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Third Circuit Clarifies Standard For Allowance of Break-Up Fees in Section 363 Sales

In a recent decision, the United States Court of Appeals for the Third Circuit further defined its standard for awarding a break-up fee to an unsuccessful "stalking horse" bidder for a debtor's assets. In *In re Reliant Energy Channelview LP*, ___ F.3d ___, 2010 WL 143678 (C.A. 3 (Del.) 2010), the debtors sought to sell their largest asset, a power plant, pursuant to Section 363 of the Bankruptcy Code. Following a comprehensive marketing process, the debtors accepted a $468 million bid of Kelson Channelview LLC (Kelson). The contract with Kelson simply required the debtors to seek an order approving certain bid protections and procedures, including the payment of a $15 million break-up fee to Kelson, if the bankruptcy court were to require the debtors to hold an auction, which it subsequently did.

In response to the debtors' request to approve the proposed break-up fee, a potential competing bidder, Fortistar, LLC (Fortistar), argued that it was discouraged from submitting a higher bid by the proposed break-up fee. After the bankruptcy court refused to allow the break-up fee, Kelson withdrew its offer on the ground that it was no longer valid and did not participate in the auction process. The debtors accepted Fortistar's bid, which exceeded Kelson's original bid by $32 million, and the bankruptcy court approved the sale of the power plant to Fortistar. Kelson appealed the bankruptcy court's denial of a break-up fee to the district court, which affirmed the bankruptcy court's ruling. Kelson then appealed to the Third Circuit.

The court in *Reliant* noted its decision in *Calpine Corp. v. O'Brien Environmental Energy, Inc. (In re O'Brien Environmental Energy, Inc.)*, 181 F.3d 527 (3d Cir. 1999), where it held that the allowance of a break-up fee was subject to the standard for allowance of an administrative priority claim under Section 503(b) of the Bankruptcy Code; that is, the fees had to be necessary to preserve the value of the bankruptcy estate. In *O'Brien*, the court ruled that a break-up fee did not meet that standard where the unsuccessful bidder would have bid even without the assurance of a break-up fee (which, in that case, it did).

The court in *Reliant* further defined the *O'Brien* standard by ruling that to preserve the value of the estate, the break-up fee must have either induced or preserved a bidder's bid. The court held that because Kelson did not condition its bid on the provision of a break-up fee, but only required the debtors' agreement to seek a break-up fee, the fee was not necessary to induce Kelson's bid.

Additionally, the court held that the break-up fee was not necessary to preserve Kelson's bid because, among other things, it was reasonable to assume that Kelson would not have abandoned its contract with the debtors if no other bidders materialized.

Reliant teaches that buyers of assets in Section 363 sales who seek maximum bid protections, including a break-up fee, should make allowance of those protections a material condition of their contract with a debtor, and specifically provide that failure to obtain court approval of such protections will constitute an event of default under the contract.

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