The stalking horse as a tool to maximize value in insolvency workouts:

a study from the perspectives of the United States and Brazil

Rodrigo Saraiva Porto Garcia [(*)]

ABSTRACT: The present paper aims to discuss how to maximize asset values and generate better returns to the debtor and creditors in a distressed sale of assets through the use of a stalking horse in informal insolvency workouts or prenegotiated bankruptcy filings. The first part addresses the importance of maintaining control of the company's situation of distress by acting early on in an organized and timely restructuring, through a workout or a prenegotiated bankruptcy filing, looking at the problem from the perspectives of the United States and Brazil. Once the importance of a quick turnaround is established, the second part sets out to examine how a stalking horse could be used to maximize asset value in a workout or a prenegotiated bankruptcy filing. A public auction with a stalking horse bid ensures the debtor and creditors that the asset will be sold and, if structured correctly, may foster competition and attract higher bids, generating more proceeds to be distributed to stakeholders.

KEYWORDS: insolvency workouts; sale of assets; maximization of asset value; stalking horse; auction theory.

TABLE OF CONTENTS: Introduction. 1. Workouts and prenegotiated bankruptcy filings: How to (try to) maintain control during financial distress. 1.1. Plan A: Why choose informal insolvency workouts? 1.2. Plan B: When a workout does not work, choose a prenegotiated bankruptcy filing. 2. The sale of assets to a stalking horse as a way out of financial distress. 2.1. Maximizing asset value through a public auction. 2.2. Further maximizing asset value with a stalking horse in a public auction. Conclusion. Bibliography.

INTRODUCTION

Why does a business fail? Certain signs point to a business' failure, such as diminishing financial resources and negative profitability.[1] Although there are different schools of thought to explain why an organization fails, some looking to internal factors and others to external factors, Kamel Mellahi and Adrian Wilkinson affirm that "*any attempt to explain organizational failure will not be complete*

[(*)] Doctor of Laws candidate in Corporate Law at the University of São Paulo. Master of Laws in Corporate and Economic Activities at the University of the State of Rio de Janeiro. Member of INSOL. Member of TMA Brasil. Partner at Galdino & Coelho Advogados. E-mail: rgarcia@gc.com.br.

[1] See MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. *International Journal of Management Reviews*, v. 5/6, n. 1, p. 21-41, 2004, p. 22.

unless the interplay between contextual forces and organizational dynamics is taken into account".[2] In other words, the reasons why organizations fail range from external and environmental factors to internal and managerial factors. Regardless of the reason for a business' failure, it is important to move quickly to address the situation of distress and implement a turnaround strategy. Such a strategy may involve a business restructuring and/or a financial restructuring.

A business restructuring, according to Jan Adriaanse and Hans Kuijl, is "a comprehensive plan the aim of which is to restore the (operational) profitability of a company in financial difficulties",[3] and may be divided into four phases: (i) stabilizing, whereby management is tasked at identifying the crucial issues and critical problems that need to be immediately resolved to stabilize the company's situation, to promote an increase in their cash flow and consequently allow the firm to satisfy impending financial obligations (a divestment of excessive assets may be implemented in this phase);[4-5] (ii) analyzing, through which management shall draft a reorganization plan indicating the company's short and long-term objectives in order to reorganize the company;[6] (iii) repositioning, according to which the company's management implements the measures outlined in the reorganization plan (what is called by Adriaanse and Kuijl as the "value recovery process");[7] and (iv) reinforcing, meaning that management will be reinforced (i.e., replacing old managers, changing management positions), as well as the company's balance sheet, which can be achieved by the transfer of the company to a new owner that would be able to meet any future obligations (this is closely linked to the financial restructuring).[8]

A financial restructuring may also be used by the distressed firm, through which "relevant creditors voluntarily commit to revised terms with regard to the funding they made available" and

[2] MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. In: *International Journal of Management Reviews*, v. 5/6, n. 1, p. 21-41, 2004, p. 22.
[3] ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? In: *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 140.
[4] *Ibidem*, p. 140-141.
[5] See SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. In: *British Journal of Management,* v. 12, p. 183-199, 2001, p. 185 (affirming that "[t]he efficiency/operating turnaround stage aims to stabilize operations and restore profitability by pursuing strict cost and operating-asset reductions"). See also SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. In: *Journal of Management Studies*, v. 50, n. 7, p. 1216-1244, November 2013, p. 1218 (indicating that these might be retrenchment strategies, through which the debtor sets out to improve operational efficiencies by reducing operational costs through layoffs and process improvements).
[6] ADRIAANSE; KUIJL, *op. cit.*, p. 141 (according to the authors, such a reorganization plan may include (i) a strategic and financial analysis tracing the causes of financial distress, (ii) an examination of the actual financial position and an assessment of the company's viability, (iii) proposed restructuring measures and long-term projections, (iv) short and long-term cash flow projections showing that the firm can perform their obligations, and (v) cash flow projections showing a future improvement on liquid assets. This plan may provide for the sale of excessive fixed assets).
[7] *Ibidem*, p. 143.
[8] *Ibidem*.

provide new funding.[9] In other words, a financial restructuring may reduce repayment obligations, interest rates, extend maturity dates, defer repayment, among other measures.[10-11]

One of the tools commonly found in the turnaround toolbox is the sale of assets. But considering that the distressed firm is a melting ice cube, asset values may greatly diminish with the passing of time and the deepening financial and/or economic crisis the company is undergoing. This poses the following question: how would it be possible to maximize asset values and generate better returns to the debtor and creditors in a distressed sale of assets? This paper aims to answer exactly this question and is structured in two parts.

The first part addresses the importance of maintaining control of the firm's situation of distress by acting early on to avoid a messy insolvency filing, looking at the problem from the perspectives of the United States and Brazil. An organized and timely restructuring, either through a workout or a prenegotiated bankruptcy filing, allows the debtor to control the situation, reduce reputational damage and, what is most important to this paper, retain asset value, especially when the turnaround strategy involves the divestment or the sale of assets.

Once the importance of a quick turnaround is established, the second part sets out to examine how a stalking horse could be used to maximize asset value in a workout or a prenegotiated bankruptcy filing. A public auction with a stalking horse bid ensures the debtor and creditors that the asset will be sold and, if structured correctly, may foster competition and attract higher bids, generating more proceeds to be distributed to stakeholders.

1. WORKOUTS AND PRENEGOTIATED BANKRUPTCY FILINGS: HOW TO (TRY TO) MAINTAIN CONTROL DURING FINANCIAL DISTRESS

1.1. PLAN A: WHY CHOOSE INFORMAL INSOLVENCY WORKOUTS?

Formal insolvency proceedings are not always expeditious or cost-effective, and they may somewhat tarnish a firm's reputation with its suppliers, consumers and the market in general, reasons for which an informal workouts may be the best alternative when the conditions are right – that is, when

[9] ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? In: *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 144.

[10] *Ibidem*, p. 145 (indicating that some examples of financial restructuring measures are (i) reducing the repayment obligations and/or reducing current debts, (ii) reducing interest obligations, (iii) deferring repayments, (iv) deferring interest obligations, (v) debt-to-equity swap, (vi) generating new-risk avoiding financing, and (vii) generating new risk-bearing financing).

[11] Likewise, see SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. In: *British Journal of Management,* v. 12, p. 183-199, 2001, p. 185 (stating that a financial restructuring via debt restructuring means "a transaction in which an existing debt is replaced by a new contract, with one or more of the following characteristics: (1) interest or principal reduced; (2) maturity extended; (3) debt-equity swap").

a group of relevant creditors, such as financial institutions, are willing to negotiate "an orderly and expeditious rescue or workout" in order "to avoid the social and economic impact of major business failures where viable alternatives exist", as expressed in the Commentaries to INSOL International's Statement of Principles for a Global Approach to Multi-Creditor Workouts II (henceforth, "Statement of Principles II").[12]

Acting once the first signs of distress appear is fundamental to widen the range of options that a company has to turn the business around and avoid a disorganized insolvency filing in the future. An out of court restructuring, or a workout, allows the debtor and creditors more flexibility when drafting restructuring proposals and reaching an agreement. According to Adriaanse and Kuijl, the informal "reorganization process is less rigid than is the case with(in) formal procedures".[13] The parties have a greater array of possible solutions at their disposal, which would better suit their needs, without (i) being bound to the legal constraints of insolvency law and the legal framework, (ii) court supervision, (iii) legal deadlines, and (iv) overall legal formalities. It is possible to point out a few advantages of an informal insolvency workout, which will ultimately help retain asset value, as follows.

First, during workout negotiations, a standstill period, although for a limited time, is important to avoid the common pool problem, as explained by Thomas Jackson.[14] According to Jackson, the common pool problem arises when each individual creditor of a debtor in financial distress tries to collect their claims through the "grab" rules of nonbankruptcy law and the debtor's assets are allocated on a first-come, first-served basis, thereby hindering a global solution to the debtor's crisis. Rather than using a formal insolvency proceeding to solve this collective action problem, a standstill agreement among relevant creditors may have the same effect as an automatic stay period, allowing all the relevant creditors to assess the situation and formulate proposals for an out-of-court workout, as well as avoiding a formal insolvency proceeding. However, for the standstill agreement to actually be effective, creditors must not initiate collection suits or enforcement proceedings seeking the repayment or the improvement of their positions against the debtor.

Second, an informal reorganization causes less reputational damage to the debtor. Although the debtor's financial distress will be known by the relevant creditors that are invited to the negotiating table, the parties often sign a non-disclosure agreement. "Furthermore, informal reorganizations take place in relative silence. That is to say, the procedure is not made public; this is opposed to formal reorganizations, which are public."[15] The debtor's stakeholders (consumers, suppliers, employees etc.) and even competitors may remain unaware of the debtor's financial distress. The debtor may continue

[12] INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 4.
[13] ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? In: *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 145.
[14] See JACKSON, Thomas H. *The logic and limits of bankruptcy law.* Washington: BeardBooks, 2001, p. 12-14.
[15] ADRIAANSE; KUIJL, *op. cit.*, p. 146.

to seek financing in the market, without the hurdles imposed by a formal insolvency proceeding – although a poor credit score due to the worsening financials might affect the terms and conditions of any loan agreement. Moreover, the less people know of the restructuring talks, the lower the chances that enforcement proceedings or collection suits may be filed to start a race for the debtor's assets.[16]

Third, the debtor's management remains in charge and in control of negotiations for the out-of-court restructuring agreement, as "they can continue to fully run the company independently".[17] Though relevant creditors might pressure for a change in the top management, or the appointment of a chief restructuring officer ("CRO"), the debtor's management is still calling the shots. The debtor's management may also decide to sell assets or divest as part of the workout agreement, without the need for outside confirmation (except as provided by security, pledge or collateral agreements), as is the case of a sale in a bankruptcy proceeding.

And fourth, an out-of-court restructuring may represent lower costs when compared to formal insolvency proceeding. Such costs are limited to the financial, accounting and legal advisors to all parties in the negotiations, often times even expert opinions, and any fees and costs necessary to implement the restructuring measures agreed by the parties.

All that being said, it is important to keep certain things in mind when choosing the informal reorganization path. An out-of-court restructuring may be the way to go when there is a small, concentrated and homogenous group of relevant creditors – if the situation of distress can only be resolved by engaging in negotiations with a larger and more heterogenous group of creditors, then a formal insolvency filing may be more suited to the task. But even with a small group of creditors that are privy to the negotiations, if just one of the creditors does not agree with the terms and conditions of the workout agreement (a holdout), negotiations may break down and all may be for naught. A workout agreement cannot bind a dissenting creditor, which would require a formal insolvency proceeding, such as a Chapter 11 in the United Stated or a judicial reorganization (*recuperação judicial*, in Portuguese) in Brazil.

Additionally, any attempt at an out-of-court restructuring requires high quality information from the debtor and transparency regarding its operation and business. Informational asymmetries only make negotiations more difficult, considering the relevant creditors will not be able to properly assess the

---

[16] ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? In: *Review of Central and East European Law*, v. 31, p. 135-154, 2006, p. 146 (affirming that "in a public context, a race to collect can easily develop; creditors 'tumble over each other' as they seek to get paid in advance of their sister creditors. This frequently also involves petitioning for liquidation of the debtor (in order to enforce payment). However, these developments place the company in a(n) (even more) vicious circle. This phenomenon is, therefore, often seen as the self-fulfilling prophecy-effect of a public procedure. The negative effects upon management and the missed opportunities as a result of publicity of procedures can also be characterized as opportunity costs. In an informal reorganization, these costs are (considerably) less—especially because of the relative silence—than is the case in a formal reorganization").

[17] *Ibidem*.

debtor's condition and draft proposals to remedy the situation.[18] Reasonable and timely access to relevant information, therefore, is the foundation upon which a workout agreement is built. If the relevant creditors do not have access to the debtor's information, or if the information that has been provided is not accurate, such unreliable information may delay negotiations and may even push creditors away from the negotiating table. The objective of sharing all of the debtor's relevant information with its principal creditors is to allow them to evaluate the debtor's financial position and assess any restructuring proposals submitted by the debtor, or draft counterproposals, which would entail equitable treatment to all relevant creditors. When assessing or drafting these proposals, creditors "need to compare the outcome they could expect from any proposals made to them against the returns they might expect to achieve in a formal insolvency process or from other options available to them".[19]

Due to the underdeveloped nature of Brazil's capital markets, it is quite common for companies to finance their business through loan facilities from financial institutions. This means that a large portion of a company's indebtedness is held by banks. In case of default, the longer the debtor takes to repay the bank, the more provisions the bank has to make in order to comply with federal banking regulations. And if the default lasts longer than a period of 180 days, the bank has to make a provision of 100% of the outstanding debt – the same provision is required when the debtor files for judicial reorganization in Brazil.

This indirectly serves as an incentive for financial institutions in Brazil to negotiate with financially distressed companies (with significant bank indebtedness) and attempt to reach an informal workout agreement, that is, before the debtor is pushed to a judicial reorganization filing by other less relevant creditors. In this sense, even though there is no soft law in Brazil to help guide negotiations toward an informal restructuring, it is somewhat common for debtor and creditors to hire financial and legal advisors to guide the negotiations under a confidentiality agreement, with the debtor's relevant information being made available to all parties in pursuit of a consensual solution (e.g., divestment of assets, spin-off and sale of non-core businesses, public offering of securities etc.). Despite the lack of a specific legal framework in Brazil regulating out-of-court restructurings, article 167 of the Brazilian Bankruptcy Law (Federal Law No. 11,101/2005) allows workout agreements outside of formal insolvency proceedings.

A public auction of assets in a controlled environment provided by a workout agreement could be a way to maximize the sale price, considering the loss of value that a formal insolvency proceeding may represent. According to Sudi Sudarsanam and Jim Lai, "[w]here the firm is in severe distress and/or

[18] George A. Akerlof gives the famous example of the used car market to show how informational asymmetries may cause assets to be undervalued, which would lead to inadequate restructuring proposals that might impose a greater-than-necessary loss to the debtor's shareholders, or a lower-than-expected return for creditors. See AKERLOF, George A. The market for "lemons": quality uncertainty and the market mechanism. In: *The Quarterly Journal of Economics*, v. 84, n. 3, p. 488-500, August 1970.

[19] INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017, p. 26.

where strategic health is weak, asset reduction is deemed imperative for turnaround".[20] However, if there is any chance that the informal restructuring will not resolve the company's financial and/or economic distress, then a sale of assets in a formal insolvency proceeding, through a public auction, may be a better alternative to maximize asset value, for two main reasons: (i) the assets are sold free and clear of any debts, obligations, liabilities or encumbrances, as long as secured creditors are assured adequate protection in the United States, and as long as the sale is performed in a public competitive bidding process in Brazil; and (ii) once the price of the winning bid is transferred to the seller and the sale is substantially consummated, the equitable mootness doctrine protects the buyer from a possible undoing of the sale – in Brazil, if the buyer is in good faith and the sale price is transferred to the seller, then the sale cannot be undone pursuant to article 66-A of the Brazilian Bankruptcy Law, while in the United States there is still some discussion in the Circuit Courts regarding the requirements for the application of the equitable mootness doctrine.[21]

If the buyer does not have to account for any obligations or liabilities involving the asset, or for any uncertainty regarding the sale itself, then there is no need to reduce the bid to accommodate these unknown contingencies that may ultimately cost the buyer and reduce their payoff, or to spend more time and money on due diligence. These rules that are specific to bankruptcy regimes in the United States and Brazil (but also in most jurisdictions across the globe) aim to cut the costs pertaining to the sale and decrease any risks that the buyer may be exposed to, which are not applicable to sales carried outside of a bankruptcy proceeding, such as the one provided by a workout agreement.

Whether the debtor and creditors could not reach an agreement regarding the informal insolvency workout, or the parties found that a sale of assets would maximize value in a formal insolvency proceeding, the debtor and creditors may agree to a prepackaged bankruptcy filing or a restructuring support agreement.

1.2. PLAN B: WHEN A WORKOUT DOES NOT WORK, CHOOSE A PRENEGOTIATED BANKRUPTCY FILING

If the consensual approach does not bear fruit (e.g., due to a holdout), it does not end in the debtor's liquidation. Rather, there is still the option of a formal insolvency proceeding to try to restructure the company's indebtedness, perhaps with a prepackaged bankruptcy or even a restructuring support agreement outlining the principal measures to be undertaken during the formal proceeding, which is quite common in the United States and is starting to gain traction in Brazilian judicial reorganizations. The negotiations for the failed workout agreement may be repurposed for a prepackaged bankruptcy filing or a restructuring support agreement, which could greatly decrease the

[20] SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. In: *British Journal of Management,* v. 12, p. 183-199, 2001, p. 186.
[21] See ROSIEK, Caroline L. Making equitable mootness equal: the need for a uniform approach to appeals in the context of bankruptcy reorganization plans. In: *Syracuse Law Review,* [*s. l.*], v. 57, p. 685-707, 2006-2007.

amount of time needed to implement the company's restructuring, thus reducing the costs associated with a formal bankruptcy filing and the reputational damage arising from litigation in a drawn-out process.

To put it plainly, the restructuring support agreement (also called a plan support agreement) is a contract entered into between the debtor and its main creditors,[22] with the objective of defining the measures to be adopted in the restructuring and obtaining support from creditors for the restructuring plan to be presented before the court in the formal insolvency proceeding, provided that the previously negotiated terms are observed.[23] In the United States, the restructuring support agreement consists of an instrument through which the debtor and creditors negotiate a prepackaged plan or a prenegotiated plan (together called pre-filings).[24]

In the United States, before filing for Chapter 11, it is common for the debtor to negotiate with its most relevant creditors to obtain the necessary support for its reorganization proceeding. Based on these negotiations, a prepackaged plan can be drafted, through which the debtor and creditors structure a reorganization plan that has favorable (and binding) votes from a number of creditors sufficient to approve the plan under the Bankruptcy Code, even before the Chapter 11 filing.[25] Therefore, together with the petition filing for Chapter 11, the debtor presents a plan already approved by the creditors in a quorum necessary for its confirmation in court,[26] shortening the processing period of the proceeding.

---

[22] The restructuring support agreement may also be concluded only between creditors, especially considering the possibility of presenting an alternative plan. See JANGER, Edward J.; LEVITIN, Adam J. Badges of opportunism: principles for policing restructuring support agreements. In: *Brooklyn Journal of Corporate, Financial & Commercial Law*, [*s. l.*], v. 13, p. 169-189, 2018, p. 173.

[23] SASSON, Isaac. Judicial review of plan support agreements: a review and analysis. In: *NYU Journal of Law & Liberty,* New York, v. 9, p. 850-886, 2015, p. 851 (stating that "[p]lan support agreements, otherwise known as restructuring support agreements or lock-up agreements (hereinafter 'PSA' 'lock- up agreement' or 'agreement'), are pre- or post-petition contracts entered into by the debtor and certain creditors, wherein the debtor and creditors agree to support a proposed reorganization plan subject to specific terms or conditions. PSA's are executed in order to 'bind [the creditor and debtor] to a deal, even when the underlying restructuring documents remain to be drafted and executed[,]' usually to complement prepackaged bankruptcy plans. Typically, the PSA prohibits both parties from soliciting or supporting any plan not memorialized within the agreement").

[24] See JANGER; LEVITIN, *op. cit.*, p. 175. See also BAIRD, Douglas G. *Elements of bankruptcy.* 4. ed. New York: Foundation Press, 2006, p. 604. From a Brazilian perspective, see SATO, Juliana Fukusima. As vantagens da negociação prévia no plano de recuperação judicial: a experiência americana do *prepackaged plan* e *prenegotiated plan*. MARTINS, André Chateaubriand; YAGUI, Márcia (Coord.). *Recuperação judicial:* análise comparada Brasil–Estados Unidos. São Paulo: Almedina, 2020, p. 62.

[25] AYER, John D.; BERNSTEIN, Michael L.; FRIEDLAND, Jonathan. Out-of-court workouts prepacks and pre-arranged cases: a primer. In: *American Bankruptcy Institute Journal,* [*s. l.*]. v. 24, n. 3, 2005 (affirming that "[u]nlike a traditional chapter 11 case, the prepackaged bankruptcy is negotiated and accepted by creditors before a proceeding is commenced in the bankruptcy court. In theory, therefore, the prepackaged bankruptcy itself can be quick (sometimes as fast as 30-45 days), and therefore less costly and damaging to the restructuring company. It is particularly useful for those businesses that are very sensitive to public image, such as retailers. If they are in bankruptcy for a long time, the public may become skeptical and their image may be tarnished, sometimes beyond repair. If they can get in and out quickly and without a lot of public fighting, they have a better chance to emerge unscathed").

[26] See SASSON, *op. cit.*, p. 855. See also DREHER, Nancy C.; FEENEY, Joan N. *Bankruptcy law manual.* 5. ed. New York: Westlaw, 2010, v. 2, p. 388. See also MCCONNELL, John J.; LEASE, Ronald C.; TASHJIAN, Elizabeth. Prepacks as a mechanism for resolving financial distress: the evidence. In: *Journal of Applied Corporate Finance,* [*s. l.*]. v. 8, p. 99-106, 1996, p. 100.

Theoretically, the same may be done in a judicial reorganization in Brazil, pursuant to the recent legislative change enacted by Federal Law No. 14,112/2020, which substantially altered the Brazilian Bankruptcy Law, although it has not been tried.

In other cases, the debtor may be unable to obtain the necessary quorum to approve the plan without soliciting votes from creditors in the course of the reorganization proceeding[27] but is still able to negotiate an agreement in support of the plan (the prenegotiated plan[28]),[29] with the general outline of the measures to be undertaken in the reorganization,[30] using vague and open terms. In this case, it is possible that certain creditors expressly affirm their vote in favor of the plan through a restructuring support agreement or a lock-up agreement.[31] Such an agreement can be concluded both before the bankruptcy filing, as well as during the proceeding, with the aim of reducing litigation and raising support for a plan to be presented by the debtor.[32]

Through the agreement executed between debtor and creditors, the debtor undertakes to negotiate the final version of a reorganization plan observing the guidelines imposed by the restructuring support agreement, following a timeline agreed between the parties.[33] In turn, creditors[34] undertake to

---

[27] JANGER, Edward J.; LEVITIN, Adam J. Badges of opportunism: principles for policing restructuring support agreements. In: *Brooklyn Journal of Corporate, Financial & Commercial Law*, [*s. l.*], v. 13, p. 169-189, 2018, p. 175.

[28] AYER, John D.; BERNSTEIN, Michael L.; FRIEDLAND, Jonathan. Out-of-court workouts prepacks and pre-arranged cases: a primer. In: *American Bankruptcy Institute Journal,* [*s. l.*]. v. 24, n. 3, 2005 (expressing that "[t]he terms 'pre-arranged bankruptcy' or 'pre-negotiated bankruptcy' do not have specific definitions. In a most general sense, they refer to any chapter 11 case in which the debtor has discussed with some constituency prior to the commencement of bankruptcy some form of corporate reorganization or restructuring to be accomplished through the chapter 11 process and has received some form of commitment (which may or may not be contractual or binding by its terms) from the constituency to support a chapter 11 plan that accomplishes that reorganization or restructuring").

[29] BAIRD, Douglas G. *Elements of bankruptcy.* 4. ed. New York: Foundation Press, 2006, p. 604 (stating that "[w]hen there is not enough consensus for an easily confirmable prepackaged plan, restructuring support agreements provide a base camp. Either before bankruptcy or during it, two or more parties can agree on a time table and the basic elements of a plan. Even if the details need to be worked out and additional parties brought on board, it at least provides a point of departure. Restructuring support agreements provide conspicuous benefits. They provide a clearer, quicker, and more reliable path toward exit from chapter 11").

[30] JANGER; LEVITIN, *op. cit.*, p. 173 (asserting that "RSAs are bargains, negotiated in contemplation of, or during, a bankruptcy case. In an RSA, key creditors commit to support the debtor's proposed plan of reorganization, provided that the plan satisfies certain broad characteristics. This allows the debtor to gather support for the business plan and distributional scheme it wishes to implement through Chapter 11 prior to the formal disclosure and solicitation process. Sometimes cases with RSAs are referred to as 'prearranged' or 'prenegotiated'. As such, RSAs allow the debtor and key creditors to overcome coordination problems and to reorganize in the face of (and in anticipation of) holdouts"). See also SATO, Juliana Fukusima. As vantagens da negociação prévia no plano de recuperação judicial: a experiência americana do *prepackaged plan* e *prenegotiated plan*. MARTINS, André Chateaubriand; YAGUI, Márcia (Coord.). *Recuperação judicial:* análise comparada Brasil–Estados Unidos. São Paulo: Almedina, 2020, p. 61-62.

[31] AYER; BERNSTEIN; FRIEDLAND, *op. cit*.

[32] JANGER; LEVITIN, *op. cit.*, p. 175.

[33] *Ibidem*, p. 184.

[34] It is common for the restructuring support agreement to authorize the creditor to transfer their claim to third parties during the course of the reorganization proceeding, provided that the transferee agrees to the same terms of the restructuring support agreement. See BAIRD, *op. cit.,* p. 605 (maintaining that "[t]he holder of a particular claim may be a bank one day and a vulture investor the next. To push the plan process forward, it is useful to bind parties and their successors to ensure support garnered today persists").

(i) support the reorganization process (in certain cases, committing themselves to vote in favor of the plan); (ii) not oppose any requests for urgent relief to be made by the debtor at the beginning of the proceeding and which have been previously agreed by the parties; (iii) not take any measures that may thwart or obstruct the restructuring process; and (iv) not propose or participate in the negotiation of an alternative reorganization plan.

Creditor support conveyed in the restructuring support agreement is subject to certain conditions,[35] such as (i) sharing information with creditors on the debtor's real situation, with the objective of ensuring adequate information[36] and reducing information asymmetries; (ii) the submission of a reorganization plan that complies with the general guidelines set out in the restructuring support agreement; and (iii) the absence of substantial changes in the debtor's economic situation in the course of the reorganization proceeding, which may change the assumptions adopted in the structuring of the prenegotiated plan – or the absence of subsequent verification that the information presented was incomplete or inaccurate.[37] In other words, the restructuring support agreement sets out the circumstances in which the agreement can be ended by the parties.

The restructuring support agreement may represent some general benefits for the debtor's restructuring, among which are (i) the shortening of the reorganization process, signaling to the market (i.e., its suppliers, consumers etc.) that the debtor will be able to get back on their feet and continue operating as a going concern, rather than having their assets liquidated piecemeal;[38] (ii) the alignment of incentives between debtor and creditors, mitigating moral hazard and reducing the debtor's appetite to take risks at the expense of creditors, as a viable solution to the company's crisis has already been negotiated; (iii) less litigation during the reorganization process (i.e., fewer challenges, fewer objections, fewer appeals), since the bases of the reorganization plan are previously negotiated out of court in order to achieve the alignment of the main parties,[39] and the reduction of opportunistic behavior by creditors seeking to improve their bargaining position; (iv) the consequent decrease in the transaction costs of the reorganization process, due to the greater speed in its processing and the reduced litigation;[40] (v) possibly keeping preexisting management and the shareholders in control of the debtor (or at least the retention of an equity interest by shareholders); and (vi) the comfort and security for creditors and investors that the reorganization strategy outlined in the prenegotiated agreement is economically viable,

---

[35] BAIRD, Douglas G. *Elements of bankruptcy.* 4. ed. New York: Foundation Press, 2006, p. 262 (stating that "[n]egotiations are the lifeblood of a reorganization, but relying on negotiations makes sense only if the parties are well informed").

[36] JANGER, Edward J.; LEVITIN, Adam J. Badges of opportunism: principles for policing restructuring support agreements. In: *Brooklyn Journal of Corporate, Financial & Commercial Law*, [*s. l.*], v. 13, p. 169-189, 2018, p. 176.

[37] *Ibidem*, p. 178.

[38] SASSON, Isaac. Judicial review of plan support agreements: a review and analysis. In: *NYU Journal of Law & Liberty,* New York, v. 9, p. 850-886, 2015, p. 858.

[39] SATO, Juliana Fukusima. As vantagens da negociação prévia no plano de recuperação judicial: a experiência americana do *prepackaged plan* e *prenegotiated plan*. MARTINS, André Chateaubriand; YAGUI, Márcia (Coord.). *Recuperação judicial:* análise comparada Brasil–Estados Unidos. São Paulo: Almedina, 2020, p. 60.

[40] SASSON, *op. cit*., p. 858. See also SATO, *op. cit.*, p. 60.

indirectly fulfilling the objectives of bankruptcy law to ensure the recovery of claims, maintaining jobs and continuing to pay taxes (evidenced in Brazil by the provisions of article 47 of the Brazilian Bankruptcy Law).[41]

In a study carried out on prepackaged and prenegotiated plans in the United States, it was found that pre-filings "tend to produce a more-streamlined chapter 11 reorganization process, fewer unpredictable outcomes, shorter case lengths, and fewer case-related expenses for the debtor".[42] From January 2010 to June 2018, the study analyzed 434 reorganization proceedings of companies with an indebtedness over US$ 50 million and it was observed that in 191 cases (or 44% of the total) there was a pre-negotiated agreement; in the most recent cases, from January 2015 to June 2018, 71 of the 109 cases (or 65%) involved pre-filing agreements.[43] The study also identified a reduction in the period in which companies remained in Chapter 11: from January 2010 to December 2015, the average proceeding was 401 days long, while from January 2016 to June 2018, the average proceeding was 212 days long, potentially reducing costs related to the reorganization process; compared to the proceedings without pre-filing agreements, the average times were 515 days and 344 days, respectively.[44]

In another study, older and with a smaller sample of only 49 cases between January 1986 and June 1993, it was identified that the average rate of recovery of claims in cases that had pre-filing agreements was 72.9%,[45] while in ordinary Chapter 11 proceedings, without prior negotiation, the recovery rate was 50.9%.[46] The study also found that the direct costs of restructuring represented 1.85% of the companies' equity when there were pre-negotiated plans, and 2.8% in common processes.[47] The data indicate that the use of pre-filing agreements for the restructuring of companies can ultimately bring about a reduction in transaction costs.[48]

Although there have not been many cases in Brazil with prepackaged or prenegotiated plans, it has been done on a few occasions, as in the judicial reorganization proceedings of Constellation Group, Oi Group and OGX Group.

Furthermore, the execution of pre-filing agreements, such as a restructuring support agreement or a prepackaged bankruptcy, allows the *ex-ante* allocation of costs in the negotiation prior to the filing

---

[41] SASSON, Isaac. Judicial review of plan support agreements: a review and analysis. In: *NYU Journal of Law & Liberty,* New York, v. 9, p. 850-886, 2015, p. 858.
[42] YOZZO, John; STAR, Samuel. For better or worse, prepackaged and pre-negotiated filings now account for most reorganizations. In: *American Bankruptcy Institute Journal*, [*s. l.*], v. 37, p. 18, November 2018.
[43] *Ibidem*.
[44] *Ibidem*.
[45] MCCONNELL, John J.; LEASE, Ronald C.; TASHJIAN, Elizabeth. Prepacks as a mechanism for resolving financial distress: the evidence. In: *Journal of Applied Corporate Finance,* [*s. l.*]. v. 8, p. 99-106, 1996, p. 101.
[46] The percentage of 50.9% was identified by another study, involving a sample of 37 cases. See FRANKS, Julian R.; TOROUS, Walter N. A comparison of financial recontracting in distressed exchanges and Chapter 11 reorganizations. In: *Journal of Financial Economics,* [*s. l.*], v. 35, p. 349-370, 1994.
[47] The percentage of 2.8% was identified by yet another study, also involving a sample of 37 cases. See WEISS, Lawrence A. Bankruptcy resolution: direct costs and violations of priority of claims. In: *Journal of Financial Economics*, [*s. l.*], v. 27, p. 285-314, 1990.
[48] MCCONNELL; LEASE; TASHJIAN, *op. cit.*, p. 101.

for reorganization, with the objective of reducing *ex-post* costs resulting from the protraction of the proceeding and a possible scenario of greater litigation between the debtor and creditors.

As previously mentioned, a sale of assets carried out according to a prenegotiated agreement in the course of a formal insolvency proceeding has the benefits of transferring the asset free and clear of obligations and liabilities, as well as providing some level of certainty toward the conclusion of the sale once the price is paid and it is substantially consummated. However, a divestment or a sale of assets is only an effective measure for a company's turnaround, either through an informal or a formal insolvency proceeding, if there is at least one interested buyer. Here is where the part of the stalking horse gains importance.

2. THE SALE OF ASSETS TO A STALKING HORSE AS A WAY OUT OF FINANCIAL DISTRESS

A sale of assets by a distressed company may serve to optimize the business activities, directing new cash resources to the debtor's main and most profitable activities, whilst avoiding the expenditure of funds for the conservation of unnecessary assets for the company.[49] The sale may be piecemeal, of the assets individually considered, in which case the price for such assets should be considerably lower than the price for the assets organized and allocated to an activity, on a going concern basis. When thinking about a proposal for a company's turnaround, both debtor and creditors should consider if there are assets or businesses that may be divested and converted into quick cash. The challenge here is maximizing the output of the sale: how much the buyer is willing to pay for the asset in a public auction, with competition from other bidders.

An informal workout may be used to improve the purchase price in the sale of a company's assets due to the following reasons: (i) the company's situation of distress may not yet be widely known by the market and, if management were quick to act, the financial and/or economic distress may not even be as aggravated as it would be had they remained inert, which in turn leads to a lower depreciation of the company's assets; (ii) if management act early on, the company may have more time to shop the asset around and look for a better offer, whereas in a situation of deepening insolvency and distress, the sale may be rushed and lead to a lower purchase price; and (iii) an informal workout is not bound by the same constraints and formalities of a formal insolvency proceeding, which allows more flexibility and a speedier conclusion for the sale.

Unlike in an informal reorganization, in a formal insolvency proceeding, as previously mentioned, the bankruptcy framework usually provides mechanisms that are intended to maximize asset

[49] SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. In: *British Journal of Management,* v. 12, p. 183-199, 2001, p. 186 (stating that "[a]sset reduction at the portfolio (corporate) level covers divestment of subsidiaries/ divisions. The objective at this level may be to divest non-profit generating assets (and halt cash drain), non-core assets or even profitable assets for the purpose of raising cash to alleviate financial distress and fund restructuring. Divestment of subsidiaries is perhaps the most common turnaround strategy by all but the smallest firms").

values, such as (i) the free and clear rule provided §363(f) of the United States Bankruptcy Code or article 60 of the Brazilian Bankruptcy Law, and (ii) the equitable mootness doctrine, as provided by case law in the United States and article 66-A of the Brazilian Bankruptcy Law.

The purpose of the free and clear rule is to encourage the sale of the distressed company's assets, protecting the buyer and causing the economic activity linked to those assets to continue,[50] thus promoting an efficient reallocation of assets. By eliminating the debts, obligations, liabilities or encumbrances attached to the asset put for sale, its appraisal value may be increased, and a higher purchase price may be obtained from the sale, which can be directed to the debtor's reorganization process. Outside of a formal insolvency proceeding, such as an insolvency workout, the risk of any debts, obligations or liabilities is accounted by the potential buyer when setting the purchase price for the asset – with the removal of this variable by bankruptcy legislation, the pricing of the asset becomes easier and more favorable to the seller, since such contingencies may be disregarded altogether.

Not only that, the free and clear rule seeks to reduce transaction costs, as the buyer will not need to spend time or money on a complete and exhaustive due diligence of the debts, obligations and liabilities of the asset that is intended to be sold, in order to reduce uncertainties around the business. The fact is that the higher the transaction costs, the greater the chances of making the sale unfeasible.

On the other hand, the equitable mootness doctrine may also work in favor of a higher purchase price, by preventing the sale from being undone in challenges or appeals, after the price has been paid and the operation has been substantially consummated, which generates greater legal certainty for the buyer and seller, allowing assets to be sold more quickly and with lower risks, consequently increasing the purchase price and maximizing the asset's value.

In whichever scenario, to further maximize asset values, an open and public auction may be held, with broad publicity and competition, in order to attract the largest number of possible bidders.

2.1. MAXIMIZING ASSET VALUE THROUGH A PUBLIC AUCTION

"Auction design is not 'one size fits all'. A good auction needs to be tailored to the specific details of the situation, and must also reflect the wider economic circumstances".[51] According to auction theory, for different situations, a different type of competitive bidding process may be the most appropriate. The choice of the type of auction and the rules that apply to it may impact the amount of proceeds obtained from the sale of the asset.

The ascending bid auction, also known as the English auction, starts from a base price and progresses with incremental bids from the participants, either through oral bids or by submitting bids

[50] From a Brazilian perspective, see WAISBERG, Ivo. Da não sucessão pelo adquirente por dívidas trabalhistas e tributárias na aquisição de unidades produtivas isoladas perante a lei 11.101/2005. In: *Revista de Direito Empresarial e Recuperacional*, v. 1, n. 0, p. 159-171, January-March 2010.
[51] KLEMPERER, Paul. *Auctions*: theory and practice. New Jersey: Princeton University Press, 2004, p. 4.

online. The auction is usually carried out in the presence of an auctioneer (with the right to a commission established in advance) and the bidder with the highest bid is declared the winner.[52] In the auction, the bidding starts with the base price and all participants are immediately aware of the bids of the other bidders. This allows participants to adjust their strategies by watching other participants' bids (and withdrawals from bidding) and increase their bids accordingly until only one bidder remains.[53] There is an incentive to start with the lowest possible bid (the base price) and raise bids as little as possible (just enough to eliminate the other bidders). Thus, the winner will pay the amount that the runner-up attaches to the asset, even if they were willing to offer more in light of their own valuation of the asset. In this case, the bidder is always the one with the highest valuation of the asset.[54]

Paul R. Milgrom and Robert J. Weber came to the conclusion that the English auction should be preferred over other types of competitive bidding processes, since it provides the bidder with information regarding the pricing of the asset by the other bidders as the auction unfolds.[55] In this way, the structure of the auction reduces the participants' concern of falling prey to the winner's curse,[56] a perception of the highest bidder of the auction that he overpaid for the asset, generating a loss for the bidder – this, as a result of incomplete information about the asset, which would have led the bidder to a wrong valuation.

Other than allowing the participants to adjust their valuation of the asset in real-time, an open and public English auction is usually preceded by (i) widespread publicity, which is associated with the idea that the more interested parties in the acquisition of the asset, the higher the auction price;[57] and (ii) the most complete information regarding the asset the seller is able to provide, since, uncertainty about the value of the asset by both the seller and the buyer is an inherent characteristic of the auction,[58] any and all information can be extremely relevant for the valuation of the asset.[59]

Publicity and adequate information are important to attract more bidders to participate in the auction. According to R. Preston McAfee and John McMillan, "[t]he more bidders there are, the higher on average is the valuation of the second-highest-valuation bidder".[60] By increasing the number of

---

[52] MCAFEE, R. Preston; MCMILLAN, John. Auctions and bidding. In: *Department of Economic Research Reports*, 8601, London, ON: Department of Economics, University of Western Ontario, 1986, p. 6.
[53] DENTON, J. Russel. Stacked deck: go-shop and auction theory. In: *Stanford Law Review,* [*s. l.*], v. 60, p. 1529-1554, 2008, p. 1535.
[54] MILGROM, Paul R.; WEBER, Robert J. A theory of auctions and competitive bidding. In: *Econometrica*, [*s. l.*], v. 50, n. 5, p. 1089-1122, set. 1982, p. 1091.
[55] *Ibidem*, p. 1095. See also ROTEM, Yaad; DEKEL, Omar. The bankruptcy auction as a game – designing an optimal auction in bankruptcy. In: *The Review of Litigation*, [*s. l.*], v. 32, p. 323-394, 2013, p. 384.
[56] ROTEM; DEKEL, *op. cit.*, p. 365-366.
[57] TOLEDO, Paulo Fernando Campos Salles de; PUGLIESI, Adriana V. A falência: realização do ativo. In: CARVALHOSA, Modesto (Coord.). *Tratado de direito empresarial* [digital edition]. 2 ed. São Paulo: Revista dos Tribunais, 2018, v. 5. See also CRUZ, André Santa. *Direito empresarial*. 8 ed. Rio de Janeiro: Forense, 2018, p. 823-824.
[58] KRISHNA, Vijay. *Auction theory*. 2 ed. London: Elsevier, 2010, p. 2-3.
[59] By making public (or at least known to the bidders) the information they have about the real value of the asset, the seller can increase the expected proceeds from the sale, as potential buyers are able to better evaluate the asset. See DENTON, *op. cit.,* p. 1535. See also MCAFEE; MCMILLAN, *op. cit.*, p. 45.
[60] MCAFEE; MCMILLAN, *op. cit.*, p. 21-22.

bidders, it is possible to increase the potential proceeds of the sale.[61] The authors go on to argue that "[a]s the number of bidders approaches infinity, the price tends to be the highest valuation".[62] Such is the relevance of having widespread publicity and broad information in a public auction: the possibility of obtaining the highest amount for the asset.

2.2. FURTHER MAXIMIZING ASSET VALUE WITH A STALKING HORSE IN A PUBLIC AUCTION

The presence of a stalking horse in a public auction may also further maximize asset values. "The term 'stalking horse' refers to a tactic used in hunting whereby a hunter conceals himself behind an image of a horse in order to get closer to his target", according to Zachary R. Frimet.[63] The stalking horse can play a very important role in the sale of assets in the course of a company's restructuring. Upon realizing the need to sell assets or businesses, the company may (in fact, must) carry out market research to identify if there are interested parties in the acquisition of the assets – or, better yet, hire an investment banker or agent to seek potential buyers.[64]

If there is someone interested, the company and the potential buyer may enter into a stalking horse agreement, in order to define the structure of the deal (which assets will be sold), the general terms and conditions that must regulate the deal and the stalking horse's binding offer, which consists of the minimum price for the public auction.[65] The agreement signed by the stalking horse with the company is subject to a precedent condition: the submission of a better offer by a third party in the competitive bidding process. In this case, the purchase and sale agreement entered into with the stalking horse will not be concluded. However, if there are no better offers, the asset is transferred to the stalking horse and the price is paid.

Not only that, but there may also be interested parties in the purchase of the assets who are not willing to submit a binding offer that will be made public. It may be more advantageous to wait for the pricing of the assets by the stalking horse bidder before deciding to participate in the public auction, limiting the costs of carrying out due diligence. In this case, the stalking horse may serve as an incentive

---

[61] Even the threat of competition may increase the sale price. See DENTON, J. Russel. Stacked deck: go-shop and auction theory. In: *Stanford Law Review,* [*s. l.*], v. 60, p. 1529-1554, 2008, p. 1534.

[62] MCAFEE, R. Preston; MCMILLAN, John. Auctions and bidding. In: *Department of Economic Research Reports*, 8601, London, ON: Department of Economics, University of Western Ontario, 1986, p. 21-22. See also WILSON, Robert. A bidding model of perfect competition. In: *The Review of Economic Studies*, [*s. l.*], v. 44, n. 3, p. 511-518, October 1977, p. 511.

[63] FRIMET, Zachary R. Reward the stalking horse or preserve the estate: determining the appropriate standard of review for awarding break-up fees in § 363 sales. In: *Fordham Journal of Corporate & Financial Law,* [*s. l.*], v. 20, p. 461-496, 2014-2015.

[64] See ROTEM, Yaad; DEKEL, Omar. The bankruptcy auction as a game – designing an optimal auction in bankruptcy. In: *The Review of Litigation*, [*s. l.*], v. 32, p. 323-394, 2013, p. 387 (arguing that "the relatively uncompetitive environment of bankruptcy auctions merits any boost possible. Investment bankers disseminate information among potential bidders and may play an important role in overcoming informational asymmetries").

[65] BOWSHER, David K. *et al.* Perspectives: buyers. In: FRIEDLAND, Jonathan P.; HAMMEKE, Robert A.; VANDESTEEG, Elizabeth B. (Coord.). *Strategic alternatives for and against distressed businesses.* St. Paul: Thomson West, 2015, v. 1, p. 327-328.

for the participation of other interested parties in the sale and possibly increase the initial offer (fostering competition and possibly raising the base price), as well as deter opportunistic behavior. Others interested in the asset will be forced to submit higher bids and will not be rewarded by lowering the minimum price in a second auction in the future (if the first auction fails, and if the company desperately needs to sell the asset to stay afloat), as the asset will be sold to the stalking horse if the first auction does not attract any other bidders.

It is usual for the stalking horse to be afforded certain incentives and protections in the competitive bidding process, such as (i) negotiating which of the seller's assets will be purchased, which contracts will be transferred, how payment will be made and any other provisions in the purchase and sale agreement;[66] (ii) time to perform due diligence,[67] seek funding and apply for the necessary regulatory authorizations;[68] (iii) how the competitive bidding process will be structured and carried out (i.e., ascending bid auction, first price, sealed bid auction etc.),[69] providing an overbid amount,[70] a minimum sum or percentage (greater than the stalking horse's bid) that the third party interested in buying the assets must offer, as well as bidding increments, an incremental sum or percentage the bids must comply with;[71] (iv) a right to match or a right to top the highest bid in the competitive bidding process,[72] and (v) break-up fees to compensate the stalking horse for all the effort made in the valuation of the assets and in the submission of a binding offer,[73] if (a) the stalking horse is not the winner in the

[66] WARREN, William D.; BUSSEL, Daniel J. *Bankruptcy.* 8 ed. New York: Foundation Press, 2009, p. 667 (stating that "[p]resumably, buyer and debtor have configured buyer's bid, the assets being sold and the consideration being paid in a manner that is especially advantageous to this particular buyer. Forcing others to compete on those terms (rather than their own preferred terms) places those others at an immediate disadvantage"). See also HABER, Michael S.; ELLIS-MONRO, Barbara; FASS, David M. Asset dispositions in a bankruptcy case. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 1, p. 373-388, 2005-2006.

[67] Due diligence reduces the information asymmetry that exists between the seller and the buyer and avoids the submission of an offer that is distant from the reality of the market. Otherwise, the price offered by the potential buyer would account for all possible risks and liabilities and could be significantly lower.

[68] See WARREN; BUSSEL, *op. cit.*, p. 666. See also FISHER, J. Mark. Bankruptcy sales to facilitate open-bank recapitalizations. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 7, p. 64-73, 2011.

[69] See BOLNICK, Joseph; MILLER, Ken. Acquiring real property from a bankrupt seller. In: *Real Property, Trust and Estate Law Journal,* [*s. l.*], v. 47, p. 413-434, 2012-2013.

[70] When establishing the overbid amount or bidding increments, both the seller and the potential buyer must be careful not to set sums or percentages that are too high, to the point of discouraging the participation of other interested parties, in which case the bankruptcy court may even consider such provisions void. See PIERCE, Clare; VANCE, Cathy; WHEELER, John. Asset sales in bankruptcy: the financial advisor's perspective. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 4, p. 351-356, 2008. See also BOLNICK; MILLER, *op. cit.*, p. 413-434.

[71] See FISHER, *op. cit.*, p. 64-73.

[72] BOWSHER, David K. *et al.* Perspectives: buyers. In: FRIEDLAND, Jonathan P.; HAMMEKE, Robert A.; VANDESTEEG, Elizabeth B. (Coord.). *Strategic alternatives for and against distressed businesses.* St. Paul: Thomson West, 2015, v. 1, p. 332.

[73] BAIRD, Douglas G. *Elements of bankruptcy.* 4. ed. New York: Foundation Press, 2006, p. 249-250 (asserting that "[b]reakup fees are a frequently litigated question in the context of going-concern sales. No buyer wants to become a 'stalking horse', doing the due diligence and satisfying itself that the business is worth keeping intact as a going concern only to watch someone else enjoy the fruits of its research, make a slightly higher bid, and walk away with the company. Outside of bankruptcy, the first bidder commonly insists on being paid a fixed amount if the corporation is ultimately sold to someone else. This breakup fee can have a chilling effect on the bidding, but it can also entice someone to make a solid bid that generates additional bids").

competitive bidding process, (b) the seller breaches the stalking horse agreement before the transaction is closed, or (c) the sale does not take place before a previously determined date.[74]

The incentives and protections established in favor of the buyer actually work as counteracting institutions to information asymmetry, as coined by George A. Akerlof,[75] mitigating (at least in part) the risk to which the buyer is exposed by submitting a minimum binding offer to purchase the asset.

The seller also benefits from the stalking horse, as they will (i) receive a binding offer that ensures the asset will be sold for a minimum price at a public auction,[76] and serve as an anchor to any other bids submitted in the competitive bidding process; (ii) send signals to the market and other potential buyers that the asset is good,[77] attracting other bidders and fostering competition; (iii) have an influx of cash that may boost confidence in the success of the workout agreement or the reorganization plan, in case of a court-supervised restructuring; and (iii) have a competitive bidding process that may maximize the asset's value and generate a greater return to both the debtor and their creditors.

That being said, it is important to highlight that certain incentives and protections may have a chilling effect on bidding, and possibly reduce competition for the asset.[78] There is a tradeoff here: although the presence of a stalking horse may somewhat chill competition, it may be balanced by the certainty of the sale by the seller (and their creditors) and the signal sent to the market and other potential bidders that the asset is good.

---

[74] To William D. Warren and Daniel J. Bussel, break-up fees should be around 2.5% to 3% (See WARREN, William D.; BUSSEL, Daniel J. *Bankruptcy.* 8 ed. New York: Foundation Press, 2009, p. 666-667), while for Nancy C. Dreher *et al.* it should be between 1% and 5% (See DREHER, Nancy C. *et al. Bankruptcy law manual.* 5 ed. New York: Westlaw, 2014, v. 2, p. 871). For Bruce A. Markell, the amount of the break-up fees must be equal to the direct costs for the submission of the initial binding offer, which approximates them to an expense reimbursement, although the author's final conclusion is against the use of break-up fees in a bankruptcy context (See MARKELL, Bruce A. The case against breakup fees in bankruptcy. In: *American Bankruptcy Law Journal,* [*s. l.*], v. 66, p. 349-386, 1992). In Brazil, a 5% break-up fee was allowed in the OAS Group's judicial reorganization proceeding (See São Paulo State Court, Case No. 1030812-77.2015.8.26.0100, Judge Daniel Carnio Costa, 1st Bankruptcy Court of São Paulo, 14 July 2015), while a 6.25% break-up fee was declared void in the Abengoa Concessões' judicial reorganization proceeding (See Rio de Janeiro State Court, Case No. 0029741-24.2016.8.19.0001, Judge Maria da Penha Nobre Mauro, 5th Corporate Court of Rio de Janeiro, 8 November 2017).

[75] AKERLOF, George A. The market for "lemons": quality uncertainty and the market mechanism. In: *The Quarterly Journal of Economics*, v. 84, n. 3, p. 488-500, August 1970 (using the example of durable goods, Akerlof argues that "[n]umerous institutions arise to counteract the effects of quality uncertainty. One obvious institution is guarantees. Most consumer durables carry guarantees to ensure the buyer of some normal expected quality. One natural result of our model is that the risk is borne by the seller rather than by the buyer").

[76] PIERCE, Clare; VANCE, Cathy; WHEELER, John. Asset sales in bankruptcy: the financial advisor's perspective. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 4, p. 351-356, 2008 (arguing that "[t]he seller is almost always better off if a stalking horse bidder can be found because a good amount of uncertainty is eliminated. The sale terms negotiated between the seller and the stalking horse bidder will form the basis of the notice that will go out to all affected parties, which means that the notice itself will be more specific. In addition, the seller knows its worst case scenario; if no one makes a higher or better offer, the seller has a buyer and can move forward with the sale").

[77] Regarding the notion and importance of signaling, see SPENCE, Michael. Job market signaling. In: *The Quarterly Journal of Economics*, v. 87, n. 3, p. 355-375, 1973. See also GREENWALD, Bruce C.; STIGLITZ, Joseph E. Externalities in economies with imperfect information and incomplete markets. In: *The Quarterly Journal of Economics*, v. 101, n. 2, p. 229-264, 1986.

[78] See MARKELL, *op. cit.,* p. 349-386.

Obviously, if the sale will be carried out in a formal insolvency proceeding, the bidding procedure structured with the stalking horse must be authorized by the bankruptcy court,[79] which may exclude certain provisions if the court finds that they will not stimulate the competitive bidding process or maximize the value of the assets – an auction in an informal insolvency workout would not be under such scrutiny.

The combination of an open and public auction with a stalking horse bid, in a context of broad publicity and adequate information, may ultimately promote the maximization of the asset's value, whether in a workout agreement or a formal insolvency proceeding. The more the seller receives for the asset, the better the recovery for their creditors and the greater the chances of success of a business restructuring. If at all possible, and in light of all of the above, a sale of assets should be carried out in an English auction with a stalking horse bid, in order to (try to) maximize asset value in a distressed scenario.

CONCLUSION

When a business shows the first signs of failure and distress, it is important for management to act as soon as possible, allowing the company to have a broader range of options to turn the business around and avoid a disorganized insolvency filing in the future. A workout allows the debtor and creditors more flexibility when drafting restructuring proposals and reaching an agreement, but if the parties do not reach an agreement (or if there is a holdout) a prepackaged bankruptcy or a prenegotiated plan may aid the restructuring effort, with a speedier and less litigious bankruptcy proceeding, which could also retain asset value.

One of the tools most commonly found in the turnaround toolbox is the sale of assets. To avoid the depreciation of asset values with the passing of time and the deepening financial and/or economic crisis the company is undergoing, a quick sale through a workout agreement or in a pre-filing agreement. An organized and timely restructuring, either through a workout or a pre-filing agreement, allows the debtor to control the situation, reduce reputational damage and retain asset value, especially when the turnaround strategy involves the divestment or the sale of assets. Both the jurisdictions of the United States and Brazil allow for such a strategy to be implemented.

It is possible to further maximize asset values and generate better returns to the debtor and creditors in a distressed sale of assets through a public auction with a stalking horse, which ensures the debtor and creditors that the asset will be sold and may foster competition and attract higher bids, generating more proceeds to be distributed to stakeholders.

[79] See STRATTON, David B.; KOVSKY-APAP, Deborah. Buyer beware: third circuit denies $15 million break-up fee for failure to meet O'Brien standard. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 6, p. 143-146, 2010.

BIBLIOGRAPHY

ADRIAANSE, Jan; KUIJL, Hans. Resolving financial distress: informal reorganization in the Netherlands as a beacon for policy makers in the CIS and CEE/SEE regions? In: *Review of Central and East European Law*, v. 31, p. 135-154, 2006.

AKERLOF, George A. The market for "lemons": quality uncertainty and the market mechanism. In: *The Quarterly Journal of Economics*, v. 84, n. 3, p. 488-500, August 1970.

AYER, John D.; BERNSTEIN, Michael L.; FRIEDLAND, Jonathan. Out-of-court workouts prepacks and pre-arranged cases: a primer. In: *American Bankruptcy Institute Journal,* [*s. l.*]. v. 24, n. 3, 2005.

BAIRD, Douglas G. *Elements of bankruptcy.* 4. ed. New York: Foundation Press, 2006.

BOLNICK, Joseph; MILLER, Ken. Acquiring real property from a bankrupt seller. In: *Real Property, Trust and Estate Law Journal,* [*s. l.*], v. 47, p. 413-434, 2012-2013.

BOWSHER, David K. et al. Perspectives: buyers. In: FRIEDLAND, Jonathan P.; HAMMEKE, Robert A.; VANDESTEEG, Elizabeth B. (Coord.). *Strategic alternatives for and against distressed businesses.* St. Paul: Thomson West, 2015, v. 1.

CRUZ, André Santa. *Direito empresarial*. 8 ed. Rio de Janeiro: Forense, 2018.

DENTON, J. Russel. Stacked deck: go-shop and auction theory. In: *Stanford Law Review,* [*s. l.*], v. 60, p. 1529-1554, 2008.

DREHER, Nancy C.; FEENEY, Joan N. *Bankruptcy law manual.* 5. ed. New York: Westlaw, 2010, v. 2.

FISHER, J. Mark. Bankruptcy sales to facilitate open-bank recapitalizations. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 7, p. 64-73, 2011.

FRANKS, Julian R.; TOROUS, Walter N. A comparison of financial recontracting in distressed exchanges and Chapter 11 reorganizations. In: *Journal of Financial Economics,* [*s. l.*], v. 35, p. 349-370, 1994.

FRIMET, Zachary R. Reward the stalking horse or preserve the estate: determining the appropriate standard of review for awarding break-up fees in § 363 sales. In: *Fordham Journal of Corporate & Financial Law,* [*s. l.*], v. 20, p. 461-496, 2014-2015.

GREENWALD, Bruce C.; STIGLITZ, Joseph E. Externalities in economies with imperfect information and incomplete markets. In: *The Quarterly Journal of Economics*, v. 101, n. 2, p. 229-264, 1986.

HABER, Michael S.; ELLIS-MONRO, Barbara; FASS, David M. Asset dispositions in a bankruptcy case. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 1, p. 373-388, 2005-2006.

INSOL INTERNATIONAL. *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*. 2 ed. London: INSOL International, April 2017.

JACKSON, Thomas H. *The logic and limits of bankruptcy law.* Washington: BeardBooks, 2001.

JANGER, Edward J.; LEVITIN, Adam J. Badges of opportunism: principles for policing restructuring support agreements. In: *Brooklyn Journal of Corporate, Financial & Commercial Law*, [*s. l.*], v. 13, p. 169-189, 2018.

KLEMPERER, Paul. *Auctions*: theory and practice. New Jersey: Princeton University Press, 2004.

KRISHNA, Vijay. *Auction theory*. 2 ed. London: Elsevier, 2010.

MARKELL, Bruce A. The case against breakup fees in bankruptcy. In: *American Bankruptcy Law Journal,* [*s. l.*], v. 66, p. 349-386, 1992.

MCAFEE, R. Preston; MCMILLAN, John. Auctions and bidding. In: *Department of Economic Research Reports*, 8601, London, ON: Department of Economics, University of Western Ontario, 1986.

MCCONNELL, John J.; LEASE, Ronald C.; TASHJIAN, Elizabeth. Prepacks as a mechanism for resolving financial distress: the evidence. In: *Journal of Applied Corporate Finance,* [*s. l.*]. v. 8, p. 99-106, 1996.

MELLAHI, Kamel; WILKINSON, Adrian. Organizational failure: a critique of recent research and a proposed integrative framework. In: *International Journal of Management Reviews*, v. 5/6, n. 1, p. 21-41, 2004.

MILGROM, Paul R.; WEBER, Robert J. A theory of auctions and competitive bidding. In: *Econometrica*, [*s. l.*], v. 50, n. 5, p. 1089-1122, set. 1982.

PIERCE, Clare; VANCE, Cathy; WHEELER, John. Asset sales in bankruptcy: the financial advisor's perspective. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 4, p. 351-356, 2008.

ROSIEK, Caroline L. Making equitable mootness equal: the need for a uniform approach to appeals in the context of bankruptcy reorganization plans. In: *Syracuse Law Review,* [*s. l.*], v. 57, p. 685-707, 2006-2007.

ROTEM, Yaad; DEKEL, Omar. The bankruptcy auction as a game – designing an optimal auction in bankruptcy. In: *The Review of Litigation*, [*s. l.*], v. 32, p. 323-394, 2013.

SASSON, Isaac. Judicial review of plan support agreements: a review and analysis. In: *NYU Journal of Law & Liberty,* New York, v. 9, p. 850-886, 2015.

SATO, Juliana Fukusima. As vantagens da negociação prévia no plano de recuperação judicial: a experiência americana do *prepackaged plan* e *prenegotiated plan*. MARTINS, André Chateaubriand; YAGUI, Márcia (Coord.). *Recuperação judicial:* análise comparada Brasil–Estados Unidos. São Paulo: Almedina, 2020.

SCHMITT, Achim; RAISCH, Sebastian. Corporate turnarounds: the duality of retrenchment and recovery. In: *Journal of Management Studies*, v. 50, n. 7, p. 1216-1244, November 2013.

SPENCE, Michael. Job market signaling. In: *The Quarterly Journal of Economics*, v. 87, n. 3, p. 355-375, 1973.

STRATTON, David B.; KOVSKY-APAP, Deborah. Buyer beware: third circuit denies $15 million break-up fee for failure to meet O'Brien standard. In: *Pratt's Journal of Bankruptcy Law,* [*s. l.*], v. 6, p. 143-146, 2010.

SUDARSANAM, Sudi; LAI, Jim. Corporate financial distress and turnaround strategies: an empirical analysis. In: *British Journal of Management,* v. 12, p. 183-199, 2001.

TOLEDO, Paulo Fernando Campos Salles de; PUGLIESI, Adriana V. A falência: realização do ativo. In: CARVALHOSA, Modesto (Coord.). *Tratado de direito empresarial* [digital edition]. 2 ed. São Paulo: Revista dos Tribunais, 2018, v. 5.

WAISBERG, Ivo. Da não sucessão pelo adquirente por dívidas trabalhistas e tributárias na aquisição de unidades produtivas isoladas perante a lei 11.101/2005. In: *Revista de Direito Empresarial e Recuperacional*, v. 1, n. 0, p. 159-171, January-March 2010.

WARREN, William D.; BUSSEL, Daniel J. *Bankruptcy.* 8 ed. New York: Foundation Press, 2009.

WEISS, Lawrence A. Bankruptcy resolution: direct costs and violations of priority of claims. In: *Journal of Financial Economics*, [*s. l.*], v. 27, p. 285-314, 1990.

WILSON, Robert. A bidding model of perfect competition. In: *The Review of Economic Studies*, [*s. l.*], v. 44, n. 3, p. 511-518, October 1977.

YOZZO, John; STAR, Samuel. For better or worse, prepackaged and pre-negotiated filings now account for most reorganizations. In: *American Bankruptcy Institute Journal*, [*s. l.*], v. 37, p. 18, November 2018.

Author statement

(name, surname)

RODRIGO SARAIVA PORTO GARCIA

DECLARATION OF HONOUR:

I declare that the paper, titled "THE STALKING HORSE AS A TOOL TO MAXIMIZE VALUE IN INSOLVENCY WORKOUTS"

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) .....

Date: 8 FEBRUARY 2022

Place: SÃO PAULO, BRAZIL