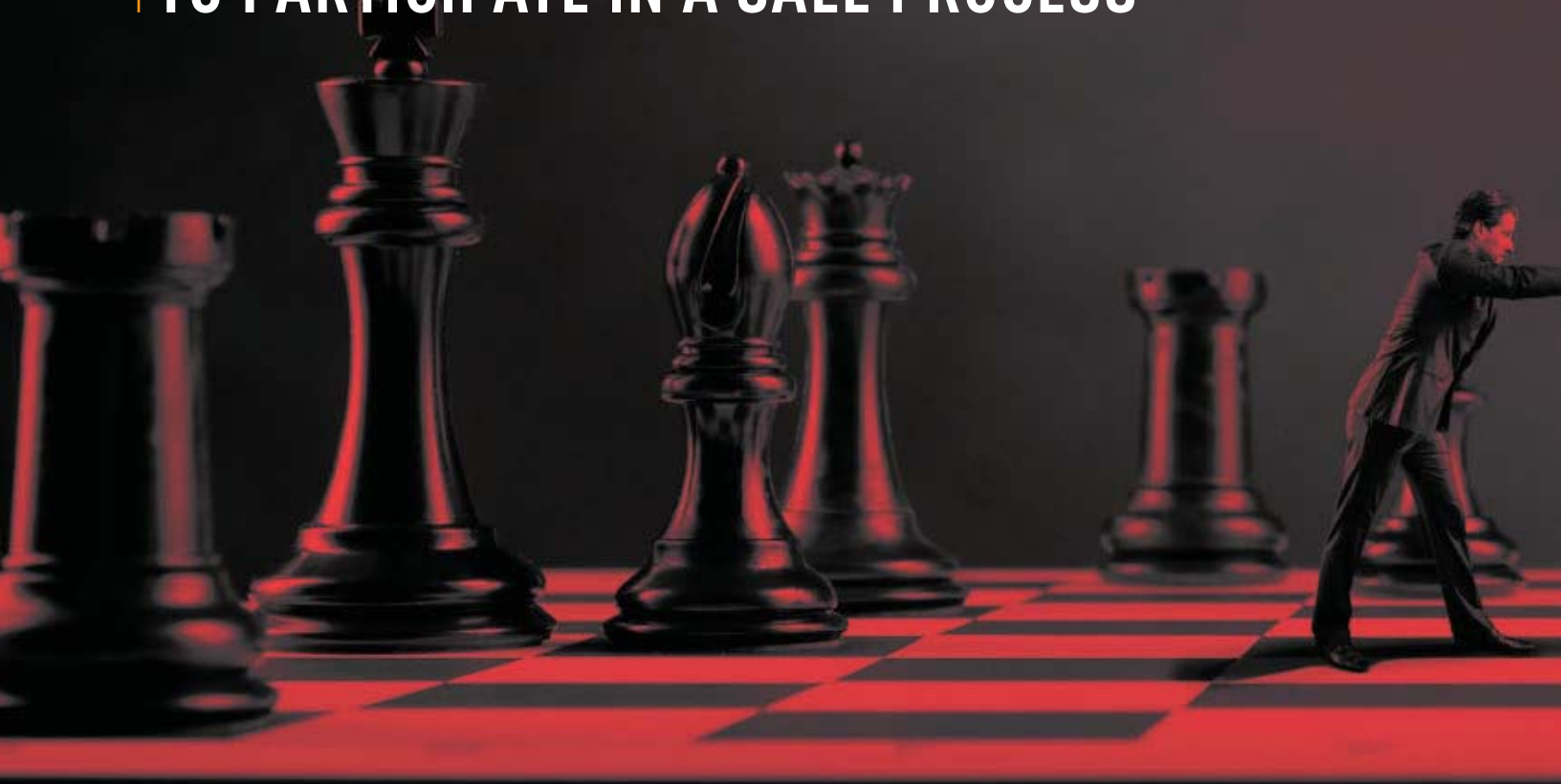


# Getting Paid to Play:

## INCENTIVIZING DISTRESSED INVESTORS TO PARTICIPATE IN A SALE PROCESS



BY BRADFORD J. SANDLER & PETER J. KEANE, PACHULSKI STANG ZIEHL & JONES LLP

**D**istressed investors often spend hundreds of thousands, or even millions, of dollars conducting diligence, negotiating transaction documents, and participating in uncertain auction and legal proceedings. The process is not for the faint of heart. A distressed investor may end up with the proverbial goose egg after spending substantial time and resources because of different variables.

For example, an investor might decide to walk away based on what it learns from due diligence or, after deciding to submit a bid and participate in an auction, it might lose to a higher bidder. Chapter 11 bankruptcy sale cases often proceed along an accelerated timeline, and interested investors may be reluctant to incur due diligence costs with such a limited chance of an upside. Because of this uncertainty,

the typical distressed investor will be opportunistic in choosing its potential investment target.

While the universe of distressed investors may be limited for any given special opportunity, a debtor in bankruptcy wants to encourage as many potential distressed investors as possible to conduct diligence and participate in a sale process so that



the chances of a spirited and robust auction are maximized. But, an auction only occurs if there is more than one bidder, and in an environment with overleveraged companies and shifting business models, numerous debtors in recent years have found themselves at the end of the sale process with interest only from a stalking horse bidder,<sup>1</sup> or no bidder at all, leading to a canceled auction.

From the company's perspective the issue is how to ensure that there is more than one bidder for the assets so there actually is an auction; the question becomes how to encourage investors to opt-in to the process rather than self-select to opt-out.

Some debtors have recently answered that question by offering to pay potential bidders an incentive fee to

participate in the sale process. These incentive fees—sometimes called a participation fee and sometimes taking the form of a guaranteed expense reimbursement—are designed to incentivize a potential bidder to conduct or complete due diligence or to keep buyers interested during the auction to continue bidding.

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These incentive fees are different from bid protections in that the purpose of the incentive fee is a guaranteed payment, whereas the traditional bid protections—breakup fees, topping fees, expense reimbursements, etc.—are designed to incentivize and protect the stalking horse bidder for its effort in setting the floor on the value of the assets being sold. For distressed investors other than the stalking horse, incentive fees minimize the risk of incurring substantial time and resources by allowing them to recoup some, if not all, of their expenses incurred in due diligence and participating in an auction, even if they end up losing to another bidder.

### Back to Basics

A sale process under Section 363 of the U.S. Bankruptcy Code often includes certain bidding incentives or protections for a potential acquirer that serves as a stalking horse bidder. Bidding incentives, when properly developed, encourage a potential distressed investor or acquirer to invest time, money, and effort to negotiate with the seller and perform the necessary due diligence required to make the threshold bid to purchase

the debtor's assets, despite the inherent risks and uncertainties of the Chapter 11 process. Bidding incentives are typically negotiated with the potential purchaser as part of the asset purchase agreement, and they most frequently come in two forms (and often together): a breakup fee and an expense reimbursement.

Breakup, or termination, fees usually range from 2 to 5 percent of the proposed asset purchase price, depending on the jurisdiction and the size of the transaction, to be paid to the stalking horse in the event that it is not the prevailing bidder at auction.<sup>2</sup> Expense reimbursement amounts can vary but usually have a cap at an agreed amount that is substantially lower than the breakup fee.

These bid protections serve to incentivize and reward the stalking horse bidder. The importance of the stalking horse bid is that it sends a message to the market by establishing a floor value for the assets the stalking horse bidder seeks to acquire. But the existence of a stalking horse bidder is no guarantee that it will attract other potential bidders so that the debtor will be in a position to conduct an auction. Since value is maximized when there is more than one

bidder, it is incumbent upon debtors and creditor committees to both attract multiple bidders to the auction and to keep bidders active during the auction to drive up the ultimate sale price. One way to attract distressed investors is by using incentive fees that essentially pay for, or minimize the risk of, their participation in the sale process.

A recent bench decision from the U.S. Bankruptcy Court for the District of Delaware in *Golfsmith International Holdings*<sup>3</sup> invites some discussion about a type of bidding incentive that was proposed to qualified, non-stalking horse bidders during the auction—a so-called auction “participation fee.” This is a type of fee proposed to other bidders involved in an auction to “juice up” and reignite stalled bidding and maximize the overall sale price by inducing other parties to continue bidding.

For example, at the start of the auction a debtor selects a baseline starting bid of \$10 million, but the other bidders either do not seem interested, are thinking of withdrawing from the auction, or the economics of the terms of various bids are hard to compare on an apples-to-apples basis, which leads to delays or an impasse in starting or continuing

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the bidding. At that point, to motivate bidders to stay involved a debtor might agree to give a participation fee to each unsuccessful bidder if they agree to continue bidding in the auction. Auctions of large assets or businesses in Chapter 11 can be protracted events that run all night or over the course of many days, during which people become tired and impatient. Additional cash on the table, provided the case economics allow for it, can invigorate the atmosphere and keep parties excited about the buying opportunity.

One of the leading decisions setting forth the legal standard for evaluating the appropriateness of bidding incentives in the bankruptcy context was issued by the 3rd U.S. Circuit Court of Appeals several years ago. In *Calpine Corp. v. O'Brien Env'tl. Energy, Inc.*,<sup>4</sup> the 3rd Circuit held that even though bidding incentives are measured against a business judgment standard in nonbankruptcy transactions, the administrative expense provisions of Section 503(b) of the Bankruptcy Code govern in the bankruptcy context.<sup>5</sup> Accordingly, to be approved, bidding incentives must be actually necessary to preserve the value of the debtor's estate.<sup>6</sup>

The *O'Brien* court identified at least two instances in which bidding incentives may provide a benefit to the estate. First, a benefit may be found if "assurance of a breakup fee promoted more competitive bidding, such as by inducing a bid that otherwise would not have been made and without which bidding would have been limited."<sup>7</sup> Second, where the availability of bidding incentives induces a bidder to research the value a debtor's assets and submit a bid that serves as a minimum or floor bid on which other bidders can rely, "the bidder may have provided a benefit to the estate by increasing the likelihood that the price at which the debtor is sold will reflect its true worth."<sup>8</sup>

While much of the case law surrounding the interpretation and application of *O'Brien* concerns the traditional stalking horse protections, it is important to note that there is nothing in the *O'Brien* test that prohibits auction participation fees.

### Participation Fees in Practice

In *Golfsmith*, the debtors conducted an auction over the course of several days with three qualified bidders and no stalking horse. After two days of negotiations to start the auction, the debtors eventually selected a starting baseline bid and also agreed to give the

baseline bidder a breakup fee, subject to court approval. The debtors then adjourned the auction to discuss with various parties and the other bidders and reconvened to announce that a \$500,000 participation fee would be given to each of the two losing bidders if they participated in the live auction.<sup>9</sup>

The live auction then started and bidding ensued with a winning joint venture bid that was approximately \$20 million higher than the starting baseline bid. The debtors then sought court approval of the sale as well as the \$500,000 participation fees for the losing bidders. The testimony at the sale hearing was that the bidding stalled and never really got started because the losing bidders had some reservations about the breakup fee offered to the baseline bidder during the course of the auction. But once the \$500,000 participation fees were offered to the other bidders, bidding became active, and the total sale price was ultimately increased by approximately \$20 million.<sup>10</sup>

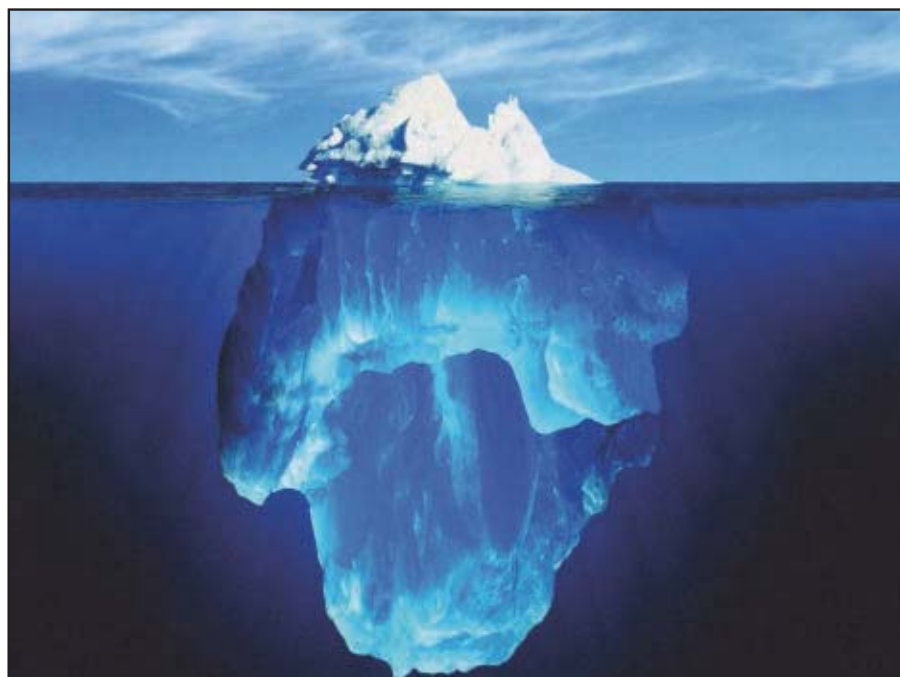
Notwithstanding the increased purchase price, the *Golfsmith* court denied the request to approve the participation fees, noting that neither it nor *Golfsmith's*

counsel previously had seen such a fee. The court analyzed the fee request under the *O'Brien* standard and held that it could not, based on the record, find that the participation fees were actually necessary to preserve the value of the estate. The court noted that granting the baseline bidder a breakup fee two days into the auction more likely than not led directly to the need to provide the participation fees to the other bidders.<sup>11</sup>

Also, the other bidders had significant experience in bankruptcies and each decided to proceed with bidding knowing that the fee had not been approved in advance and was subject to court approval. The court tempered its ruling by noting that it understood that auctions are fluid, and, although it had concerns about starting a precedent, such fees would not necessarily be barred simply because they have never been previously approved. So the debtor ultimately received the benefit of the participation fee that drove up the sale price, but the debtor never had to pay the cost.

Notably, *Golfsmith* is not the only

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case that has seen participation fees or participation expense reimbursements, and other courts have recently approved them in certain circumstances. For example, in the *International Shipholding*<sup>12</sup> case pending in U.S. Bankruptcy Court for the Southern District of New York, Judge Stuart M. Bernstein approved an expense reimbursement that would be provided to multiple bidders. The debtors in that case were able to obtain a stalking horse bidder, but another bidder wanted to be the stalking horse and threatened to walk away from the auction process if it was not the stalking horse.

Both the debtors and the official creditors' committee believed that at best there would be only two parties interested in the assets subject to the stalking horse agreement. Again, keeping in mind that the best way to maximize value is to have an auction, the debtors and the official creditors' committee decided to offer a "swing" expense reimbursement to the non-stalking horse party, if it would agree to participate in the auction. Assuming

there were only two parties at the auction, only one of them would be entitled to the expense reimbursement.

Similarly, in the *Aeropostale*<sup>13</sup> case pending in the Southern District of New York Bankruptcy Court, the debtors obtained approval to pay a \$500,000 work fee, or expense reimbursement, in connection with the auction and sale of the debtors' assets to a third-party bidder. The fee was for actual and reasonable due diligence expenses incurred after a certain date and in the weeks leading up to the scheduled auction to incentivize the potential bidder to continue diligence

The debtors filed a bid procedures motion without a stalking horse bidder. The third-party bidder had been negotiating to serve as a potential stalking horse bid for a going concern sale transaction of substantially all of the debtors' U.S. retail operations. Because a going concern transaction was so critical to maximizing value, and because the proposed transaction with the third-party bidder provided the best prospect on the table, the debtors, with support from the creditors' committee,

sought court approval in advance of the auction to pay the \$500,000 work fee/expense reimbursement.<sup>14</sup>

The *Aeropostale* court approved the work fee/expense reimbursement, which importantly had certain protections for the estates that would require a reimbursement to the debtors if the third-party bidder was determined to be the successful bidder after the auction.<sup>15</sup> These cases demonstrate that in certain circumstances distressed investors may be able to minimize the cost of their participation in the sale process.

And taking a lesson from *International Shipholding*, *Goldsmith*, and *Aeropostale*, best practice dictates that professionals may need to seek court approval of participation fees (or at least the possibility of such fees) in advance of the auction by building flexible bid procedures that provide for the option to offer participation fees at or before the auction. Similarly, professionals will also need to ensure that an auction process with participation fees does not encourage collusive-like behavior among losing bidders that could work together and

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**Notwithstanding the potential benefits of participation fees, practitioners should make every effort to ensure that debtors do not pay fees to “bottom feeders” who are most likely seeking a participation fee with no real intention of bidding.**

refuse further bidding only to extract a participation fee. Of course, the debtor and each unsuccessful bidder that is the beneficiary of a participation fee should be prepared to offer evidence supporting the necessity of the fee.

Although the *Golfsmith* court declined to approve the participation fees, its ruling left open the door for the allowance of such fees in the future. Of course, merely because there is no precedential case law to prohibit participation fees, each set of facts and circumstances need to be analyzed to determine if these types of fees will help the sale process; there are both benefits and drawbacks to their use.

Both *Aeropostale* and *International Shipholding* demonstrate how participation fees can help minimize risk for distressed investors while also encouraging involvement in the sale process, and each of these cases allowed distressed investors to get paid to play, so to speak, while giving those debtors and their creditors an opportunity to obtain increased asset value. Notwithstanding the potential benefits of participation fees, practitioners should make every effort to ensure that debtors do not pay fees to “bottom feeders” who are most likely seeking a participation fee with no real intention of bidding.

For example, paying a work fee to a potential investor who likely is not a realistic acquirer is detrimental to the process. The determination of when, how, and to whom a participation fee is structured and paid requires judgment from experienced professionals, and it is a critical and necessary determination so that assets are not wasted.

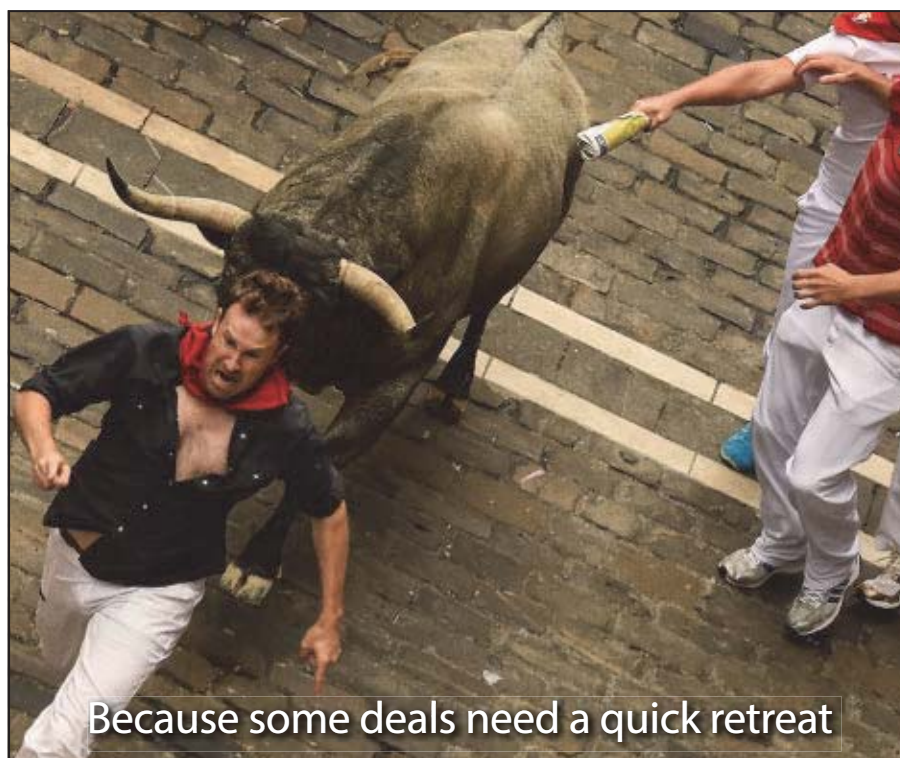
### **Minimizing Risk, Maximizing Value**

The goal of participation fees is to incentivize bidding, regardless of whether bidding is doubtful prior to an auction or bidding has stalled during the auction. When estate professionals are confronted with depressed asset values, overleveraged companies, and an uncertain economic environment, they need to be creative to maximize value by encouraging distressed

investors to ease their risk aversion. Offering a well-structured participation fee may provide the incentive needed to encourage distressed investors to participate in a sale process, leading to potentially increased asset value.

Case professionals should make sure that any bid procedures build in maximum flexibility and optionality so that they have the

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tools available to ensure that they can fulfill their fiduciary duties and maximize value for the estate.<sup>16</sup> From the perspective of distressed investors looking to purchase assets through a bankruptcy sale process, participation fees can minimize risk of participating in an uncertain sale process. Simply put, participation fees can help minimize risk for distressed investors and maximize value to a debtor and its creditors. ■

*The views expressed in this article are those of the authors and do not necessarily represent the views of any other person or entity, including, without limitation, Pachulski Stang Ziehl & Jones, LLP and its partners.*

<sup>1</sup> A stalking-horse bid is an initial bid on a debtor company's assets from an interested buyer chosen by the debtor. A stalking-horse bid supplies public notice of the "worst case" price and, theoretically, encourages other investors to engage in diligence and potentially bid for the assets at a competitive auction to follow later.

<sup>2</sup> For example, the "standard" breakup fee in the 3rd Circuit is 3 percent, but Bankruptcy Courts will deviate from this standard if the transaction is small.

<sup>3</sup> *In re Golfsmith International Holdings, Inc.*, Case No. 16-12033 (LSS) (Bankr. D. Del. Nov. 1, 2016).

<sup>4</sup> 181 F.3d 527 (3d Cir. 1999).

<sup>5</sup> *Id.* at 535 ("the business judgment rule should not be applied" to breakup fees in bankruptcy).

<sup>6</sup> *Id.* at 533.

<sup>7</sup> *Id.* at 537.

<sup>8</sup> *Id.*

<sup>9</sup> A \$500,000 "pivot fee" was also offered for the winner in the event the debtors determined to go forward with a reorganization plan rather than a sale.

<sup>10</sup> Notably, in *Golfsmith*, the debtors did not designate a stalking horse bidder when they filed their sale motion, and so they did not seek approval of any bid protections before the auction. And the bidding procedures order that was entered before the auction provided that no party submitting a bid would be entitled to a breakup fee, expense reimbursement, or other bid protection unless it was approved by the court.

<sup>11</sup> *In re Golfsmith International Holdings, Inc.*, Case No. 16-12033 (LSS), Nov. 1, 2016 Hearing Tr. at 17.

<sup>12</sup> *In re International Shipholding Corp.*, Case No. 16-12220 (SMB) (Bankr. S.D.N.Y.). The authors' firm represents the Official Committee of Unsecured Creditors in the *International Shipholding* case.

<sup>13</sup> *In re Aeropostale, Inc.*, Case No. 16-11275 (SHL) (Bankr. S.D.N.Y.). The authors' firm represents the Official Committee of Unsecured Creditors in the *Aeropostale* case.

<sup>14</sup> *In re Aeropostale, Inc.*, Case No. 16-11275 (SHL) (Bankr. S.D.N.Y.) at Docket No. 553.

<sup>15</sup> *In re Aeropostale, Inc.*, Case No. 16-11275



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(SHL) (Bankr. S.D.N.Y.) at Docket No. 587.

<sup>16</sup> See, e.g., *Cheng v. K & S Diversified Invs., Inc.* (*In re Cheng*), 308 B.R. 448, 455 (9th Cir. BAP 2004) ("The debtor in possession performing

the duties of the trustee is the representative of the estate and is saddled with the same fiduciary duty as a trustee to maximize the value of the estate available to pay creditors.")



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