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It's critical to properly structure, draft bid documents

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On Jan. 15, 2010, the 3rd U.S. Circuit Court of Appeals issued a decision concerning break-up fees in section 363 bankruptcy sales, which underscores the need for careful structuring and drafting of bid documents. In *In re Reliant Energy Channelview LP*, 2010 WL 143678 (3d Cir. Jan. 15, 2010), the 3rd Circuit upheld the denial of a $15 million break-up fee to a stalking horse bidder because, inter alia, (i) the break-up fee was not conditioned upon court approval of the break-up fee, and (ii) the break-up fee was not found necessary to preserve the value of the estate.

Section 363 of the Bankruptcy Code governs the sale of assets in a bankruptcy case, which usually occurs by public auction. Typically, the initial bidder – the "stalking horse bidder" – seeks certain protections to guard against the risk that another bidder will prevail at the auction for the debtor's assets, and to compensate the stalking horse for the energy and expense it has expended in pursuing the transaction. A stalking horse bidder will often seek to protect its interests by including a floor for competing bids, reimbursement of expenses, and a break-up fee (typically between 1 to 3 percent of the stalking horse bidder's purchase price). These protections are not automatic – they must be approved by the bankruptcy court. As the *Reliant Energy* case teaches, it is critical to properly structure and draft the bid documents to ensure that the court will approve the requested break-up fee.

In *Reliant Energy*, the debtor sought to sell substantially all of its assets, consisting mainly of a co-generation power plant in Texas. The assets were extensively marketed to over 100 potential purchasers, which resulted in 12 offers. The debtor entered into an asset purchase agreement with Kelson Channelview LLC (Kelson) to sell the assets for about $468 million. Included in the asset purchase agreement was a covenant by the debtor that provided that if the bankruptcy court required an auction, the debtor would seek approval of a $15 million break-up fee and the reimbursement of Kelson's expenses of up to $2 million.

If there are multiple expressions of interest in the debtor's assets from bidders who have the financial capacity to close a deal, then a bankruptcy court will likely require a public auction.

Pursuant to the sale agreement, the debtor requested that the assets be sold without a public auction. After hearing the motion, and an objection by a spurned bidder, Fortistar LLC (Fortistar), the court denied the debtor's request for the break-up fee. The bankruptcy court based its ruling on, inter alia, Fortistar's statements that, but for the break-up fee and expense reimbursement provision, it would make another offer for the debtor's assets. The court held that because Fortistar had expressed its intent to bid for the assets, the break-up fee was not necessary to preserve the estate's value. Notwithstanding the denial of the break-up fee, the Court allowed the request for Kelson's expense reimbursement. Kelson chose not to participate at the court-ordered auction, and Fortistar ultimately prevailed.

Kelson appealed the bankruptcy court decision, which was affirmed by the district court. On further appeal, the 3rd Circuit, following its prior decision in *Calpine Corp. v. O'Brien Environment Energy Inc.*, 181 F.3d 527 (3d Cir. 1999), framed the matter as whether the break-up fee was an actual and necessary cost and expense of preserving the value of the debtor's estate. The court considered whether the break-up fee was necessary to induce Kelson to bid, and whether the break-up fee was necessary to preserve Kelson's bid.

The 3rd Circuit held that a break up fee may be awarded when it induces the stalking horse bidder to make an initial bid or to pursue the acquisition even in the event of a court-ordered public auction. In this case, the court held that the break-up fee was not necessary to induce Kelson to bid because the asset purchase agreement only required the debtor to seek approval of the break-up fee. There was no condition in the asset purchase agreement that the debtor actually obtain the court's approval of the break-up fee. The court also held that the break-up fee was not necessary to preserve Kelson's bid because (i) Kelson was required to consummate the transaction regardless of whether the break-up fee was approved; (ii) Fortistar indicated that the break-up fee was not necessary and that, in fact, it had a chilling effect on bidders; and (iii) the court's contention that Kelson would have closed the deal if it was the sole bidder.

Notably too, the 3rd Circuit held that the decision to award a break-up fee is not subject to the business judgment rule, regardless of the fact that none of Reliant's creditors or equity holders objected to the break-up fee. The court held that unanimity among creditors does not permit a court to ignore the statutory requirement that the break-up fee be an actual and necessary cost of preserving the value of the debtor's estate.

Practical Considerations:

There are several take-aways for practitioners from *Reliant Energy*. First, it reinforces the rule of thumb that if there are multiple expressions of interest in the debtor's assets from bidders who have the financial capacity to close a deal, then a bankruptcy court will likely require a public auction. Second, and more pointedly, it teaches that in order to maximize the stalking horse bidder's chances of recovering a break-up fee, the asset purchase agreement should explicitly provide that the stalking horse bidder shall have the right to terminate the asset purchase agreement if the bankruptcy court does not approve the break-up fee. The asset purchase agreement should reflect the facts that the stalking horse bidder was induced to bid for the assets by the break-up fee and that the break-up fee is necessary to preserve the stalking horse bidder's continued involvement in the auction.

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