Bidders Beware: Private Equity Club Deals Could Be Challenged in Bankruptcy

September/October 2007

Brad B. Erens
Mark G. Douglas

The aggregate value of private-equity acquisitions worldwide in 2006 exceeded $660 billion. If this number seems mind-boggling, consider that this record-breaking volume of transactions appears well on the way to being eclipsed in 2007. Even with corporate financing for leveraged buyouts harder to come by as a consequence of the sub-prime mortgage fallout, there is, by some estimates, $300 billion sitting globally in private-equity funds. Already on tap or completed in 2007: a $32 billion takeover of energy company TXU Corp. by Kohlberg Kravis Roberts (soon to go public) and Texas Pacific Group; Blackstone Real Estate Advisors' acquisition of Equity Office Property Trust, a national network of office buildings, in a transaction valued at up to $38.7 billion (the largest private equity buyout of all time); the $7.4 billion acquisition announced on May 14, 2007 of an 80.1 percent stake in Daimler Chrysler and its related financial-services business by Cerberus Capital Management; the acquisition announced on June 30, 2007 of Bell Canada by Ontario Teachers Pension Plan, Providence Equity Partners and Madison Dearborn Partners LLC for $48.8 billion in the largest leveraged buyout ever; newly public Blackstone Group's $26 billion offer for Hilton Hotels; the $26 billion acquisition of credit card payment processor First Data Corp. by Kohlberg Kravis Roberts; and most recently, the August 30, 2007 sale by The Home Depot Inc. of HD Supply, its wholesale distribution business, to a group of private equity firms consisting of Bain Capital Partners, The Carlyle Group, and Clayton, Dubilier & Rice for $8.5 billion. More deals are on the way.

Private equity funds have raised record amounts of capital and are taking bigger and bigger companies private. Eight out of the 10 largest private equity buyouts have occurred since the beginning of 2006. As private-equity funds and transactions have grown larger, however, they have invited increased scrutiny. One area of concern has been directed toward the increasing incidence of private equity funds joining forces to acquire businesses. Some have argued that these relationships may result in depressed acquisition prices. For example, General Electric, which put its plastics business up for sale in April of 2007 for approximately $10 billion, insisted that private equity bidders cannot talk to one another about teaming up in connection with any acquisition. The U.S. Department of Justice entered the fray last fall. Deviating from their traditional hands-off approach to the buy-out business, regulators sent letters, initially to four of the largest private equity firms, requesting information on recent deals, apparently in an effort to determine whether any of the record-breaking deals in 2006 involved collusion among competing bidders or were otherwise anti-competitive.

In the next wave of bankruptcies and restructurings, private equity transactions may increasingly start to focus on distressed companies. Federal bankruptcy law has long been concerned with maximizing the value of a debtor or its assets in any sale. The Bankruptcy Code establishes a framework of rules formulated to facilitate sales of a debtor's assets either as part of a chapter 11 plan or pursuant to a stand-alone sale transaction. Those rules are designed to ensure that the highest and best offer is made for a debtor's assets, and that, once approved by the court, any sale is "final," in the sense that a good-faith purchaser can be confident that it acquires unblemished and unencumbered title to the assets. Notwithstanding the strong policy favoring finality of asset sales, however, the Bankruptcy Code at the same time provides a mechanism for invalidating sale transactions that are tainted by collusion.

Invalidation of Collusive Sales in Bankruptcy

Section 363(b) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to sell estate assets (including all or substantially all of a debtor's business or property) outside of a chapter 11 plan. The sale can be free and clear of competing claims and interests under the conditions specified in section 363(f). Most bankruptcy courts will approve a non ordinary-course asset sale if the DIP or trustee demonstrates that a business justification supports the transaction, the sale was negotiated at arm's length and in good faith, the proposed purchaser has submitted the highest and best offer for the assets and the sale is in the best interests of creditors and the estate.

Any order approving a sale under section 363(b) is stayed until 10 days after it is entered (absent a contrary directive by the court), at which point the order becomes "final," unless it is the subject of a timely appeal or motion for rehearing. Moreover, unless the appellant obtains a further stay pending the resolution of its appeal, any reversal or modification of the sale order on appeal has no effect on the validity of the sale to a good-faith purchaser. Finality is critical to the bankruptcy sale process. It gives prospective purchasers a measure of assurance that the sale will be final and the parties can proceed to consummate the transaction without any fear that it will be undone, which generally makes purchasers willing to pay more for the assets in question.

Notwithstanding the importance of finality to the bankruptcy sale process, the Bankruptcy Code creates a mechanism to invalidate sales that are tainted by fraud, collusive bidding or other misconduct. Section 363(n) provides as follows:

> The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.

Section 363(n) is a statutory exception to the rule of finality of bankruptcy sale orders. As courts of equity, bankruptcy courts have traditionally possessed the authority to set aside sales "tinged with fraud, error, or similar defects which would in equity affect the validity of any private transactions" and when "compelling equities outweigh the interests in finality."

A sale can be invalidated under section 363(n) only if: (i) there is an agreement; (ii) between potential bidders; (iii) that controlled the price at bidding. The agreement can be either written or oral. The parties must have intended the agreement to control the price, not merely affect it. The existence of a joint bid does not in and of itself amount to collusive bidding. Section 363(n) applies to both public auctions and private sales.

While the case law under section 363(n) remains relatively sparse, it appears that courts are most concerned with situations where one potential bidder agrees not to bid on an asset, or drops out of the bidding, so that another bidder can prevail at the auction at a lower price than if there had been competitive bidding, with the two bidders later adjusting the "spoils" of this process between them. As a result, section 363(n) has generally been applied only in the most obvious and blatant collusive-bidding circumstances. Still to be seen is the extent to which bankruptcy courts may attempt to infer agreements to control the price at an auction from circumstantial evidence, rather than as a result of a clear agreement to do so.

Nothing in section 363(n) expressly exempts bidders from liability under applicable antitrust laws for collusive bidding as a restraint of trade under section 1 of the Sherman Act. Non-bankruptcy courts have consistently held that agreements to submit noncompetitive "rigged bids" are a form of price fixing that constitute per se violations of that statute. Such violations may subject the defendant to treble damages and, potentially, even criminal liability, although criminal prosecution is unlikely if a joint enterprise is "open and notorious." In addition, a private right of action is available to the aggrieved party (presumably, the seller) to impose civil liability under the statute.

The antitrust field has developed a body of case law as to when a plaintiff may use circumstantial evidence to show the existence of an agreement to restrain trade under section 1 of the Sherman Act. Under that law, the plaintiff relying on such evidence "must show the inference of conspiracy is reasonable in light of the competing inference of independent action." Moreover, as noted by an Indiana district court in *Boyer v. Gildea*, "[b]ecause there is often a fine line separating unlawful concerted action from legitimate business practices, conduct that is as consistent with permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy."

Addressing the application of federal antitrust law in the bankruptcy context, the court in *Boyer* ruled that circumstantial evidence of a collusive agreement would be insufficient to show such an agreement if "it is as compatible with permissible conduct as it is with impermissible conduct, and the Plaintiff cannot point to any evidence tending to exclude the possibility that the Defendant's conduct was permissible." Based on that standard, the court found that the circumstantial evidence in that case, comprised mostly of various discussions and negotiations among the bidders and an actual agreement between the bidders after the sale, was insufficient to show a collusive agreement, especially since it appeared that one of the bidders ultimately could not offer a competitive bid on its own, instead needing to find a partner to place such a bid and obtain financing. Bankruptcy courts might analogize to *Boyer* and similar cases to determine whether facts short of an actual, proven agreement that one bidder refrain from bidding can support a section 363(n) claim.

Published opinions finding the existence of collusive bidding remain rare. Even so, if the court determines that a sale is tainted by bid rigging, two primary possible remedies are available: (i) avoidance of the sale transaction; or (ii) recovery from the buyer of damages equal to the amount by which the actual value of the asset exceeds the price at which the sale was consummated. In addition, any costs, attorneys' fees or expenses incurred in avoiding a collusive sale or recovering the shortfall may be recovered by the trustee or DIP. Punitive damages may also be assessed against colluding bidders who act in willful disregard of section 363(n).

Both of the primary remedies are problematic for any buyer of assets in bankruptcy. Avoiding the sale transaction means that the sale will be unwound. Besides creating a variety of logistical issues, this means that any increase in value to the target subsequent to the sale, including as a result of investments or operational changes effectuated by the purchaser, may revert to the debtor. As a result of logistical issues, it may be more likely that a court would instead order damages to be assessed against the purchaser equal to the difference between the “actual” value of the target and the price paid. However, a bankruptcy court has considerable discretion in determining the “actual” value of assets that are sold in a collusive sale transaction. As a result, the court may determine that the actual value is well in excess of what the purchasers believe the true value to be at the time of the auction, especially since the court will be making that determination in the context of a sale that it already has ruled was tainted. In addition, the availability of punitive damages as a remedy for “willful” bid-rigging subjects an acquiror to additional and not readily ascertainable exposure in connection with a collusive sale transaction.

Finally, one issue that has arisen in the courts is the length of time that a party can bring suit to avoid a sale transaction under section 363(n). The longer the period of time after a sale transaction a suit is brought, the more prejudicial it likely will be to the buyer. Neither section 363(n) nor any other provision in the statute specifies a limitation period for challenges to a sale on the basis of collusion. Most courts, however, have ruled that a motion to invalidate a sale under section 363(n) must be filed within the one-year period governing requests under Fed. R. Civ. P. 60(b)(3) for relief from a judgment or order on the basis of fraud, misrepresentation or other misconduct, which applies to bankruptcy cases pursuant to Fed. R. Bankr. P. 9024.

Boyer v. Gildea, 2006 WL 2868924 (N.D. Ind. Oct. 5, 2006).

A version of this article originally appeared in the September 2007 edition of *The Bankruptcy Strategist*. It has been reprinted here with permission.