

Buyer Beware: Third Circuit Denies \$15 Million Break-Up Fee for Failure to Meet *O'Brien* Standard

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Stalking horse bidders are a common feature of Section 363 asset sales in bankruptcy. A “stalking horse” is the first bidder for the debtor’s assets, who performs the initial due diligence, sets the minimum purchase price and jump-starts the bidding process, often attracting higher and better offers. In exchange for the work and risks undertaken by the stalking horse, it is typically given certain protections: Any overbids must exceed the stalking horse’s bid by a certain minimum amount, and in the event that the stalking horse is outbid, it will usually be entitled to reimbursement of its expenses and payment of a break-up fee.

These “bid protections” are not guaranteed, however, since they must be approved by the bankruptcy court. In the Third Circuit, expense reimbursements and break-up fees will not be granted unless the stalking horse bidder can demonstrate that reimbursement and fee were “*actually necessary to preserve the value of the estate.*” *Calpine Corp. v. O’Brien Env’t Energy, Inc. (In re O’Brien Env’t Energy, Inc.)*, 181 F.3d 527, 535 (3d Cir. 1999) (emphasis added).

The Third Circuit recently applied the *O’Brien* test to deny a \$15 million break-up fee to a stalking horse bidder, even though the motion to approve the fee was supported by both the debtors and the Creditors’ Committee, and despite the fact that, even after payment of the fee, the debtors’ estates still would have been solvent and able to pay all creditors in full. *Kelson Channelview LLC v. Reliant Energy Channelview LP (In re Reliant Energy Channel LP)*, No. 09-2074 (3d Cir. Jan. 15, 2010).

In *Reliant*, the debtors decided to sell their largest asset, a power plant in Channelview, Texas. The plant was marketed extensively; more than 100 potential purchasers were contacted, more than

A BIDDER CONSIDERING ACTING AS A STALKING HORSE SHOULD BE AWARE THAT PREVIOUSLY-REJECTED BIDDERS WHO ANNOUNCE AN INTEREST IN BIDDING AT AUCTION MAY BE GRANTED STANDING TO OBJECT TO BREAK-UP FEES AND OTHER BID PROCEDURES.

three dozen signed confidentiality agreements, and 12 ultimately submitted bids. Many of the bids, however, were contingent on the bidder’s obtaining financing – an uncertain undertaking in the prevailing business environment. Kelson, on the other hand, submitted a complete and non-contingent bid for \$468 million and was selected as the winning bidder.

Kelson and the debtors entered into an asset purchase agreement (APA) for the plant. Since the debtors were in bankruptcy, the APA provided that the debtors would immediately seek an order from the bankruptcy court approving the sale. Moreover, the APA required the debtors to seek an order approving certain bid protections for Kelson’s benefit in the event the bankruptcy court determined there should be an auction for the plant before the sale. The proposed bid protections provided that the debtors

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could not accept a competing bid unless it exceeded Kelson's bid by \$5 million, and that Kelson would be entitled to a break-up fee of \$15 million and expense reimbursement of up to \$2 million if a competing bid were accepted.

While the bankruptcy court was considering the debtors' motion to approve the sale without an auction, the debtors – with the support of the Creditors' Committee – asked the court to approve the bid protection measures. Fortistar LLC, which had submitted one of the contingent bids, objected to the motion.¹ Fortistar asserted that it was willing to submit a “higher and better” bid at an auction, but was deterred by the proposed \$15 million break-up fee and \$2 million reimbursement.

Following an evidentiary hearing, the bankruptcy court denied the debtors' request to sell the assets without an auction, approved the \$5 million overbid requirement and allowed the reimbursement of Kelson's expenses up to \$2 million,² but denied the \$15 million break-up fee. The bankruptcy court concluded that the break-up fee was not “actually necessary to preserve the value of the estate” based primarily on two factors: (1) Kelson's bid was not expressly conditioned on *approval* of the break-up fee, so that it would be bound by the APA even if it weren't approved; and (2) there was another willing bidder waiting in the wings, ready to bid at auction.

As it turned out, Kelson did not participate in the subsequent auction and asserted that its offer was no longer available. Fortistar submitted the winning, fully-financed auction bid, which topped Kelson's bid by \$32 million. Kelson appealed the order denying its break-up fee. The district court, and eventually the Third Circuit, affirmed the bankruptcy court's order. The Third Circuit, while recognizing the risks incurred and benefits provided by stalking-horse bidders, reiterated *O'Brien's* position that a break-up fee isn't always necessary to induce a stalking horse to take those risks and provide those benefits. On the facts present in *Reliant*, where Kelson's bid was conditioned on the debtors' *seeking* (but not actually obtaining) approval of the break-up fee, the Third Circuit found that it was clear that the break-up fee was not required to induce Kelson to bid.

The Third Circuit conceded that the break-up fee could have benefited the estate in another way, by keeping Kelson committed to the purchase after the court ordered an auction. However, the Third Circuit found that the bankruptcy court had appropriately weighed that potential benefit against the detriment of deterring other bids in deciding that the break-up fee was

not necessary for the protection of the estate. Fortuitously, the bankruptcy court's decision benefited the estates because Fortistar outbid Kelson by \$32 million. Of course, if the bankruptcy court's gamble had been wrong, and another suitable bid did not materialize while Kelson walked away permanently from its offer, the estates would have been severely harmed.

The *Reliant* saga has important lessons for potential stalking-horse bidders in bankruptcy. First and foremost, a stalking-horse bidder should ensure that its bid is expressly conditioned on *approval* of a break-up fee. Furthermore, stalking horses should understand that where there is another party willing to bid at auction, it is highly possible that the court will deny a break-up fee. (Although the Third Circuit insisted that the bankruptcy court had not announced a *per se* rule against break-up fees where there is another bidder, it noted with approval the bankruptcy court's position that “as a factual matter break-up fees often are not needed when there are bidders for an asset other than the initial bidder.” In light of that position, it is hard to imagine a factual scenario involving another bidder where a break-up fee *would* be approved.) Finally, a bidder considering acting as a stalking horse should be aware that previously-rejected bidders who announce an interest in bidding at auction may be granted standing to object to break-up fees and other bid procedures, even though such rejected bidders have no existing stake in the proceedings. In short, stalking-horse bidders must exercise greater caution and be cognizant of the increased risk that – despite promises of reimbursement and break-up fees – they may not walk away whole from attempted asset purchases in bankruptcy.

ENDNOTES

- 1 Over the objections of the debtors and the Creditors' Committee, the bankruptcy court determined that Fortistar, as a potential bidder, had standing to be heard on bid procedures.
- 2 The bankruptcy court found that the reimbursement of expenses was warranted as an administrative claim against the estates; Kelson had benefited the estates by assisting in the creation of the asset purchase agreement against which other potential purchasers would be required to bid.