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An Analysis of the Use of "Stalking Horse" Proceedings to Maximise Value in an Insolvency Workout

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Acknowledgment

INSOL International is pleased to publish this new technical paper, "An Analysis of the Use of 'Stalking Horse' Proceedings to Maximise Value in an Insolvency Workout", authored by Jo-Anne Mitchell-Marais of Deloitte, South Africa.

This paper has been adapted from the work originally submitted by the author as part of INSOL's Global Insolvency Practice Course.

The paper sets out the process for a stalking horse bid – describing its origins, application, advantages and disadvantages before analysing whether such proceedings do indeed maximise value for creditors in a workout scenario through comparison with both an out of court restructuring process and sale of assets through a confirmed reorganisation plan as part of a Chapter 11 process.

The author also provides a cross-jurisdictional analysis of the stalking horse concept in Canada.

The paper is a valuable resource for INSOL's members – providing an in-depth analysis of a concept that has received little commentary in judicial and extra-judicial contexts to date and setting out key considerations that may guide future legal and practical developments.

INSOL expresses its sincere thanks to the author for her considerable work and expertise in writing this paper.

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An Analysis of the Use of "Stalking Horse" Proceedings to Maximise Value in an Insolvency Workout

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1. Introduction

This paper analyses the "stalking horse" concept, most widely used in practice in the United States according to procedures set out in section 363 of the Bankruptcy Code. The paper assesses whether the stalking horse concept achieves the goal of Chapter 11 restructurings in maximising the value of the estate for the benefit of creditors. In so doing, the construct of a stalking horse bid is unpacked and evaluated in terms of its relative advantages and disadvantages to the stalking horse bidder and creditors / stakeholders alike. A comparison against an out of court restructuring process is also discussed in terms of value maximisation.

Finally, the adoption of the stalking horse process in Canada is also considered to provide a cross-jurisdictional comparison.

2. What is a stalking horse?

The origin of the term "stalking horse" lies in hunting circles where a hunter would use a screen traditionally in the shape of horse to hide behind, while stalking his prey. The rationale was that the prey would be less likely to be frightened away by another animal than it would be by a human approaching, and therefore the "stalking horse" would draw out the prey.[1]

Applied in a business context, a "stalking horse" has evolved to mean "anything that is put forward or proposed anonymously, or through a third party, to test the waters or mask the real plan".[2] In an insolvency context, the term has been applied to describe the initial bid that seeks to set the floor price in a section 363 sale of assets under the United States Bankruptcy Code. As the initial bid, it seeks to draw out other potentially interested parties to bid in an auction-style process to achieve greater value for the assets in question while ensuring that the assets are not susceptible to low-ball offers during the auction process.

However, there is nothing that is concealed about the "stalking horse" bid in a section 363 process, and therefore potential bidders should not be misled by the origins of this term. During the process, and in line with the objectives of Chapter 11, the purchaser is forced to disclose much more information about the deal and themselves than in a non-public deal, for example in an out of court restructuring.[3]

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[*] The views expressed in this technical paper are the views of the author and not of INSOL International.
[1] https://en.wikipedia.org/wiki/Stalking_horse.
[2] R Blackwell, "What's A Stalking Horse Bid?", available at <<https://www.theglobeandmail.com/globe-investor/investor-education/whats-a-stalking-horse-bid/article4288100/>>.
[3] B Erens, "Bankruptcy Sales: The Stalking Horse", available at <<www.jonesday.com/en/insights/2015/03/bankruptcy-sales-the-stalking-horse>>.

3. The objective of Chapter 11 and its evolution

Chapter 11 is the clause of the United States Bankruptcy Code, enacted in 1978, that provides protection to a company from its creditors, while giving the company a chance to reorganise in the hope it can return to profitability and continue as a going concern.

Following its enactment, Chapter 11 cases were mostly resolved through negotiation of a plan, sanctioned by the court, between a debtor and its secured and unsecured creditors.[4] The benefit of negotiating a plan under the protection of Chapter 11 is largely attributed to the automatic stay the debtor enjoys under section 362 of the Bankruptcy Code. The automatic stay is the suspension of any enforcement action (including but not limited to judgments, collection activities, foreclosures and repossessions of property)[5] by any creditor.

Under section 363 of the Bankruptcy Code, court approval is required for the sale of assets that are not in the ordinary course of business. This is a protection mechanism for creditors, mostly in terms of value.

During the first few decades of the operation of the Bankruptcy Code, section 363 was mostly used to sell individual assets, and not necessarily the entire business and assets of the debtor, to a prospective purchaser.[6] Indeed, in the early days of Chapter 11 cases, there needed to be an emergency[7] or perishability concerning the assets to be able to sell all of the assets of a debtor. *In re Lionel Corp* 722 F.2d 1063 (2nd Cir. 1983), it was held that there needed to be some “articulated business justification, other than the appeasement of major creditors, for using, selling or leasing property out of the ordinary course of business” before the bankruptcy judge may order such disposition under section 363(b).

In re White Motor Credit Corp 14 B.R. 584 (Bankr. N.d. Ohio 1981), it was held that a sale through section 363 “side-steps the procedural and substantive provisions of Chapter 11”; and that the” sale of so much of the estate’s property amounts to liquidation which should be handled under the [liquidation chapter of the Bankruptcy Code] and not in the context of an arrangement or reorganisation” in Chapter 11.

However, the changing credit construct of the last few decades has resulted in fewer reorganisation plans and more sales of businesses through section 363.[8] In an attempt to understand this shift, Peter Blain argues that the economic boom of the 1990s resulted in the over-leveraging of assets due to the ease and availability of credit. Consequently, when businesses experienced financial distress, the secured creditors found themselves under water as the level of borrowings often far outweighed the value of the assets and therefore the deficit of the secured creditors fell to the unsecured creditors’ pool and was often a significant, controlling proportion of the unsecured creditors’ pool. As a

[4] P Blain, “Let’s Make a Deal”, *Buying and Selling Distressed Businesses*, “Inside the Minds Series”, 2010, Aspatore Books, 138.
[5] https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics.
[6] See above, n 4.
[7] *Ibid*.
[8] I Volkov, “Pros and Cons of ‘Stalking Horse’ Bids in Chapter 11 Sales”, available at <<https://www.coleschotz.com/?t=40&an=37993&anc=326&format=xml>>,140.

result, secured creditors could block any Chapter 11 reorganisation plan that sought to compromise unsecured creditors.[9]

Concurrently, the secured lenders were cognisant of the expense of a Chapter 11 process – the significant administrative expenses and Chapter 11 professional costs – none of which were spent on trying to resolve the underlying issues in the business that led to the financial distress. Equally, secured lenders were weary of the weapons available to debtors in Chapter 11 – for example the cram-down provision, which could force the secured lenders' hand to cooperate with the debtor.

Lenders also sought to control the debtor, via the provision of debtor in possession (DIP) finance through a section 364 DIP financing arrangement. By making the DIP financing conditional on (say) the sale of a business by a certain date, the lenders had a measure of control over the process. With over-leveraged assets, it made obtaining court approval for a third-party loan, or subordinated financing, very unlikely. Therefore, debtors rarely had little choice but to agree to the terms and conditions of the DIP financing from existing lenders.

The sale of the business under section 363 has certain distinct advantages to creditors / lenders, which include:

- the entire Chapter 11 process from filing to the approval of a reorganisation plan does not need to be funded;[10]
- foreclosure / enforcement costs are avoided;
- value obtained on enforcement sales is often significantly discounted taking into account the requirement of the lender to realise proceeds quickly and acknowledging the financial distress inherent in this process;
- the fact that section 363 sales are court-approved also eliminates the argument that a sale in terms of this process is fraudulent;[11] and
- a section 363 process allows for the assets to be transferred free and clear of any liens,[12] claims or encumbrances,[13] and this is value-enhancing.

Peter Blain argues that due to these advantages, section 363 sales of businesses are in recent years by far the "norm" when resolving financial distress.[14]

4. Section 363 of the Bankruptcy Code and its application

The use of section 363 allows for a sale of the business' assets through a court-approved process and can be quicker to resolve, less risky and less subject to delays than the

[9] See above, n 4.
[10] See above, n 8.
[11] See above, n 3.
[12] *Ibid.*
[13] Smith, Gambell & Russell LLP "Asset Dispositions in a Bankruptcy Case: Guidelines for the Successful Stalking Horse", available at <<www.sgrlaw.com/ttl-articles/895/>>.
[14] See above, n 4.

traditional sanctioning of a Chapter 11 reorganisation plan. As described above, it is for this reason that the section 363 sales process can be more attractive to lenders as: (i) they do not need to fund the entire Chapter 11 process, which can be very expensive purely through its administration; and (ii) given that the section 363 process may be quicker, it is likely that value is preserved and possibly enhanced. Section 363(b) provides a procedure for the company to obtain this approval on a motion and a hearing which is termed a "section 363 sale" and is described in more detail below.

4.1 Section 363 sale process

Generally, there is a two-part marketing process,[15] which is designed to generate the highest or otherwise best offer. "Otherwise best" may include value inherent in an offer, but not necessarily included in the offer value as monetary proceeds. An example would include where more staff are retained, which would lower the retrenchment liability that would need to be funded from the sale proceeds.

The first of the marketing processes is to select which bidder will be the "stalking horse" bidder and the second part of the process is to market the assets externally, taking the stalking horse bid into account.

In order to market the assets, an auction process is usually held which, once concluded, is followed by a hearing where the court approves the winning bid and authorises the debtor to close the transaction. The competitive auction process assists the court in determining that the maximum value has been obtained for the creditors. At this sale hearing, the court will address any objections filed by unsuccessful bidders or creditors. If the auction has been properly conducted and through the testimony of key witnesses (which may include the financial advisor of the debtor) who can corroborate that the assets were adequately exposed to the marketplace and ultimately that the bid that was selected as the winning bid was either the highest or otherwise best offer, then the court will approve the sale. If the sale has been properly conducted, the burden of proof on the objecting party will be high and the sale will likely be approved over the objections raised.

5. How do you identify the stalking horse?

Sales processes without a "stalking horse" are termed "naked auctions" and these are deemed relatively rare.[16] but are used when there is little interest in the asset, or the floor price is not acceptable to the secured lender.

The DIP or the financial advisor to the DIP are usually involved in the selection of the stalking horse. The stalking horse is identified as a party that is likely to conclude a purchase – be it strategic or as part of an investment portfolio. The advantages of being a stalking horse are described below and are often the reason that parties lobby to be the stalking horse to take advantage of these benefits.

The stalking horse is required to make an offer, which is binding, following a period of due diligence of the debtor. This offer acts as the "floor" price, as it is binding on the

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[15] See above, n 4,145.
[16] *Idem*, 148.

stalking horse if they are the successful bidder. It is envisaged that an asset purchase agreement (APA) is negotiated ahead of the auction and that any potential counter-offer would only improve upon the APA between the debtor and the stalking horse – i.e. a counter-bidding party has to practically use the same APA that has been negotiated between the debtor and stalking horse bidder. They can make minor amendments and may only improve it.

Given the stalking horse bidder is participating in a time-consuming and expensive process to conclude a bid, only to participate in a process where it knows there is a risk that it may be out-bid, one does need to ask the question: why be the stalking horse? The answer lies in certain advantages and court-approved incentives that are made available to the "stalking horse" to compensate the stalking horse bidder for their time, effort and expense.[17]

5.1 Advantages attributed to the stalking horse

- The stalking horse bidder is able to conduct due diligence on the target entity and its assets and therefore gain access to and build a relationship with the incumbent management team,[18] as well as gain valuable insights into the business to assist in establishing a bid value.

- The stalking horse bidder can also include "no-shop" provisions,[19] ensuring that it has exclusivity and preventing the DIP or trustee from allowing any other party access to develop a competing bid against the stalking horse, while the stalking horse is preparing their bid.

- The stalking horse bidder will have an advantage in that it has more time to ensure access to finance and determine the regulatory approvals that are required, if necessary.[20]

- The stalking horse bidder may also have the ability to engage with key customers, vendors and landlords – taking advantage of the opportunity to get these stakeholders comfortable with the stalking horse bidder and its proposed transaction.[21]

- The stalking horse bidder has the opportunity to work closely with the key stakeholders in the case, including secured and unsecured creditors.[22] This could prove advantageous as these stakeholders are important when it comes to determining the highest and otherwise best offer for the assets.

- Given that an APA is required to be submitted as part of the initial bid and used for potential bidders to match or improve upon, the APA can be negotiated and

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[17] J Brereton, "Concepts Imported from the US – Something Borrowed or Something New? Imitation is the Sincerest Form of Flattery".
[18] K Howie, "Becoming a Stalking Horse in Distressed Energy M&A Transactions", June 2015, available at <<www.lexology.com/library/detail.aspx?g=b58e2ce5-7c7c-49fb-b65f-d075a94fd654>>.
[19] See above, n 8.
[20] *Ibid.*
[21] *Ibid.*
[22] See above, n 18.

structured to specifically suit the stalking horse bidder. It is very difficult for other bidders to significantly alter the scope and framework of the APA.[23]

5.2 Incentives conferred on the stalking horse bidder

For stalking horse bidders, the purchase of assets under section 363 comes with certain risks, including uncompensated due diligence. To provide an incentive to prospective stalking horse bidders, Bankruptcy Courts will often approve bid protections / incentives, which will be contained in the procedures order.[24] These include:

- Expense reimbursement – the stalking horse dedicates substantial resources on the transaction and the fees it incurs for legal, financial, due diligence and other out of pocket expenses are typically reimbursed. The Bankruptcy Court must approve the expense reimbursement, and this is usually at the bidding procedures hearing.

- Breakup fee – the stalking horse bidder can also negotiate a "breakup" fee payable to it which then serves as a financial inducement to serve as the "floor" bidder for the assets. This is generally between 2% and 5% of the purchase price as the Bankruptcy Court needs to approve this proposed cost and will be cognisant of anything that is deemed unreasonable and could be seen to be "chilling" the bidding.[25] Because the stalking horse bidder is contractually bound to complete the transaction in the instance where there is no higher or otherwise better bid, the stalking horse bidder has to reserve capital for the duration of the sales process to be able to close the transaction successfully. This certainty of having a buyer, with sufficient committed capital to close the transaction, is another justification for the breakup fee.[26] It is generally possible to credit-bid the breakup fee.

- Bid structure – this is a very important element that the stalking horse can seek to control. Essentially this dictates the terms of the auction process and can be designed to discourage other bidders from participating in the auction process. This structure is also subject to the Bankruptcy Court approval, and therefore does require justification for the structures that the stalking horse seeks. Typical bid structure negotiations and requirements of the stalking horse include:

    - the criteria to determine whether a bid is a competing bid in the auction process;

    - the terms under which the secured creditors may be allowed to credit-bid;

    - the required cash deposit that must accompany any bid;[27]

    - the timeframe within which competing bidders need to submit their bid;

[23] G Marsh and B Chandler, "The Pros and Cons of Being a Stalking Horse Bidder for Assets in Bankruptcy", available at: <<www.nreionline.com/distress/pros-and-cons-being-stalking-horse-bidder-assets-bankruptcy>>.
[24] K Tarazi, and B Paisner, "The Stalking Horse Bid Protections: The Auction Credit Conundrum, and How to Avoid It", available at <<www.jdsupra.com/legalnews/the-stalking-horse-bid-protections-the-11944>>.
[25] See above, n 19.
[26] See above, n 4, 150.
[27] See above, n 23.

- the minimum amount by which other bids must exceed the stalking horse bid;[28]
- further bidding increments, or over-bid;
- whether the bid is open or silent; and
- whether the competing bids can be shared with the stalking horse.

5.3 Disadvantages of being the stalking horse

The stalking horse, in its position as the first party to make a binding offer (subject to higher or otherwise better bids) for the assets of a business in bankruptcy proceedings, does naturally carry risk.

There is risk in the value that the stalking horse bidder ascribes to the assets, which would form the foundation of their bid. To the extent that the value of the assets deteriorates through the process (but not sufficiently to trigger a material adverse change clause in the APA), there is risk that the floor bid is overvalued. If there is no competing bid, then the stalking horse may be concerned that they have overpaid for the assets, as their initial bid is binding if there is no higher or otherwise better bid.

The risk that the stalking horse is outbid is also significant, given the time, effort and expense that the stalking horse bidder would have expended to put in the initial bid. While there are bid protections in place, if the stalking horse saw significant strategic advantage in acquiring the assets of the business, then being outbid during the auction process would be very disappointing and potentially damaging to its own business. In this situation, the stalking horse bidder would usually be able to be reimbursed for the actual expenses during the process and compensated for its time by means of the "breakup fee".

The process itself carries risk for the stalking horse bidder in that the deal may be publicly announced before the bidding procedures and incentives are approved by the Bankruptcy Court. Therefore, a third party could make use of the diligence and efforts of the stalking horse and submit an offer at a slightly higher amount, but with no bid incentives.[29] The Bankruptcy Court would be hard-pressed to approve the stalking horse bid if another bid, with no incentives, is before court.

6. Out of court restructuring as an alternative to maximise value for stakeholders

An out of court restructuring or "workout" is an informal process (i.e. it does not take place within the bounds of legislation and the court) through which a financially stressed company and its significant creditors reach an agreement to restructure the company's financial obligations, in terms of, *inter alia*, seniority of debt, value, tenor and repayment profile, with the objective of providing a sustainable platform (commonly referred to as "right-sizing" the balance sheet) for the business to continue as a going concern. A successful workout generally requires the participation of the company's lenders, major suppliers and, depending on the circumstances, other organisations or entities such as

[28] *Ibid.*
[29] See above, n 3.

unions or governmental agencies.[30] Negotiating with these stakeholders and agreeing on the way forward can be time consuming, especially if the stakeholders have a differing view regarding the required outcome of the restructured obligations and a strategic way forward for the company.

Due to the potential protracted nature of out of court restructuring negotiations, the impact on the day-to-day responsibilities of management needs to be considered. Management, without the benefit of a restructuring advisor, will be required to invest significant effort into the restructuring process which can, and often does, detract from their management responsibilities. In turn, this may have a detrimental impact on the performance of the business during the restructuring process.

Before an out of court restructuring of the company can be progressed, the following additional factors require consideration to ensure there is a sufficient likelihood that the out of court restructuring will succeed, failing which a Chapter 11 petition and a section 363 sale may be a more viable alternative to reaching agreement:

- Liquidity – sufficient liquidity is required to fund the process of negotiating an out of court restructuring. Robust cash flow forecasts are required to be presented to the stakeholder group to demonstrate there is sufficient liquidity over the restructuring horizon, minimising disruption in the operations of the business and minimising the threat of any enforcement action of creditors not part of the pool of stakeholders negotiating in the restructuring process.

- Complexity of the capital structure – simply put, the more lenders that are included in the capital structure, with varying terms of their facilities (i.e., security, ranking or seniority and pricing), the more onerous the informal process can be, as unanimous consent is required for the proposed out of court restructuring plan to be implemented. A complex capital structure also increases the opportunity for a “hold-out” creditor to emerge, which can derail the entire negotiation.

- Competence and trustworthiness of management – if either the competence or trustworthiness of management is called into question by the stakeholder group, a consensual restructuring plan will be less likely to be capable of adoption and implementation without the requirement to file for Chapter 11 and the benefits that an independent trustee may bring to the situation.

7. Chapter 11 as an alternative process for the sale of assets

The traditional Chapter 11 reorganisation plan is one such mechanism within which the assets of the business can also be sold through the procedural mechanisms under section 1123(a)(5) of the Bankruptcy Code. However, sales pursuant to the reorganisation plan involve more potential obstacles and longer periods of time compared to a section 363 process, as they are subject to the confirmation process of a plan of reorganisation, which can be lengthy and uncertain.[31]

[30] J Acosta, “United States: Restructuring Debts In and Out of Court”, 3 August 2010, available at <<https://www.mondaq.com/unitedstates/insolvencybankruptcy/105646/restructuring-debts-in-and-out-of-court>>.
[31] See above, n 12.

Therefore, one of the key differences between this and the stalking horse use of section 363 is the time it takes to get to a plan confirmed by the Bankruptcy Court. There is potentially significant delay, process and administration that would need to complete before such an offer is binding. The court would still need to satisfy itself that value had been attained, and without a competitive bidding process, this may require substantial witness testimony and evidence – all of which add to the time it takes to conclude the sale.

Further considerations in determining whether the sale of assets should occur under the plan confirmation process include:

- Liquidity – does the estate have the liquidity to survive until the plan is confirmed? Has sufficient DIP financing been obtained?
- Opportunity – will the sale opportunity still exist at the time of the plan confirmation? If not, will there be a reasonable alternative that is equally beneficial for creditors?

8. Relative advantages and disadvantages of informal and formal processes

The relative advantages and disadvantages of an out of court restructuring process compared to a Chapter 11 process, including the use of a section 363 mechanism, are analysed in the table below:

	Out of court restructuring (i.e. informal)	**Chapter 11 process (i.e. formal)**	**Section 363 sale (i.e. formal)**
Advantages	Considered to be more cost effective than a formal process due to avoidance of court costs and nature of the process	Ability to raise DIP financing to fund the operations during the process	Assets are sold “free and clear” of any liens and encumbrances
Advantages	Considered a more efficient process from a length of time perspective	Automatic stay conferred by section 362 may assist with improving liquidity during the Chapter 11 process	The time differential between concluding a section 363 sale and a sale through a confirmed reorganisation plan can sometimes be the determining factor in the success or failure of a business organisation
Advantages	The process is private and not publicised through court documentation and benefits from the absence of potential challenges by stakeholders part of the bankruptcy process – e.g. creditor committees and the trustee	Court-sanctioned plan provides robust oversight and comfort to stakeholders	Ability to bind non-consenting parties
Advantages	Management drives the negotiation process and remains in control	Ability to sell assets via section 363 “free and clear”	Favourable contracts and leases can be “cherry-picked” to be in included in a section 363 sale

Disadvantages	No benefit of the automatic stay; vulnerable to "hold-out" creditors	A Chapter 11 process is considered an expensive and timely process to run. A reorganisation plan needs to be filed within 120 days, which may be extended to 18 months dependent on the court	Competing bids may result in the sale of assets to a party that is not the "stalking horse"
	Any sale of assets is not "free and clear" of accompanying obligations	Negative publicity and sentiment towards the company as a result of filing for bankruptcy may limit options available for including in the reorganisation plan	Negative publicity and sentiment as a result of having filed for bankruptcy may impact value offered during the process
	Restructuring solution requires unanimous consent and complexity within a capital structure may reduce the likelihood of obtaining such unanimous consent	Relative bargaining strength of creditors and equity holders is diminished as now subject to Bankruptcy Court authority and the provisions of the Bankruptcy Code	Purchasing assets through a reorganisation plan may provide the purchaser with greater flexibility through leveraging more favourable plan terms
	Reduced ability to raise finance during the period of restructuring due to perceived heightened credit risk, without court protections		

9. Examination of a relevant case and application during the COVID-19 pandemic

Relevant cases demonstrate the mechanics and considerations of a stalking horse bid. One such relevant example relates to the retail clothing chain, Forever 21 Inc. Further, during the COVID-19 pandemic, the initial spate of insolvencies did create an opportunity for purchasers looking to acquire assets. One such sector where stalking horse bids were prevalent was aviation.

9.1 Forever 21 Inc

Forever 21 Inc and seven affiliated debtors (the Debtors) each filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware on 29 September 2019.

On 27 January 2020, the Debtors filed a Motion for the entry of an order to:

- approve the bidding procedures and bid protections in connection with the sale of substantially all of the debtors assets;
- approve the form and manner of notice thereof;
- schedule an auction;

- approve procedures for the assumption and assignment of contracts;
- approve the sale of the debtors' assets; and
- grant related relief.

The order specifically included wording to approve the use of a stalking horse bidder.

The deadline for competing bids was set at 7 February 2020, with the auction to be held on 10 February 2020. The order also stated that two hours after the auction, the Debtors were required to file a notice of the successful bidder and back-up bidder. The hearing to approve the sale was on 11 February at 1pm, and any objections needed to be lodged by 9am on that date. As is evident, the timelines were constrained for any potential competitive bidder to adhere to.

On 4 February, an order was issued which confirmed that the Debtors had entered into an APA with the stalking horse bidder, whose bid was for US $81 million. The stalking horse bidder had paid a deposit of US $13.5 million.

The order also approved the bidding procedures and bid protections, which included a breakup fee of US $3.1 million, together with expense reimbursement of US $1 million to be paid to the stalking horse bidder in the event its bid was not the highest or otherwise best bid. Other bid protections included the requirement to demonstrate the ability to close the transaction through the provision of evidence that the competing bidder had sufficient financial capacity,[32] without which any such bidder would not be an acceptable bidder. The following were also required:

- a deposit of 10% of the aggregate cash purchase price of the bid;
- an APA on the "same or better" terms as the stalking horse purchase agreement; and
- each bid was required to exceed the aggregate value of: (i) US $81,100,000 in cash, plus the value of standby letters of credit and assumed liabilities; (ii) the bid protections referred to above, being the breakup fee and expense reimbursement; and (iii) the minimum bid increment of US $300,000.

What is interesting to note is that the bid protections were reduced compared to the initial motion, where a US $4.65 million breakup fee was initially proposed and bid increments of US $1 million were requested. Judge Gross stated that the original amount was "simply too high". Vendors had also complained that the fee would discourage potential bidders.

On 9 February, the Debtors filed the Notice of Suspended Auction,[33] thereby cancelling the auction, citing that no qualifying bids (other than the stalking horse bid) had been received.

At the hearing on 11 February, the Debtors had the right to call witnesses including the Chief Restructuring Officer and Investment Banker on behalf of Forever 21 Inc.[34] In

[32] Case 19-12122-KG Doc 814-1, page 16.
[33] Case 19-12122-KG Doc 884 Filed 02/09/20.
[34] *Ibid*.

previous motions, the Debtors had stated how they believed this process was designed to maximise value for the stakeholders and how their process for selecting the stalking horse and garnering alternative bidders had been a rigorous one.[35]

What benefit has accrued to the creditors of Forever 21 Inc? The stalking horse bid ensured that an offer would be accepted for substantially all of the assets of the Debtors. The value obtained was tested through a bidding process, which included the Bankruptcy Court reducing the requested bid protections to ensure a fair and transparent sales process. Without that assurance of a bid at an acceptable offer price, a bid may have been put forward for a significantly lower amount, and if no other bids were received, this could have been the closing price.

9.2 Application in the aviation sector

During the COVID-19 pandemic, the aviation sector was hard hit as a result of global lockdowns and restricted travel requirements, resulting in many airlines across the globe needing to file for some form of bankruptcy protection.

Market investors and potential new entrants had an opportunity to obtain assets at competitive market prices – often below market value. The demand for aircraft was, however, particularly low during the pandemic, as market conditions were uncertain and the supply of aircraft most likely outstripped demand.

In an attempt to stimulate interest in purchasing aircraft assets and also to ensure that these assets would indeed be sold at a minimum price,[36] certain debtors entered into stalking horse agreements with potential buyers.

Two high-profile examples of this type of stalking horse bid agreement can be found in VMO Aircraft Leasing's stalking horse agreement for 10 Boeing 737-800s owned by Norwegian Air Shuttle's enhanced equipment trust certificate (EETC) issuance and the 17 aircraft that were associated with LATAM's EETC issuance.[37]

In utilising the stalking horse mechanism, substantial break-up fees were payable to the stalking horse bidder if they were outbid at auction, and competing bids were required to sign confidentiality agreements, provide evidence they could execute on the transaction and agree to an overbid increment.

By so doing, the stalking horse investors were able to provide relative certainty to at least the secured creditors in these cases and in an expedited fashion, but not without criticism that the process was designed to ensure the stalking horse bidder was the successful bidder.

[35] *Ibid*.
[36] A Chambers, M Trottier and B Paisner, "The Bankruptcy Pegasus: Stalking Horse Agreements in Aviation", 18 January 2022, available at <<https://www.jdsupra.com/legalnews/the-bankruptcy-pegasus-stalking-horse-1622723/>>.
[37] *Ibid*.

10. The use of stalking horse proceedings outside the United States

Inherent in stalking horse proceedings is the potential for abuse of process if the proceedings are not closely monitored, overseen and sanctioned through a court of law. Therefore, in jurisdictions where there is minimal court involvement and direction in the restructuring or reorganisation process, the likelihood of stalking horse proceedings resulting in a "rigged" auction process increases. Therefore, it is likely to only be effective in jurisdictions where court involvement is significant.

The adaptation of existing law north of the United States border has allowed for the stalking horse concept to be successfully applied in certain circumstances. In Canada, a sealed competitive bidding process is predominantly used. However, stalking horse strategies have been deployed in a number of cases.

One distinct difference between Chapter 11 and the Canadian Companies Creditors Arrangement Act (CCAA) is the requirement for a court appointed "monitor" in Canadian proceedings. Contrast this to the Chapter 11 process, wherein it is the exception, rather than the rule, that a trustee is appointed. The monitor can significantly influence the court's decision on matters including DIP financing, plan approval, and most notably in the context of this paper, the sales process. The monitor is the eyes and ears of the court,[38] and will need to persuade the court that the stalking horse process is indeed required and will likely achieve or enhance value for the estate.

The 2009 amendments to the CCAA resulted in amendment of section 36, which now provides that the debtor may seek court approval for a sale of assets outside the ordinary course of business and that court approval may be obtained to override any shareholder approval rights which may exist under applicable corporate law. Likewise, there has also been a newly enacted section 65.13 of the Bankruptcy and Insolvency Act (BIA), which effectively mirrors section 36 of the CCAA to create a regime under which a sale of assets outside the ordinary course of business may be conducted within a BIA proposal process.

In the case of *Boutique Euphoria Inc*,[39] a company registered under the CCAA, the Honourable Clément Gascon, JCS of Québec, developed a set of considerations in assessing whether or not a stalking horse bid process should be authorised and approved. These considerations were as follows:

1. Has there been some control exercised at the first stage of the competition, namely to become the stalking horse bidder?

2. Is there a need for stability within a very short time frame for the debtor to continue operations and the restructuring contemplated to be successful?

3. Are the economic incentives for the stalking horse bidder, in terms of breakup fee, topping fee and overbid increments protection, fair and reasonable?

[38] M Nied and N Levine, "Pre-Packaged Sales Transactions Under the CCAA: Where Are These Packages From, What Do They Look Like and Where Are They Going?", *Annual Review of Insolvency Law 2016*.
[39] Boutique Euphoria Inc. and Lingerie Studio Inc., C.S.M. no 500-11-030746-073.

4. Are the timelines contemplated reasonable to ensure a fair process at the second stage of the competition, where there is a successful over bidder?

The overriding concern was the fairness of the process – recognising that the stalking horse process is stringent compared to the more flexible traditional "call for tenders" approach and noting that the contents of the bidding process could have a chilling effect on other bidders, which could render the process inefficient.

In this particular case, the Honourable Judge denied the request as the stalking horse bid was presented as a *fait accompli* and was burdened with excessive fees.[40]

Looking to other decisions in Canada, in the matter of the receivership of *Blutip Power Technologies Limited*,[41] Justice Brown made the following observations regarding the use of the stalking horse process in bankruptcy proceedings in Canada:

> The use of stalking horse bids to set a baseline for the bidding process, including credit bid stalking horses, has been recognised by Canadian courts as a reasonable and useful element of a sales process. Stalking horse bids have been approved for use in other receivership proceedings, BIA proposals, and CCAA proceedings.

One of the most significant cases in the use of stalking horse strategies was the Nortel receivership. In the sale of Nortel's patents, Google was identified as the stalking horse and submitted a stalking horse bid of US $900 million.[42] During the auction process, a consortium of competitors was successful in the purchase of the patents for US $4.5 billion,[43] with Google bowing out as the stalking horse bidder with a ceiling bid of US $4 billion. As in the Boutique Euphoria case, the Judge in the Nortel matter, Justice Morawetz, identified factors which the court should consider in assessing whether to approve a sale of substantively all of the assets in the absence of a plan, these being:

1. Is the sale transaction warranted at this time?

2. Will the sale benefit the whole "economic community"?

3. Do any of the debtors' creditors have a bona fide reason to object to a sale of the business?

4. Is there a better viable alternative?

[40] Boutique Euphoria Inc., Re, 2007 QCCS 7129, 2007 CarswellQue 14279, para 74.
[41] *In Re CCM Master Qualified Fund Ltd v Blutip Power Technologies Ltd* 2012 CarswellOnt 3158, 2012 ONSC 1750, 213 A.C.W.S. (3d) 12, 90 C.B.R. (5th) 74.
[42] J Kincaid, "Google Makes $900 Million Stalking Horse Bid For Nortel Patents as it Looks to Fend Off Trolls", available at <<www.techcrunch.com/2011/04/04/google-makes-900-million-stalking-horse-bid-for-nortel-patents>>.
[43] A Sharp and S Carew, "Apple/RIM Group Top Google in $4.5 Billion Nortel Sale", available at <<www.reuters.com/article/us-nortel/apple-rim-group-top-google-in-4-5-billion-nortel-sale-idUSTRE7600PF20110701>>.

These considerations have further been referenced in later cases in Canada including *Brainhunter Inc*[44] and *CanWest.*[45]

11. Does the stalking horse mechanism maximise value?

Taking into account the relative advantages and disadvantages of the various options available to a stressed or distressed company, and in circumstances where an out of court restructuring is not a possibility (due to issues concerning liquidity, complexity of the capital structure and / or trust in management), the stalking horse process does have the ability to maximise value for creditors / key stakeholders when the following is true of a stalking horse bid:

- the floor value is representative of "value" for the assets in question - i.e. it is not a low-ball bid, on the basis that the stalking horse bidder does not want to put forward an initial offer too low because this could entice further bidders. The stalking horse bidder is therefore more inclined to ensure that the initial bid (the floor price) is indicative of value; and

- the bid protection mechanisms (or stalking horse incentives) are structured in such a way as to not deter competing bids, or "chill the bidding".

It is clear that the role of the Bankruptcy Court is critical in allowing the stalking horse process to maximise value, as it is the arbiter of the bid protections which most often would deter a competing party from making a bid. Examples of deterrent bid protections include if the breakup fee is too high, if the time frame for submitting a bid is too short, if the bid increments are too high and if the APA is structured in such a way as to uniquely benefit the stalking horse bidder while not being fit-for-purpose for a competing bid to step into the stalking horse's shoes.

Enabling a mechanism where there is competitive tension in the bidding process – where a floor has already been established that is largely acceptable to the stakeholders – does create a platform to drive up value as compared to traditional sales processes. The increase in value as a result of the competitive tension created and the available advantages to potential counter-bidders facilitates a process to maximise value.

[44] *In Re Brainhunter Inc*. (2009), 62 C.B.R. (5th) 41 (Ont. S.C.J).
[45] *In Re CanWest Publishing Inc*. [2010] O.J. 2190.

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