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What's Your Bid?

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Family Christian: Cautionary Tale of Best Auction Practices

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While the number of chapter 11 filings continues to fan, the percentage of 363 sales in chapter 11 cases continues to rise. For example, the number of 363 sales in large public bankruptcy cases in 2014 rose 4 percent, to 38 percent of all chapter 11 cases filed during the year.[1] With this continued rise in asset sales comes an increase in the number of auctions held, raising the likelihood that auction participants will encounter a variety of pitfalls, conundrums and other issues.

Two such auction pitfalls were addressed in a recent decision by the U.S. Bankruptcy Court for the Western District of Michigan in *In re Family Christian LLC*.[2] This decision is a cautionary tale of what can go wrong at an auction and provides a helpful starting point in discussing other issues that may arise from the ever-increasing number of auctions held each year.

Family Christian

In *Family Christian*, the debtors sought to sell substantially all of their assets pursuant to § 363 of the Bankruptcy Code. Several parties submitted bids for the assets, including (1) a joint venture between Gordon Brothers Retail Partners LLC and Hilco Merchant Resources LLC (together, "GBH"); and (2) an insider entity called FCS Acquisition LLC that was formed by Richard Jackson for the purpose of purchasing the debtors' assets. Jackson was considered an insider because he also controlled the nondebtor holding company that owned certain of the debtors.

The bids submitted by FCS Acquisition during the auction differed from the bids submitted by GBH and other liquidator bidders (together, the "liquidators") in several ways. For example, FCS Acquisition's bid included a broad release of avoidance actions and claims against the debtors' insiders and established a minimum value for the debtors' estates. In contrast, the liquidators' bids did not establish a concrete minimum value for the debtors' estates.

After several contentious rounds of bidding, GBH ultimately declined to bid further, and FCS Acquisition was declared to be the highest and best bidder. GBH and others objected to the proposed sale to FCS Acquisition, arguing, *inter alia*, that the auction was unfair and that the release of insider claims and avoidance actions contemplated in FCS Acquisition's bid was inappropriate.

Although the creditors' committee and other key constituents supported the sale, the court declined to approve the sale, finding that "the insider nature of sale to Acquisition simply [did] not permit [the] court to approve the transaction"[3] since the debtors did not articulate a sound business justification for the sale under the heightened standard applicable to insider transactions. The court also addressed the allegation that the auction process was unfair, finding that although such an allegation was unfounded, certain mistakes were made. These "mistakes," and other auction pitfalls, will be explored below.

The Pitfalls

No. 1: Failing to Value Insider Releases and Avoidance Actions

Although FCS Acquisition's bid contained a release of avoidance actions and insider claims, the debtors failed to value these releases, which the bankruptcy court viewed as "fatal." The court reasoned that if the debtors had valued the

1 *See* UCLA-LoPucki Bankruptcy Research Database, "363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies, as a Percentage of All Cases Disposed, by Year of Case Disposition," *available at* lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf (last visited Aug. 18, 2015). The database is co-supported by a grant from ABI's Anthony H.N. Schnelling Endowment Fund.

2 No. GG 15-00643-jtg, 2015 WL 3824980 (Bankr. W.D. Mich. June 18, 2015).

3 *Id.* at 21.

releases, they would have been able to adjust their bid valuations in order to credit the liquidators' bids for causes of action proposed to be left behind in the estates.

The court's finding is both clear and reasonable. Debtors, particularly in instances where an insider is participating in an auction, should work to establish a value for insider releases and avoidance actions before soliciting bids. These valuations should ideally reflect not only the face amount of any such claims, but also the strength of any defenses and the likelihood of recovery. Such valuations enable participants to be more specific as to the value left behind in a debtor's estate and lead to more meaningful bidding.

No. 2: The *Ex Parte* Phone Call

The second "mistake" identified in *Family Christian* was an *ex parte* phone call made by the debtors' chief executive officer (CEO) to Jackson on the final night of the auction. Specifically, the CEO testified that on the second night of the auction, he telephoned Jackson and another insider to ask Jackson to increase FCS Acquisition's bid. The bankruptcy court determined that this communication was inappropriate due to the insider relationship between Jackson and the debtors, as well as the relationship between Jackson and the CEO. Not only was the CEO hired by Jackson and others to serve in his capacity as CEO, but the CEO had also received reassurance that he would continue in his role if FCS Acquisition were the winning bidder.

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The bankruptcy court reasoned that "[a]ny requests for higher bids should have been placed on the record at the auction or communicated through legal counsel."[4] The court also determined that the request for higher bids should have been made to *all* qualified bidders.

The court's conclusion with respect to the "*ex parte* phone call" is reasonable in many respects and troubling in others. During an auction, estate professionals frequently talk to representatives of bidders off the record as they work to negotiate asset-purchase agreement terms and stimulate further bidding. Certainly, it is not unusual for bidders to be asked to increase their bids, and such requests are not always on the record, in front of other bidders or addressed solely to legal counsel. One might accordingly argue that requiring auction participants and their professionals to observe these formalities would hamper the flexibility that is needed to drive up value during an auction.

Notably, *Family Christian* does not necessary prohibit *ex parte* communications, but instead highlights how, depending on the circumstances, such communications can undermine the propriety of the auction process. The bankruptcy court's troubles in *Family Christian* rested primarily with the fact that the telephone call was made to an insider by a CEO with a conflict of interest. There is no dispute that where an insider is involved, auction participants must take extra care in exercising formalities — such as avoiding *ex parte* communications or communications outside the presence of counsel — even if such steps appear to impede upon flexibility in negotiations, to avoid any appearance of impropriety.

No. 3: If You Bid $X, You Win

Family Christian describes two auction pitfalls, but the bankruptcy court's discussion of the "*ex parte* phone call" raises a third: whether it is appropriate to tell a bidder that it will win if it bids a certain amount or includes certain terms in its bid. In *Family Christian*, after FCS Acquisition submitted its final bid, it left the auction despite the fact that the auction had not been closed. This conduct left the court with the impression that FCS Acquisition was informed that it would be declared the winning bidder if it increased its bid as requested.

The court's concern with this conduct raises the question of whether it is wrong to tell a bidder that it will win if it submits a specified bid. On the one hand, this approach may encourage a bidder to go "just a bit further," particularly where it appears that active bidding might be drawing to a close, and may generate additional value for the debtor. On the other hand, such a statement is arguably contrary to the purpose and spirit of the § 363 auction process. After all, who is to say that the increased bid from one party would not necessarily lead to a higher and better bid from another party? Promising one party that a bid on certain terms will lead to victory undercuts the possibility that another party might offer better terms than the predetermined winner and undercut the potential for increased value.

Whether it is appropriate to make promises such as this during an auction is a judgment call that estate professionals need the flexibility to make, depending on the circumstances at the time. *Family Christian*, however, offers fair warning that such statements may be negatively construed by a court, particularly when made to an insider.

No. 4: Keeping a Party in the Game to Drive Up Bidding

Family Christian highlights just some of the pitfalls that may arise from the auction process, but there are others. A bid that is "highest" is not necessarily "best," and bids often include terms and conditions that prevent them from being considered "best" even if their consideration is highest. For example, a bid may be contingent upon receipt of third-party consents, may have financing contingencies or, as in *Family Christian*, may not guaranty a minimum value to the estate. These structural issues, which are often known at the outset of an auction, raise difficult questions, including whether a debtor can appropriately keep a less-attractive bidder at the table and, more significantly, whether

4 *Id.* at 19.

a debtor can or should declare such a bidder "highest and best" at any point during the auction. Less-attractive bidders, for example, may challenge the results of the auction by arguing that their bids, which were described as "highest and best" during the auction, remained "highest and best." A winning bidder may argue that it was inappropriately induced or "tricked" into increasing its bid in order to outbid a bidder that never stood a chance.

Estate professionals may reason that keeping a less-attractive bidder at the table is, at times, a necessary strategy. Nevertheless, to avoid allegations of unfairness, debtors should (to the best extent possible) quantify the risks and contingencies contemplated by particular bids so that the shortcomings of the bids, at each stage of the bidding process, are clear. Moreover, disclosure and transparency are key. Any potential taint caused by keeping a less-attractive bidder at the table will be diminished if *all* bidders are informed, on the record, and at each stage of the auction, that a particular bid suffers from certain defects. Accordingly, while estate professionals may choose to keep bidders with inherent risks at the table to ensure a robust auction, disclosure and, if possible, quantification of those risks is necessary to avoid any element of unfairness.

No. 5: Is It Collusive Bidding or Not?

One final auction pitfall to consider centers on collusive bidding and the determination of whether conduct is collusive or merely collaborative. Section 363(n) of the Bankruptcy Code prohibits collusive bidding and provides that a trustee "may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale."[5]

A finding of collusive bidding has significant repercussions. Not only may the trustee set aside the sale or seek damages based on the loss in value, but the statute also contemplates the recovery of costs, attorneys' fees and expenses incurred in pursuing such relief, and, in certain instances, punitive damages.[6]

A full discussion of collusive bidding is well beyond the scope of this article. However, given the significant repercussions of collusive bidding, auction participants, particularly estate professionals, must be able to identify and prohibit collusive bidding. While the law is clear that a joint bid, by itself, is not sufficient to constitute collusion,[7] the determination of whether a joint bid is collusive can be tricky and largely depends on the facts of a particular case. For example, a bidder at a recent chapter 11 auction announced off the record, during a break in the auction, that it could not bid any higher, then left the auction. Several hours later, and without formally withdrawing from the auction as a standalone bidder or otherwise indicating that it was in discussions for a joint bid, the bidder returned and submitted a "higher and better" joint bid with another bidder that had remained at the auction. After significant discussion among interested parties, the joint bid was not accepted, but whether or not this outcome was proper is debatable.[8]

Several considerations may help professionals decide whether joint bidding is appropriate. In particular, estate professionals should focus on whether the joint bid will add value to a debtor's estate. Estate professionals should also consider the motivations of the parties to the joint bid, in addition to the terms of the deal, to determine whether the bid reflects an agreement to control price, or whether it is meant to achieve other objectives, such as enabling one or both bidders to overcome financial limitations that would otherwise inhibit them from bidding competitively on their own.[9] The parties' disclosure of the terms of the agreement to submit a joint bid is also important. Indeed, openness not only about the agreement to jointly bid, but the consideration and other benefits to be afforded to each joint bidder, may remove any taint that would otherwise apply to the bid.

Conclusion

There are many instances in which one can run into unexpected challenges at an auction. *Family Christian* shows that sensitivities to these challenges are heightened whenever a bidder is an insider and that irrespective of whether it is most efficient, certain precautions and formalities must be taken to avoid the types of mistakes that may ultimately lead a court to invalidate a sale.

The "pitfalls" described in this article are but a few of the many variations of pitfalls and ethical conundrums that one may face during an auction. No two auctions are alike, and with the number of § 363 sales steadily increasing each year, the challenges facing estate professionals and bidders in identifying and circumventing pitfalls such as these will only increase. abi

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5 11 U.S.C. § 363(n) (2014).
6 *Id.*
7 *See In re Edwards*, 228 B.R. 552, 556 (Bankr. E.D. Pa. 1998); *In re GSC Inc.*, 453 B.R. 132 (Bankr. S.D.N.Y. 2011).
8 *See* Transcript of Proceedings Before Hon. Brendan L. Shannon, at 28, 30, 49-55, *In re Hussy Copper Corp.* (Bankr. D. Del. 2011) No. 11-13010 (BLS).
9 *See, e.g., Boyer v. Gildea*, No. 05-CV-129-TLS, 2006 WL 2868924, at *15 (N.D. Ind. Oct. 5, 2006); *In re Edwards*, 228 B.R. at 564; *In re Bakalis*, 220 B.R. 525, 537 (Bankr. E.D.N.Y. 1998); *see also* Jason Binford, "Collusion Confusion: Where Do Courts Draw the Lines in Applying Bankruptcy Code Section 363(n)?," 24 *Emory Bankr. Dev. J.* 41, 66 (2008) (suggesting that bidders will probably not run afoul of § 363(n) if motivated to collaborate for innocent reasons).