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Sales to Insiders: Are They Entirely Fair?

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The recent confirmation of the chapter 11 plan in *In re Station Casinos Inc.* in the District of Nevada[1] is one of the latest examples of a case that focused attention on the fairness of the §363 sale process that allows insiders to acquire a business as a going concern while creditors are left unsatisfied. The press reports and news releases from the debtors tout the fact that Frank and Lorenzo Fertitta will continue to control the business founded by their father 30 years ago and will be the largest shareholders of the new company formed to succeed the debtors. The plan met with vigorous opposition from the unsecured creditors and a dissident secured lender group until compromises were reached following the completion of the § 363 sale. Secured creditors of the operating company received substantial recoveries, but were not paid in full. Unsecured creditors will see no recovery at all except to the extent they realize value from warrants to acquire a small interest in the new holding company. How is it that the controlling shareholders managed to preserve the enterprise's going-concern value and repurchase the assets for their own benefit at a fraction of the company's debts?

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The answer lies in the degree of scrutiny applied to insider sales and the court's assessment of the fairness of the sale process and the price paid by the insiders. Fairness of insider transactions outside of the bankruptcy arena typically requires that the transaction be "entirely fair" to a corporation and its stakeholders. Should bankruptcy courts be bound by that same standard, or will a lower threshold be acceptable where a sale to insiders appears as the only viable alternative to liquidation? By requiring a sale to insiders to meet the entire fairness doctrine, public perception of the bankruptcy process will be enhanced, and the appearance of insiders reaping the benefits of chapter 11 at the expense of creditors can be avoided.

About the Author

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Heightened Scrutiny for Insider Transactions

The normal rule in sales of assets under § 363(b)(1) is that the bankruptcy courts will not substitute their own views regarding a proposed sale as long as it is supported by a reasonable exercise of the debtor's business judgment.[2] Where the sale is to an insider or insiders who stand to benefit from the sale, the standard for approval is higher.[3] The level of inquiry required for sales to insiders is not spelled out with precision and had been developed on a case-by-case basis, focusing on the nature of the sale process, exposure of the assets to market, openness of the proceedings and fairness of the price paid by the insiders. In the *Bidermann Industries* case, for example, the court refused to approve a letter agreement for a management-sponsored leveraged buyout where the debtor had not hired an investment banker to test the market, the debtor's turnaround consultant and CEO would own stock in the purchaser and the debtor's majority shareholder would receive multiple stock options, a five-year consulting agreement, a $750,000 cash payment for his agreement not to compete and release of all claims by the debtor.

In a nonbankruptcy setting, transactions with corporate insiders are subject to a high degree of scrutiny. In *Weinberger v. UOP Inc.*,[4] the Delaware Supreme Court held that directors of a Delaware corporation must demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain when they stand on both sides of a transaction. Under the "entire fairness" standard of judicial review, directors must demonstrate that the challenged transaction is entirely fair to the stockholders both in terms of "fair dealing," which entails an examination of when the transaction was timed and how it was initiated, structured, negotiated and disclosed to the directors, and "fair price," which entails an examination of the economic and financial considerations of the transaction. In determining whether a transaction is entirely fair, the Delaware courts consider factors such as (1) the presence of an independent board majority, (2) the active and aggressive search for third-party bidders that preceded the execution of the agreement, (3) diligent efforts by a special committee that has engaged in true arm's-length negotia-

1 Case no. 09-52477-GWZ.

2 *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063, 1071 (2d Cir. 1983); *Off. Comm. of Subordinated Bondholders v. Integrated Resources Inc. (In re Integrated Resources Inc.)*, 147 B.R. 650, 656 (Bankr. S.D.N.Y. 1992); *In re Global Crossing Ltd.*, 295 B.R. 726, 742-43 (Bankr. S.D.N.Y. 2003).

3 *In re Bidermann Indus. U.S.A. Inc.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997). *See also In re Summit Global Logistics Inc.*, No. 08-11566, 2008 Bankr. LEXIS 896, at *27 (Bankr. D. N.J. March 26, 2008); *In re Univ. Heights Ass'n*, No. 06-12672, 2007 Bankr. LEXIS 1200, at *13 (Bankr. N.D.N.Y. Jan. 22, 2007); *C & J Clark Am. Inc. v. Carol Ruth Inc. (In re Wingspread Corp.)*, 92 B.R. 87 (Bankr. S.D.N.Y. 1988) (sales to fiduciaries in chapter 11 cases are not *per se* prohibited but are subject to heightened scrutiny because they are rife with possibility of abuse).

4 *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983).

tions with the controlling stockholder, (4) the ability of the special committee to abandon the transaction with the controlling stockholder in favor of a better deal without an unreasonable penalty and (5) the price offered being at a premium to the price determined by the special committee's financial adviser.[5]

The Station Casinos *Case*

The *Station Casinos* case presents the latest example of a contested sale to insiders. Station Casinos and its subsidiaries owned and operated 10 major hotel/casino properties, plus eight smaller casino properties in the Las Vegas metro area. After nearly nine months in chapter 11 and the negotiation of interim compromises with the mortgage lenders on the leased Las Vegas properties (the Propco properties), the debtors proposed to pursue separate paths for the Propco properties and their remaining casinos (the Opco assets). As to the 11 casinos included in the Opco assets, the debtors proposed a § 363 sale to a newly formed entity as the stalking-horse bidder for $772 million. The Fertitta family, through a newly formed gaming company, would initially own nearly half of the equity in the purchaser and would sell part of their interest to the investment group that had led the 2007 going-private transaction for Station Casinos. The Propco properties, along with rights in certain intellectual property and other intangibles owned by Station Casinos, were excluded from the § 363 sale but were transferred to the same new entity under the plan of reorganization. The Fertittas' gaming company continues to operate all of the casinos. Clearly, the participation of the Fertitta family in the purchasing entity made the § 363 sale of the Opco assets an insider transaction and implicated the heightened scrutiny for such transactions.

The debtors' primary competitor in the local Las Vegas market had attempted to buy the debtors' business for some time, but was not selected as the stalking-horse bidder and ultimately withdrew from the § 363 auction, citing the alleged unfairness of the bidding procedures and the exclusion of player databases and information technology critical to operation of the casinos. Creditor groups complained that the proposed division of assets between the Propco properties and Opco assets would depress prices and divert value away from Station Casino creditors. They claimed that the debtors' investment banker had not actively marketed the Opco assets prior to selection of the insider group as the lead bidder, had not distributed a book to potential buyers and had not established a data room for due diligence. The creditor groups also objected to the proposed 30-day timeframe for interested purchasers to conduct due diligence and submit letters of intent, particularly because the assets being sold comprised a multibillion dollar enterprise with thousands of employees in a highly regulated industry. The bankruptcy court overruled the objections to the § 363 sale and approved the bidding procedures. When no counteroffers were submitted, the stalking-horse bidder was declared the successful purchaser.

The court evaluated the bid-procedures motion for the § 363 sale under a heightened standard of scrutiny and concluded that the debtors satisfied a heightened review of the transactions, citing *Brown v. Kinross Gold U.S.A. Inc.*[6] and *In re Zenith Elecs. Corp.*[7] In reaching its conclusions, the court found that the stalking-horse bid was "a fair and reasonable reflection of what stakeholders who know the most about the Station enterprise believe to be the true potential worth of such enterprise in the right hands,"[8] that the debtors and the agent banks had "conducted a vigorous competition between [the competitor] and the ultimate Stalking-Horse Bidder to determine who they would propose to be the stalking-horse bidder"[9] and that "the Auction will take place pursuant to appropriate court supervision and overseen by...SCI's Independent Director and the consultation parties."[10]

To Sell or Not to Sell: An Examiner's Question?

The *Station Casinos* court refused to order the appointment of an examiner to oversee the sale process, but in other situations, examiners have played a key role in evaluating and negotiating § 363 sales where insiders are competing for the assets. In the *Summit Global Logistics* case, the debtor's investment banker conducted a thorough pre-petition marketing effort, which did not result in a third-party offer. After the filing, an examiner was appointed when there was insufficient creditor interest in forming a creditors' committee. The court tasked the examiner with evaluating the debtor's proposal to sell the business to a management group for $65 million to $70 million. The examiner and debtor provided the court with ample evidence as to the diligent—but unsuccessful—attempts to sell the business as a going-concern, both pre- and post-petition. The examiner also reviewed the fairness of the purchase price and concluded that it represented a fair valuation of the assets.[11] Because the debtor was a public company, the sale process involved an independent committee of the board with its own independent counsel. The court found that the public nature of the § 363 sale provided the necessary ratification of an insider transaction to satisfy Delaware Code title 8, § 144, and that the transparency of the sale process and the marketing efforts of the debtor satisfied the heightened burden with respect to the proposed management-led purchase.[12]

In the *Fontainebleau Las Vegas Holdings* chapter 11 case, the bankruptcy court *sua sponte* ordered the appointment of an examiner to negotiate and supervise a § 363 sale of the debtors' 63-story hotel and casino complex on the Las Vegas strip, which had been under construction until financing ran out in 2008 and was then only 70 percent complete.[13] The examiner's appointment was in response to the imminent failure of the reorganization efforts due to lack of funding, the inability to strike a deal with a third-party stalking-horse bidder and allegations of conflict of interest by the debtors and the controlling stockholders over a potential insider purchase proposal and allocation of sale proceeds between the different debtors' estates. The examiner was given the responsibility of negotiating the terms of any agreement with potential purchasers, including any stalking-horse bidder, and was directed to report on his progress every 10 days. The examiner's appointment led to an improved recovery for creditors through a sale to a new entrant in the bidding process, Icahn Nevada Gaming.

The *Fontainebleau Las Vegas Holdings* case also highlights a weak-

5 *In re Cysive Inc. S'holdrs. Litig.*, 836 A.2d 531 (Del. Ch. 2003).

6 *Brown v. Kinross Gold U.S.A. Inc.*, 531 F.Supp.2d 1234, 1246 (D. Nev. 2008) (articulating "entire fairness" standard, which "entails evaluating both whether the offer price constituted fair value and whether the offer was the product of fair dealing").

7 *In re Zenith Elecs. Corp.*, 241 B.R. 92, 108 (Bankr. D. Del. 1999). *In re Station Casinos Inc.*, No. 09-52477, *slip op.* at 8 (Bankr. D. Nev. July 14, 2010) (findings of fact and conclusions of law).

8 *Id.* at 13.

9 *Id.*

10 *Id.* at 18.

11 *In re Summit Global Logistics Inc.*, 2008 Bankr. LEXIS 896, at *30.

12 *Id.* at *35-37.

13 *In re Fontainebleau Las Vegas Holdings LLC*, No. 09-21481 (Bankr. S.D. Fla. Oct. 14, 2009) (Order Appointing Examiner to Examine, Negotiate and Supervise § 363 Sale of Assets).

ness in the examiner option. The bankruptcy court's order appointing the examiner provided that the examiner's fees and expenses should be paid from the secured creditors' collateral, without resolving pending disputes as to the scope and priority of liens. In response to an appeal by one group of secured creditors, the district court reversed this aspect and directed the debtor to recover all fees paid to the examiner and his professionals.[14] The district court noted that only a trustee, and not an examiner, may avail himself or herself of § 506(c),[15] and that an examiner's fees cannot be surcharged against secured creditors' collateral.

Sales by Trustees

A natural question is whether the heightened scrutiny of insider sales should apply to a sale proposed by a trustee instead of a debtor in possession (DIP), which was answered in the affirmative in *In re Blixseth*.[16] In this case, the court refused to approve a sale of property owned by debtor Edra Blixseth, which was located in the midst of the Yellowstone Mountain Club development. The sale proposed by the chapter 7 trustee was to a secured creditor for an $8 million credit-bid, plus a $500,000 carve-out for the estate, and included a general release of all claims against the creditor. The court found that the creditor had very close ties to the debtor and the Yellowstone Mountain Club, and refused to apply the standard applicable to noninsider sales under *In re Canyon Partnership*,[17] or to give deference to the trustee's business judgment. Instead, the court applied the more rigorous *Bidermann* standard for evaluating insider transactions. The trustee claimed that he had no funds to hire an appraiser and had not engaged a broker to market the property or obtain an opinion of value. The trustee relied solely on the purchaser's appraisal and on his belief that no other party would bid more for the property given the extent of the secured claim and the creditor's right to credit-bid under § 363(k). Primarily due to the trustee's failure to test the market prior to proposing the sale to the secured creditor, the court denied the limited notice and bidding procedures proposed by the trustee. The court also questioned the proposed release of claims because another party had just been authorized to pursue potential claims against the secured creditor.

The *Blixseth* court's focus on value and evaluation of an insider sale under heightened scrutiny is appropriate. While the independent trustee had the exclusive authority to sell assets and was not burdened by the conflicts of interest that apply when a DIP seeks to sell assets to an insider, applying heightened scrutiny to any purchase by an insider advances the public policy of assuring that "the conduct of bankruptcy proceedings not only should be right but must seem right."[18]

Conclusion

Courts should critically evaluate the fairness and timing of the sale process to determine whether the debtor has truly pursued sales to third-party buyers and created a level playing field for outsiders to compete against the interested insiders. Where a special committee of independent directors has been formed, the functioning and independence of the committee needs to be evaluated to determine whether the interests of insiders have been favored over a sale to outsiders. This may involve greater reliance on fiduciaries such as trustees and examiners, but where the appointment of an examiner is not a viable option, the evidence presented by the debtor and the purchaser will need to prove the fairness of the sale process.

The fairness of the price paid by an insider is more difficult to evaluate. The absence of higher or better offers under the constraints of a typical § 363 auction sale does not necessarily prove the fairness of the sale price because timing issues may prevent legitimately interested buyers from submitting bids. Only in a truly open auction proceeding with free access to information and adequate time to formulate bids will the auction mechanism establish fairness of price and satisfy the heightened scrutiny that applies to insider sales. Credible expert opinion should be introduced to establish that the price is fair. By drawing on the standards that apply to public companies under the entire fairness doctrine and requiring objective proof of the fairness of a sale price, courts will be able to assure that § 363 sales involving insiders are not only right, but also "seem right" to the public. ■

14 *Desert Fire Prot. v. Fontainebleau Las Vegas Holdings LLC (In re Fontainebleau Las Vegas Holdings LLC)*, No. 09-23683, slip op. at 59 (S.D. Fla. July 14, 2010).

15 Citing *Hartford Underwriters Ins. Co. v. Union Planters Bank NA*, 530 U.S. 1, 6 (2000).

16 *In re Blixseth*, No. 09-60452, 2010 Bankr. LEXIS 585 (Bankr. D. Mont. Feb. 23, 2010).

17 *In re Canyon P'ship*, 55 B.R. 520 (Bankr. S.D. Cal 1985).

18 *In re Bidermann Indus. U.S.A. Inc.*, 203 B.R. at 549, citing Judge Friendly's comments in *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).