Client Alert

January 2015

The Delaware Supreme Court's Decision in the *C&J Energy Services, Inc*. Case May Provide an Opportunity for Debtors and Asset Purchasers to Further Expedite Approval of a Section 363 Sale of Substantially All a Debtor's Assets at the Outset of a Bankruptcy

The Delaware Supreme Court in *C & J Energy Services, Inc., et al. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust, No. 655/657* ("*C & J Energy*") recently entered an order confirming that, even in a change of control situation, a board of directors does not need to actively shop a company before or after signing a merger agreement and can negotiate with only a single bidder in seeking a sale as long as there is a "viable passive market check" of the process.[1]

There has been a recent trend in bankruptcy cases to pursue a sale of substantially all a debtor's assets through a sale under 11 U.S.C. §363 early in the case. These "fast track" 363 sales have drawn some criticism within the bankruptcy community as sometimes providing insufficient protection to various stakeholders and not always maximizing the value of the debtors' assets[2]; however, if bankruptcy courts are willing to accept a pre-bankruptcy sale process similar to what the Delaware Supreme Court approved in *C & J Energy*, it is possible that a debtor could seek approval of a sale of substantially all its assets in the case's infancy — or even as part of first day motions — without running an auction or seeking to engage multiple bidders pre-petition.

Case Background

C&J Energy, Inc. ("C & J") entered into a merger agreement with Nabors Industries Ltd. ("Nabors")[3]; however, before C & J's shareholders could approve the merger agreement the City of Miami General Employees' and Sanitation Employees' Retirement Trust (the "Plaintiffs") brought a class action on behalf of itself and other shareholders to enjoin a merger between C & J and Nabors. In the class action litigation, the Plaintiffs asserted that C & J's board of directors improperly entered into a change of control transaction without properly executing its fiduciary duties.[4]

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[1] *See C & J Energy Services, Inc., et al. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust, No. 655/657*, 2014 WL 7243153 (Del. Dec. 19, 2014).

[2] *See generally*, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 Report (December 8, 2014).

[3] The transaction was a tax inversion deal in which C & J, a US company, was acquiring a subsidiary of Nabors, which was domiciled in Bermuda, but Nabors would retain the majority of the equity in the new corporation. The combined entity would be based in Bermuda and would be subject to a lower corporate tax rate than what C & J was previously paying.

[4] Even though C & J's board had five independent directors, the Plaintiffs argued that the CEO, chairman and founder of C & J — Joshua Comstock — exerted undue influence on the board and was motivated to obtain a lucrative employment package for himself as part of the transaction.

The proposed merger between C & J and Nabors involved only a single bidder and there was a provision in the deal that prohibited C & J from soliciting other bids; however, C & J did have a "fiduciary out" of the deal if a superior proposal was presented during a lengthy passive market check of the transaction and, so as not to dissuade higher and better offers, there was only a modest termination fee of 2.27 percent of the value of the deal.[5]

The Delaware Court of Chancery reviewed the proposed merger and the process C & J's board of directors undertook in arriving at the merger agreement. After conducting its analysis, the Court of Chancery issued a preliminary injunction enjoining the shareholder vote on the merger for 30 days and ordered C & J to solicit competing bids. The Court of Chancery held that even though C & J's board had no conflict of interest in entering into the merger agreement with Nabors and was fully informed of C & J's value, the court determined that there was a "plausible" violation of the board's duties under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).[6]

C & J and certain of its directors pursued an expedited appeal of the Court of Chancery's order to the Delaware Supreme Court. In *C & J Energy* the Delaware Supreme Court reversed the order of the Chancery Court and allowed the merger to proceed to a shareholder vote without requiring C & J to solicit other bids.

In arriving at its decision to reverse the Court of Chancery, the Delaware Supreme Court noted, "[w]hen a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal, we cannot conclude that the board likely violated its *Revlon* duties."[7] The Delaware Supreme Court further noted that "[s]uch a market check does not have to involve an active solicitation, so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal. The ability of the stockholders themselves to freely accept or reject the board's preferred course of action is also of great importance in this context."[8]

Potential Impact on Fast Track Section 363 Sales in Bankruptcy

The Delaware Supreme Court's determination that a board can comply with its fiduciary duties attendant to the sale of a company without engaging multiple bidders or actively confirming the market value through an auction process may provide debtors and asset purchasers a roadmap and persuasive authority for proceeding with an accelerated sale of substantially all a debtor's assets in bankruptcy.[9]

Section 363 of the Bankruptcy Code allows a trustee or debtor-in-possession the opportunity to sell a debtor's assets outside the ordinary course of business free of all liens, claims or interests after notice, a hearing and court approval.[10] Although it is not required by the Bankruptcy Code, typically there is a

[5] *C & J Energy Services Inc.,* WL 7243153 at *10.

[6] *Revlon* and its progeny provide that a court must exercise enhanced scrutiny in reviewing a change of control transaction to ensure a board does not take actions inconsistent with obtaining the highest immediate value for the company that can be readily attained; however, *Revlon* does not require that the directors undertake any particular methodology to arrive at the maximum value for the company. *C & J Energy Services, Inc.,* WL 7243153 at *14. The key factor for courts to apply the heighten standard of review under *Revlon* is "whether the directors made a *reasonable* decision, not a *perfect* decision." *See Barkan v. Amsted Industries, Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

[7] *C & J Energy Services, Inc.,* WL 7243153 at *2.

[8] *Id.* at *14.

[9] It should be noted, a sale of assets in the bankruptcy context is distinct from a merger or acquisition outside bankruptcy. Once a bankruptcy petition is filed there are statutory requirements for the approval of a sale of a debtor's assets outside the ordinary course of business; however, bankruptcy provides debtors the unique ability to sell assets free of liens, claims and interests and provides significant protection to good faith purchasers of a debtor's assets that the sale will not be collaterally attacked.

[10] *See* 11 U.S.C. §363 (b) and 11 U.S.C. §363(f).

public sale and auction process conducted.[11] The *C & J Energy* court, however, highlighted that Delaware state law does not require an auction sale in order for the board to be found in compliance with its *Revlon* duties, holding that "…*Revlon* does not require a board to set aside its own view of what is best for the corporation's stockholders and run an auction whenever the board approves a change of control transaction."[12]

Compliance with state law alone, however, may not be sufficient to satisfy the bankruptcy court. The publicity surrounding a bankruptcy filing and the ability to acquire assets in a manner not possible outside the bankruptcy context — free and clear of liens, claims or interests and with certain protections for good faith purchaser — may lead to the emergence of new bidders with higher and better offers after the commencement of the case. Consequently, a bankruptcy court may require a post-filing auction or it may delay the debtor's proposed sale believing that the market for the debtor's assets may be improved by slowing down the sale process.[13]

Conversely, even the most expedited public 363 sale and auction may materially impact the value of the debtor's assets as any delay can result in further deterioration in value and ever-increasing administrative expenses associated with the bankruptcy case may further depress a potential recovery to creditors. A potential bankruptcy debtor seeking to combat these dual causes of diminution in value by proposing to sell its assets at the beginning of a bankruptcy case may be able to successfully follow the *C & J Energy* game plan of only engaging a single bidder; bypassing an auction sale process prior to, or after, its bankruptcy filing; and present an executed asset purchase agreement to the bankruptcy court for approval as soon as the filing date of the bankruptcy petition or shortly thereafter. If the bankruptcy court agrees that the debtor subjected the sale to a passive market check prior to the bankruptcy filing, that the debtor conducted a reasonable process in seeking to maximize its value and no creditor or rival bidder appears to object to the sale after sufficient notice, the bankruptcy court should allow the sale to proceed.

Conclusion

In *C & J Energy* the Delaware Supreme Court confirmed there is no exact blueprint for a board of directors to comply with their duties under *Revlon* in the selling a company. The analysis hinges on whether the board in exercising its business judgment makes a reasonable decision in seeking to maximize the value of the company during a sale. A sale in a distressed context pursuant to Section 363 of the Bankruptcy Code introduces certain statutory requirements that are not present in a non-

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[11] *See* Rachael M. Jackson, *Survey: Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, Colum. Bus. L. Rev. 451, 469-70 (2005) ("The process of conducting an auction generally establishes that a successful bidder has paid the fair market value for the asset. Therefore, considering the tremendous emphasis that bankruptcy courts place on maximizing the value of the estate, auction sales are advisable because judges do not tend to scrutinize closely such transactions before approving the final sale. In addition, the security of an auction sale is enhanced because appellate courts review bankruptcy court confirmations with considerable deference, and therefore, disgruntled bidders are rarely successful in challenging a court approved sale."

[12] *C & J Energy Services, Inc.,* WL 7243153 at *14.

[13] *See In re Engman*, 395 B.R. 610, 626 (Bankr. W.D. Mich. 2008) ("…there is more to court approval of a proposed Section 363(b) sale than just whether the trustee has brought to the table an offer that will meet the minimum that is required to satisfy his fiduciary responsibilities to the estate. Also open for consideration are all of the other options that might be available. Is a competing bid better? Is an auction preferable to considering only the private offer made? Should the sale be delayed until the market improves?"); *In re Decora Industries, Inc.,* 2002 WL 32332377, *3 (Bankr. D. Del. 2002) ("…the auction process proposed by the Debtors, approved by the Court in the Procedures Order and required by section 363 of the Bankruptcy Code has permitted the Purchaser's offer to be fairly tested against other offers and has resulted in the highest and best offer for the sale of those assets."); *In re Tempo Tech. Corp.*, 202 B.R. 363, 369 (D. Del. 1996) ("[b]efore the section 363(b)(1) sale could be approved under Chapter 11, the Debtor was required to conduct an auction after giving three week's notice to the Debtor's thirty-five largest creditors, its secured creditors and its landlords and lessors").

bankruptcy sale of a company; however, a debtor will be faced with a similar duty to maximize the value of the assets — this time not for shareholders or equity, but for creditors. Debtors have argued that expedited 363 sales significantly reduce administrative expenses in bankruptcy cases and *C & J Energy* may provide support for a debtor who wants to pursue a sale of substantially all its assets at the beginning of a case without an auction process. As it was with the board in *C & J Energy*, the burden will be on the debtor to show that its presale process was reasonable and maximized the value of the assets. Debtors and asset purchasers should be prepared that an early 363 sale, especially without an auction, will likely draw intense scrutiny from the bankruptcy court and various creditor representatives; however, just as the Delaware Supreme Court did not see a need to stand in the way of the shareholder vote on a no-shop, single bidder sale, a bankruptcy court will likely approve an expedited sale under similar circumstance if the creditors are satisfied that the debtor's sale process has resulted in the best deal for its assets.

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