Do Private Equity “Club Deals” Violate the Anti-Collusive Bidding Prohibitions of Bankruptcy Code Section 363(n)

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Introductions

**Anthony J. Napolitano**
- Insolvency and Financial Solutions Practice Group
- Represents financial institutions, creditor committees, asset purchasers, unsecured creditors, lessors and debtors in various financial restructuring and bankruptcy matters.
- Represented industries include commercial real estate, retail, manufacturing, hospitality, energy and transportation.

**Philip C. Schroeder**
- Corporate Practice Group; Intellectual Property Group (Chair)
- Represents early stage and middle market companies with an emphasis on financing transactions and technology agreements.
- Advises on mergers and acquisitions, bridge loan financings, preferred stock financings, and entity formation.
Collusion (kəˈlōoZHən) – noun:

• A secret agreement, especially for fraudulent or treacherous purposes; conspiracy.
• An agreement between two or more persons to defraud another or to obtain something forbidden by law.
• A non-competitive agreement between rivals that attempts to disrupt the market's equilibrium.
Chapter 11
What is Private Equity?

• An alternative source of capital for businesses.
What is Private Equity?

• Broadly defined to include the following different investments:
  – **Leveraged Buyout**: Leveraged buyout (LBO) refers to the purchase of all or most of a company or a business unit by using equity from a small group of investors in combination with a significant amount of debt. The targets of LBOs are typically mature companies that generate strong operating cash flow.
  – **Growth Capital**: Growth capital typically refers to minority equity investments in mature companies that need capital to expand or restructure operations, finance an acquisition or enter a new market, without a change of control of the company.
  – **Mezzanine Capital**: Mezzanine capital refers to an investment in subordinated debt or preferred stock of a company, without taking voting control of the company. Often these securities have attached warrants or conversion rights into common stock.
  – **Venture Capital**: Venture capital refers to equity investments in less mature non-public companies to fund the launch, early development or expansion of a business.
Explosion of Private Equity Deals

Private Equity Assets Under Management Reached $1.2 Trillion in 2008
Leveraged buyout assets under management 1, 2003 – 2008, $ in billions

Note 1: Assets under management defined as sum of funds raised in the current year plus the previous four years.
Source: McKinsey Global Institute; Preqin
## Major Private Equity Club Deals

<table>
<thead>
<tr>
<th>Date</th>
<th>Company</th>
<th>Price</th>
<th>Buyers</th>
</tr>
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<tbody>
<tr>
<td>July 2005</td>
<td>Toys “R” Us</td>
<td>$6.6 billion</td>
<td>Kohlberg Kravis Roberts (“KKR”); Bain Capital; Vornado</td>
</tr>
<tr>
<td>Aug. 2005</td>
<td>SunGard Data Systems</td>
<td>$11.3 billion</td>
<td>Silver Lake Partners; the Blackstone Group; TPG Capital; Thomas H. Lee Partners; KKR; Providence Equity Partners</td>
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<tr>
<td>Dec. 2005</td>
<td>Hertz Corp.</td>
<td>$15.0 billion</td>
<td>Clayton, Dubilier &amp; Rice; the Carlyle Group; Merrill Lynch Global Private Equity</td>
</tr>
<tr>
<td>Jun. 2006</td>
<td>Univision Communications</td>
<td>$12.3 billion</td>
<td>Thomas H. Lee Partners, TPG Capital, Providence Equity Partners, Madison Dearborn Partners, Saban Capital</td>
</tr>
<tr>
<td>Jul. 2006</td>
<td>HCA Corp.</td>
<td>$33.0 billion</td>
<td>Bain Capital; KKR; Merrill Lynch Global Private Equity</td>
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<td>Aug. 2006</td>
<td>Kinder Morgan</td>
<td>$15.0 billion</td>
<td>Goldman Sachs, the Carlyle Group, Riverstone Holdings</td>
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<td>Sept. 2006</td>
<td>Freescale Semiconductor</td>
<td>$17.6 billion</td>
<td>The Blackstone Group; The Carlyle Group; Permira; TPG Capital</td>
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<tr>
<td>Nov. 2006</td>
<td>Clear Channel Communications</td>
<td>$26.7 billion</td>
<td>Thomas H. Lee Partners, Bain Capital Partners</td>
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<td>Feb. 2007</td>
<td>TXU</td>
<td>$45.0 billion</td>
<td>KKR, TPG Capital, Goldman Sachs</td>
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<tr>
<td>Sept. 2007</td>
<td>Biomet</td>
<td>$11.4 billion</td>
<td>KKR, The Blackstone Group, TPG Capital, Goldman Sachs</td>
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Most Active Club Participants

• Number of Club Deals Among Top 50 PE Firms:
  – TPG Capital (18)
  – Goldman Sachs (13)
  – Blackstone Group (12)
  – KKR (11)
  – Thomas H. Lee (6)
  – Bain Capital (6)
  – Providence Equity (6)
It’s Quite “Clubby” at the Top

- Frequency of teaming in major deals through 2007:

<table>
<thead>
<tr>
<th></th>
<th>Blackstone</th>
<th>KKR</th>
<th>Goldman</th>
<th>Providence</th>
<th>Bain Capital</th>
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<td>TPG</td>
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<td>Blackstone</td>
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<td>KKR</td>
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Club Deals Can Be Competitive

• Univision Communications (2006) ($12.3bn)
  – Prevailing Club:
    • TPG, Thomas H. Lee, Providence, Madison Dearborn, Saban Capital
  – Losing Club:
    • KKR, Blackstone, Bain Capital, Carlyle Group, Grupo Televisa
  – Increase in Sale Proceeds: $1.3bn

• Freescale Semiconductor (2006) ($17.6bn)
  – Prevailing Club:
    • TPG Capital, Blackstone, Carlyle, and Permira
  – Losing Club:
    • KKR, Bain Capital, Silverlake Partners
  – Increase in Sale Proceeds: $1.6bn
Increased Scrutiny of Club Deals

• U.S. Department of Justice Investigation
  – Were there agreements to depress prices on deals?
  – Fishing Expedition: Inquiry Letters vs. Search Warrants
  – DOJ Competitor Collaborations Guidelines
    • Absent collusion club deals are viewed under “rule of reason”

• And then . . . the lawsuits:
  – In re Toys “R” Us, Inc. Shareholder Litigation
  – Pennsylvania Avenue Funds v. Borey
  – Murphy v. Kohlberg Kravis Roberts & Company
In re Toys “R” Us

• “Their rationale for joining together, to spread the risk that would be incurred by undertaking what the plaintiffs have said is the largest retail acquisition by financial buyers ever, was logical and is consistent with an emerging practice among financial buyers.”

• “By banding together, these buyers are able to make bids that would be imprudent, if pursued in isolation.”

• “The plaintiffs’ continued description of the KKR’s group as ‘collusive,’ is not only linguistically imprecise, it is a naked attempt to use inflammatory words to mask a weak argument.”
Pennsylvania Avenue Funds v. Borey

• Price Fixing Allegations
  – Vector Capital agreed to refrain from bidding against Francisco Partners.
  – One month after the sale Vector purchased 50% of the company from Francisco Partners.

• Court’s Findings
  – “Plaintiff has adequately alleged ‘price fixing in the literal sense,’ and the court’s task is to determine whether Defendants engaged in ‘price fixing in the antitrust sense.’”

  – The per se rule does not bar price fixing among rival bidders in a contest for corporate control because such conduct is not invariably anticompetitive and bidders who join forces can even enhance competition.

  – Under a rule of reason analysis, the conduct at issue was not anticompetitive because the shareholder failed to allege the existence of a relevant market in which Francisco Partners and Vector Capital had market power.

  – The problem the court noted was not that the bidders had market power, but that there was little market interest in WatchGuard.
Murphy v. Kohlberg Kravis & Roberts

- Involved multiple club acquisitions:
  - Univision, HCA, and Harrah’s

- Involved multiple private equity players:
  - KKR, Blackstone, Carlyle Group, TPG Capital, Thomas H. Lee Partners, Silver Lake & Apollo

- Allegations:
  - Bid rigging, agreements to refrain from bidding, and lender lock up agreements.

- Voluntarily dismissed following the Supreme Court’s decision in *Bell Atlantic v. Twombly*
**Dahl v. Bain Capital Partners**

- TPG Capital Executive: “KKR has agreed not to jump our deal since no one in private equity ever jumps an announced deal.”

- Blackstone Executive: “Henry Kravis just called to say congratulations and that they were standing down because he had told me before they would not jump a signed deal of ours.”

- KKR Executive: “Given the increased size of the [Toys “R” Us] transaction, and our desire to effectively eliminate a competitor from the auction process, we decided to partner with Bain and Vornando.”
Carlyle Executive: Partnering with Permira would “keep [the] only other knowledgeable party on [the] company out of competition.”

Blackstone Executive: “The reason we didn’t go forward [with HCA] was basically a decision on not jumping someone else’s deal and creating rjr 2 with us as kkr . . . .”

Blackstone Executive: “I think [HCA] deal represents good value and is a shame we let kkr get away with highway robbery but understand decision. There may also be something else at play with henry [Kravis of KKR] and steve [Schwartzman of Blackstone].
The court found that PE firms have independent and legitimate business reasons for joining clubs.

- Minimizing costs, pooling resources.

The court viewed the club etiquette of refraining from “jumping” announced deals to be problematic and allowed the case to go to trial on that claim only.

Settlements, settlements, and more settlements:

- Goldman settled first for $67 million.
- Blackstone, KKR and TPG settled for $325 million total.
- Carlyle is the lone defendant facing trial this November.
The Resurgence of Club Deals

• New Club Deals after The Great Recession
  – Life Technology, a life sciences company
    • KKR, Blackstone and Carlyle submitted a bid for $11bn
  – Gates Global, an auto parts manufacturer
    • Blackstone and TPG submitted an initial bid of $5.4bn
    • TPG backed out and Blackstone pursued as a co-investment deal.

• Co-Investment Deals Come to Life
  – Private equity firms team together with their investing partners rather than other PE firms
    • Pension funds, sovereign wealth funds, family offices
Bankruptcy Sales
Two Methods for Selling Assets

• Plan of Reorganization
  – Slow process that can take up to two years to complete.
  – Requires a comprehensive plan and multiple-party agreement.
  – Permits complex financing techniques, issuance of new securities.
  – Two step approval: first the disclosure statement and then the plan itself.

• Section 363 Sales
  – Sale of substantially all or some of the Debtor’s assets.
  – Much faster process that can be accomplished in less than 90 days.
  – Prospective buyer can be more easily overbid.
  – Similar to a traditional M&A transaction, except:
    • Limited representations and warranties—“as is, where is”
    • Generally no indemnification (but may have holdback or escrow)
    • Limited closing conditions
    • Deposit or down payment typical
Timeline for a Typical 363 Sale

- **Weeks 1-5**: Expedited Marketing Process (competitive, but fast)
- **Weeks 6-7**: Select Stalking Horse (typical)
- **Week 8**: Filing of Sale Motion
  - Bid Procedure
- **Week 11**: Competitive Bid Deadline
  - Court Auction
- **Weeks 13-15**: Closing

(Describes breakup fee, deposit requirements and overbid amounts)
Advantages of a Section 363 Sale

- Sale free and clear of liens and interests.
- Assumption or rejection of unexpired leases and executory contracts.
- Ability for lenders to credit bid (e.g., loan to own).
- Avoidance of transfer taxes.
- Protections for good faith purchasers.
- Limited ability for creditors to block the sale
Disadvantages of a Section 363 Sale

• Significant sales generally require a public auction and competitive bidding.
• Involvement with other parties.
• Increased transaction time and costs.
• Net operating losses are not transferable.
• Breakup fees and bid protections are not guaranteed.
• Ability for lenders to credit bid.
• Sales can be set aside for lack of good faith or collusion.
Collusion Under Section 363(n)

• 11 U.S.C. § 363(n):

  – The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated . . . .

  – In addition . . . the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into to such an agreement in willful disregard of this subsection.
Elements of Section 363(n)

Is there an agreement to collude?

• *In re Hat*, 310 B.R. 752 (E.D. Cal. 2004)
  – Involved written memorandum of understanding between competing bidders.
  – Memo: “Purchase price can be kept down by avoiding serious overbid situation.”
  – Court: “As a direct result [of the collusion], there was no competitive bidding. The auction was improperly restrained . . . .”

• *Boyer v. Gildea*, 475 B.R. 647 (N.D. Ind. 2012)
  – Sets standard for circumstantial evidence of collusion.
  – Competing bidders post-sale buyout agreement not evidence of collusion since it did not control the price at the auction.
  – Inferences could be made that the bidders were working together to bid cooperatively and to keep their collusion a secret.
  – Particularly, since the actual value of the assets exceeded the auction price.
Elements of Section 363(n)

Is the agreement among potential bidders?

- Courts have construed this provision broadly.
- “Potential bidders” includes:
  - Interested parties that don’t bid at the sale.
  - Official committees of unsecured creditors.
  - Debtors in possession.
- Standing to pursue Section 363(n) actions.
  - Trustees and debtors in possession have standing.
  - Official committees of unsecured creditors have standing.
  - Chapter 7 debtors generally do not have standing.
  - Competing bidders typically do not have standing unless they can show a pecuniary interest (not a speculative interest).
Elements of Section 363(n)

Did the agreement control the sale price?

• *In re New York Trap Rock, Corp.*, 42 F.3d 747 (2d Cir. 1994)
  – “An agreement to ‘control’ the sale price is very different from an agreement that ‘affects’ the sale price.”
  – “The term ‘control’ implies more than acts causing an incidental or unintended impact on the price; it implies an intention or objective to influence the price.”

  – Addressed whether joint bids to acquire assets constitute an agreement to control the sale price.
  – “A joint bid is not necessarily an attempt to restrict bidding. Parties might make a joint bid where they could not afford to make a bid individually.”
How to Avoid Collusion?

• Step 1: Do not collude!

• Step 2: Document legitimate business purposes for club.
  – Acquire larger target companies.
  – Access debt financing on more favorable terms.
  – Obtain management expertise and operational efficiencies.
  – Better manage risk allocation of investment portfolio.

• Step 3: Do not routinely team up with the same club players.

• Step 4: Do not write careless emails or other documents.

• Step 5: Avoid quid pro quo arrangements.

• Step 6: Avoid inviting losing bidders to join the prevailing club.

• Step 7: Fully document reasons from standing down from bidding.
With thanks . . .

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