Close Scrutiny of Breakup Fees in Bankruptcy Asset Sales Continues

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Section 363(b)(1) of the Bankruptcy Code authorizes a bankruptcy trustee or chapter 11 debtor in possession, "after notice and a hearing," to use, sell, or lease property of the state outside the ordinary course of business. While a sale under section 363(b)(1) is most frequently undertaken by means of a public auction, in which assets are generally sold to the highest bidder, the bankruptcy court may also approve a private sale entered into between the debtor and a purchaser.

Generally speaking, the initial bidder in a public auction held under section 363—the "stalking-horse bidder"—sets the minimum price and other terms of the transaction. Because of the time and effort expended by the stalking-horse bidder in performing due diligence and engaging in the negotiations necessary to arrive at the initial bid, bankruptcy courts will generally allow reasonable bid protections for the bidder in the event the court does not approve the sale or the stalking-horse bidder does not prevail at the auction. These bid protections often include reimbursement of expenses incurred by the bidder in connection with the transaction, a "breakup" fee equal to a specified percentage of the bidder's purchase price, auction procedures, and certain other rights related to the stalking-horse bid. These bid protections are typically the subject of extensive negotiations.

Outside bankruptcy, such protections are typically accorded deference under the business judgment rule. In the bankruptcy context, however, three different approaches have been applied by courts in assessing the propriety of bid protections. Some courts apply a "business judgment" standard to the issue, which, of all the approaches followed by the various courts, involves the highest degree of deference to the debtor's decision to agree to the bidding protections in question. Other courts apply stricter scrutiny, requiring evidence that proposed bid protections are in the "best interests of the estate." Finally, some courts, particularly in the Third Circuit, have generally allowed or disallowed bid protections, including breakup fees, according to the standards governing the allowance of administrative expenses under section 503(b) of the Bankruptcy Code.

The Third Circuit Court of Appeals recently had an opportunity to revisit the application of the section 503(b) administrative-expense standard to breakup fees. In *In re Reliant Energy Channelview LP*, the court of appeals reaffirmed its previous rulings, holding that such fees may be allowed only if they are necessary to induce a stalking-horse bidder either to enter into a transaction or to adhere to its bid after the court orders a public auction.

Reliant Energy

Reliant Energy Channelview LP and its affiliate, Reliant Energy Services Channelview LLC (collectively, the "debtors"), owners and operators of a cogeneration power plant in Channelview, Texas, filed for chapter 11 protection in Delaware in 2007. In 2008, the debtors decided to sell their Texas power plant. With the assistance of consultants with expertise in the energy industry, the debtors contacted 115 potentially interested purchasers and sought bids in a private bidding process. A total of 12 bids were submitted for the plant. The winning bid was submitted by Kelson Channelview LLC ("Kelson"), in the amount of $468 million. Unlike many of the bids submitted with a financing contingent in a difficult business environment, Kelson's bid was not contingent on financing.

Under the asset purchase agreement with Kelson, the debtors were required to seek: (i) an order of the bankruptcy court authorizing the sale without an auction; and (ii) if the court determined that there should be a public auction, an order approving certain "bid protections and procedures" for Kelson's benefit. The bid protections included: (i) a $5 million minimum overbid threshold; (ii) a $15 million breakup fee; and (iii) reimbursement of up to $2 million in expenses incurred by Kelson in connection with the sale process.

The bankruptcy court delayed ruling on the debtors' motion to authorize the sale without conducting a public auction after one of the debtors' equity holders objected to the expedited pace of the transaction. Confronted with the delay, the debtors, with the support of their creditors, asked the bankruptcy court to approve the bid protections. Fortistar, LLC ("Fortistar"), a competing bidder that previously submitted a losing bid based on contingent financing, objected, asserting that it was willing to enter a "higher and better" bid at auction, but claimed that the $15 million breakup fee and the $2 million expense reimbursement would be a deterrent to its competing bid.

The bankruptcy court ultimately refused to approve the $15 million breakup fee, but it approved both the $5 million overbid threshold and the expense reimbursement provision. The court also refused to authorize the sale of the plant without an auction. Kelson declined to participate in the auction that ensued, arguing that its initial bid was no longer available. Fortistar ultimately submitted the winning bid, which topped Kelson's bid by $32 million. The debtors paid Kelson approximately $1.2 million for expense reimbursement, but in light of the court's ruling, they did not pay Kelson any breakup fee.

Kelson appealed to the district court, arguing, among other things, that as a stalking-horse bidder, it should have been entitled to a breakup fee as a matter of fundamental fairness. The district court affirmed the rulings below, after which Kelson appealed denial of its breakup fee to the Third Circuit.

The Third Circuit's Ruling

The Third Circuit affirmed. In its decision, the court of appeals cited its 1999 ruling in *Calpine Corp. v. O'Brien Environmental Energy, Inc.*, where the court held that a breakup fee is allowable only if it is "necessary to preserve the value of the estate" under section 503(b) of the Bankruptcy Code. According to the Third Circuit, there are two ways that a breakup fee can preserve the value of an estate: (i) by inducing the stalking-horse bidder to make an initial bid; and (ii) by inducing the bidder to adhere to its bid after the court orders an auction.

Kelson's bid, the court of appeals emphasized, was conditioned on the debtors' mere "promise" to *seek* court approval of the breakup fee, rather than court approval itself or Kelson's actual receipt of the breakup fee. As such, the court found that the breakup fee was not necessary to preserve the value of the debtors' estate because the fee did not "induce" Kelson's bid. The fact that Kelson submitted its bid before court approval with the explicit understanding that it might not receive the fee supported the Third Circuit's determination that the breakup fee was not necessary to induce Kelson's bid. In addition, the court held that the breakup fee was not needed to maintain Kelson's bid from the estate's standpoint once an auction was ordered, because there was no reason to believe Kelson would have abandoned its fully negotiated agreement, and in any event, there was another willing and able bidder—Fortistar—waiting in the wings.

The Third Circuit concluded that, although the debtors' estates might have benefited to the extent that the grant of the breakup fee would have secured Kelson's adherence to its earlier bid in a public auction, this benefit was outweighed by the potential harm to the estate that a breakup fee would cause by deterring other bidders from participating in the bidding process.

The Third Circuit rejected Kelson's argument that, because none of the debtors' creditors or equity holders objected to the breakup-fee request, the business judgment rule was the proper standard to apply. According to the court, in accordance with *O'Brien*, the section 503(b) standard applies and is not satisfied merely because no objections are interposed. The court also rebuffed Kelson's claim that it was entitled to the breakup fee as a matter of "fundamental fairness" because: (i) Kelson did not raise the argument in the bankruptcy court; and (ii) the two types of claims are clearly distinct—a breakup fee under section 503(b) is a statutory claim, whereas a breakup-fee claim predicated on "fundamental fairness" is a common-law or equitable claim.

Finally, the Third Circuit rejected Kelson's argument that the debtors were estopped from opposing Kelson's appeal because they supported the request for a breakup fee in the bankruptcy court. A chapter 11 debtor in possession, the court emphasized, has a fiduciary duty to maximize the value of the estate. In this case, the debtors argued convincingly that if they had adhered to their earlier position in the face of the changed circumstances, they would have harmed the estate and violated their fiduciary duty. As such, the Third Circuit ruled that the debtors were not estopped from opposing the appeal.

Outlook

Reliant Energy illustrates the importance that courts in the Third Circuit place on public auctions in conducting bankruptcy asset sales and indicates that bankruptcy courts will continue to scrutinize closely the necessity of breakup fees in such sales. Under this ruling, courts in the Third Circuit will continue to review breakup fees applying the standard for administrative-expense allowance under section 503(b).

In re Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010).

Calpine Corp. v. O'Brien Environmental Energy, Inc., 181 F.3d 527 (3d Cir. 1999).