KIRKLAND & ELLIS LLP

KIRKLAND ALERT

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Break-Up Fee Denied for Stalking-Horse Bidder in Bankruptcy Asset Sale

Introduction

Chapter 11 debtors often sell all or part of their assets pursuant to section 363 of the Bankruptcy Code. These bankruptcy sales typically involve an auction process that uses an initial or "stalking horse" bidder to set the minimum price and other transaction terms against which other bidders bid. To compensate the stalking horse bidder for the time and money invested in formulating the transaction, providing a "floor" price, and establishing the potential terms for higher and better offers, the bidder is often awarded a court-approved break-up fee and expense reimbursement in the event it is outbid at auction.

Nonetheless, in *In re Reliant Energy Channelview LP*, 2010 WL 143678 (3d Cir. Jan. 15, 2010), the Third Circuit Court of Appeals recently upheld the denial of a break-up fee for a stalking-horse bidder whose bid was not conditioned on court approval of the break-up fee. The *Reliant Energy* decision illustrates that any stalking horse should carefully structure its bid and related purchase documentation to ensure bankruptcy court approval of a break-up fee.

Reliant Energy Decision

On August 20, 2007, Reliant Energy Channelview LP and Reliant Energy Services Channelview LLC (collectively, the "Debtors"), owners and operators of a cogeneration power plant in Channelview, Texas, filed chapter 11 cases in the Delaware bankruptcy court. As part of their chapter 11 cases, the Debtors decided to market and sell their Texas power plant. To ensure they obtained the best price, the Debtors conducted an extensive marketing process, contacted over 100 potential purchasers, and evaluated twelve offers. Ultimately, the Debtors entered into an asset purchase agreement with Kelson Channelview LLC ("Kelson") with a purchase price of $468 million.

The purchase agreement required the Debtors to seek immediate bankruptcy court approval of the sale. However, if the court required the Debtors to conduct an auction of the power plant before approving the sale, the Debtors were obligated under the purchase agreement to seek court approval of certain bid protections for Kelson, including a $15 million break-up fee and $2 million expense reimbursement. Notably, the purchase agreement did *not* condition Kelson's bid on the Debtors obtaining court approval of the bid protections.

On February 25, 2008, as required by the purchase agreement, the Debtors requested that the bankruptcy court approve the sale to Kelson without any auction. The court refused, and required the Debtors to conduct an auction. Forced to conduct an auction, the Debtors, with the support of their creditors, requested court approval of the $15 million break-up fee and $2 million expense reimbursement as required under the purchase agreement. An interested purchaser who had submitted a prior offer for the power plant, Fortistar, LLC, objected to the break-up fee and expense reimbursement, asserting that the size of the break-up fee and expense reimbursement would deter it from submitting an otherwise higher and better bid at the auction.

The bankruptcy court approved the $2 million expense reimbursement, but denied the break-up fee. The court found that the break-up fee was not necessary to preserve value where another bidder already had expressed an intention to bid at the auction. With its break-up fee denied, Kelson asserted that its bid was no longer binding and that it would not participate in the auction. At the auction, Fortistar submitted the winning $500 million bid and the bankruptcy court entered an order approving the sale of the power plant to Fortistar.

After entry of the sale order, Kelson appealed the denial of its break-up fee to the district court. The district court affirmed the bankruptcy court's decision; Kelson then appealed to the Third Circuit Court of Appeals.

On appeal, the Third Circuit affirmed the lower courts' decisions. Consistent with its prior decision in *Calpine Corp. v. O'Brien Environment Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999), the court held that a break-up fee should be approved only if it is necessary to preserve the value of a debtor's estate.

Recognizing that "stalking horse" bids benefit a debtor's estate by providing a floor price for the debtor's assets, the court explained that a break-up fee may be awarded where it induces the stalking horse bidder to (1) first make its bid or (2) adhere to its bid after a court orders that an auction be held. In analyzing Kelson's bid, the court found that neither of these factors justified awarding Kelson the break-up fee. As reflected in the purchase agreement, Kelson's bid was only conditioned on the Debtors *seeking* (as opposed to actually *obtaining*) court approval of the break-up fee. By not conditioning its bid on obtaining court approval of the break-up fee, the court determined that the break-up fee did not induce Kelson to make its bid.

The court also found that the bankruptcy court was justified in finding that the break-up fee was not necessary to preserve Kelson's bid for the auction. The court explained that it was reasonable to assume that, because Kelson made its bid without assurance of a break-up fee, it would comply with its obligations under the purchase agreement and not abandon the bid based on the failure to secure the break-up fee. Fortistar's expressed intention to bid at the auction if the break-up fee was not approved further underscored that the break-up fee was not necessary to preserve estate value, and, in fact, may have harmed the estate by discouraging other potential purchasers from bidding.

Importance of Carefully Structuring Bids

The *Reliant Energy* decision highlights one court's close scrutiny of break-up fees and other bid protections. Break-up fees and expense reimbursement may be at risk where a bid is not conditioned on court approval of these bid protections, especially if other bidders are present. In light of this decision, to best protect its ability to obtain a break-up fee, a stalking-horse bidder should carefully structure its bid and related purchase documentation in a manner that conditions the bid and continued participation in the sale process on court approval of all bid protections.

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