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Breaking Up (and Getting Paid) Is Hard to Do

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On the Edge

A "break-up fee" is a very common deal-protection mechanism, both inside and outside of chapter 11, designed to compensate an initial bidder in an auction for its efforts in connection with the transaction, thereby inducing the bidder to make its bid in the first instance. In the chapter 11 context, break-up fees are particularly important because courts often require debtors to conduct an auction process in connection with the sale of any material assets.[2] While break-up fees differ in the myriad ways they can be triggered, it is common for a break-up fee to become payable in the event that the parties do not complete the sale at no fault of the buyer, or in cases where the seller ultimately decides to complete the transaction with a different buyer.

Timothy E. Graulich

In the event a break-up fee is not necessary to bring a bidder to the table, and a robust auction would occur notwithstanding the possibility of a break-up fee, a break-up fee could chill the bidding because all subsequent bids would have to meet a higher hurdle and a portion of the consideration would be diverted from the estate to the initial bidder. Therefore, even though break-up fees are commonly requested and often granted, courts have increasingly scrutinized the facts and circumstances surrounding break-up fee requests, and a recent case from the Third Circuit, *In re Reliant Energy,*[3] which builds on the precedent established by the Third Circuit in *Calpine Corp. v. O'Brien Environmental Energy Inc.,*[4] highlights the heightened standard of review applicable to break-up fee requests in that circuit.

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Standard of Review Applicable to Break-Up Fee Requests

When a party challenges a break-up fee in an M&A transaction outside the bankruptcy context, courts generally examine whether the fee requested is "reasonable" and whether it deters others from submitting bids that may result in greater value for the seller and its stakeholders.[5] Some bankruptcy courts outside the Third Circuit have likewise applied a similar standard. In one of the earliest published decisions on the subject, *In re Integrated Resources,*[6] the district court in the Southern District of New York set forth the following three-part test: (1) is the relationship of the parties tainted by self-dealing or manipulation; (2) would the fee hamper rather than encourage bidding; and (3) is the amount of the fee unreasonable as a percentage of the purchase price? Applying the business-judgment rule to these questions and reasoning that it is not the court's function to second-guess the company's judgment as to the size of the break-up fee, the court approved the fee.[7] Other courts apply a "best interests of the estate" test, pursuant to which a break-up fee will be approved if it will further the diverse interests of the debtor and its creditors and shareholders.[8]

Brian M. Resnick

These various tests contrast with the test espoused by the Third Circuit in which courts analyze the request under a heightened level of scrutiny pursuant to the traditional administrative expense standard pursuant to which the critical question is whether the fee is "actually necessary" in benefiting and preserving the debtor's estate.[9] As further discussion

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2 While non-bankruptcy purchase agreements differ in that they are usually not followed by auctions, such agreements often include conditions that allow for the submission of a higher offer from other bidders prior to closing. Thus, while the risk to a potential buyer of being outbid may seem more obvious in a bankruptcy setting where auctions frequently accompany the transaction, it is nevertheless a legitimate concern for buyers outside of bankruptcy as well.

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

4 *Calpine Corp. v. O'Brien Envtl. Energy Inc.*, 181 F.3d 527 (3d Cir. 1999). *O'Brien* was the first court of appeals opinion to articulate a governing standard for a break-up fee determination in an asset sale transaction under chapter 11.

5 *See, e.g., Cottle v. Storer Communication Inc.*, 849 F.2d 570 (11th Cir. 1988) (termination fee protected by business-judgment rule where fee not shown to be unreasonable in relation to size of transaction); *Samjens Partners I v. Burlington Indus.*, 663 F.Supp. 614 (S.D.N.Y. 1987) (break-up fee protected by business-judgment rule).

6 *Official Comm. of Subordinated Bondholders v. Integrated Res. Inc. (In re Integrated Res. Inc.)*, 147 B.R. 650, 657 (S.D.N.Y. 1992).

7 *Id.* at 662-63.

8 *See, e.g., In re America West Airlines Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994); *Wintz v. American Freighways Inc., et al. (In re Wintz Co.)*, 230 B.R. 840, 846 (B.A.P. 8th Cir. 1999), *aff'd*, 219 F.3d 807 (2000).

9 11 U.S.C. §503(b).

of *O'Brien* and *In re Reliant Energy* will show, this standard often leads to a highly fact-intensive analysis that, for the initial bidder, can lead to unfavorable results. In particular, *Reliant Energy* demonstrates just how challenging it is to get a break-up fee approved where the initial bid is not unambiguously conditioned on the approval of the fee, or where the fee is sought after the conclusion of the auction. This is true even when the debtor, its creditors and its sole shareholder support the request, and even where the initial bid is sufficient to pay all of the debtor's creditors in full.

In re Reliant Energy: *Factual Background*

In August 2007, Reliant Energy Channelview LP and Reliant Energy Services Channelview LLC (Reliant) filed for chapter 11 and pursued a sale of their largest asset, a power plant in Channelview, Texas. To ensure that the assets were marketed to a large audience of prospective purchasers, Reliant hired consultants and engaged in an extensive marketing campaign, contacting more than 100 potential bidders. Ultimately, Reliant received offers from 12 bidders—11 of which conditioned their bids on obtaining financing. In light of the depressed economic climate and the difficulty with which Reliant believed financing could be obtained, Reliant selected as the winning bid the only unconditional bid of the group, submitted by Kelson Channelview LLC (Kelson). Shortly thereafter, Kelson and Reliant executed an asset purchase agreement (APA) for the power plant. The APA contemplated that in light of the broad marketing of the asset, Reliant would seek approval of a private sale to Kelson without the need for an auction. Nonetheless, the APA provided that in the event the bankruptcy court were to require an auction, Reliant would seek approval of certain bid protections. Chief among those protections was a $15 million break-up fee, equaling approximately 3 percent of the bid's overall value, which was payable to Kelson in the event Reliant ultimately accepted another bid.

At the hearing to approve the APA in February 2008, the bankruptcy court refused to permit the sale to proceed without an auction, and Reliant moved to have the court authorize the bid protections negotiated with Kelson. Fortistar LLC (Fortistar), one of the 11 losing bidders, objected and noted that, but for the requested protections,[10] it would be willing to submit a "higher and better" bid at the ensuing auction. The court approved certain bid procedures and protections, but declined to authorize the break-up fee, finding that it would chill bidding. Kelson refused to participate in the subsequent auction and contended that its initial bid was no longer available to Reliant. Fortistar eventually submitted the winning bid, topping Kelson's original bid by $32 million.

> O'Brien *and* Reliant Energy *represent a body of Third Circuit case law that turns a scrutinizing eye toward break-up fee provisions customarily found in bankruptcy asset-purchase agreements. Courts are naturally wary of fee protections because such fees increase the cost of acquisition for a competing bidder and divert proceeds from the estate to the stalking-horse bidder.*

Kelson subsequently appealed to the district court, arguing that the bankruptcy court abused its discretion by applying an incorrect legal standard in denying an administrative expense priority claim for $15 million in respect of the break-up fee. The district court affirmed the bankruptcy court's decision, and Kelson appealed to the Third Circuit, which relied primarily on the standard it set forth in *O'Brien,* holding that a break-up fee is only justified in instances where the requesting party could show that the fee is "actually necessary" to preserving the value of the estate under the standard generally applicable to requests for administrative expense priority.

The O'Brien *Standard*

In *O'Brien,* the debtor solicited bids from various interested parties for a sale of its assets. After evaluating several prospective purchasers' bids, the debtor accepted a bid from Calpine Corp. (Calpine). Calpine and the debtor executed a purchase agreement that specifically conditioned its effectiveness on the debtor obtaining bankruptcy court approval of its $2 million break-up fee request. Although the debtor and many of its creditors supported the fee request, the court nevertheless refused to approve the fee, finding that it would complicate, or even worse, chill the bidding process, but the court said it would permit Calpine to renew its request at a later date. In the ensuing auction, Calpine lost to another bidder and renewed its request for the $2 million break-up fee, which the bankruptcy court denied and the district court affirmed. The Third Circuit upheld the order denying the request, holding that the award of the break-up fee was not actually necessary to preserve the value of the estate.

In *O'Brien,* the court considered the opinions of various lower courts that had decided the issue under tests not falling under §503(b), and the court found that none of them "offer[ed] a compelling justification for treating an application for break-up fees and expenses under §503(b) differently from other applications for administrative expenses under the same provision."[11] Ultimately, the court relied on the language in §503(b) of the Bankruptcy Code—that the benefit conferred be "actually necessary" to preserving the value of the estate—to create the standard against which all break-up fee requests in the Third Circuit are now measured.

The *O'Brien* court held that the decision on the allowability of break-up fees turns on whether the debtor has the "ability to show that the fees were actually necessary to preserve the value of the estate."[12] Although the bankruptcy court had evaluated the fee request under an elaborate nine-factor balancing test, the Third Circuit chose instead to focus on the language of §503(b)(1)(A), which specifically requires that the requested expense provided an actual and necessary benefit to the estate. The court also noted that a merely permissible purpose or speculative benefit did not meet this "actually necessary" standard. The *O'Brien* test looks beyond whether a benefit *could have been conferred* by allowing the fees and asks whether the granting of fees provided an *actual* benefit that was *necessary* to the estate.

The Third Circuit Expands on O'Brien *in* In re Reliant Energy

In *Reliant Energy,* the Third Circuit closely examined two questions that it

[10] Because Fortistar ultimately submitted a bid that exceeded Kelson's bid by more than twice the amount of the requested break-up fee, this contention seems suspect.

[11] *Calpine Corp. v. O'Brien Envtl. Energy Inc.*, 181 F.3d 527, 535 (3d Cir. 1999).

[12] *Id.*

believed would determine whether the break-up fee met the standard articulated in *O'Brien*: (1) whether the break-up fee was necessary to induce the initial bid; and (2) whether the break-up fee was necessary to preserve Kelson's bid in the auction. Answering both of these questions in the negative, the Third Circuit declined to award Kelson the break-up fee[13] and emphasized several key factors worth considering in more detail.

1. *Was the break-up fee necessary to induce the initial bid?* The Third Circuit found that the break-up fee was in fact unnecessary in inducing Kelson's bid. Relying primarily on its interpretation of a contested provision of the APA, the court focused on the requirement that Reliant *seek* court approval, rather than actually *obtain* court approval, for the bid protections. From this, the court inferred a willingness on the part of Kelson to bind itself to the purchase agreement before actually knowing with certainty whether the break-up fee would be allowed. In other words, the court reasoned that the fee could not possibly have induced Kelson to bid because Kelson already committed to the bid before the fee was approved. The court drove home this point by stating that "there [was] no escape from the fact that Kelson did make its bid without the assurance of a break-up fee, and this fact destroy[ed] Kelson's argument that the fee was needed to induce it to bid."[14]

2. *Was the break-up fee necessary to preserve Kelson's bid for the auction?* The court answered this question in the negative as well, drawing several noteworthy conclusions from the facts. First, because the court held that Kelson's obligations under the APA were not conditioned on approval of the break-up fee, Kelson had no legitimate "outs" and its bid remained binding.[15]

Second, a competing bidder, Fortistar, made clear that it would be willing to outbid Kelson but for the requested protections. This fact considerably weakened Kelson's arguments that granting the break-up fee would have no effect on the competitive aspect of the auction process and that Kelson's bid was the best and only bid available.

Third, the court believed, as a matter of common sense and good business practice, that a bidder who had already invested so much would not readily abandon its efforts and remove itself from the process simply because its request for a break-up fee was denied. The court seemed to create an implied presumption that a bidder who had already put in the work and diligence needed to submit an initial bid would not simply walk away from its own efforts. Interestingly, the court's observations in this regard were belied by the fact that Kelson actually abandoned its bid and did not participate in the auction.

Finally, despite the court's acknowledgement that the fee analysis should be based on the facts known at the time approval was initially sought (*i.e.,* prior to the auction), the court noted that there was no escaping the benefit of 20/20 hindsight. The fact remained that after the bidding concluded, the auction resulted in a higher bid by nearly $32 million from a bidder (Fortistar) that had previously voiced its intention that it would submit a higher bid as long as the requested protections were not in place.

Additional Arguments Made by Kelson

Kelson argued that two factors distinguished this case from others and supported the application of the business-judgment test in this case: (1) None of Reliant's creditors or shareholders objected to Kelson's initial break-up fee request; and (2) Kelson's initial bid was sufficient to pay all creditors in full.

With respect to the first factor, the court noted that while consensus among the parties is often weighed heavily by courts, it cannot outweigh a failure to meet the statutory test for approval of administrative expenses. Kelson argued that Reliant, having initially supported the break-up fee request, was then estopped from contesting it after the auction and later on appeal. In a determination that could have wide-ranging consequences outside the realm of break-up fees (albeit an unsurprising determination), the court stated that Reliant's fiduciary duties to maximize value for the estate permitted them to reverse their position in light of the changed circumstances.[16] With respect to the second factor, the court declined the opportunity to hold solvent debtors to a different standard (namely the standard generally applicable to solvent enterprises outside of chapter 11—the business-judgment standard).[17]

Conclusion

O'Brien and *Reliant Energy* represent a body of Third Circuit case law that turns a scrutinizing eye toward break-up fee provisions customarily found in bankruptcy asset-purchase agreements. Courts are naturally wary of fee protections because such fees increase the cost of acquisition for a competing bidder and divert proceeds from the estate to the stalking-horse bidder. To increase the chances of getting such a break-up fee approved, buyers should be explicit in the documentation that the bid is conditioned on actual court approval of the break-up fee (rather than the satisfaction of the debtor's obligation to seek court approval of the fee). This should help guard against a finding by the court that the requested fees are not "necessary" to induce the first bid.

Second, the parties should advance as strong a case as possible (in the motion and any supporting affidavits and testimony) that the break-up fee was necessary to induce the bidder to participate in the auction as the stalking-horse and that it will likely maximize the value to be realized by the estate by encouraging, rather than chilling, more competitive bidding.

It is also sensible for initial bidders to be cognizant of other interested bidders in the process to formulate a realistic view of the impact those other bidders may have on the court's analysis of the appropriateness and effectiveness of the fee provisions. It may make sense to moderate the amount of the fee request if the facts do not seem to warrant approval of a sizable fee that may chill bidding (such as where there may be other parties that express a willingness to make a bid if the court declines to approve the break-up fee).

Finally, it is a mistake to assume that a consensus among the parties or the fact that the bid is sufficient to satisfy all of the claims against the estate will be dispositive. There is no escaping the fact that—at least in the Third Circuit—a break-up fee will only be approved if it meets the standard generally applicable to requests for administrative expenses under §503(b) of the Bankruptcy Code: The fee must be "actually necessary" to preserve value for the estate. ■

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13 Kelson was, however, awarded approximately $1.2 million in respect of its actual expenses incurred in connection with its initial bid.

14 *In re Reliant Energy Channelview LP*, 594 F.3d 200, 207 (3d Cir. 2010).

15 Apparently Kelson did not share this view and contended that its bid was no longer available after the bankruptcy court declined to approve the break-up fee.

16 *In re Reliant*, 594 F.3d at 210.

17 *Id.* at 209.