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Building Blocks

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An Overview of a § 363 Sale Involving a Stalking-Horse Bidder

A “363 sale” is a term that many bankruptcy professionals encounter early in their careers. Additional terms will typically follow, such as “stalking-horse bidder,” “bidding procedures” and “free-and-clear order.” A new practitioner might find these phrases to be novel. The purpose of this article is to place these and other similar terms into context through a basic overview of a proposed asset sale by a chapter 11 debtor in possession (DIP) to a stalking-horse bidder under § 363 of the Bankruptcy Code.

effort to satisfy this fiduciary duty to creditors, the DIP will market the assets to be sold in consultation with professionals such as brokers, auctioneers, accountants, legal counsel, financial advisors and/or investment bankers.⁴ This marketing process should commence pre-petition with the goal of identifying an initial bidder (the stalking horse).

Following the negotiation of an asset-purchase agreement (APA) and bidding procedures with the initial bidder, the DIP will file a motion seeking approval of, *inter alia*, the (1) bidding procedures, inclusive of bid protections and critical dates for the sale process; and (2) sale of the DIP’s assets. If the court approves the bidding procedures, marketing continues, and an auction will be conducted if additional qualified bids are submitted. At the auction, the DIP will select the highest and best bidder.⁵ Subsequently, the DIP will seek the entry of an order approving the sale of the DIP’s assets to the winning bidder, typically at a hearing shortly after the conclusion of the auction. Following entry of the sale order, closing will occur in accordance with the approved terms of the sale.

Section 363 Sale: Basic Process Overview

A common way for a DIP to generate funds for the benefit of creditors is through a court-approved sale of all, or substantially all, of its assets. This strategy is advantageous for both the seller/DIP and buyer. A § 363 sale provides the DIP with an expeditious process to liquidate (often encumbered) assets at market value and for the highest and best amount that it can obtain. For the buyer, the process provides an opportunity to acquire assets free and clear of liens, claims, encumbrances and interests.

The statutory authority for this type of transaction is found in § 363. This provision provides, in relevant part, that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate....”¹ Pursuant to § 363(f), a DIP may sell property of the estate free and clear of any interest or lien in such property if certain requirements have been satisfied.²

When selling assets, the DIP’s main responsibility, and the court’s primary concern, is the maximization of the value of the assets to be sold.³ In an

The Stalking Horse

In the bankruptcy sale context, a stalking horse is an entity that is willing to submit a bid to purchase a DIP’s assets to either establish a baseline bid from which the true value of the assets can be assessed, or to serve as a catalyst to encourage additional bidders to submit competing offers.⁶ Filling a



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1 11 U.S.C. § 363(b)(1).

2 See 11 U.S.C. § 363(f).

3 See, e.g., *In re Integrated Res. Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992) (citing Jerome & Drain, “Bankruptcy Court Is Newest Arena for M&A Action,” N.Y.L.J. (June 3, 1991)).

4 A DIP will be required to seek court approval of the retention of professionals providing services post-petition upon the bankruptcy filing. See 11 U.S.C. § 327.

5 A DIP may alternatively seek approval of a private sale (without an auction) to a buyer, which would also be subject to higher and better offers.

6 See *In re Energy Future Holdings Corp.*, 990 F.3d 728, 744 (3d Cir. 2021) (citing *Integrated Res. Inc.*, 135 B.R. at 750); *Calpine Corp. v. O’Brien Env’t. Energy Inc. (In re O’Brien Env’t Energy Inc.)*, 181 F.3d 527, 537 (3d Cir. 1999).

critical role in the bankruptcy-sale process, the stalking horse will have the opportunity to strategically set the tone for various aspects of the sale process, can seek certain protections, and will have early access to critical information concerning the proposed transaction.

Due Diligence

The stalking horse will have a significant advantage with regard to due diligence compared to subsequent bidders. The stalking horse's diligence period should commence pre-petition, whereas competing bidders will likely have less time to conduct diligence post-petition pursuant to the bidding procedures. A stalking horse will also have early access to financial and other information about the assets to be purchased. Depending on the magnitude of the proposed sale, such information might be maintained in an electronic data-room. In addition, the stalking horse can request access to the DIP's management and employees, as well as additional critical third parties (e.g., landlords and vendors).

Further, depending on the assets to be sold, the stalking horse will have more time than competing bidders to investigate issues relating to, *inter alia*, licensing, permits, title history, liens and contracts to be assumed and/or assigned. This head start and extended due-diligence period is invaluable, as it places the stalking horse in the best position to evaluate the extent of its offer (if any), have its offer deemed highest and best, and ultimately close the proposed transaction.

The Stalking Horse APA

While conducting due diligence, the stalking horse will negotiate the terms of the initial APA (the "stalking-horse APA"), which will serve as the baseline bid. In connection with these negotiations, the stalking horse will, *inter alia*, identify with specificity what assets it will purchase and what liabilities it will assume. The stalking horse will often strategically ensure that the proposed transaction is free of contingencies (including for due diligence and/or financing), thus making it potentially difficult for other bidders to close in accordance with the agreed-upon terms. It has an advantage, as competing bidders will be required to submit a redlined version of the stalking-horse APA to reflect any changes associated with a competing bid. These revisions will be reviewed by the DIP during bid evaluation. Significant monetary and/or non-monetary deviations from the terms of the stalking-horse APA could lead to the DIP deeming the stalking horse's offer the highest and best.

Bidding Procedures and Bid Protections

On a parallel track, the stalking horse and DIP will negotiate the bidding procedures, which will establish critical dates and requirements with respect to the sale process. The stalking horse will have a strategic advantage due to its ability to have direct input in significant aspects of the bidding procedures, including (but not limited to) the requirements to be deemed a qualified bidder, the amount of the deposit to be tendered with a competing bid, the amount of the initial over or topping bid, bidding increments, bid packet contents, bid submission deadline, what parties will be considered "consultation parties" and receive bid packets for review (often the DIP, its professionals, secured creditor(s) and commit-

tee), and submission of documentation evidencing a bidder's ability to close in accordance with the stalking-horse APA (or revised version).

As a backstop, the stalking horse should insist that the bidding procedures and stalking-horse APA include certain fees to be paid by a winning bidder to the stalking horse in the event that it is outbid. These bid protections are often in the form of a break-up fee and/or expense reimbursement, and are subject to the bankruptcy court's approval. Such protections are of critical importance to the stalking horse because of the time, expense (e.g., professional fees and other out-of-pocket diligence expenses) and risk associated with the stalking horse serving as the baseline bidder.

By design, a break-up fee incentivizes a stalking-horse bidder that places "'estate property in a sales configuration mode ... to attract other bidders to the auction.'"⁷ Bid protections are important tools to encourage bidding and increase the chances that the DIP is able to maximize the value of its assets.⁸ Due to the associated risks, "[b]reak-up fees and other strategies may be legitimately necessary to convince a 'white knight' to enter the bidding by providing some form of compensation for the risks it is undertaking."⁹ Without such incentives, bidders might be "reluctant to make an initial bid for fear that the first bid will be shopped around for a higher bid from another bidder who would capitalize on the initial bidder's ... due diligence."¹⁰

Generally, "[a] break-up fee should constitute a fair and reasonable percentage of the proposed purchase price, and should be reasonably related to the risk, effort, and expenses of the prospective purchaser."¹¹ When the fee is reasonable in relation to a bidder's efforts and commensurate with the magnitude of the proposed sale, break-up fees are generally permissible.¹² Conversely, if the bid protections are too large, a bankruptcy court might decline to approve the fees because of a concern that the fees will have a chilling effect on bidding.¹³

The stalking horse must be cognizant that courts utilize different approaches when evaluating bid protections. In some jurisdictions, courts analyze bid protections under a business-judgment standard, while other courts consider such fees and expenses administrative claims.¹⁴ While bid protections of approximately 3 percent of the purchase price have been deemed reasonable,¹⁵ stalking-horse bidders

7 *Off. Comm. of Subordinated Bondholders v. Integrated Res. Inc., et al. (In re Integrated Res. Inc.)*, 147 B.R. 650, 659 (S.D.N.Y. 1992) (quoting *In re Fin. News Network*, 126 B.R. 152, 154, n.5 (Bankr. S.D.N.Y. 1991)).

8 *Id.*; see also *Calpine Corp. v. O'Brien*, 181 F.3d at 537 (noting that availability of break-up fees and expenses may induce bidder to research DIP's value and/or its assets, and that this research may yield a figure that can be relied on by other bidders, making offers on assets; in this way, stalking horse may have provided benefit to estate by increasing likelihood that price at which DIP's assets are sold will reflect their true value).

9 *Integrated Res. Inc.*, 147 B.R. at 660 (quoting *Samjens Partners I v. Burlington Indus. Inc.*, 663 F. Supp. 614, 624 (S.D.N.Y. 1987)).

10 *In re Hupp Indus. Inc.*, 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992).

11 *Integrated Res. Inc.*, 147 B.R. at 662.

12 *Id.* (quoting *In re 995 Fifth Ave. Assoc.*, 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989)).

13 Compare *In re ASARCO LLC*, 650 F.3d 593, 602 (5th Cir. 2011) (discussing difference between fees that chill bidding and those that increase competition "by providing bidders an incentive to undertake costly but necessary due diligence"); with *Integrated Res. Inc.*, 135 B.R. at 750 ("[W]hen the fee is so large that it chills the bidding process, it will not be protected by the business-judgment rule").

14 *Official Comm. of Unsecured Creditors v. Bouchard Transp. Co. Inc. (In re Bouchard Transp. Co. Inc.)*, 639 B.R. 697, 708-09 (S.D. Tex. 2022) (citations omitted). For example, courts in the Second Circuit analyze bidding incentives under the business-judgment rule, while courts in the Third Circuit analyze break-up fees and expense reimbursement as administrative expenses under § 503(b). Compare *Integrated Res. Inc.*, 147 B.R. at 657, with *O'Brien*, 181 F.3d at 535.

15 See, e.g., *In re Metaldyne Corp.*, 409 B.R. 661, 670 (Bankr. S.D.N.Y. 2009) ("The total amount of the proposed break-up fee and expense reimbursement is less than 3 percent of the total purchase price. This falls within the range of what courts in this jurisdiction have found to be acceptable break-up fees.")

should be aware of the precedent in the jurisdiction that the DIP's case is pending.

As a practical matter, regardless of the applicable test in connection with the approval of the bidding procedures and for maximum protection, the stalking horse should strive to have its protections approved as administrative priority expenses under § 503(b) of the Bankruptcy Code. A stalking horse should also have the bidding procedures provide that the break-up fee and expense reimbursement will be credited to the stalking horse when the DIP evaluates multiple bids.

The Sale Motion and Sale Order

The stalking horse will request advanced drafts of the underlying sale motion for review to ensure that the motion seeks the relief required by the stalking horse. Importantly, the stalking horse will also review the proposed sale order and insist on the inclusion of language as favorable as possible to it as the prospective successful bidder. This should include language authorizing the sale free and clear under § 363(f) and protections as a good-faith purchaser under § 363(m) (which protects a good-faith purchaser's interest in property purchased from a DIP at arm's length in the event that an approved sale is later reversed or modified on appeal).¹⁶ The stalking horse and other bidders should represent in their bid submissions that they have not engaged in any collusive conduct that would cause the sale to be set aside under § 363(n), which was designed by Congress to prevent collusive bidding and provides a trustee with an ability to avoid a sale.¹⁷ Evidence of collusion could destroy a finding of the buyer's good faith, which is required for protection under § 363(m).¹⁸ The stalking horse might also seek to include a waiver of the 14-day stay under Rule 6004(h) of the Federal Rules of Bankruptcy Procedure in the sale order to pave the way to close the transaction as soon as practicable following approval by the court.

Additional Considerations

While there are significant advantages to serving as a stalking-horse bidder, a stalking horse should be aware of certain disadvantages. For example, various disclosures about the potential transaction and the stalking horse itself will be made in connection with the proposed sale that would not otherwise be required outside of bankruptcy. Further, prior to an auction, the stalking horse will have expended potentially significant time and expense. If the court does not approve the bid protections, the stalking horse could be left in a position where it will not be compensated through an expense reimbursement or break-up fee if it is not deemed a successful bidder.

In addition, even if the stalking horse is deemed the successful bidder, the sale will be subject to the objections of third parties and ultimately might not be approved by the court. The stalking horse also runs the risk of overpaying for assets if there are not additional bids or if the assets decline in value between the execution of the stalk-

ing-horse APA and the closing of the transaction pursuant to a sale order.

Conclusion

While there is one upside, for a stalking horse there are also serious risks that must be considered. While this article does not address all issues relating to a § 363 sale, the items addressed herein will hopefully provide new bankruptcy practitioners with a general roadmap of the sale process and enable them to anticipate issues that may arise if such a transaction crosses their desks. **abi**

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¹⁶ See 11 U.S.C. § 363(m). Sales to insiders, even those at "arm's length," will be highly scrutinized due to the good-faith requirement.

¹⁷ See *Runsey Land Co. LLC v. Res. Land Holdings LLC (In re Rumsey Land Co. LLC)*, 944 F.3d 1259, 1276 (10th Cir. 2019).

¹⁸ See *In re Abbotts Dairies of Pennsylvania Inc.*, 788 F.2d 143, 147 (3d Cir. 1986) (citations omitted).