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Breaking Up is Easier to Do: Third Circuit Denies Section 363 Buyer its "Break-Up Fee" in *Reliant Energy* Decision

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Introduction: Stalking Horses and Break-Up Fees

"Stalking horse" bidders seeking to buy distressed assets under Section 363 of the Bankruptcy Code routinely request "break-up" fees to compensate them for their efforts if they are overbid at a bankruptcy auction. Ideally for the stalking horse, the break-up fee is documented as an integral part of its asset purchase agreement and approved by the Bankruptcy Court prior to any open auction required as part of the bankruptcy process.

The *quid pro quo* of a break-up fee is basic: on the one hand, the stalking horse bidder performs the initial diligence on the distressed assets and provides an entering bid that may attract other bidders at higher prices and better terms; on the other hand, the seller agrees to pay the stalking horse a break-up fee in the event that the assets are sold to a higher bidder. The break-up fee may be considered a "win-win" deal, because no break-up fee is payable if no other bidder surfaces, and the bidding procedures provide that any other bidder must submit a bid that is greater than the stalking-horse bid plus the break-up fee.

However, an alternate view also exists—that the break-up fee may chill

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other bidders from submitting bids, because the other bidders must submit bids at a level that covers the break-up fee. In a case where competitive interest in the distressed assets exists even before the stalking horse bid is submitted, the break-up fee may not be worth its cost.

The *O'Brien* Standard: The Facts Matter

This alternate view was adopted by the Third Circuit Court of Appeals in its January 15, 2010 decision in the case of *In re Reliant Energy Channelview LP* (Case No. 09-2074). In its *Reliant* decision, the Third Circuit denied a stalking horse the $15 million break-up fee it had negotiated for the purchase of a Texas power plant. The Court of Appeals affirmed the prior decisions of the Bankruptcy Court and District Court, both of which also denied the break-up fee. The Court of Appeals applied the well-known *O'Brien* standard, from the 1999 Third Circuit decision of that name, and considered whether the award of the break-up fee to the stalking horse was necessary to preserve the value of the power plant to the bankruptcy estate.

The Court of Appeals recognized two possible sources of value: that the break-up fee may have induced the stalking horse to make its bid before the auction, or that the break-up fee may have induced the stalking horse to remain a potential purchaser once other bidders arrived on the scene. On the first point, the Court of Appeals looked to the asset purchase agreement signed by the stalking horse, which conditioned the bid not on the seller's promise to pay a break-up fee in the event of an overbid, but rather on the seller's promise to seek court approval of a break-up fee if competitive bidding were to ensue. In other words, the stalking horse had not required the break-up fee as a firm condition precedent to its continued participation in the sale process and had not required Bankruptcy Court approval of the break-up fee prior to moving forward with competitive bidding. On the

second point, the Court of Appeals noted that, as a matter of fact, the Bankruptcy Court denied the break-up fee in the midst of the auction on the basis of its determination that the stalking horse would not abandon the purchase even without the break-up fee. Moreover, the Court of Appeals noted, the auction actually resulted in a higher bid for the power plant than had existed before the auction, such that a break-up fee was not required to raise the purchase price at auction.

Notably, the Court of Appeals was not swayed by the fact that only the other competitive bidder, and not any creditor of the seller, objected to the break-up fee, nor that the seller was solvent (even though in bankruptcy) and therefore able to pay the break-up fee without harming creditors. The Court of Appeals stated that the *O'Brien* standard is applicable notwithstanding these circumstances, and also discarded other theories espoused by the stalking horse regarding the alleged unfairness of the result.

The Bottom Line

Potential buyers of distressed assets out of bankruptcy, especially in the active Delaware Bankruptcy Court, should be aware of the *Reliant* decision and its potential impact on future requests for break-up fees. Stalking horse bidders should consider making the approval of their break-up fees at the outset a firm condition to their proceeding with the sale, because the lack of such an express contractual condition precedent was a crucial fact in the *Reliant* case. Subject to issues surrounding standing and the circumstances of any particular case, other competitive bidders should consider whether there are ways to challenge a break-up fee of a stalking horse in order to make a Section 363 auction more competitive and reduce the end price for the distressed assets on the block.

While Section 363 sales can present opportunities for potential buyers of distressed assets, seizing those opportunities and successfully consummating transactions require an understanding of the legal rules regarding break-up fees and similar conventions of the bankruptcy sale process.

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