view the question of whether to reopen bidding on a continuum. A bankruptcy court's discretion to allow an upset bid diminishes the closer a sale comes to finalization, thereby solidifying the expectations of the bidders. At one end of the spectrum, there is a sale approved by an order of the bankruptcy court. There, the parties have a high expectation of finality, and a late bid may be allowed where it shows the initial purchase price to be so "grossly inadequate" as to shock the conscience of the court or if the original auction was tainted by fraud, mistake or some comparable defect. *See, e.g., In re Chung King Inc.*, 753 F.2d 547, 550 (7th Cir. 1985). At the other end of the scale, no order approving the sale has been entered, and the court has broader discretion, which may include setting aside a bid if greater financial gain for the estate exists. *See, e.g., In re Financial News Network Inc.*, 980 F.2d 165, 170 (2d Cir. 1992). A bankruptcy judge confronted with this scenario thus faces the unwelcome job of "walking a tightrope" between the competing interests. *Id.* at 166.

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Because courts seemingly have such broad discretion in deciding whether to reopen an auction or allow additional bids, potential buyers are subject to uncertainty. Such uncertainty may be more or less depending on which court has jurisdiction over the sale. Recent cases from bankruptcy courts in the SDNY suggest a tendency toward honoring the finality of the sale, while cases from the Delaware Bankruptcy Court suggest that if there is greater value to be had, the court may be more willing to reopen a sale process.

CASES IN THE SOUTHERN DISTRICT OF NEW YORK

In re Finlay Enterprises Inc.

In August 2009, jewelry retailer Finlay Enterprises and its affiliates commenced their Chapter 11 case seeking to sell substantially all of their assets pursuant to a court supervised auction process. After obtaining court approval to enter into an agency agreement with Gordon Brothers for the liquidation of the debtors' merchandise at certain of their retail locations, the debtors filed a motion seeking the sale of certain intellectual property (IP) assets. Prior to the auction, Zale Corporation, another jewelry retailer, submitted an initial bid to purchase substantially all of the debtors' intellectual property for the price of \$500,000, which another bidder, Synergies Corp., submitted an initial bid of \$300,000. The debtors conducted an auction which was attended by Synergies and Zale, among others, and which lasted over 11 hours consisting of many rounds of bidding. During each such round, Zale was given the opportunity to match the highest and best offer currently outstanding and, on multiple occasions, opted to pass rather than submit a higher and better offer. At the conclusion of the auction, the highest bid was an offer from Synergies for \$555,000. Zale's final bid was \$550,000.

A week later, the debtors filed a notice identifying Synergies as the successful bidder for the IP assets, and Zale objected, questioning whether the debtors complied with the bidding procedures and offering to submit a revised bid that was \$200,000 more than the successful Synergies bid. The debtors maintained their proper compliance with the bidding procedures, on the one hand, but expressed their willingness to reopen the auction to consider the enhanced Zale offer as well as any other offers from Synergies, on the other hand. At the sale hearing, Judge

James M. Peck noted that while potential additional value could be brought into the estate if additional bids were allowed, his guiding principle was whether the bidding procedures had been followed. Otherwise, there was no need for "judicial intervention." Hearing Transcript at 44 [Dkt. No. 378]. Judge Peck further emphasized that the need for finality in auctions is critical and that the parties who bid are entitled to rely on the fact that their bids would be honored as final. Ultimately, Judge Peck determined that the debtors had properly followed the bidding procedures and approved the sale to Synergies over the objection of Zale and others.

In re Extended Stay Inc.

Seven months after he decided in favor of finality in the *Finlay* bankruptcy case, Judge Peck once again conveyed his predilection toward finality of a sale process in the Chapter 11 cases of *Extended Stay Inc.* In *Extended Stay*, the debtors ran an auction process, pursuant to court approved bidding procedures, that Judge Peck described as having been "fairly conducted" involving "very sophisticated parties" which "produced an extraordinarily good result." Hearing Transcript at 27 [Dkt No. 1102]. In fact, the auction ran for almost 19 hours of active bidding between the stalking-horse bidders, Centerbridge/Paulson/Blackstone, and the Starwood Capital Group, each fighting for the right to become the debtors' plan sponsor. Just minutes after the stalking horse bidders submission of their high bid of \$3.92 billion, the Starwood CEO stated "We are done. Thank you very much. Congratulations." *Id.* at 22. The \$3.9 billion bid was selected as the highest and best offer. However, just two weeks later, Starwood objected to the debtors' sale motion, claiming that the auction was flawed, and that it was not able to submit its best offer because it appeared the debtors were only accepting all-cash bids. Judge Peck noted at the outset that he would be very unsympathetic to any after the fact collateral attack on the auction in the absence of credible assertions that there was a deviation from the bid procedures. Ultimately, the judge concluded that the bidding procedures had been followed and that "Starwood had its opportunity, voluntarily chose to participate in the auction, but more to the point, voluntarily chose to walk away." *Id.* at 151. Starwood ultimately had no choice but to withdraw its objections to

the outcome of the auction and the court approved the debtors' sale to the stalking horse bidders.

In re C2 Media LLC

In February 2010, C2 Media LLC and affiliates commenced their Chapter 11 cases and proposed a sale of their business as a going concern to a stalking-horse bidder, Vomela Specialty Company, for \$6.4 million. The court approved bidding procedures established March 29, 2010 as an alternate bid deadline. A competing bidder, Britten Banners, Inc. (BBI), submitted a timely alternate bid in the amount of \$7.9 million; however, a day after the bid deadline, the debtors' special corporate counsel unilaterally declared that BBI was not a qualified bidder under the bidding procedures. Thereafter, the creditors' committee discovered that BBI had not been contacted by the debtors' investment banker during its pre or post-petition marketing processes. Rather, BBI was contacted by the debtors' president less than two weeks prior to the alternative bid deadline. As a result, the creditors' committee objected to the debtors' motion seeking approval of the Vomela sale.

In response, the debtors argued that the BBI bid was properly rejected because, among other things: BBI had failed to provide the requisite evidence of its financial wherewithal to complete the sale; and the contract signed by BBI was less favorable in limiting damages to \$250,000 if it failed to close, as well as in releasing BBI from the obligation to be a backup bidder, in violation of the court-approved bidding procedures. In addition, the debtors argued they would have rejected BBI's bid even if the bid fully complied with the bidding procedures because the bid: 1) contemplated the firing of over 55% of the debtors' workforce (whereas Vomela's bid offered employment to substantially all of the debtors' employees); 2) rejected more leases and assumed fewer obligations; and 3) did not provide anything for unsecured creditors. It is important to note that the debtors considered the creditors' committee's attack on the quality of the marketing process as being irrelevant given the debtors' deteriorating financial condition and the need for the immediate approval of sale.

In granting the debtors' motion to sell their assets to the stalking horse bidder over the objections of the creditors' committee, Judge Robert E. Gerber concluded

that: 1) the purchase price offered by the stalking horse constituted fair and reasonable consideration and reasonably equivalent value for the assets; 2) the purchaser acted in good faith under an asset sale and purchase agreement with the debtors; and 3) the debtors fully complied with the bidding procedures.

In re Global Crossing Ltd.

Eight years ago, XO Communications, a company controlled by investor Carl Icahn, sought to reopen the bidding process for bankruptcy telecom carrier Global Crossing (GX). In that case, GX had entered Chapter 11 with a deal in hand to receive a cash investment from Hutchison Telecommunications and Singapore Technologies (STT) in exchange for a 61.5% stake in a new company (Hutchison later dropped out of the deal). Icahn opposed the sale to STT and, in the months leading up to the STT sale hearing, made numerous proposals to purchase GX. Each such proposal was considered by GX's board and financial advisers, as well as the advisers to the official creditors' committee, and determined to be inferior to the existing STT deal. In fact, in a last-ditch effort to convince the court that greater value for the estate existed, Icahn, on the second day of the sale hearing, made what he described as a "firm, non-contingent offer" to serve as a backstop should GX and STT be unable to obtain the requisite regulatory approvals for the STT acquisition. Ultimately, Judge Gerber framed the issue of whether GX could proceed with the STT bid as a classic question in 363 sales: Did it exercise reasonable business judgment in choosing the winning bid? *See In re Global Crossing Ltd.*, 295 B.R. 726, 743 (Bankr. S.D.N.Y. 2003). In answering in the affirmative, Judge Gerber focused on the disinterestedness of the board, the extent of the board's deliberations, and their lengthy consideration of the relevant facts and their options. The sale motion was approved and the bidding process was never reopened.

DELAWARE CASES

In re Women First Healthcare, Inc.

The debtor, Women First Healthcare Inc., executed an asset purchase agreement with Sun Pharmaceuticals as the stalking horse. *See In re Women First Healthcare, Inc.*, 332 B.R. 115, 118 (Bankr. Del. 2005). No other bids were submitted, and the court entered an order approving the sale. However, a few days after

the sale approval, Mutual Pharmaceutical Company contacted the debtor and stated that it was interested in buying the assets. Counsel for the debtor informed Mutual that the assets had been sold, and Mutual filed a motion for reconsideration of the sale order. Sun Pharmaceuticals opposed the motion, stating that it had expended considerable time and expense and should be declared the winner of the auction. The court disagreed and granted the motion, finding that Mutual had not been given proper notice of the sale, and reopened the auction.

Ultimately, Mutual's bid was selected as the highest and best offer, and Judge Walrath approved the sale. The court found that reopening the auction provided benefit to the estate (by increasing the price the debtor received for the assets by more than \$2.5 million) and was in the best interests of the debtor, the estate and the creditors. The fact that Mutual had not been given notice of the original sale no doubt played a part in the court's decision, but it is instructive that the court was willing to reopen the auction even though the sale order had been entered because of added value for creditors.

In re Foamex International, Inc.

In February 2009, Foamex and affiliates commenced their Chapter 11 cases and a month later filed their motion seeking to sell substantially all of their assets to an affiliate of debt investment firm MatlinPatterson for approximately \$105 million. An order approving bidding procedures was entered by the court and the debtors ultimately conducted an auction which lasted about 14 hours, during which over 60 bids were submitted by three different bidders. The initial stalking-horse purchase price of \$104.5 million ultimately increased to an all-cash \$141.5 million bid from Wayzata Capital Investment Partners LLC. At the conclusion of the auction, the debtors selected Wayzata's \$141.5 million all-cash bid as the highest and best offer over the \$146.5 all-cash bid of the stalking horse, an affiliate of MatlinPatterson, which also owned a majority of the debtors' first-lien loans.

Not surprisingly, each of the debtors' significant creditor constituencies, including the first lien agent, at the direction of MatlinPatterson, and the official creditors' committee, interposed objections to the debtors' sale motion arguing that the Wayzata bid was in fact not the highest

and best offer. Ultimately, Judge Carey agreed with the objectors and ordered the resumption of the auction because he was convinced that "there may be more value to be had for the estate." *See* Hearing Transcript at 77 [Dkt. No. 485]. In addition, Judge Kevin J. Carey specifically permitted the first lien agent to credit bid pursuant to section 363(k).

At the resumed auction, the debtors chose the first lien agent's credit bid of \$155 million as the winning bid. This time it was Wayzata who objected, offering to increase its cash bid if the auction was reopened once again. However, Judge Carey was not convinced that another round of bidding would be of any use. In granting the debtors' sale motion over Wayzata's objection, Judge Carey framed the issue as: "What's best for the estate? What creates more value?" and concluded that the "sale process was an extensive one, that the auction was fairly conducted, that the price arrived at was adequate, and that the sale was in good faith." *See* Hearing Transcript at 112-13 [Dkt. No. 493].

CONCLUSION

To reopen or not to reopen; that is the question facing bankruptcy courts where additional value for creditors is at stake. And whether 'tis nobler in the minds of bankruptcy judges to enforce finality of process over value maximization may very well depend upon where the bankruptcy judges are sitting. To be sure, although individual circumstances in each of the cases outlined above obviously influenced each final decision, it seems clear that in looking for a balance between finality and value, bankruptcy courts in the SDNY lean toward finality, while the Delaware bankruptcy court leans toward potential added value.

Debtors, as well as potential bidders, should pay close attention to the court they find themselves in during an auction process, and be aware of such court's particular inclination in these matters, lest they suffer the slings and arrows of outrageous fortune.