3rd Circuit Affirms Rejection of $15 Million Break-up Fee in Section 363 Bankruptcy Sale

by Donovan W. Burke, Jonathan J. Russo and K. Brian Joe

On January 15, 2010, in In re Reliant Energy Channelview LP*, the Third Circuit Court of Appeals affirmed the decision of the U.S. Bankruptcy Court for the District of Delaware denying payment of a $15 million break-up fee to the initial bidder of a power plant in conjunction with the debtor's Section 363 bankruptcy asset sale. The Court based its ruling on the fact that it did not consider the fee necessary to preserve the value of the bankruptcy estate.*

Section 363 Sales and Break-up Fees

Section 363 of the Bankruptcy Code controls asset sales by a debtor in bankruptcy and imparts a procedure to obtain the necessary approval. While a Section 363 sale is usually a public auction where assets are sold to the highest bidder, the bankruptcy court may also approve a private sale entered into independently by the debtor and a purchaser.

Often, an initial bidder (a stalking horse) establishes a minimum price and a set of offer terms for other bidders. Because the stalking horse undertakes due diligence in connection with its bid and other bidders may later rely upon the due diligence and the offer terms of the initial bidder in submitting their own higher bids, bankruptcy courts will generally allow reasonable deal protections for a stalking horse bidder as recompense for money and effort spent in the event the court does not approve the transfer or the initial bidder is not the ultimate auction winner. Such protections include reimbursement of actual expenses and break-up fees, both of which stalking horse bidders regularly request.

In re Reliant Energy Channelview LP

In *Reliant Energy*, Reliant Energy Channelview LP and Reliant Energy Services Channelview LLC (the Debtors) filed for bankruptcy and decided to sell a power plant in Channelview, Texas. Opting for a private sale, the Debtors conducted their own search, contacting 115 potential purchasers, with 24 conducting due diligence and 12 ultimately making bids for the plant. Kelson Channelview LLC (Kelson) submitted the winning bid of $468 million and entered into an Asset Purchase Agreement (the APA) that was subject to the

Bankruptcy Court's approval. The APA provided that the Debtors would *seek* the entry of an order approving certain "bid protections and procedures" benefitting Kelson if the Court determined there should be an auction for the plant before its sale. These protections included a $5 million minimum overbid term and a provision that if a competing bid were to be accepted, Kelson would be entitled to a $15 million break-up fee and reimbursement of actual expenses of up to $2 million. Kelson went forth with its bid knowing that the Court had not yet approved these measures.

The Bankruptcy Court did not approve the private sale and instead required a sale by auction. Even though the Court issued an order approving Kelson's $5 million overbid requirement as well its reimbursement of up to $2 million for expenses incurred in the transaction, it declined to authorize payment of the $15 million break-up fee. Kelson did not participate in the subsequent auction. Kelson was awarded about $1.2 million for its bid expenses and appealed the order denying the break-up fee to the District Court. The District Court affirmed, holding that the Bankruptcy Court did not abuse its discretion in denying Kelson's request for the fee.

The Third Circuit, relying on its prior ruling in *Calpine Corp. v. O'Brien*, analyzed the request for a break-up fee by the same general standard used for all administrative expenses: a break-up fee is allowable only if the requesting party is able to show that the fees were actually necessary to preserve the value of the estate. In *Reliant Energy*, the Third Circuit contemplated that there were two ways a break-up fee could have preserved the value of the estate: (1) to induce Kelson to make its bid before the Bankruptcy Court ordered the auction, or (2) to induce Kelson to adhere to its bid after the Court ordered the auction. The Third Circuit found that Kelson made its bid without expressly conditioning the bid on court approval of a break-up fee, and therefore the fee was not needed to induce Kelson to bid.

Significance of *Reliant Energy*

In *Reliant Energy*, the Third Circuit stressed that Kelson's bid was conditioned on the Debtor's "*promise to seek* authority" to pay Kelson the break-up fee, not the approval or receipt of the fee itself (emphasis added). Because the *O'Brien* case underscored the fact that break-up fees will only be granted for the "actual, necessary costs and expenses of preserving the estate" and Kelson submitted its bid before the Court's approval, knowing that it might not receive the fee, the Third Circuit concluded that the break-up fee could not have induced Kelson's bid. It is therefore incumbent upon purchasers to assure that a bankruptcy court, especially in Delaware, views the break-up fee as an essential term of the sale, because the lack of expression of this intent was a central fact in *Reliant Energy*.

Initial bidders participating in a Section 363 sale should take special care in drafting agreements to specify that the actual approval of break-up fees is a firm condition precedent to proceeding with the transaction, and should make this known from the outset of negotiations. Failure to obtain approval of the break-up fee should result in a termination event extinguishing further obligations on the part of the purchaser.

If you have any questions about the content of this advisory, please contact the Pillsbury attorney with whom you regularly work, or the authors of this advisory.

Donovan W. Burke (bio)
New York
+1.212.858.1216
donovan.burke@pillsburylaw.com

Jonathan J. Russo (bio)
New York
+1.212.858.1528
jonathan.russo@pillsburylaw.com

K. Brian Joe*
New York
+1.212.858.1681
k.brian.joe@pillsburylaw.com
* Mr. Joe is awaiting admission to practice.