Use of "Bidding Incentives" in Bankruptcy Sales

This article describes types of bidding incentives or "bid protections" that are commonly used in bankruptcy sales and auctions, particularly in the sale of substantially all of the operating assets of a company.

Potential bidders are often reluctant to participate in bankruptcy auctions because of the complexity, the expense, and the judicial nature of the sale, which usually requires competitive bidding and always requires bankruptcy court approval. In these situations the seller may encourage bidding by using devices such as expense reimbursement, minimum overbid amounts, and "break-up fees."

Expense reimbursement may be offered to a potential bidder who agrees to sign a purchase contract and usually covers the out of pocket costs incurred in conducting due diligence and the buyer's legal and accounting fees. Usually the amount of reimbursable expenses is capped at a negotiated amount that bears a reasonable relationship to the anticipated purchase price. The expense reimbursement agreement is not enforceable unless it is approved by the court.

Minimum overbid amounts were described by Howard Berman, a bankruptcy attorney in New York City: "The minimum overbid protects both the first bidder and the debtor's estate. It should be high enough to cover any reimbursable expenses or other costs that the debtor will have to pay if the first bidder loses. Frequently the first bidder tries to set the minimum overbid high enough to discourage other bidders and chill the competition. When this is done the bankruptcy court is not likely to approve the overbid amount."

Berman suggested that an effective device to protect the initial bidder is a "break-up fee." Break-up fees involve payment of a sum of money to a potential buyer if the purchase proposed by the buyer does not close, usually because the bidder is outbid. Berman said, "The party submitting the first firm bid to purchase assets is called the 'stalking horse' because the initial bid can be used to solicit interest from other bidders and also acts as a floor for what will be realized at the auction. Having an initial bid gives the debtor something of value in negotiation with other bidders since they know the debtor is not completely desperate to complete a sale." As a result, Berman said, "debtors will often agree to pay a reasonable break-up fee to the initial bidder if the bidder is outbid at the bankruptcy auction."

The amount of the break-up fee is subject to negotiation, but is rarely more than an amount equal to 2-5% of the purchase price. For bid protection devices to be enforceable, they need to be approved by a written order of the bankruptcy court, which must be signed before the auction begins. While many of the details of bid protections will be negotiated by the lawyers and financial advisors to the different parties, the auctioneer plays an important role by giving its client insights into the market of prospective purchasers and the value of the assets if they are properly marketed. In some cases the auctioneer's estimate of the asset liquidation value at a public sale will help the debtor in negotiating with bidders trying to "steal" the assets, since the bidders know the auctioneer is standing in the wings ready to conduct a traditional auction. Some well-financed auctioneers will act as the stalking horse, particularly when they are confident that there will be bidders at auction.

Another bidder "protection device" used in bankruptcy sale agreements is the "no-shop" or "no-solicitation" provision. These provisions are used by buyers to discourage the seller from taking a signed purchase contract and actively using it or shopping it around to try to get other potential bidders to participate in a bidding war. The "no-shop" clause is a prohibition on this practice by sellers, while the "no solicitation clause" permits the seller to respond to inquiries, but not to solicit them. Chester Salomon, a New York City bankruptcy lawyer, pointed out: "These provisions are subject to many exceptions. For example, they don't prevent the seller's creditors or its committee of creditors from actively soliciting other bidders. The official creditors' committee may have its own lawyers and advisors who are free to contact potential purchasers so that there will be a lively auction." Salomon said, "Moreover, if a new bidder does approach the seller, the seller's board of directors has a fiduciary duty to maximize the value of estate assets and will have to answer to the bankruptcy court if it does not run a fair sale process."

Break-up fees, expense reimbursement, and no-shop clauses are important tools to encourage the bidding process and to maximize the value of the debtor's estate. Bankruptcy judges scrutinize bidding incentives; those that chill the bidding process or are excessive relative to the size of the transaction should not be enforceable.

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