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Reward the Stalking Horse or Preserve the Estate: Determining the Appropriate Standard of Review for Awarding Break-Up Fees in §363 Sales

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Reward the Stalking Horse or Preserve the Estate: Determining the Appropriate Standard of Review for Awarding Break-Up Fees in §363 Sales*

Zachary R. Frimet

Abstract

Following the surge of bankruptcies in the wake of the Great Recession, a growing and somewhat controversial trend has emerged whereby companies seeking to purchase a debtor's assets in bankruptcy frequently make use of Section 363 of the United States Bankruptcy Code ("§363"). In general, §363 sales are accomplished via public auction. This aspect of §363 exposes initial bidders, known in bankruptcy as "stalking horse bidders," to the risk that they will commit time and resources in pursuit of the acquisition and yet fail to succeed as the prevailing bidder. To hedge against this risk, stalking horse bidders frequently request "break-up fees" when negotiating a purchase agreement for a §363 sale. There is no consensus among the Bankruptcy Courts as to how to treat break-up fee provisions. Thus, the foundation of this Note is that the lack of a uniform break-up fee standard is detrimental to the consistency of bankruptcy law and leaves debtors and stalking horse bidders on unstable ground when utilizing §363. Courts predominantly use three standards when reviewing a break-up fee provision in a §363 asset sale: the business judgment standard, the best interests of the estate test, and the administrative expense test. Because all bankruptcy law is, at its core, based in principles of equity, it only makes sense to develop a theory of break-up fees based upon the philosophies underlying the law's procedures. As such, this Note analyzes break-up fees with a view toward the purpose of §363 and Chapter 11 bankruptcy. Using that perspective, this Note argues in favor of using the best interests of the estate test when determining whether to award break-up fees to stalking horse bidders in §363 sales.

KEYWORDS: Bankruptcy, 363, Stalking Horse Bidders, Break-up Fees

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Following the surge of bankruptcies in the wake of the Great Recession, a growing and somewhat controversial trend has emerged whereby companies seeking to purchase a debtor's assets in bankruptcy frequently make use of Section 363 of the United States Bankruptcy Code ("§ 363"). In general, § 363 sales are accomplished via public auction. This aspect of § 363 exposes initial bidders, known in bankruptcy as "stalking horse bidders," to the risk that they will commit time and resources in pursuit of the acquisition and yet fail to succeed as the prevailing bidder. To hedge against this risk, stalking horse bidders frequently request "break-up fees" when negotiating a purchase agreement for a § 363 sale. There is no consensus among the Bankruptcy Courts as to how to treat break-up fee provisions. Thus, the foundation of this Note is that the lack of a uniform break-up fee standard is detrimental to the consistency of bankruptcy law and leaves debtors and stalking horse bidders on unstable ground when utilizing § 363.

Courts predominantly use three standards when reviewing a break-up fee provision in a § 363 asset sale: the business judgment standard, the best interests of the estate test, and the administrative expense test. Because all bankruptcy law is, at its core, based in principles of equity, it only makes sense to develop a theory of break-up fees based upon the philosophies underlying the law's procedures. As such, this Note analyzes break-up fees with a view toward the purpose of § 363 and Chapter 11 bankruptcy. Using that perspective, this Note argues in favor of using the best interests of

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TABLE OF CONTENTS

INTRODUCTION 462
I. § 363 SALES AND THE STALKING HORSE BIDDER 466
A. § 363 Sales: An Overview 466
B. The Stalking Horse Bidder 468
II. BREAK-UP FEES 470
A. Non-Bankruptcy Break-Up Fees 471
B. Break-Up Fees in Bankruptcy 474
C. The Business Judgment Rule 477
D. The Best Interests of the Estate Test 479
E. The Administrative Expense Standard—§ 503(b) 481
F. The Need For Uniformity 483
III. BALANCING THE APPROACH 485
A. The Role of the Bankruptcy Court in Chapter 11 485
B. The Administrative Expense Test Goes Too Far 487
C. The Business Judgment Rule Is Inapt Because § 363 Sales Are Distinct From Non-Distressed Sales 489
D. The Non-Plan Liquidation Aspect of § 363 Justifies the Use of The Best Interests of the Estate Test 491
CONCLUSION 496

INTRODUCTION

In recent years, the United States has seen a significant increase in the number of distressed companies seeking to liquidate assets.[1] To complete this objective in bankruptcy, many companies make use of § 363 of the United States Bankruptcy Code, which authorizes debtors to sell assets outside "the ordinary course of business."[2] This statute

1. Corinne Ball & John K. Kane, *How to Handle Corporate Distress Sale Transactions*, *in* ALI-ABA Business Law Course Materials Journal 38723 (2003), *available at* http://www.jonesday.com/files/Publication/7fbdc211-d634-4ae3-8377-6fbe2cd6a0e5/Presentation/PublicationAttachment/dd598749-67d2-455f-997f-9598c2e05623/ALI_ABA_KANE.pdf.

2. 11 U.S.C. § 363 (2012); *see* Ind. State Police Pension Trust v. Chrysler LLC (*In re* Chrysler LLC), 576 F.3d 108, 115 (2d Cir. 2009) (noting that § 363 sales "may well replace the main route of Chapter 11 reorganization plans") (quotations omitted) (citation omitted).

permits debtors to sell assets free and clear of all liabilities and protects good faith purchasers from fraudulent transfer claims.[3] In this regard, § 363 provides for an orderly process by which bankrupt companies can maximize the resale value of their assets, while offering protections to buyers that make these distressed acquisitions very enticing to outside investors.[4]

Alas, it is not always smooth sailing for § 363 purchasers.[5] More often than not, a debtor sells its assets via public auction in order to maximize the sale price.[6] Consequently, a potential purchaser exposes itself to the risk that it will commit valuable resources to pursue the acquisition yet ultimately fail to consummate the sale.[7] This risk has led these proverbial stalking horse[8] bidders to negotiate bidding incentives to hedge against their back-end risks.[9] Taking cues from traditional acquisition practice, a stalking horse bidder frequently requests break-up fees when negotiating a purchase agreement in a § 363 sale.[10] A "break-up fee" is a sum paid to the stalking horse bidder in the event that the stalking horse does not finalize the sale.[11] Judicial treatment of break-up fees in traditional corporate combinations[12] has been deferential to the

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3. *See* 11 U.S.C. § 363(f) (2012); *id.* § 363(m) (2012).

4. Andrew S. Brown, *Breaking Up and Making Out (Rich): Recommendations for Revision of Bankruptcy Code Provisions Governing Break-Up Fees Used by Stalking Horse Bidders in § 363 Bankruptcy Asset Sales*, 62 Fla. L. Rev. 1463, 1465 (2010) (noting that the protections of § 363 "encourage private equity funds to venture into the bankruptcy court system and acquire bankrupt companies in whole or in part").

5. *See infra* Part I.

6. *See* Ball & Kane, *supra* note 1, at 395 ("The objective of the auction process is to obtain the 'highest and best' offer for the assets, thus maximizing the proceeds to the estate and, indirectly, the seller's creditors.").

7. *See* Nicholas M. McGrath, *Breaking Down Break-Up Fees: The Appropriate Standard*, 2011 Ann. Surv. of Bankr. Law 14, n.40-44 and text (2011) ("Cognizant of . . . the fact that the debtor is free to 'window shop' the asset, the stalking horse has a realistic concern that its time, expenses, and efforts may be wasted, or worse, utilized by a competitive bidder without any 'assurance' that it will ultimately be successful in acquiring the assets.") (internal quotations and citations omitted).

8. *See infra* note 46 and accompanying text.

9. *See* McGrath, *supra* note 7, n.7-11 and text.

10. *See infra* Part II.A-B.

11. Peter C. Blain, *Let's Make a Deal: Sales of Distressed Businesses in Insolvency Proceedings*, *in* Buying and Selling Distressed Businesses 137 (2010), *available at* 2010 WL 6425211, at 9.

12. "Corporate Combinations" refers to a corporate mergers or acquisitions.

parties of the deal.[13] Courts routinely approve negotiated break-up fees in challenged transactions.[14] In the context of bankruptcy, however, courts and scholars have not universally agreed upon the legitimacy of break-up fees. Contrary to most procedural aspects of bankruptcy law, a field in which almost everything is codified, determining the appropriate standard of review for break-up fees in § 363 sales has been left entirely to the discretion of the courts.[15] As such, debate over the advantages, disadvantages, and necessity of break-up fees has led courts in different directions when deciding whether to award these fees to the stalking horse.[16] The issue is inextricably linked to one of bankruptcy's central purposes, the maximization of the value of the debtor's estate.[17]

Courts predominantly use three standards when reviewing a break-up fee provision in a § 363 asset sale: the business judgment standard,

13. *See* Mark F. Hebbeln, *The Economic Case for Judicial Deference to Break-Up Fee Agreements in Bankruptcy*, 13 Bankr. Dev. J. 475, 478-79 (1997) (noting that "[o]utside bankruptcy, break-up fee agreements are presumptively valid under the business judgment rule" and that a decision protected by the business judgment rule can only be challenged on the basis of "bad faith, negligence, or self-dealing").

14. *Id.* at 480-81; *see e.g.*, *In re* Smurfit-Stone Container Corp. S'holder Litig., 2011 WL 2028076, at *21 (Del. Ch. May 20, 2011), *as revised* (May 24, 2011) (denying a plaintiff's challenge to a termination fee, where the fee "appear[ed] to have resulted from good faith, arm's-length negotiations"); *In re* Bear Stearns Litig., 870 N.Y.S.2d 709 (Sup. Ct. 2008) (protecting a board of directors decision to approve a merger agreement that contained, *inter alia*, a "termination fee", under the business judgment rule); *In re* Lear Corp. S'holder Litig., 926 A.2d 94, 119 (Del. Ch. 2007) (granting summary judgment in favor of the defendant corporation with respect to the plaintiff shareholders challenge of certain deal protection provisions in a merger agreement, including a termination fee).

15. *See* Bruce A. Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 Am. Bankr. L.J. 349, 353 (1992) (noting that, *In re* 995 Fifth Ave. Assocs. L.P., 96 B.R. 24, 29 (Bankr. S.D.N.Y. 1989), the first reported case to deal directly with break-up fees, used principles of corporate law to determine whether the break-up fee in question was valid).

16. *See infra* Part II.

17. *See* Rhett Frimet, *The Birth of Bankruptcy in the United States*, 96 Com. L.J. 160, 160 (1991) (noting that one of the primary objectives of "all bankruptcy law" is "to prevent on the part of the insolvent debtor conduct detrimental to the interests of [its] creditors"); *see, e.g.*, Matter of Midway Airlines, Inc., 6 F.3d 492, 494 (7th Cir. 1993) (noting that "one of the Code's central purposes" is "the maximization of the value of the bankruptcy estate for the benefit of creditors").

the best interests of the estate test, and the administrative expense test.[18] Thus, at the outset it is imperative that courts come to a consensus with respect to an appropriate standard of review. Congress designed the Bankruptcy Code[19] to provide a uniform framework under which entities can operate while insolvent.[20] The lack of a uniform break-up fee standard is detrimental to that principle and leaves debtors and stalking horse bidders in a precarious position.[21]

Courts and scholars advocating for a particular standard have used statistical analysis, economic theory, and principles of law to defend their respective positions. However, few have analyzed this issue in a manner that goes beyond the general purpose of bankruptcy law and toward the specific nuances of Chapter 11.[22] Since bankruptcy law, at its core, is based in principles of equity, it only makes sense to develop a theory of break-up fees based in the philosophies underlying its procedures. Therefore, this Note does not arrive at its position via empirical evidence, but rather, its conclusion is based on an overview of the shifting function of § 363 sales in Chapter 11 bankruptcy.[23]

This Note argues in favor of using the best interests of the estate test when determining whether to award break-up fees to stalking horse bidders in § 363 sales. Part I begins with a brief overview of § 363 sales in bankruptcy, focusing specifically on the role of the stalking horse bidder. Part II discusses break-up fees and the three main standards that bankruptcy courts use when determining whether to award break-up fees to a stalking horse bidder. Finally, Part III argues in favor of the best interests of the estate test as the appropriate standard of review, which

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18. 2 William L. Norton, Jr., Norton Bankruptcy Law & Practice § 44:27 (3d ed. 2010).

19. *See generally* 11 U.S.C. §§ 101-1532 (2012) (containing the provisions of the Bankruptcy Code).

20. *See* Maryland Port Admin. v. Premier Auto. Services, Inc. (*In re* Premier Auto. Servs., Inc.), 492 F.3d 274, 284 (4th Cir. 2007) ("The purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state.") (quotations omitted) (citations omitted).

21. *See infra* Part II.

22. *See generally* 11 U.S.C. §§ 1101-1174 (2012) (containing the provisions of Chapter 11 of the Bankruptcy Code).

23. *See infra* Part III.

represents a strong middle ground between the three approaches and is implicated by § 363's role in modern Chapter 11 bankruptcy.

I. § 363 SALES AND THE STALKING HORSE BIDDER

A debtor can pursue two avenues when selling significant assets of its business in bankruptcy.[24] The debtor can use § 1123 of the Bankruptcy Code, which involves the oft lengthy process of developing a plan of reorganization and having it confirmed by the court.[25] Alternatively, the debtor can use § 363(b), which permits the debtor to sell assets outside of the ordinary course of business subject to the procedures set forth in the Bankruptcy Code.[26] Typically, § 363 sales happen fast and via public auction, and therefore are more prone to being targeted by distressed asset investors.[27] Consequently, the issue of break-up fees is far more prevalent in the context of § 363 sales as opposed to plan sales.[28] This part discusses § 363 sales and the role of the stalking horse bidder in § 363 sales conducted via public auction.

A. § 363 SALES: AN OVERVIEW

In the modern bankruptcy world many debtors opt to sell assets via § 363 as opposed to a traditional Chapter 11 plan.[29] Section 363 permits

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24. *See* Rakhee V. Patel & Vickie L. Driver, *Toto, I've A Feeling We're Not in Kansas Anymore: Bankruptcy Sales Outside the Ordinary Course of Business*, 57 Fed. Law. 56, 56 (2010) (discussing § 1123 versus § 363 for sales outside of the ordinary course of business).

25. *See* 11 U.S.C. § 1123 (2012).

26. *See id.* § 363.

27. *See* Elizabeth B. Rose, *Chocolate, Flowers, and § 363(B): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 Emory Bankr. Dev. J. 249, 269 (2006) (noting that "the number of § 363 preplan sale motions for all or substantially all of the debtor's assets dramatically increased in the 1990s and preplan sales enjoy even more use since 2000").

28. *See* Kimberly W. Osenbaugh & David C. Neu, *Asset Sales in Bankruptcy Break-Up Fees and Topping Fees*, SJ076 ALI-ABA 829, 832 (2004) (noting that break-up fees are often requested in § 363 sales as opposed to 1123 plans because "[s]ales of assets pursuant to Section 363 of the Bankruptcy Code are often conducted pursuant to sophisticated bidding procedures").

29. Jacob A. Kling, *Rethinking 363 Sales*, 17 Stan. J.L. Bus. & Fin. 258, 262 (2012) (noting the trend toward § 363 sales, and proffering that two possible

a debtor to sell assets outside the ordinary course of business, prior to a confirmed plan of reorganization, following notice and hearing, and upon approval of the court.[30] The shift from a traditional Chapter 11 case, one which would have the debtor's assets disposed pursuant to a confirmed plan of reorganization, to § 363 sales, "has been driven by efficiency, from the perspectives of sellers and buyers alike."[31] A significant impetus for this trend is the speed of a § 363 sale, which "can maximize asset value by sale of the debtor's business as a going concern."[32] In addition, § 363 sales tend to enhance the purchase price of the distressed asset because they are sold to the purchaser free and clear of all liens, claims, and liabilities under § 363(f).[33] Furthermore, § 363(m) limits the ability to appeal a § 363 sale to a "good faith" purchaser.[34] These two provisions, "provide a degree of finality to the sale that is very appealing to prospective purchasers."[35] As a result, debtors are able to receive a higher price for the sale as buyers jump on the opportunity to receive distressed assets at a discount while receiving the protections of the Bankruptcy Code.[36]

Recently, "it has become more commonplace for debtors to hold § 363 sales with the purpose of selling *substantially all* of their assets."[37] In effect, bankrupt corporations are using § 363 as a way of selling their businesses while foregoing the traditional Chapter 11 process.[38] Debtors can execute § 363 sales by private or public auction,[39] although, in order

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explanations are: "that a 363 sale can be accomplished more quickly and at less cost than a full blown reorganization . . . [,] [and] assets have become less firm specific; as a result, a firm's going concern surplus can generally be preserved as effectively through a 363 sale as through a reorganization").

30. 11 U.S.C. § 363(b)(1) (2012).

31. Ind. State Police Pension Trust v. Chrysler LLC (*In re* Chrysler LLC), 576 F.3d 108, 115 (2d Cir. 2009) *vacated on other grounds In re* Chrysler, LLC, 592 F.3d 370 (2d Cir. 2010).

32. *Id.*

33. *See id.* at 115-16; *see also* 11 U.S.C. § 363(f) (2012).

34. 11 U.S.C. § 363(m).

35. Douglas E. Deutsch & Michael G. Distefano, *The Mechanics of A Section § 363 Sale*, 30-FEB Am. Bankr. Inst. J. 48, 48 (2011).

36. Kling, *supra* note 29, at 263 (noting the functions of a § 363 sale to "offer an important and efficient mechanism to maximize the value of the estate").

37. Deutsch & Distefano, *supra* note 35, at 48 (emphasis in original).

38. *Id.*

39. Fed. R. Bankr. P. 6004f)(1).

to maximize value for the estate, major assets are rarely sold at private auctions.[40] Generally, sale through public auction involves selecting an initial bidder to begin the process and then sending the sale to auction where competing bidders can drive up the sale price.[41] The role, necessity, and treatment of the initial bidder in § 363 sales have become increasingly debated topics in bankruptcy.[42]

B. THE STALKING HORSE BIDDER

The initial bidder plays an important role in the § 363 sale process.[43] This bidder will negotiate the purchase agreement with the debtor, and the debtor will ultimately use that purchase agreement as the vehicle through which the sale will be consummated at auction.[44] In bankruptcy, practitioners typically refer to the initial bidder as the stalking horse bidder.[45] The term "stalking horse" refers to a tactic used in hunting whereby a hunter conceals himself behind an image of a

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40. Harvey R. Miller, John J. Rapisardi, & Reginald A. Greene, *Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers the New Value Controversy in Bank of America National Trust & Savings Ass'n v. 203 North Lasalle Street Partnership*, 30 U. Mem. L. Rev. 553, 565 (2000) (noting that "major assets are rarely sold at private auctions").

41. *See* Deutsch & Distefano, *supra* note 35, at 49 (noting that "[t]he first step of a § 363 sale is often for the debtor to identify a 'stalking horse' bidder" who will establish the floor price of the assets, "which can be shopped around to other potential bidders").

42. *See, e.g.*, Oscar Garza, Jesse S. Finlayson, & Solmaz Hamidian, *Rethinking the Scope of the O'Brien Decision: Why the Third Circuit's Administrative Claims Analysis Should Not Be Applied to the Debtor's Request for Approval of A Breakup Fee in Connection with Bankruptcy Sales in Chapter 11 Cases*, 28 Cal. Bankr. J. 1, 2 (2005) (criticizing the Third Circuit's use of the administrative expense test to review a break-up fee); *see e.g.*, Markell, *supra* note 15 (arguing against allowing break-up fees in bankruptcy).

43. *See* Blain, *supra* note 11, at 8 ("While some sales proceed as 'naked auctions' with no stalking horse bids, these are relatively rare.").

44. *See generally* Sharon Alexander, *Bankruptcy Sales: The Stalking Horse*, JONES DAY, Nov. 2003, at 2-3, *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S2177 (explaining bidding procedures and describing incentives for the stalking horse).

45. David H. Kleiman, *Alternatives for Awarding Break-Up Fees to Stalking-Horse Bidders*, 29-OCT Am. Bankr. Inst. J., 26, 26 (2010) (citation omitted).

horse in order to get closer to his target.[46] Analogously, the debtor in a § 363 sale uses the stalking horse bidder to stimulate the bidding process and draw other bidders into the sale.[47] The stalking horse performs extensive due diligence and typically drafts the asset purchase agreement used to consummate the sale.[48] Ultimately, the stalking horse sets the floor for the deal by determining the value of the debtor's assets.[49] During this process, the stalking horse will generally expend far more resources than other bidders when trying to secure the deal because subsequent bidders can rely on the stalking horse's due diligence when crafting their own bids.[50]

It may seem unlikely that a purchaser would volunteer to serve as a stalking horse given the nature of the job.[51] Nevertheless, there are several reasons why a potential purchaser would assume the role.[52] First, the role of the stalking horse puts the potential purchaser in the best position to structure a favorable deal.[53] In addition to developing the financial terms of the purchase agreement, the stalking horse can also negotiate favorable bidding procedures that will enhance its ability to close the sale.[54] Second, oftentimes a debtor will offer certain bidding

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46. *See* Alexander, *supra* note 44, at 2.

47. *Id.*

48. Blain, *supra* note 11, at 10.

49. *See* Brown, *supra* note 4, at 1465 (discussing the issues a stalking horse bidder faces when setting the floor for a deal).

50. Monica E. White, *Give Me A Break-Up Fee: In Re Reliant Energy Channelview LP and the Third Circuit's Improper Rejection of a Bankruptcy Bid Protection Provision*, 48 Hous. L. Rev. 659, 668 (2011) (noting that subsequent bidders can rely on the stalking horse's due diligence and therefore incur less costs).

51. *See* Alexander, *supra* note 44, at 1 (noting that "[p]otential purchasers may be reluctant to the take on the role of the stalking horse" given that the "initial bidder typically has to expend greater resources than other bidders in negotiating the deal, performing due diligence, and otherwise setting the 'floor' for the terms of the transaction).

52. *See* Osenbaugh & Neu, *supra* note 28, at 833-36 (discussing the variety of reasons why a potential purchaser would agree to become the stalking horse).

53. *See* Blain, *supra* note 11, at 9 ("Another significant benefit available to the stalking horse bidder is the ability to influence the sale process. . . . By custom, the stalking horse bidder usually drafts the asset purchase agreement used in connection with the transaction. . . . A stalking horse bidder that may be willing to assume various contracts or exclude certain assets may be able to craft an asset purchase agreement that gives it a competitive advantage over other buyers.").

54. *See* Alexander, *supra* note 44, at 2.

incentives to solicit a potential purchaser to become the stalking horse.[55] Two of the most common compensatory bidding incentives are expense reimbursements and break-up fees.[56] Under expense reimbursement arrangements, the debtor will reimburse the stalking horse for reasonable fees incurred with respect to the stalking horse's due diligence.[57] The amount and timing of the reimbursement will generally be limited in order to ensure that the bankruptcy court does not perceive it as an unreasonable drain on the debtor's estate.[58] Break-up fees, on the other hand, represent compensation paid to the stalking horse unrelated to any costs incurred.[59] This distinction has led to courts and scholars disagreeing as to how to classify and analyze break-up fees in bankruptcy.[60]

II. BREAK-UP FEES

In its most basic form, a break-up fee is a predetermined amount payable to one party if an agreed upon transaction with another party fails to close.[61] In an auction context, a break-up fee compensates an unsuccessful bidder through a payment that goes beyond covering the

55. *See* Blain, *supra* note 11, at 9 ("[U]sually a number of interested parties vigorously seek to become the stalking horse because of the significant benefits that flow from that status.").

56. *Id.* ("Among the most significant benefits that accrue to the stalking horse is the ability to receive a break-up fee and/or reimbursement of expenses.").

57. *Id.* ("Expense reimbursement is the reimbursement of actual expenses the stalking horse can prove it expended in connection with the transaction.").

58. *See* Alexander, *supra* note 44, at 2 (commenting that bidding incentives often include "expense reimbursements, break-up fees, favorable bidding procedures, and exclusivity arrangements").

59. *See* Blain, *supra* note 11, at 9 ("A true break-up fee is a fixed number paid if the stalking horse is not the successful bidder, without regard to the actual expenses incurred by the stalking horse.").

60. *See e.g.*, Markell, *supra* note 15. *Compare In re* Reliant Energy Channelview LP, 594 F.3d 200, 206 (3d Cir. 2010) (analyzing the break-up fee using the administrative expense standard) *with In re* S.N.A. Nut Co., 186 B.R. 98 (Bankr. N.D. Ill. 1995) (analyzing the break-up fee using the best interests of the estate test).

61. Simon M. Lorne & Joey Marlene Bryan, *Acquisitions and Mergers: Negotiated and Contested Transactions*, *in* 11 Acquisitions & Mergers § 3:62 (2014).

bidder's pre-sale expenses.[62] In a simple scenario, one company makes an offer to buy a target entity, and the offer is accepted.[63] The two entities finalize "the terms of the acquisition, but prior to the closing of the transaction, a third company offers a higher offer for the target company" that the target company ultimately accepts.[64] In this scenario, the original offeror has taken the time to set up the deal yet ends up receiving nothing in return. To mitigate this risk, the initial bidder will request that the target entity stipulate to pay a fee to the initial bidder in the event that the transaction is not consummated.[65] This way, the initial bidder guarantees itself compensation for the resources expended while valuing the target entity and formulating an appropriate offer.[66] Given the modern propensity for strategic acquisitions both in and out of bankruptcy, the issue of break-up fees has become a frequent topic of debate among courts and scholars.[67]

A. NON-BANKRUPTCY BREAK-UP FEES

Judicial examination of break-up fees first developed in non-bankruptcy law.[68] Parties often negotiate break-up fees as part of corporate merger and acquisition transactions.[69] When considering a potential merger or acquisition, the acquiring company will spend "time, effort, and capital in order to determine such factors as corporate compatibility and economic feasibility."[70] Given the complexity of many

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62. Brown, *supra* note 4, at 1465 ("The break-up fee compensates the unsuccessful initial bidder through a fee greater than the initial bidder's actual due diligence expenses.").

63. Ely R. Levy, *Corporate Courtship Gone Sour: Applying a Bankruptcy Approach to Termination Fee Provisions in Merger and Acquisition Agreements*, 30 Hofstra L. Rev. 1361, 1366-67 (2002).

64. *Id.*

65. *Id.* at 1367.

66. *Id.* at 1366 (noting that initial bidders spend "a great deal of time and capital in the process of appraising the target entity for the purpose of formulating an accurate bid or offer").

67. *See infra* notes 79-81 and accompanying text.

68. *See* McGrath, *supra* note 7, at n.17 ("The concept of a break-up fee in a section 363 sale originally derives from non-bankruptcy case law.").

69. *Id.* (commenting that "break-up fees are routinely seen in acquisition transactions throughout the corporate world").

70. Levy, *supra* note 63, at 1402.

of these transactions, the initial bidder may end up investing substantial financial resources toward due diligence efforts and preparation of its offer or bid.[71] In addition to the considerable up-front costs, the competitive nature of the modern corporate landscape further increases the risk to the potential bidder.[72] Making matters more challenging for the parties in interest is the requirement that corporate shareholders approve most major corporate combinations.[73] Because shareholders in public companies are often numerous and widely dispersed, this approval requirement can significantly delay the closing of the transaction.[74] This allows competitors time to use the information gathered by the initial bidder and make a competing bid with potentially better terms.[75] The initial bidder may end up losing out on the deal if the shareholders approve an alternative offer,[76] leaving the bidder uncompensated for the tremendous costs of investigating the transaction.[77] In addition to the sunk costs, the bidder incurs the opportunity cost of not profiting from another strategic merger.[78]

The increasing trend of corporate combination transactions[79] coupled with the substantial risk of losing a deal to a rival bidder[80] have caused break-up fees to become a commonplace deal provision in

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71. *See id.*

72. *See* Levy, *supra* note 63, at 1370 n.47 (noting that "in the current merger landscape, large corporations have been using mergers to gain advantage within their industries") (citing Constance L. Hays, *Unilever Deal for Bestfoods Signals More Acquisitions*, N.Y. Times, June 7, 2000, at C1).

73. *See* Markell, *supra* note 15, at 353 ("Acquirers often ask for breakup fees due to the requirement that corporate shareholders must approve most major corporate combinations.").

74. *Id.*

75. *See id.*

76. *See id.*

77. *See id.*

78. *See id.* at 353 (concluding that, in effect, "the breakup fee is designed . . . to compensate for the risk of losing a [finished] deal").

79. *See* Richard G. Parker & David A. Balto, *The Merger Wave: Trends in Merger Enforcement and Litigation*, 55 Bus. Law. 351, 356 (1999) (noting this trend).

80. *See* Levy, *supra* note 63, at 1370 n.51 (noting that second bidders prevailed in 75% of the forty-eight acquisition cases examined) (citing Richard S. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. Part Fin. Econ. 141, 147 (1983)).

corporate merger and acquisition deals.[81] As with many issues that arise in corporate law, courts evaluate break-up fees under the "business judgment rule." [82] The business judgment rule operates under the "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[83] As discussed *infra*, judicial scrutiny under the business judgment rule differs slightly between the corporate and bankruptcy contexts, yet the overarching premise is the same.[84] The rule requires courts to defer to the business judgment of corporate directors regarding the affairs of the corporate enterprise.[85] Under the rule, courts will not interfere with decisions that fall within corporate directors' discretion in the absence of bad faith, negligence, or self-dealing.[86] It is important to note, however, that some courts consider additional factors when analyzing the legitimacy of break-up fees in corporate combinations, namely, whether the break-up fee "enhance[s] rather than stop[s] bidding." [87] This addition to the otherwise relatively unmodified use of the business

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81. *See id*. at 1363 n.16 ("[T]here's little debate these days over break-up fees. When lawyers sit down to negotiate, everyone at the table pretty much knows what's going to happen . . . Every buyer expects to get it, and every seller expects for it to be asked for.") (citation omitted).

82. *See, e.g.*, Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 574-75 (11th Cir. 1988); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 277 (2d Cir. 1986) (using the business judgment rule to evaluate a target corporation's assent to a break-up fee provision in the acquisition agreement).

83. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

84. *See infra* Part II.

85. 3A Fletcher Cyclopedia of the Law of Corp. § 1036 (2014).

86. *See* Hebbeln, *supra* note 13, at 479 ("A plaintiff challenging the business judgment of the board of directors bears the burden of proving bad faith, negligence, or self-dealing.") (citing Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)), *overruled by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

87. *See* CRTF Corp. v. Federated Dep't Stores, Inc., 683 F.Supp. 422, 440 (noting in its analysis that break-up fees in corporate combinations "are not illegal where they enhance rather than chill bidding"); *see also, e.g.*, Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 624 (S.D.N.Y. 1987) ("In coordinating the bidding process, the board can institute strategies, such as . . . a break-up fee . . . but only if their strategies enhance the bidding.").

judgment rule highlights the controversial nature of break-up fees as they apply to judicially reviewable transactions.[88]

B. BREAK-UP FEES IN BANKRUPTCY

Despite break-up fees' relatively new role in asset purchases in bankruptcy, they have come to the forefront of judicial debate, and for good reason.[89] Procedurally, break-up fees in bankruptcy are similar to their corporate counterparts.[90] The fees are a payment made by the debtor to the proposed purchaser "in the event that the transaction contemplated fails to be consummated for various reasons delineated in the purchase agreement, including the [debtor's] acceptance of a later bid."[91] Although similar in structure, break-up fees in bankruptcy asset sales, particularly § 363 sales, are far more nuanced than those that occur in corporate combinations.[92]

The reasons why a potential § 363 purchaser would insist on break-up fees are similar to the reasons traditionally used to justify break-up fees in corporate combinations, although potential purchasers arguably have even more incentive to pursue break-up fees in bankruptcy, given the heightened stakes.[93] As in corporate combinations, the potential purchaser will incur many expenses in negotiating the sale.[94] However, because the subjects of § 363 transactions are distressed assets, oftentimes initial bidders will spend more time and money conducting due diligence as compared to a non-distressed acquisition.[95] Broadly speaking, the debtor's distressed situation may have encouraged its

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88. *See supra* note 87 and accompanying text.

89. *See* Markell, *supra* note 15, at 354 (discussing the first reported bankruptcy case to address the issue of break-up fees, *In re* 995 Fifth Ave. Assocs. L.P., 96 B.R. 24 (Bankr. S.D.N.Y. 1989)).

90. *See* Levy, *supra* note 63, at 1390 ("While termination fee provisions originated in the context of corporate mergers and acquisitions, such fees are included in bankruptcy asset purchase agreements.").

91. *In re* APP Plus, Inc., 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998).

92. *See infra* notes 192-199 and accompanying text.

93. *See* Hebbeln, *supra* note 13, at 494 ("When a firm makes a decision to invest time and money in one project, it must forgo another because the firm's resources are limited and it cannot invest in everything it might like.").

94. *See supra* note 70 and accompanying text.

95. Brown, *supra* note 4, at 1480 ("Initial bidders argue that they need [break-up fees] in order to justify researching and bidding for risky bankrupt companies.").

management to take aggressive or atypical measures, particularly with regard to the business' working capital, expenditures, and maintenance.[96] As opposed to a healthy corporate combination, in which a buyer may want to purchase the target entity as a going concern, a distressed situation encourages buyers to sift through the debtor's assets and choose the ones most likely to be profitable in the future.[97] From a contractual standpoint, the seller will be unlikely or unable to stipulate to post-closing indemnifications for the buyer with respect to breaches of representations and warranties.[98] As such, thorough due diligence will be critical for the buyer in order to formulate an offer that corresponds with these post-closing risks.

In addition, a sensible initial bidder must always be concerned that the debtor will use the first bid as a stalking horse to attract other bidders.[99] During the time it takes to garner court approval of the sale, the stalking horse runs the risk that a competing bidder will use the due diligence conducted by the stalking horse, make a superior bid, and win court approval.[100] Making matters more difficult for the stalking horse is the fact that creditors can legitimately object to a § 363 sale if there is a higher or better offer.[101] The considerable uncertainty as to whether the initial bidder will ultimately close the § 363 sale combined with the risks

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96. *See* Ball & Kane, *supra* note 1, at 31 (noting that "the"[t]he seller's distressed situation may have caused its management to take aggressive or unusual measures in operating the business, such as using working capital in peculiar ways or deferring maintenance or capital expenditures").

97. *See* Corinne Ball & John K. Kane, *A Practical Guide to Distress M&A (Part 2)*, 6 M & A Law, no. 7-8, 2003 at 1, 6, *available at* http://www.jonesday.com/files/Publication/7caf39ca-b5af-4018-8005-a438b96635c9/Presentation/PublicationAttachment/021f5fce-5fac-422d-8230-7e08207af727/GuideToDistress.pdf ("Unlike a conventional M&A transaction, in which a buyer may be pressured to buy a particular business or company as a going concern, warts and all, a distress situation may permit buyers to pick and choose assets, liabilities and contractual obligations.").

98. *See id.* (noting that "post-closing indemnification for breaches of representations and warranties will not be available" and thus are unlikely to occur in Chapter 11 sales). In addition, if a debtor sells all or substantially all of its assets it will generally end all operations and cease to exist upon consummation of the Chapter 11 proceeding. Consequently, there often may not be a post-closing entity from which the buyer can be reimbursed.

99. *See* McGrath, *supra* note 7, at n.8-9 and accompanying text.

100. *Id.* at n.3 and accompanying text.

101. *Id.* at n.156 and accompanying text.

inherent to the acquisition of distressed assets strongly encourages potential § 363 bidders to seek break-up fees.

While it seems as though only a stalking horse bidder would pursue break-up fees when entering into a § 363 sale, many scholars and courts argue that break-up fees are useful for the bankrupt entity as well.[102] There are a variety of legitimate reasons why a debtor would stipulate to a break-up fee.[103] First, the break-up fee can serve to attract an initial bid.[104] Without the promise of guaranteed compensation, a potential purchaser may be hesitant to conduct the due diligence required to value the bankrupt company properly.[105] As a corollary, the assurance of a break-up fee may help establish a high bidding floor early on in the process.[106] Moreover, debtors use the initial bid to lure other bidders into the auction because later bidders can rely on the due diligence conducted by the stalking horse.[107] Therefore, the initial bid may ultimately attract higher subsequent bids during the auction process.[108]

The delicate nature of break-up fees in § 363 sales is due to the competing interests present in bankruptcy. The overarching impediment is that one side of the deal does not simply constitute the assets of a seller, but rather, the assets of the estate of a debtor.[109] The bankruptcy court must approve any transaction outside the ordinary course of business, which can make finalizing the sale precarious for all parties involved.[110] Here, the court must approve the break-up fee and terms of

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102. *See infra* notes 103-106 and accompanying text.

103. *See* Hebbeln, *supra* note 13, at 478 ("The reasons that a bankrupt corporation may want to enter into a break-up fee agreement are less obvious but no less legitimate.").

104. *Id.*

105. *Contra* Markell, *supra* note 15, at 360-63 (arguing that break-up fees are not necessary to induce a healthy bidding process).

106. *In re* APP Plus, Inc., 223 B.R. 870, 874 (Bankr. E.D.N.Y. 1998).

107. *See* Hebbeln, *supra* note 13, at 478 (noting that once the initial bid has been submitted, other bidders "may become more willing to enter the bidding process because they can rely on the due diligence conducted by the initial bidder").

108. *See In re APP Plus, Inc.*, 223 B.R. at 874. (discussing the seller's rationale in requesting break-up and topping fees).

109. *See generally* 11 U.S.C. § 363 (2012) (providing the DIP or the debtor's trustee with the power to "use, sell, or lease, other than in the ordinary course of business, *property of the estate*) (emphasis added).

110. 11 U.S.C. § 363(b) (2012) (requiring court approval of any transaction, sales or leases outside of the ordinary course of business).

the purchase agreement, but more importantly, the court must approve the use of a § 363 sale by the debtor.[111] In this regard, the court must take into account not only the position of the stalking horse and the debtor, but also the interests of the estate, which includes the interests of the estate's creditors.[112] Courts faced with the decision of whether to approve a break-up fee have to weigh these interests when choosing which standard of review to employ, as there is no explicit guidance in the Bankruptcy Code.[113] Left to their own interpretations, courts in different circuits have utilized varying standards of review based on several rationales and factors.[114] Currently, the courts use three main standards when deciding whether to authorize a break-up fee for a stalking horse bidder: (1) the business judgment rule, (2) the best interests of the estate test, and (3) the administrative expense standard.[115]

C. THE BUSINESS JUDGMENT RULE

With break-up fees roots entrenched in corporate law, it is hardly surprising that early bankruptcy courts looked to corporate law for guidance as to how to review such fees.[116] In a case of first impression, *In re 995 Fifth Avenue Associates*, the Supreme Court determined that the principles underlying the business judgment rule were appropriate in the Chapter 11 context.[117] Accordingly, the Court followed the traditional approach towards break-up fees in corporate law, using the business judgment rule in combination with other factors to determine the validity of the fee.[118] The court noted that, in the corporate context,

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111. *See* Comm. of Equity Sec. Holders v. Lionel Corp (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) (stating that bankruptcy courts will require a "sound business purpose" for the use of § 363, including a showing that a non-plan sale is justified).

112. *See* Hebbeln*, supra* note 13, at 481.

113. *See supra* note 15 and accompanying text.

114. *See infra* Part II.B.1-3.

115. *See supra* note 114.

116. *See, e.g.*, *In re* 995 Fifth Ave. Assocs., 96 B.R. 24, 28 (Bankr. S.D.N.Y. 1989) (noting with respect to break-up fees, that corporate "principles have vitality by analogy in the chapter 11 context") (internal citations omitted).

117. *Id.* at 28.

118. *See, e.g.*, Cottle v. Storer Commc'n, Inc.*,* 849 F.2d 570, 574-79 (11th Cir. 1988); CRTF Corp. v. Federated Dep't Stores, Inc., 683 F.Supp. 422, 436-39 (S.D.N.Y.

break-up fees are generally acceptable where they enhance, rather than chill, bidding and are reasonable in relation to the bidder's efforts and magnitude of the transaction.[119] Finding both of these prongs satisfied, the Court determined that the business judgment rule encouraged the Court to defer to the debtor's business judgment as there was no evidence of "self-dealing, fraud or bad faith . . . [n]or [was] any claim made that the auction was somehow tainted by unfair dealing."[120]

The business judgment standard, insofar as it relates to break-up fees in bankruptcy, has been refined since *In re 995 Fifth Avenue Associates*.[121] The touchstone case concerning use of the business judgment rule to evaluate the validity of break-up fees in bankruptcy comes from the Second Circuit.[122] In *In re Integrated Resources Inc.*, the court, relying on prior district court decisions, formulated the modified business judgment rule for assessing the validity of break-up fees, asking: "whether (1) the negotiations leading to the break-up fee were the result of an arms-length transaction, (2) the fee encourages bidding and (3) the amount of the fee is reasonable in light of the prospective purchase price."[123] Courts have altered the specific prongs of the test in certain instances, but the guiding principle for the business judgment approach remains constant: avoid interfering with a debtor's business decisions absent a clear manifestation of bad faith or breach of fiduciary duty.[124] Thus, courts that employ the business judgment standard are far

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1988); Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 623-26 (S.D.N.Y. 1987).

119. *See In re 995 Fifth Ave Assocs.*, 96 B.R. at 28 ("In the corporate takeover context it is recognized that breakup fees are not illegal where they enhance rather than hamper the bidding. . . . When reasonable in relation to the bidder's efforts and to the magnitude of the transaction, breakup fees are generally permissible.") (internal citations omitted).

120. *Id.* at 28-29.

121. *See infra* notes 123-124 and accompanying text.

122. *See In re* Integrated Res., Inc., 147 B.R. 650 (S.D.N.Y. 1992).

123. Kleiman, *supra* note 45, at 90 (citing *In re Integrated Res., Inc.*, 147 B.R. at 658).

124. *See, e.g.*, Cottle v. Storer Commc'n, Inc., 849 F.2d 570, 574-75 (11th Cir. 1988) (noting that the business judgment rule "protects the defendants from liability absent a clear showing of fraud, bad faith, or abuse of discretion").

more likely to award break-up fees for the stalking horse bidder than courts using alternative standards.[125]

There are many courts and scholars that have criticized bankruptcy courts' use of the business judgment rule for break-up fees.[126] Many of these critics believe that a court's primary goal when overseeing a bankruptcy asset sale should be to maximize the value of the sale for the benefit of the estate.[127] This concern has led many to argue that courts should not provide a debtor with the deference of the business judgment rule because parties to a non-bankruptcy corporate combination are unconcerned with the interests of creditors.[128] Those embracing this school of thought believe that corporate standards are inappropriate for assessing bid protection mechanisms in bankruptcy.[129] Instead, there "should be an extra layer of consideration for the interests of creditors . . . not present in a corporate transaction between two fully solvent parties."[130]

D. THE BEST INTERESTS OF THE ESTATE TEST

Instead of using the business judgment standard, some circuits have refashioned their approach to draw on bankruptcy-inspired rules for the

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125. *Compare In re* ASARCO LLC, 441 B.R. 813 (S.D. Tex. 2010) (approving a break-up fee under the business judgment rule), *aff'd sub nom. In re* ASARCO, LLC, 650 F.3d 593 (5th Cir. 2011) *and In re* Metaldyne Corp., 409 B.R. 661 (Bankr. S.D.N.Y. 2009) (same), *with In re* Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010) (holding that bankruptcy court did not abuse its discretion in denying the break-up fee under the administrative expense standard), *and In re* Beth Israel Hosp. Ass'n of Passaic, No. 06-16186, 2007 WL 2049881 (Bankr. D.N.J. July 12, 2007) (denying the break-up fee under the administrative expense standard).

126. *See, e.g.*, Markell, *supra* note 15, at 376 (noting that with respect to the use of the business judgment rule in § 363 sales, "it makes little sense blindly to adopt corporate rules for bankruptcy transactions").

127. *See, e.g.*, *In re* Atlanta Packaging Prods., Inc., 99 B.R. 124, 131 (Bankr. N.D. Ga. 1988) ("It is a well-established principle of bankruptcy law that the objective of bankruptcy sales and the trustee's duty with respect to such sales is to obtain the highest price or greatest overall benefit possible for the estate.").

128. *See, e.g.*, Markell, *supra* note 15, at 376 (arguing against the use of the business judgment rule for break-up fees in bankruptcy because, *inter alia*, "[t]he increased level of protection for creditors' priority claims gives rise to an increased level of obligation and duty on the part of those who negotiate bankruptcy asset sales").

129. *Id.*

130. *See* White, *supra* note 50, at 678.

evaluation break-up fees.[131] This prominent standard of review focuses on the "best interests of the estate."[132] Courts applying the test do not focus on "whether a breakup fee is within the business judgment of the debtor, but whether the transaction will further the diverse interests of the debtor, creditors and equity holders, alike."[133]

Under the best interests of the estate test, courts use a broader approach that focuses on whether the implementation of the break-up fee maximizes the value of the sale for the estate's creditors.[134] While courts consider different circumstances when employing the best interests of the estate test, some factors that are generally considered are: (1) whether the bid is higher than it would have been had the break-up fee not been granted; (2) whether the break-up fee provided net value to the estate; (3) whether a break-up fee is necessary to start the bidding process; and (4) whether the amount of the break-up fee is small relative to the overall benefit of the estate.[135] Courts embracing the best interests philosophy are willing to award break-up fees; however, many courts using the best interests standard place a high burden on the stalking horse bidder to validate the fee.[136]

Despite representing a middle ground between the business judgment rule and the administrative expense standard, the best interests

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131. *See, e.g.*, *In re* S.N.A. Nut Co., 186 B.R. 98 (Bankr. N.D. Ill. 1995) ("This Court agrees with *America West* that the proper standard for evaluating a breakup fee should be whether the interests of all concerned parties are best served by such a fee. The test is whether the payment of a breakup fee is in the best interests of the estate.").

132. *Id.* at 103.

133. *Id.* at 104-05 (internal quotations omitted).

134. *See id.* (noting that the question to consider when approving a break-up fee "is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will further the diverse interests of the debtor, creditors and equity holders, alike") (internal quotations omitted).

135. *See In re* Tama Beef Packing, Inc., 290 B.R. 90, 97 (B.A.P. 8th Cir. 2003); *In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997); *In re* Am. W. Airlines Inc., 166 B.R. 908, 912-13 (Bankr. D. Ariz. 1994).

136. *In re S.N.A. Nut Co.*, 186 B.R. at 105 (noting that, "absent compelling circumstances which clearly indicate that payment of the fee would be in the best interests of the estate, breakup fees should not be awarded in bankruptcy auction sales"); *see, e.g.*, *In re Tiara Motorcoach*, 212 B.R. at 137 (using the best interests of the estate test and denying the stalking horse bidder's request for a break-up fee); *but see In re* Sea Island Co., 10-21034, 2010 WL 4393269 (Bankr. S.D. Ga. Sept. 15, 2010) (approving the break-up fee under the best interests of the estate test).

of the estate test is not without its detractors.[137] Among the chief concerns surrounding the best interests of the estate test is its fluidity.[138] Although individual courts have articulated factors that they believe should be considered in the analysis,[139] there has been no version of the test that provides finite elements by which judges can evaluate the legitimacy of the fee request.[140] Many critics argue that the discretion afforded to bankruptcy judges by the best interests of the estate test leads to inconsistent results.[141]

E. THE ADMINISTRATIVE EXPENSE STANDARD—§ 503(b)

Notably, the Third Circuit is the only circuit in which a court of appeals has addressed the issue of break-up fees for stalking horse bidders.[142] The court of appeals for the Third Circuit had the opportunity to choose a side in the developing dichotomy of bankruptcy break-up fee jurisprudence in the 1999 case, *In re O'Brien Environmental Energy Inc.*[143] Instead of aligning with the pre-existing positions, the Third Circuit decided that none of the case law advocating for use of the business judgment standard or the best interests of the estate test "offer[ed] a compelling justification for treating an application for break-up fees and expenses under § 503(b) differently from other

137. *See e.g.*, McGrath, *supra* note 7, part C ("[W]ithout some evidence that the board has breached its duty to maximize the value of its bankruptcy estate a bankruptcy court should review a presale request of a break-up fee under the well-established modified business judgment standard.").

138. *See, e.g.*, Brown, *supra* note 4, at 1478 ("Although the In re Lionel Corp. court pioneered the Best Interest Standard by instructing judges to consider the impact of the break-up fee upon all stakeholders, it failed to provide judges with definite factors to help guide judges in their evaluation.").

139. *See, e.g.*, *In re* Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) (listing seven factors to be used in the analysis).

140. *See, e.g.*, *In re Tiara Motorcoach*, 212 B.R. at 137-38; *In re* Am. W. Airlines Inc., 166 B.R. 908 (Bankr. D. Ariz. 1994).

141. *See e.g.*, Brown, *supra* note 4, at 1477-84 (advocating for a change to the best interests of the estate test that provides judges with specific factors to assess).

142. *See* Garza et al., *supra* note 42, at 7.

143. *See* Calpine Corp. v. O'Brien Environmental Energy, Inc. (*In re* O'Brien Envtl. Energy, Inc.), 181 F.3d 527, 533 (3d Cir. 1999) ("The bankruptcy courts and district courts that have addressed the standard for break-up fees and expenses in bankruptcy proceedings have adopted [two] very different approaches.").

applications for administrative expenses under the same provision."[144] The Court went on to conclude that "the determination whether break-up fees or expenses are allowable under § 503(b) must be made in reference to general administrative expense jurisprudence."[145]

Under the administrative expense standard, a break-up fee is justifiable (like other administrative expenses), if the requesting party can show that the fees were "actual" and "necessary" to preserve the value of the estate.[146] To assess whether the break-up satisfies this standard, courts have considered two primary questions:[147] (1) whether the break-up fee was necessary to induce the stalking horse's bid; and (2) whether the break-up fee was necessary to preserve the stalking horse's bid at auction.[148] In answering these questions, *In re O'Brien* and its progeny have not been inclined to award break-up fees.[149] For instance, in the recent case *In re Reliant Energy Channelview LP*, the court declined the stalking horse's request for a break-up fee under the administrative expense standard, despite the fact that the majority of creditors and the "sole affected shareholder" of the debtor supported approval of the break-up fee.[150]

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144. *Id.* at 535.

145. *Id.*

146. 11 U.S.C. § 503(b) (2012).

147. However, it should also be noted that some courts have fleshed out these two factors further by listing specific criteria to be considered. This type of analysis is sometimes referred to as the "multi-factor 503(b) standard." *See, e.g.*, *In re* Tama Beef Packing, Inc., 290 B.R. 90, 97-98 (B.A.P. 8th Cir. 2003) (recognizing nine factors to be considered in the break-up fee analysis and denying the stalking horse's request for a break-up fee).

148. White, *supra* note 50, at 666 (citing *In re* Reliant Energy Channelview LP, 594 F.3d 200, 206 (3d Cir. 2010)).

149. *See, e.g.*, *In re Reliant Energy Channelview LP*, 594 F.3d at 210 (holding that the bankruptcy court did not abuse its discretion in denying the break-up fee); In *re* Tama Beef Packing, Inc., 290 B.R. 90 (B.A.P. 8th Cir. 2003) (affirming the bankruptcy court's denial of the break-up fee); *In re* O'Brien Envtl. Energy, Inc., 181 F.3d 527 (3d Cir. 1990) (affirming the district court's decision to deny the break-up fee); *In re* Beth Israel Hosp. Ass'n of Passaic, 06-16186 (NLW), 2007 WL 2049881 (Bankr. D.N.J. July 12, 2007) (denying the plaintiff's request for a break-up fee).

150. *In re Reliant Energy Channelview LP*, 594 F.3d at 203, 209; *see also In re* Beth Israel Hosp. Ass'n of Passaic, 06-16186 (NLW), 2007 WL 2049881 (Bankr. D.N.J. July 12, 2007) (noting that "the fact that the Debtor agreed to the break-up fee and thought that it was reasonable and appropriate is not determinative of the allowance of such a fee as an administrative expense").

The administrative expense standard's hard stance towards awarding break-up fees has been met with criticism, especially from stalking horse bidders. At the outset, detractors believe that the standard's heightened scrutiny deters potential bidders from assuming the role of the stalking horse.[151] From a statutory perspective, those in opposition to the administrative expense standard contend that break-up fees are strikingly dissimilar from typical administrative expenses.[152] Indeed, some argue that break-up fees and § 503(b) administrative expenses are distinguishable because administrative expenses are supposed to be reimbursements or repayments to legislatively preferred creditors, while break-up fees, in their truest form, are compensatory sums that do not represent reimbursement for costs incurred.[153] As such, critics believe that § 503(b) is an inappropriate method of reviewing break-up fees, as the statute only allows for "compensatory reimbursement" under nine specific situations which focus on expenses that are actual and necessary to preserving the value of the estate.[154]

F. THE NEED FOR UNIFORMITY

The various approaches discussed above may each have advantages and disadvantages depending on one's view of break-up fees. What is apparent from the analysis of the three approaches, however, is that the outcome of the break-up fee approval determination is intrinsically linked to which approach is taken by the court.[155] A court's decision to

151. *See, e.g.*, Kleiman, *supra* note 45, at 89 ("[The administrative expense standard] may deter potential [stalking horse] bidders from incurring the time and expense needed to conduct due-diligence and prepare a bid for the asset.").

152. *See, e.g.*, Brown, *supra* note 4, at 1475 ("Break-up fees and § 503(b) administrative expenses differ primarily in that administrative expenses are supposed to be reimbursements or repayments to legislatively preferred and designated creditors, while break-up fees are often excessive damages paid to outside and non-invested bidders who lose a later auction or fail to consummate a purchase agreement for some reason other than the fault of the stalking horse bidder.").

153. *Id.*

154. *See* 11 U.S.C. § 503 (2012); Brown, *supra* note 4, at 1476.

155. *Compare In re* O'Brien Envtl. Energy, Inc., 181 F.3d 527 (3d Cir. 1999) (affirming the bankruptcy court's denial of a break-up fee under § 503), *In re* Reliant Energy Channelview, LP, 403 B.R. 308 (D. Del. 2009) (same), *aff'd sub nom. In re Reliant Energy Channelview LP*, 594 F.3d at 210 (3d Cir. 2010), *and In re* Pub. Serv. Co. of New Hampshire, 160 B.R. 404 (Bankr. D.N.H. 1993) (denying an unsuccessful

use one approach over another can have a major effect on the ultimate outcome of the § 363 sale, from both the debtor's and the stalking horse's perspective.[156] While some courts and scholars have argued that break-up fees have no place in § 363 sales at all,[157] the discussion that follows will presume that, at least for the time being, stalking horse bidders will be entitled to request approval of a break-up fee arrangement. As such, courts must come to a consensus as to the appropriate standard of review for break-up fees in bankruptcy.

The uncertainty surrounding break-up fees in § 363 sales can lead to unpredictable results in Chapter 11 cases where potential stalking horse bidders are unsure of whether the court will approve their request for a fee.[158] The differing standards encourage parties to forum shop; specifically, they encourage potential purchasers to seek investment opportunities in jurisdictions using the more lenient business judgment

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bidder's claim for a break-up fee under § 503), *with In re* Integrated Res., Inc., 135 B.R. 746, 753, *aff'd* 147 B.R. 650 (S.D.N.Y. 1992) (affirming the bankruptcy court's use of the business judgment rule to approve a break-up fee), *In re* AmTrust Fin. Corp., 09-21323, 2010 WL 4917553 (Bankr. N.D. Ohio Feb. 25, 2010) (approving the break-up fee where the fee "constituted a fair and reasonable exercise of the debtor's business judgment"), *and In re* ASARCO LLC, 441 B.R. 813 (S.D. Tex. 2010) (affirming the bankruptcy court's use of the business judgment rule to approve a break-up fee), *aff'd sub nom. In re* ASARCO, LLC, 650 F.3d 593 (5th Cir. 2011).

156. *Compare In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999) (affirming the bankruptcy court's denial of a break-up fee under § 503), *In re Reliant Energy Channelview, LP*, 403 B.R. at 312 (same), *aff'd sub nom. In re Reliant Energy Channelview LP*, 594 F.3d at 200, *and In re* Pub. Serv. Co. of New Hampshire, 160 B.R. 404 (Bankr. D.N.H. 1993) (denying an unsuccessful bidder's claim for a break-up fee under § 503), *with In re Integrated Res., Inc.*, 135 B.R. 746, 753 *aff'd*, 147 B.R. at 664 (S.D.N.Y. 1992) (affirming the bankruptcy court's use of the business judgment rule to approve a break-up fee), *In re* AmTrust Fin. Corp., 09-21323, 2010 WL 4917553 (Bankr. N.D. Ohio Feb. 25, 2010) (approving the break-up fee where the fee "constituted a fair and reasonable exercise of the debtor's business judgment"), *and In re ASARCO LLC*, 441 B.R. at 833 (affirming the bankruptcy court's use of the business judgment rule to approve a break-up fee), *aff'd sub nom. In re ASARCO, LLC*, 650 F.3d at 603

157. *See e.g.*, Markell, *supra* note 15, at 386; *In re* S.N.A. Nut Co., 186 B.R. 98, 104 (Bankr. N.D. Ill. 1995) (noting that, "absent compelling circumstances which clearly indicate that payment of the fee would be in the best interests of the estate, breakup fees should not be awarded in bankruptcy auction sales").

158. *See* Brown, *supra* note 4, at 1467 ("[T]he lack of a uniform standard leaves stalking horse bidders guessing whether bankruptcy judges will approve or deny their break-up fees . . . .") (internal citation omitted).

rule.[159] Furthermore, the task of soliciting a qualified initial bidder seems daunting for a debtor that will not be able to speak definitively as to what bidding incentives it can offer.[160] Similarly, stalking horse bidders that have preliminarily agreed to submit a bid for assets in a § 363 sale will be wary of how many resources to commit to the process if they are unsure of whether their rights to a break-up fee will be upheld.[161] Ultimately, this confusion can lengthen § 363 sale negotiations and detract from the value received for the assets.[162]

III. BALANCING THE APPROACH

Part II examined the three prominent approaches employed by bankruptcy courts when reviewing break-up fee requests and demonstrated the importance of establishing a uniform framework for making such a determination. This Part argues in favor of using the best interests of the estate test to determine whether to award break-up fees to stalking horse bidders. The best interests of the estate test represents a balanced approach implicated by the new role of § 363 sales in Chapter 11.

A. THE ROLE OF THE BANKRUPTCY COURT IN CHAPTER 11

Adversary proceedings aside, a bankruptcy judge's primary role is to oversee the debtor's estate and ensure that parties in interest comply with the bankruptcy procedures.[163] Instead of a universal approach, the

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159. *See* Lynn M. LoPucki, Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts 13-16 (Univ. of Michigan Press 2006) *(*noting that bankruptcy courts can and have solicited lucrative bankruptcy cases by using their discretion to make their jurisdiction appear more favorable for corporate bankruptcy filings).

160. *See* Hebbeln, *supra* note 13, at 505 (advocating for a uniform amendment to the Bankruptcy Code because "[p]arties" to break-up fee arrangements [in most bankruptcy courts] cannot know which line of reasoning their court will adopt" with respect to break-up fees).

161. Markell, *supra* note 15, at 375 (noting that stalking horse bidders anticipating strict review of their purchase agreement will lower their bid accordingly to compensate for the risk of losing the break-up fee).

162. *See id.*

163. Bruce M. Price, *Halting, Altering and Agreeing*, 38 S.U. L. Rev. 233, 243-44 (2011) ("[T]he role of the judge in a Chapter 11 bankruptcy case differs markedly from

Bankruptcy Code sets forth various frameworks for courts to employ depending on the type of case before the court.[164] It seems unlikely that Congress would have fashioned alternative methods by which a debtor could enter bankruptcy if Congress did not in fact wish to differentiate the role of the bankruptcy court in each proceeding.[165] It follows that a consideration of the level of scrutiny warranted by break-up fees necessarily entails an assessment of the role of the bankruptcy court in a Chapter 11 case.

Generally, a debtor remains in control of its operations as a "debtor-in-possession" ("DIP") in Chapter 11 cases.[166] Unlike Chapter 7 where a trustee is automatically appointed,[167] a bankruptcy judge will only appoint a trustee in a Chapter 11 case when a party in interest can demonstrate a need for one.[168] An analysis of the legislative history of Chapter 11 "explains that the primary reason for leaving the debtor in possession is that the continuation of experienced management will benefit both debtors and creditors by leading to a greater likelihood of successful reorganization."[169] The appointment of a trustee, on the other hand, may delay and hinder the Chapter 11 process due to the trustee's lack of familiarity with the debtor's business.[170] Accordingly, reasons

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that of a judge in an adversarial civil proceeding. Unlike all other forms of adversarial jurisprudence, the judge's essential role is not to decide between competing claims of litigants. Rather, the judge oversees the process and makes sure that the parties comply with the rules.").

164. For instance, the Bankruptcy Code uses Chapter 7 for debtor liquidations, Chapter 11 for debtor reorganizations, and Chapter 13 for consumer debt readjustments.

165. *See In re* Crouse, 9 B.R. 400, 402 (Bankr. S.D. Tex. 1981) ("The intent of the drafters of the Code was to provide similar approaches for all types of cases except where obviously inappropriate, for example rehabilitation versus liquidation.").

166. *See* John T. Roache, *The Fiduciary Obligations of a Debtor in Possession*, 1993 U. Ill. L. Rev. 133, 138 (1993) ("In most cases, the debtor remains in control of the estates as DIP.").

167. *See* 11 U.S.C. §§ 701-03 (2012).

168. *See* Roache, *supra* note 166, at 138 ("In Chapter 11 . . . a court appoints a trustee only when the need for one can be demonstrated.").

169. *See id.* at 152

170. *See In re* Bonded Mailings, Inc., 20 B.R. 781, 785-86 (Bankr. E.D.N.Y. 1982) (noting that appointment of a trustee in a Chapter 11 case is an "extraordinary remedy" because such action "will generally necessitate the [displacement] of the current experienced management with those probably less familiar with the field at a time when the enterprise itself is usually tottering on the brink of financial collapse").

for leaving a debtor in a position of control in Chapter 11 coincide with its statutory purpose: rehabilitation of the debtor's business.[171]

In keeping with the theme of rehabilitation, another statutory aim for Chapter 11 was to limit the judge's discretion in oversight over the case where Congress assumed that the debtor would re-emerge after the bankruptcy.[172] As such, bankruptcy courts typically scrutinize a Chapter 11 DIP's actions under the business judgment rule.[173] In the corporate context, the guiding view is that it is more appropriate for executives and directors to make business decisions than the courts.[174] It is no surprise, therefore, that bankruptcy courts rarely hesitate to defer to the DIP's judgment concerning transactional matters in Chapter 11 cases.[175]

B. THE ADMINISTRATIVE EXPENSE TEST GOES TOO FAR

The bankruptcy court's more limited role in the Chapter 11 process provides credence for the argument against using the administrative expense test to evaluate break-up fees in § 363 sales.[176] The

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171. C-TC 9th Ave, P'ship v. Norton Co. (*In re* C-TC 9th Ave. P'ship), 113 F.3d 1304, 1310 (2d Cir. 1997) ("[T]he purpose of Chapter 11 reorganization is to assist financially distressed business enterprises by providing them with breathing space in which to return to a viable state.") (internal quotations omitted).

172. Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 Wis. L. Rev. 729, 746 (1993) ("One of the key concepts behind Chapter 11 was to remove bankruptcy judges from the administration of bankruptcy cases and permit them to act solely in a judicial capacity.").

173. *See, e.g.*, COR Route 5 Co., LLC v. The Penn Traffic Co. (*In re* Penn Traffic Co.), 524 F.3d 373 (2d Cir. 2008); *In re* Old Carco LLC, 406 B.R. 180 (Bankr. S.D.N.Y. 2009); Covey v. Soy Capital Bank and Trust Company (*In re* T.A. Brinkoetter & Sons, Inc.), No. 09-80727, 2012 WL 1865485 (Bankr. C.D. Ill. May 22, 2012).

174. *See, e.g.*, *In re* Lyon & Reboli, Inc., 24 B.R. 152 (Bankr. E.D.N.Y. 1982) ("[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant.") (internal quotations omitted).

175. *See e.g.*, *In re* Genco Shipping & Trading Ltd., 509 B.R. 455, 463 (Bankr. S.D.N.Y. 2014) ("A court will generally not second-guess a debtor's business judgment regarding whether the assumption or rejection of a contract will benefit the debtor's estate."); *In re* Johns-Manville Corp., 60 B.R. 612, 615-16 (Bankr. S.D.N.Y. 1986) ("[T]he Code favors the continued operation of a business by a debtor and a presumption of reasonableness attaches to a debtor's management decisions.").

176. *See* Part III.A.

administrative expense test is inherently an ex-post facto method of review.[177] To decide whether to approve a payment as an administrative expense, the bankruptcy court must use hindsight to assess whether the expense was "actual" and "necessary" to preserve the value of the estate.[178] Notably, the issue before the court in *In re O'Brien* was whether or not to approve a post-sale petition for a break-up fee, as opposed to the typical scenario in which a break-up fee is considered prior to the sale.[179] Therefore, the Third Circuit was not truly evaluating the merits of a break-up fee provision.[180] Rather, the Court was really reviewing a claimant's § 503(b) request for fees that happened to arise out of a break-up fee agreement.[181] Unlike complex financial transactions, payment of an administrative claim is a feature of bankruptcy law that comes within the ken of the bankruptcy court, not the business executives of the debtor.[182] Thus, under the circumstances, the court was within its bounds to assess whether that particular request for a break-up fee was reasonable under § 503.[183]

In practice, however, most bankruptcy courts deal with pre-sale approval of break-up fee provisions.[184] Therefore, most § 363 sales require bankruptcy courts to consider the merits of a break-up fee prior

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177. Kevin M. Baum, *It's Not About Breaking Up: A Contract-Consideration Based "Dowry" as an Alternative to Breakup Fees in Bankruptcy*, 2012 Ann. Surv. of Bankr. Law 11, part C, 1 (2012) (noting that the administrative expense test requires the court to use "hindsight").

178. 11 U.S.C. § 503(b)(1)(A) (2012).

179. *In re* O'Brien Envtl. Energy, Inc., 181 F.3d 527, 530 (3d Cir. 1999).

180. *See* White, *supra* note 50, at 680-81 (arguing that "because Reliant concerned a pre-auction break-up fee request, Section 503 and O'Brien were inapplicable").

181. Garza et al., *supra* note 42, at 10-11 (arguing that the *O'Brien* court was really adjudicating a "request by an alleged administrative claimant asserting the right to payment under section 503(b)").

182. 11 U.S.C. § 503(b)(1)(a) (2012); *see also* Garza et al., *supra* note 42, at 10 (commenting that under the factual circumstances of the *O'Brien* case, "the Third Circuit's ruling that Calpine's request should be governed by section 503(b) rather than section 363(b)(1) is understandable and most likely correct").

183. *See supra* notes 180-81.

184. *See* Garza et al., *supra* note 42, at 10 (citing Harvey R. Miller & Shai Y. Waisman, *Asset Sales & Auctions: A Primer*, 826 Comm. Law & Prac. Practice Guide Handbook Series 105, 162 (2001)).

to the actual auction.[185] As one commentator has succinctly stated: "[i]n order to apply the section 503(b) standard to a presale break-up fee, a court would have to make a determination as to whether the fee is actual and necessary to preserve the value of the estate, without having seen the actual outcome of the bidding process."[186] Practically speaking, it is quite difficult for a court to determine the necessity of a break-up fee prior to observing its effects.[187] That is to say, a debtor will not be able to know if stipulating to a break-up fee with the stalking horse bidder was beneficial until after the sale is consummated.[188] Therefore, the decision to utilize a break-up fee as a bidding incentive is more of a business issue than a typical bankruptcy procedure.[189] Consequently, it is a concern that should be dealt with, at least in part, by relying on the business acumen of the Chapter 11 debtor.

C. The Business Judgment Rule Is Inapt Because § 363 Sales Are Distinct From Non-Distressed Sales

The transactional aspect of break-up fees within § 363 sales, insofar as it relates to the competing judgments of the bankruptcy court and the debtor, indicates that the administrative expense test is unsuitable for determining whether to award break-up fees to stalking horse bidders.[190] Simply put, the administrative expense test affords the court too much

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185. *See* Garza et al., *supra* note 42, at 10 (noting that a "typical" 363 sale consists of the stalking horse or debtor seeking approval of the proposed break-up fee prior to the auction).

186. McGrath, *supra* note 7, n.193-94 and accompanying text.

187. *Id.* at n.193-94 and accompanying text (concluding that "using the *O'Brien* section 503(b) administrative expense test to determine whether a presale break-up fee should be allowed is not only impractical, it is impossible").

188. *See* McGrath, *supra* note 7, at n.193-94 and accompanying text ("Courts should not be able to determine whether a break-up fee is 'actual and necessary' unless there has been an auction with which the court can determine whether the fee was actual and necessary.").

189. *See* McGrath, *supra* note 7, at n.214-15 and accompanying text ("Break-up fees only come into existence as part of a section 363 sale and are never seen in any other context in bankruptcy.").

190. *See* Part III.A (explaining that the administrative expense test is unsuitable for review of break-up fees because it is an ex-post test, whereas break-up fee approvals are typically requested prior to auction, and have more characteristics of a business decision than a bankruptcy procedure).

control in an area that is best left in the hands of the debtor.[191] This is not to say, however, that the debtor should be entitled to the deference afforded by the business judgment rule when deciding whether to include a break-up fee provision into a purchase agreement in a § 363 sale. Instead, courts should consider, but not blindly follow the debtor's judgment because § 363 sales are distinct from non-distressed asset sales.[192]

A comparative analysis of healthy versus distressed asset sales indicates that the two processes are far too different to defer to the business judgment of the debtor in the latter case.[193] In healthy corporate combinations, whether or not by auction, the management's responsibility is to produce the best return for the shareholders.[194] Consequently, in the non-distressed situation the business's management constructs a deal that ultimately affects the potential profits earned by the shareholders.[195] Whether or not a shareholder profits from its ownership stake in a company is a risk intrinsically linked to the shareholder's investment in that company.[196] Therefore, the margin for error afforded to a corporation's management in a healthy asset sale correlates to the investment risk contemplated by the corporation's shareholders.[197] On the other hand, a DIP's duty is to the estate's

191. *See* McGrath, *supra* note 7, n.190.

192. *See In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("A sale pursuant to § 363 of the Bankruptcy Code is not in the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered.").

193. *See* Markell, *supra* note 15, at 376 (arguing that "it makes little sense blindly to adopt corporate rules for bankruptcy transactions").

194. *See id.* at 372 (stating that, in the corporate context, "[e]ven if an auction duty is applicable, [management must] conduct a fair process designed to yield the best price for the shareholders").

195. *See id.* at 376 (noting that in corporate combinations "[e]very marginal dollar gained or lost through the use of breakup fees is just another dollar, more or less, of the shareholders' profit").

196. *See id.* at 376 ("The inability of management to maximize [company] profit due to bad business decisions is just one of the risks that shareholders assume when they invest.").

197. *Id*.

creditors.[198] The return reaped by a § 363 sale is not profit for the creditors, it is recompense.[199] Accordingly, the methods used by a DIP's management to consummate a § 363 sale must be limited because the beneficiaries of the sale, the creditors, are concerned with reimbursement, not reward.[200] Courts reviewing healthy corporate combinations have increased their level of scrutiny for break-up fees, despite their steadfast use of the business judgment rule for broad review of the entire transaction.[201] It stands to reason that the divergent interests present in a Chapter 11 case merit a similar, if not greater, increase in the level of scrutiny applied towards break-up fees in § 363 sales.

D. THE NON-PLAN LIQUIDATION ASPECT OF § 363 JUSTIFIES THE USE OF THE BEST INTERESTS OF THE ESTATE TEST

The absence of extra protection for the estate's creditors inherent in the business judgment rule is particularly concerning due to the tendency for § 363 sales to become non-plan liquidations of

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198. *See In re* Grabill Corp., 113 B.R. 966, 970 (Bankr. N.D. Ill. 1990) ("A Chapter 11 debtor-in-possession administers the assets of the estate and any business conducted therein, as a fiduciary for both the equity interests and creditors.") (internal citations omitted).

199. *See* 11 U.S.C. § 101 (defining creditor as, *inter alia*, an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor"). It is important to note that debts are generally incurred by the parties to a healthy business relationship, thus the cash generated by a § 363 sale goes toward the creditor's predetermined remuneration, not toward an additional return on the creditor's investment.

200. *See In re* Betacom of Phoenix, Inc., 240 F.3d 823, 829 (9th Cir. 2001) (commenting that, "shareholders expect to take more risk than creditors in return for the right to participate in firm profits. The creditor only expects repayment of a fixed debt"); *see also* Markell, *supra* note 15, at 374 ("Since creditors often face a loss even in the best of bankruptcies, bankruptcy sales are supposed to yield the best deal that will result in distributable dividends to unpaid creditors.").

201. *See* CRTF Corp. v. Federated Dep't Stores, Inc., 683 F.Supp. 422 (S.D.N.Y. 1988) (noting in its analysis that break-up fees in corporate combinations "are not illegal where they enhance rather than chill bidding"); *see also* Samjens Partners I v. Burlington Indus., Inc., 663 F.Supp. 614, 624 (S.D.N.Y. 1987) ("In coordinating the bidding process, the board can institute strategies, such as . . . a break-up fee . . . but only if their strategies enhance the bidding.").

substantially all of the debtor's assets.[202] Although Chapter 11 provides debtors with the opportunity to sell assets, that feature is typically in consideration of the debtor's re-emergence as a going concern after the bankruptcy.[203] In essence, § 363 sales have become a backdoor way for debtors to completely liquidate without going through the traditional Chapter 7 process.[204] Whether or not a break-up fee ultimately increases the price received for the liquidation sale,[205] the break-up fee does nominally reduce the net return on the assets and therefore, the value for the estate.[206] For that reason, when the debtor's focus shifts from rehabilitation to liquidation, the bankruptcy court's focus must shift from preserving the debtor's business as a going concern to securing the greatest distribution for the debtor's creditors.[207] As a corollary, this shift in focus requires a heightened level of scrutiny for the award of break-up fees.[208]

From a policy standpoint, it seems that the court's role in the § 363 process should mirror that of the heightened supervision of Chapter 7.[209] Yet, that position does not take into account the benefits of the debtor's

202. *See supra* notes 37-38 and accompanying text (noting this trend).

203. *See In re* Bombay Co., Inc., 07-44084-RFN-11, 2007 WL 2826071 (Bankr. N.D. Tex. Sept. 26, 2007) (noting that, "chapter "is not intended principally as a vehicle for sales of virtually all estate property under § 363(b)(1) . . . The court would infinitely prefer that a chapter 11 case be resolved through the plan process") (internal citations omitted).

204. *See* Rose, *supra* note 27, at 259 (noting that the sale of the debtor's entire business was neither intended nor contemplated by the drafters of § 363) (internal citations omitted).

205. *See* Markell, *supra* note 15, at 360-69 (debating this point).

206. The break-up fee lowers the net return on the sale of assets because it is deducted from the proceeds of the sale.

207. Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*, 159 U. Pa. L. Rev. 1189, 1197 (2011) (noting that the § 363 sales must be scrutinized more closely than traditional Chapter 11 sales because of the process's potential to "deviate from several goals of bankruptcy law" such as "securing equal distribution among creditors of the same class").

208. *Cf. id.*

209. *Compare* 11 U.S.C. § 704 (2012) (outlining the duties of the trustee and highlighting the necessity for court approval for the trustee's actions), *with* notes *supra* 169-171 and accompanying text.

familiarity with its own business.[210] Nonetheless, the court must provide heightened scrutiny for unique circumstances in § 363 sales, such as break-up fees, where creditors are not afforded the protections typical to an asset sale under a plan of reorganization.[211] Most notably, creditors must approve sales conducted pursuant to a Chapter 11 plan via the confirmation process.[212] In that regard, the onus is on the debtor's management to formulate a suitable plan. On the other hand, once a court allows a debtor to proceed with a non-plan sale, § 363's notice and hearing requirements put the burden on the estate's creditors to object.[213] In short, plan confirmation is conditioned upon creditor approval, whereas § 363 sale approval depends on the creditors' inability or failure to object.[214] This is particularly troubling given § 363 sales' non-specific notice provision, which merely requires the debtor to give notice "as is appropriate in the particular circumstances."[215] Unlike a plan sale's formal disclosure obligations,[216] § 363's relaxed notice requirement weakens creditors ability to both understand and object to the sale.[217]

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210. *See* Rose, *supra* note 27, at 259 (noting that the Chapter 11 DIP's "[p]re-existing business relationships and industry expertise are generally seen as tools to maximize the estate value, especially when compared to the options of distressed sales or public auctions by a trustee in Chapter 7").

211. *See In re* Naron & Wagner, Chartered, 88 B.R. 85, 88 (Bankr. D. Md. 1988) (noting that the Court had a responsibility to review this proposed § 363 sale carefully because, *inter alia*, "the sale will liquidate a substantial asset of Debtor; and the sale is a preconfirmation sale controlled by the Debtor in Chapter 11, rather than a sale within a Chapter 7 case where a disinterested trustee controls the proposed liquidation of assets").

212. *See* 11 U.S.C. §§ 1126(c) and 1129 (2012).

213. *See* 11 U.S.C. § 363(b)(1); Rose, *supra* note 27, at 260 (noting that "the onus for objecting to a § 363(b) transaction is borne by the objecting party").

214. Rose, *supra* note 27, at 262; *compare* 11 U.S.C. § 1129(a)(7)-(8) (2012) (stating that the court can only confirm a plan of reorganization if, *inter alia*, each holder of a claim or interest has accepted the plan), *with* 11 U.S.C. § 363(b)(1) (2012) (stating that "[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate").

215. 11 U.S.C. § 102(1)(A) (2012).

216. *See* 11 U.S.C. § 1125(b) (2012).

217. *See* Rose, *supra* note 27, at 259 ("With a § 363 sale, fewer people receive less information, and the lack of a disclosure requirement weakens creditor leverage when compared with what leverage they may have had with Chapter 11 plan confirmation.").

Ironically, bankruptcy courts were tasked with weighing similar conflicting interests when they first faced the issue of whether to approve § 363 sales for debtors who intended to sell the majority or all of their assets.[218] Although commonplace now, bankruptcy courts were initially hesitant to allow debtors to use § 363 in a way that would effectively circumvent the plan process.[219] The standard used today, the "sound business purpose" test,[220] was first articulated in the Second Circuit case *In re Lionel Corporation*.[221] Reviewing a § 363 sale of substantially all of the debtor's assets, the Court had to determine whether the proposed sale, although applied for by the debtor and supported by the creditor's committee, was valid under Chapter 11 where it faced legitimate objection by the debtor's equity shareholders.[222] Instead of simply relying on the business judgment rule, the court established that the business justification required to warrant a § 363 sale must ultimately take into account the interests of the estate.[223]

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218. *See In re* White Motor Credit Corp., 14 B.R. 584 (Bankr. N.D. Ohio 1981) (arguing that selling substantially all of the debtor's assets via 363 "side-steps the procedural and substantive provisions of Chapter 11 itself, including the disclosure statement, vote and confirmation standards") (internal citations omitted).

219. *Id.* at 590 (holding that "Section 363(b) does not authorize sale of all or substantially all assets of the estate").

220. *In re* Titusville Country Club, 128 B.R. 396, 399 (Bankr. W.D. Pa. 1991).

221. *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application.").

222. *See id.* at 1066 ("The Committee of Equity Security Holders . . . appealed this order claiming that the sale, prior to approval of a reorganization plan, deprives the equity holders of the Bankruptcy Code's safeguards of disclosure, solicitation and acceptance and divests the debtor of a dominant and profitable asset which could serve as a cornerstone for a sound plan. . . .The Creditors' Committee favors the sale because it believes it is in the best interests of Lionel and because the sale is expressly authorized by § 363(b) of the Code. [The Debtor] tells us that . . . [the] sale will provide the estate with the large block of the cash needed to fund its plan of reorganization.").

223. *Id.* at 1071 ("In fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike."); *see* Uziel, *supra* note 207, at 1200 ("In determining that the 'appeasement of major creditors' alone does not constitute a good business reason for judicial approval of a § 363 sale,

Similar to the sound business purpose test, the best interests of the estate test considers the business judgment of the debtor while adding an additional level of protection for the interests of the estate.[224] To achieve this effect, the best interests test allows the bankruptcy court to consider both the procedural and substantive validity of the proposed break-up fee.[225] Procedurally, the test first confirms that the debtor made an appropriate business decision when negotiating the break-up fee.[226] This ensures that the experienced judgment of the debtor is not overlooked in the § 363 process, which is fundamentally a business transaction.[227] The

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the Second Circuit implied that the business justification in the bankruptcy context must take into account equity and creditor interests, in addition to the business's interests.").

224. *Compare In re Lionel Corp.*, 722 F.2d at 1071 (describing relevant factors of the sound business purpose test to be: "the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and whether the asset is increasing or decreasing in value"), *with In re* Hupp Indus., Inc., 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) (describing the relevant factors to be considered using the best interests of the estate test as: "Whether the fee requested correlates with a maximization of value to the debtor's estate; *Whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and the negotiating acquirer*; Whether the principal secured creditors and the official creditors committee are supportive of the concession; Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price; Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders; The existence of available safeguards beneficial to the debtor's estate; Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee") (emphasis added).

225. *See In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) (explaining that the best interests of the estate test includes "a determination that *all* aspects of the transaction are in the best interests of all concerned").

226. *See, e.g.*, *In re Hupp Indus., Inc.*, 140 B.R. at 194 (noting at the outset of its analysis of whether to award the bidder's request for a break-up fee that the fee was negotiated as part of an "arms-length" transaction and constituted a fair and reasonable fee with respect to the magnitude of the transaction).

227. *See, e.g.*, *In re* Sea Island Co., 10-21034, 2010 WL 4393269 (Bankr. S.D. Ga. Sept. 15, 2010) (approving the fee, *inter alia*, because "the record establish[ed] that [the sale] was an arms-length transaction, given the lengthy negotiations between multiple parties over the terms and amount of the break-up fee from at least the second round of the process").

best interests test, however, goes one step further by reviewing the substance of the transaction to confirm that the break-up fee has or will improve the outcome of the § 363 sale.[228] This additional safeguard helps to realign the § 363 sale towards its fundamental purpose of generating value for the estate's creditors.[229]

CONCLUSION

The best interests of the estate test constitutes the appropriate level of scrutiny for break-up fees § 363 sales. The administrative expense test ignores the business expertise of the debtor and makes it exceedingly difficult for courts to award break-up fees to stalking horse bidders that take on the risk of purchasing distressed assets via public auction. On the other end of the spectrum, the deference required by the business judgment rule, if applied to the debtor's acquiescence to a break-up fee,[230] would "straightjacket the bankruptcy judge so as to prevent him from doing what is best for the estate."[231] By reviewing break-up fees under the best interests of the estate test, bankruptcy courts are able to shield creditors from undue harm to the estate while providing financially sophisticated debtors with a swift process by which to liquidate assets. Using the best interests of the estate test for break-up fees provides courts with the heightened control over § 363 sales implicated by the provision's role in modern Chapter 11 bankruptcy. If applied consistently throughout bankruptcy courts, the best interests of the estate test will provide the appropriate level of protection for Chapter 11 creditors and will help guide debtors and stalking horse bidders towards consummating efficient and fair § 363 sales.

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228. *See In re Hupp Indus., Inc.*, 140 B.R. at 195-96 (explaining that the court denied the break-up fee because, although it appeared reasonable and was fairly negotiated, the provision was non-contingent. As such, the fee was "an unwarranted expense upon the Debtor's estate").

229. *See supra* note 36 and accompanying text.

230. *See supra* Part II.B (indicating that it is most likely the situation that a stalking horse bidder would request the break-up fee and the debtor would agree to it, not vice versa).

231. *In re* Lionel Corp., 722 F.2d 1063, 1069 (2d Cir. 1983).