

Pre-qualifying Bidders at Bankruptcy Auctions



The typical bankruptcy auction of a business or of significant assets often involves a deliberate process of pre-qualifying buyers in order to weed out the “tire kickers” and narrow the field to the bidders most likely to pay a fair purchase price and who have the financial ability to pay. Other “weeding” criteria include eliminating bidders with lousy reputations for closing deals, competitors who want nothing more than improper access to confidential business information, or bidders who may want to re-trade the deal too many times. The seller and its professionals want to limit the time and costs of due diligence, as well as limiting time spent in fruitless contract negotiations. The seller also wants to control when and how the sale is closed.

In bankruptcy auctions the sale procedures are developed based on input from the debtor’s auctioneer and from the financial advisors and attorneys for the debtor/trustee, official committees of creditors, shareholders and secured creditors. There is a premium on having a well-structured sale process. There is also a much greater need to know that the buyer has the financial ability to close a sale in a timely manner because the debtor and creditors depend on the sale to raise working capital or funds for distribution to creditors.

A typical bidder qualification provision requires each bidder to submit its current financial statements to the seller’s lawyer or financial advisor, or, if the bidder is an entity formed for purposes of bidding, to provide the financial statements of the bidder’s owners. The bidder must also provide other financial disclosure acceptable to the seller that demonstrates the bidder’s financial capability to pay the projected purchase price. Any bid that is contingent on financing has to be accompanied by written evidence of binding and irrevocable commitments for financing from financial institutions acceptable to the seller.

Another way of qualifying bidders is to require each bidder to deliver a substantial bid deposit as a condition to bidding at an auction. A deposit of ten percent of the minimum bid is not unusual.

Howard J. Berman, a NYC bankruptcy attorney, says: “Most bankruptcy courts recognize that pre-qualifying bidders as to financial ability is an important task that is an integral part of a well run bankruptcy auction, particularly when substantially all the assets of a business are being sold. Many courts defer to the debtor’s business judgment on bidder qualification procedures, particularly if the official committees have agreed on the approach for marketing and selling the assets.” For example, in *In re Colony Hill Associates*, 111 F.3d 269 (2nd Cir. 1997) an appellate court approved bidder qualification procedures which had been consented to by the debtor and secured creditors and were pre-approved by the bankruptcy court,

and restricted the ability of a late bidder to participate in the court-house auction because the bidder had not pre-qualified.

Sometimes pre-qualification of bidders can hurt the auction process or discourage bidders from participating in an auction. An example is found in the case of *In re Food Barn Stores, Inc.*, 107 F.3d 558, 563 (8th Cir. 1997) (auction of shopping center lease), where one bidder tried to disqualify another bidder on a shopping center lease, but neither the debtor nor creditors opposed open bidding. The alleged basis for disqualification was not an objective test of the bidder’s financial ability to perform, but a subjective evaluation of whether the bidder could qualify for a lease assignment based on its intended use of the premises. The *Food Barn* court refused to disqualify the bidder, observing that bidders have an identifiable interest in keeping out other bidders as part of a strategy to keep the sale price as low as possible.

Some bidders do not like bankruptcy auctions because of the uncertainty of court approval, the possibility of delays and the problems caused by objecting creditors. However, if all bidders will be pre-qualified, a potential bidder at least knows that its competition is “real”, and is not in the auction merely to bid up the price. Some qualification procedures require disclosure of the identity of the bidder’s principals or shareholders. This has the risk of discouraging some high profile bidders who believe that their very presence at a public auction will attract their competitors. If public disclosure is required, this type of bidder may elect not to bid. In these circumstances the bidder and the auctioneer should discuss ways to satisfy the bidding criteria while keeping confidential the bidder’s identity and financial information.

Bidders should recognize that bankruptcy courts have broad discretion over how an auction is conducted. This is particularly so where the sale has complicated factors and the purchase offers involve non-cash payments, such as notes or stock. Even after auction procedures are approved, the court can change the procedures if that is in the best interests of the debtor, the estate or creditors. While courts do consider bidders’ expectations as to how the auction will be conducted, this factor is weighed against the goal of obtaining the highest price. If a prospective bidder wants to object to auction procedures or bidder qualification requirements, the time to do so is before the auction begins, since the court has greater discretion to modify the procedures. Once the auction is held, the hammer falls and the high bidder announced, courts are very reluctant to upset the result.

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