

INSOL GLOBAL INSOLVENCY PRACTICE COURSE (ONLINE)

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SHORT PAPER

Topic (No 2)

An analysis of the use of “stalking horse” proceedings to maximise value in an insolvency workout, using at least two jurisdictions for your analysis.

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DECLARATION OF HONOUR

I declare that the paper, titled “*What does maximise value mean in an insolvency workout, and can the use of a Stalking Horse help?*” is my own work, that it has been prepared independently and that all references, to or quotations from, the work of others are fully and correctly cited.



Signed by Bryan Edward Williams

Date: 9 February 2022

Place: Auckland, New Zealand

WHAT DOES MAXIMISE VALUE MEAN IN AN INSOLVENCY WORKOUT, AND CAN THE USE OF A STALKING HORSE HELP?

Abstract

Insolvency is a harsh commercial encounter that bears heavily upon all those that it touches. Although often perceived to be an infliction just recently manifest, the reality is, it has probably been many years in the making.

The effected persons that are third party to the cause, will understandably become despondent and are likely to consider the occurrence to be an irreversible event. Within their mind, their pre-insolvency expectations of achieving any payment will be dashed, and the vacuum non-payment leaves, will be displaced with anger and assertions of mismanagement.

In this setting of heightened perspectives, a brave heart may exist that raises their hand and asserts that they “will fix this”. At this point, the Insolvency Workout is borne. The troubled business now has hope, and the life of the proponent becomes devoted to a plan that strives to make all those that have been affected - as whole again as their efforts employed can make possible.

The work of the committed proponent is now ahead and is typically embarked upon with spirited zeal and determination. But the weight of engagement is heavy, and soon enough the depth and breadth of the task is more fully comprehended. There surfaces also, the new reality that bloody minded determination alone, will not bring home success. Help from others will be required - and that is only likely to occur if there is some reward for doing so.

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¹ The author is a student of the INSOL Global Insolvency Practice Course (Online) for the course spanning years 2021 and 2022. This paper is prepared to meet the Short Paper contribution as a requirement of that Course.

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INTRODUCTION

Overview

Insolvency events are a fact of commerce. Human actors conduct business in a setting where competition exists for the same consumer dollar. Competitors engage in activity that strives to garner more consumer appeal than others and, as a result, gain the prize of increased demand and better margins.

In this ever-evolving contest there are businesses that become overburdened and start to fail. In those circumstances, management may strive to reorganise the affairs of the enterprise by way of an insolvency workout. There may also be an advantage to engage with other parties with a view to improving the outcome of the insolvency workout. One may well be the involvement of a stalking horse².

The use of the term Stalking Horse is to refer to a person, that will make, on agreed terms, a pre-auction bid on assets to be divested by the debtor company. Ostensibly, the motivation to engage with a Stalking Horse is to establish a benchmark value of the assets prior to them being offered for sale, and to use that benchmark value to leverage higher and better offers from other parties.

Maximising value in the sale activity is of the highest importance for all parties affected. The question to be considered in this paper is whether or not, the use of a Stalking Horse will contribute to that objective within an insolvency workout.

Meaning of maximising value

Maximising value is measurable in terms of how the outcome contributed towards the company, or its business, being able to continue in existence. Turnaround management is the human element of this endeavour and is "...the dynamic process of restructuring of a company which is in a life-threatening crisis..."³ The goal is to defeat that crisis and the objective of maximising value at every transactional incident, will be an imperative.

² In its original sense, the idiom described the use of a disguise by a predator hunting prey. The use of the disguise reduced the risk that the prey would recognise the danger they were in. Often the hunter would stalk behind a horse – hence the term Stalking Horse.

³ Wessels, Bob. and Madaus, Stephan (2017) Instrument of European Law Institute – Rescue of Business in Insolvency Law. Paragraph 216

THE FRAMEWORK

The Stalking Horse involvement

Restructuring of a company⁴ will normally have three options for the Debtor to consider. LoPucki & Doherty⁵ record them to be (a) to reorganise the business, (b) to sell the business as a going concern, or (c) to close the business and sell the assets in a break-up. Each are likely to involve the sale of assets in a manner that is consistent with the purpose of the restructuring plan. Under a Court controlled insolvency workout, the Debtor will be entitled to sell property that is in the ordinary course of business but for property that is not, Court consent⁶ will be required.

The purpose of realising property in an insolvency workout is to maximise the value of the debtor's estate. The procedure adopted meets that requirement if it achieves the highest and best price. Lawrence King and Charles Seligson⁷ note that "*courts in Chapter 11 bankruptcy proceedings usually require an auction to be conducted as part of a sale under section 363.*"

The auction process is designed to extract, from willing buyers, the highest and best price by establishing a tension between competing parties in such a way that an inclination surfaces to out-bid competing interests. By this method, together with the art of the facilitating auctioneer, the bidders are teased to submit the highest price they are prepared to pay and value maximisation has the potential to be achieved as a result.

The role of the Stalking Horse in this process is to facilitate the potential for a better outcome from the auction process by providing a pre-auction bid. The underlying purpose is to enhance the potential to extract the highest and best price that is available from the marketplace by employing the many nuances that can be derived from a floor price being established.

The auction process will start with the pre-bid as a benchmark. Two vital determinants are established at once. Firstly, the pre-bid prevents lowball offers from being successful and secondly, the debtor becomes secure in the knowledge that the auction process will yield the pre-bid offer and potentially better. Both are value maximising endeavours.

⁴ Pursuant to either Chapter 11 of the US Bankruptcy Code or Part 26A of the UK Companies Act 2006

⁵ LoPucki, Lynn M, Doherty, Joseph W, Bankruptcy Fire Sales. UCLA School of Law. Law & Economics Research Paper Series. Research Paper No. 07-07. Page 5

⁶ Refer to section 363 (b) of the Bankruptcy Code (for the US restructuring model) and section 901J of the Companies Act 2006 (for the UK restructuring model)

⁷ King, Lawrence P, and Seligson, Charles. Workshop on Bankruptcy & Business Reorganization. September 18-19 (2013). NYU School of Law. New York. Page 300

Contended benefits of a Stalking Horse

The actual purpose for engagement may be different to the outwardly expressed reasons. But to gain Court consent, credible reasons will need to be submitted, which could be as described below.

- **For the debtor**, the establishment of a price floor within the bidding process is a significant advantage. It offers a level of security that the insolvency workout plan can progress on the back of the pre-bid. Although the pre-bid price may not be as high as desired, it is at least known and can be relied on.
- **For the Courts**, an application to sanction an auction plan is more likely to be consented to if there is a binding pre-bid from a Stalking Horse. The application is likely to have followed diligent and active negotiation between the Stalking Horse and the debtor as well as secured creditors if affected. Under that light, it would be reasonable for the Court to sanction a proposal as it would simply be consenting to what the affected parties have already agreed to.⁸
- **For the creditors**, the cost of a Stalking Horse becoming engaged is potentially justified by a sense of confidence that a floor price is established. The creditors can then reconcile their exposure against that floor price⁹ and become conclusive about the potential for their continued involvement.
- **For competing bidders**, merit exists in the knowledge that their own price rationalisation can be considered against the value determined by the pre-bid. Other bidders could develop the view that the Stalking Horse pre-bid will be at a discount to market value and such conclusion could incite them to engage within the bidding process.
- **For the Stalking Horse**, there will be an economic gain whether successful or not. Being successful will yield the perceived investment value of the acquisition but, if out-

⁸ This does not mean that the Court can be indifferent to interests beyond the secured creditors, but it is reasonable that the Court concludes that the auction process will yield what the market will pay, and the only parties that the Court should hear from are those that are directly affected. The Court's overarching authority will be to ensure that an open and fair process is conducted so that the claimants indirectly affected are provided for as best that can be achieved from the marketplace.

⁹ Together with any other relevant factors

bid, then compensating costs and other fees become available. The successful Stalking Horse is going to win either way.

Engagement of a Stalking Horse

The Stalking Horse agrees to become exposed to the risk of acquiring the property to be a mistake. It proceeds on its own interpretation of value without the benefit of assessment of value by any other party. For this risk, the Stalking Horse expects an appropriate reward.

Bankruptcy Courts in the US have provided consent to conduct an auction of property where a Stalking Horse is involved and is rewarded for that involvement.¹⁰

In an article¹¹, **Section 363 Sales: New Stalking Horse Strategies**, Nadia Khattak records that *“The Stalking Horse may be chosen from bids submitted in a mini-auction or it may have a prepetition relationship with the debtor”*. Engagement involves negotiation between the parties with terms being established as a result. These terms will include such items as - a threshold price for the property being auctioned, the contractual terms, the transaction structure and bidding procedures.¹²

All terms have the objective in mind that the Stalking Horse is sufficiently protected to justify the risk of making the purchase if called upon to do so, or to receive compensation if outbid. The *quid pro quo* for the Debtor is the perceived benefit in having the pre-bid, and the ability to leverage the marketplace to achieve a higher and better price because of it.

King and Seligson¹³ in their workshop, and with reference to a significant body of case law, identify the following protections that may be included in a Stalking Horse arrangement.

Compensation for costs and fees: The Stalking Horse will incur costs and fees in the establishment of a pre-bid price. The Debtor will meet an agreed reimbursement fee on the ground that beneficial due diligence has been conducted to establish the pre-bid offer. As the pre-bid serves to be a floor price, it will also be beneficial to the perceived auction outcome.¹⁴

¹⁰ Refer generally to *In Re App Plus, Inc.*, (BANKR.E.D.N.Y. 1998)

¹¹ Khattak, Nadia. *Section 363 Sales: New Stalking Horse Strategies*. Thomson Reuters, Practical Law Article 6-385-9854. Page 2

¹² *Ibid* page 2

¹³ *Supra* fn 7

¹⁴ The Court, as watchdog for the interests of creditors, is also likely to agree given that such valuation knowledge is valuable to all parties, including creditors.

Breakup fees: These will be paid to the Stalking Horse if the sale is not consummated between the contracting parties¹⁵ or the property is sold to a higher bidder. These fees are intended to compensate the Stalking Horse for a lost opportunity and can be set at between 1% to 3% of the deal value.¹⁶

Topping fees: These are in addition to the Breakup Fees and are usually a percentage of the difference between the amount paid by the successful bidder and the pre-bid Stalking Horse offer. The fee is only to be paid if another bidder is successful. Justification for this payment is that the pre-bid is intended to be used by the debtor to induce other bidders to top the pre-bid price.¹⁷ The Stalking Horse contends that the Debtor has gained a benefit on the back of the pre-bid and should therefore, share in that benefit.

Lock-out Arrangements (also called “Window Shop Clauses”, or “No Shop Clauses”): This provision prevents the Debtor from soliciting other offers from potential bidders. King and Seligson note that this will have a tendency to “chill” bidding but also note that terms of this kind have been approved by the Courts in US.¹⁸ A justification to agree to a lock-out arrangement will be in circumstances where a bidder will become advantaged by the work and effort of the Stalking Horse.

PERCEPTION OF BENEFITS

Duality of a benefit

The monitor of a benefit is how the engagement of the Stalking Horse is of real and tangible value in an insolvency workout. Much of the literature, and treatment within cases, tend to focus on the value for the Stalking Horse. Without belittling that requirement, the purpose of this analysis is to determine the benefit for the Debtor and whether or not, that benefit will maximise value in the Debtor estate.

¹⁵ Debtor and the Stalking Horse

¹⁶ Supra fn 11 page 2

¹⁷ In re App Plus, Inc., (BANKR.E.D.N.Y. 1998) 223 BR 870 at 874

¹⁸ King and Seligson cite re APP plus, Inc., 223 B.R. at 875

Judicial acknowledgement of the Stalking Horse rationale

In re App Plus Inc.¹⁹ the Court identified a marketplace rationale for requesting break up and topping fees. An abridged version of the Court's record, is set out below.²⁰

The Stalking Horse justification is that it will:

- I. compensate the Stalking Horse for its legal and other professional fees,
- II. compensate the Stalking Horse for its time spent, efforts made and use of resources,
- III. compensate the Stalking Horse for facilitating an outcome that may induce other purchasers and,
- IV. if unsuccessful, compensate the Stalking Horse for losing other business opportunities.

The Debtors justification is that:

- I. the payment of fees would encourage the Stalking Horse to make an offer,
- II. discourage a bidding strategy of delaying competitive bids until late in the process,
- III. aid in the negotiation of an initial bid,
- IV. by engagement and negotiation, increase the potential to establish a high floor price early in the bidding process and
- V. enhance the bidding process by creating momentum towards the consummation of a sale.

While the stated rationale is reasonable, they are descriptive labels that can be appropriate, or not, in the circumstances of the case. Often more subtle motivations will exist, that may be covert, and motivated by interest inconsistent with the proper purpose of the insolvency workout.²¹

In Integrated Resources Inc., the Court confirmed that three questions should be asked when assessing break up fees: *“(1) is the relationship of the parties who negotiated the break-up tainted by self-dealing or manipulation; (2) does the fee hamper, rather than encourage bidding; (3) is the amount of the fee unreasonable relative to the proposed purchase price?”*²²

¹⁹ Supra fn 17 at page 874

²⁰ Note that the Court did not express agreement with them but simply recorded them as being a rational basis for such terms to be sanctioned.

²¹ For example the establishment of a triangular relationship between a Debtor, Secured Creditor and the Stalking Horse that is designed to minimise contending bidders and optimise and outcome for the organising parties.

²² In re Integrated Resources, Inc. 147 B.R. 650 (S.D.N.Y. 1992) page 657

While there may be an apparent benefit contended for by proponents, there is also the potential for self-dealing and manipulation to feature. This will cause an outcome that is at odds with the fiduciary obligations of the Debtor, its Officers and its appointed consultants. Such was the case in *In re Bidermann Industries* where the Court included the text of the complaint of the Official Committee when the Court said *“Viewed as a whole, the proposed sale does not reveal the effective exercise of business judgment but rather the ‘illicit manipulation of a board’s deliberative process by self-interested corporate fiduciaries’”*.²³

STALKING HORSE RELATED FACTORS WITHIN AN INSOLVENCY WORKOUT

Integrating conceptual elements

The proposition that the engagement of a Stalking Horse will contribute value maximisation, is measured by any value input being directly attributable to the terms of the engagement. Conceptual elements, framed by such terms, are considered below.

Price threshold (or floor price)

Auction activity is designed to yield the highest and best price. Engaging competition is required for the auctioneer to extract value from combating contenders. When a Stalking Horse is engaged, at once there is knowledge of the floor price established. To be successful, another bidder must pay the pre-bid price of the Stalking Horse as well as the contracted for exit costs²⁴ that the Stalking Horse will be paid. This extra portion that the successful bidder must pay, is not representative of value in the property. From an investment perspective, the purchase price paid is not the most efficient use of capital allocation. As a result, it is questionable that the mere knowledge of a price threshold, will improve the bid price of competitors. Arguably, the knowledge that a margin will be paid to the Stalking Horse, may well dissuade bidding activity. In this context, the engagement of a Stalking Horse may not be beneficial to an insolvency workout.

Stalking Horse contributes to the process of attracting bidders

The Debtor contends that the Stalking Horse undertakes valuable activity by determining the value of the property for all concerned. There is cost involved in this undertaking and compensation should be made because of the benefit this knowledge will bring to the process.

It is highly likely that bidders will grasp upon this knowledge to challenge their own assessment of value. If a conclusion is reached that it is lower than market value, then an incentive exists

²³ *In re Bidermann Industries United StatesA., Inc.* 203 B.R. 547 (Bankr.S.D.N.Y 1997) Page 551

²⁴ Costs and fees, breakup fees and topping fees.

for other bidders to enter and engage in competitive bidding. The price may prove to be higher and better because of pre-bid knowledge. If that outcome is achieved, then the engagement of the Stalking Horse is beneficial.

Broad benefit in the knowledge

Undeniably, there is a benefit in knowledge of the pre-bid value placed on the property. One reason is that the pre-bid price is not solely determined by the Stalking Horse. The achievement of the price will be robust bargaining engagement between the Debtor, which will inevitably include secured creditors, and the Stalking Horse. When the price is agreed to, it will be accepted that it will carry an investment return for the Stalking Horse, but this will be as suppressed as the Debtor based negotiators can achieve.

By this process, a sense of completeness will be adopted by the Debtor in the knowledge that, although perhaps a better outcome can be achieved, at least this outcome will be sufficient for progress to be made. In this regard, a benefit will be found in the subtleties of reaching agreement, as much as the price that is achieved.

Price floor established

The establishment of a price floor will be enabling on many fronts. For example, working capital may well be freed up, supply side issues may be resolved, parties to executory contracts may become more malleable and secured creditors may become less intransigent. If there is a link between the realisation of the property and the success of the insolvency workout program, then the establishment of a floor price, that results in ameliorated positions, may finesse that link. Accordingly, parties external to the process will grow a beneficial sense of trust and confidence in the knowledge of a floor price being established.

The bona fides of the Stalking Horse

An insolvency workout plan will be acceptable to the consenting parties²⁵ only if the process is transparent and ethical. While equity may not necessarily feature,²⁶ integrity is paramount in the process.²⁷ There can be however, covert motivations that may drive the engagement of a Stalking Horse. For example where the Debtor seeks to dissuade other bidders on the back of an incentive available to an approving fiduciary that included the provision of continued employment and an equity interest if the Stalking Horse is successful.²⁸ In circumstances

²⁵ Court and affected creditors and shareholders

²⁶ Because the Court may authorise a plan that does not demonstrate equity.

²⁷ For blatant demonstration of incompetency and self interest refer to *In re Big Rivers Electric Corporation* 233 B.R. 754 (Bankr. W.D. Ky. 1999)

²⁸ *Supra* fn 23 page 553

where self-dealing is evident, there is little potential for the Stalking Horse engagement to be beneficial to the parties who should benefit from the insolvency workout.

CONCLUSION

The purpose of this paper was to establish what is meant by the term maximising value in an insolvency workout and then to pose the question as to whether or not the use of a Stalking Horse will help that outcome.

While there have been benefits noted flowing from the engagement of a Stalking Horse, the question that remains to be answered is whether or not the integration of a Stalking Horse in an insolvency workout will assist in maximising value. It is contended that there can be no definite answer to this question. In some instances the answer will be yes, but in others, it will be no. The determinates of either outcome will be the integrity of the process, the ability to leverage upon the pre-bid and whether the costs outweigh the benefit. These three vectors generally describe a dynamic about which there are as many iterations as there are interests that comprise that dynamic. The outcome, either positive or negative, will be determined by the merits and integrity of the process.

Clearly there is a distinct advantage in having knowledge of the value placed upon the property by an independent and interested acquirer. But will that encourage other bidders - or will that chill other bidders knowing that part of their purchase price is meeting the costs and fees of a disappointed Stalking Horse. It is contended that a bid made by any intending purchaser will be based in the perceived value of the property in their hands – not what some other party is prepared to pay. In this context, the price achieved and potential for value maximisation is not correlative to the engagement of a Stalking Horse

Perhaps the most significant advantage of the Stalking Horse is the confidence that will manifest because a floor has been established. On the basis that this will result from honest negotiation from disinterested fiduciaries, that may involve secured creditors, the wheels of the insolvency workout are likely to start rolling in this knowledge. Does that maximise value though? It is contended that it will do so if the workout is successful. However, while there may be a causative connection between the knowledge of the offer and the commencement of the operations of the workout, there will be many and significant other factors that will dilute any notion that the workout success can be directly attributed to the engagement of a Stalking Horse. Nevertheless, trust and confidence are powerful elements that leverage human actors to achieve positive results.

Importantly, it is somewhat naive to categorise human pursuit into a few classical strategies. Adam Smith's²⁹ invisible hand³⁰ illustrates the notion that human endeavour will take as varied a form as the skill and capability of the persons involved will allow. It is likely that, what might have started as simply a process of hedging risk,³¹ has nuanced itself into processes that may maximise value but for the wrong persons.

As a result of all the above, it is contended that the only reasonable conclusion that can be reached is that maximising value is wholly dependent on the facts of the insolvency workout and that maximising value for the correct persons is entirely dependent on protections imposed to ensure everyone gets what they should, and no-one gets what they should not.

²⁹ Adam Smith was an 18th Century Scottish Economist that authored "An Inquiry into the Nature and Causes of the Wealth of Nations" in 1776

³⁰ A metaphor describing the benefit to society generally of self-interest. See <https://www.investopedia.com/terms/i/invisiblehand.asp>

³¹ The engagement of a Stalking Horse to provide knowledge to the process and a floor price.

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