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## Negotiating Break-Up Fees In A Stalking Horse Bid

*Law360, New York (January 27, 2010)* -- The term "stalking horse" originally referred to a horse or type of screen a hunter used to conceal his position from intended prey. Today the term takes a new meaning altogether thanks to its application in the bankruptcy context.

A modern day "stalking horse" is an interested buyer of a debtor's assets who is offered incentives for being the first to announce its intent. As the initial bidder, the stalking horse sets the minimum purchase price and other terms of the transaction.

Often included in the stalking horse bid are reimbursements for the stalking horse bidder's expenses incurred in connection with the transaction, a break-up fee equal to some percentage (usually 3 percent to 5 percent) of the stalking horse bidder's purchase price and bid protections for the stalking horse bidder.

The incentives are highly sought after and often are the result of intense negotiations between the debtor and the stalking horse bidder.

The United States Court of Appeals for the Third Circuit previously ruled, in O'Brien v. Calpine (In re O'Brien Environmental Energy), 181 F.3d 527, 537 (3rd Cir. 1999), that break-up fees and expense reimbursements for a stalking horse are to be considered under section 503(b) of the Bankruptcy Code and will not be granted administrative priority status unless the stalking horse bidder demonstrates the requirements of section 503(b), namely that (1) it provided an actual benefit to the estate and (2) the break-up fee and expense reimbursement were necessary to preserve the value of the estate's assets.

Recently, the Third Circuit issued a follow-up opinion to O'Brien, in Kelson Channelview LLC v. Reliant Energy Channelview LP (In re Reliant Energy Channelview LP), No. 09-2074 (3d Cir. Jan. 15, 2010). The Reliant opinion reaffirmed O'Brien and denied a $15 million break-up fee despite the fact the fee was not opposed by the debtors or the Official Committee of Unsecured Creditors.

In Reliant, the debtors decided to sell their largest asset, a power plant in Channelview, Texas. To this end, the debtors contacted over a hundred interested purchasers and entered into confidentiality agreements with about a third of those parties.

Ultimately 12 parties submitted bids for the assets. Many of the bids, however, were contingent on the bidder first obtaining financing. Kelson submitted a bid that was not contingent on financing and was selected as the winning bidder.

The debtors and Kelson entered into an asset purchase agreement ("APA") for the purchase of the power plant. The APA included several provisions benefiting Kelson, including a promise by the debtors to ask the Bankruptcy Court to approve the sale without an auction.

The APA further provided that if an auction was required by the court, the debtors would seek Court approval of a break-up fee of $15 million (equivalent to about 3 percent of the purchase price) and an expense reimbursement of up to $2 million.

The APA also required the debtors to seek an order approving certain bid protections providing, among other things, that the debtors could not accept a competing bid unless it exceeded Kelson's stalking horse bid by $5 million.

Since the APA only required the debtors to seek court approval for the break-up fee — as opposed to conditioning the original bid on an assured break-up fee — Kelson's bid was made before the auction knowing that it might not receive such a fee.

In accordance with the APA, the debtors filed a motion with the Bankruptcy Court requesting authority to sell the assets to Kelson without an auction. Fortistar, one of the parties that submitted a contingent bid, objected to the motion. Fortistar stated it was willing to submit another bid, but was deterred by the proposed $15 million break-up fee and $2 million expense reimbursement.

Following an evidentiary hearing, the Bankruptcy Court denied the proposed break-up fee and the debtors' request to sell the assets without an auction. However, the Bankruptcy Court allowed reimbursement of Kelson's expenses (up to $2 million) and required competing bidders to offer at the auction at least $5 million more than Kelson's initial bid. Kelson did not participate in the auction.

Fortistar ultimately was declared to be the winning bidder at the auction with an offer exceeding Kelson's by $32 million, and the Bankruptcy Court approved the sale to Fortistar. Kelson received an expense reimbursement of $1.21 million.

Kelson appealed the Bankruptcy Court's approval of the Fortistar bid and denial of the break-up fee to the district court, which affirmed both orders. Kelson appealed the district court's order to the extent it affirmed the Bankruptcy Court's denial of the break-up fee.

The Third Circuit affirmed the district court's decision, thereby affirming the Bankruptcy Court's denial of the break-up fee to Kelson. In doing so, the Third Circuit reaffirmed its holdings in O'Brien and explained that in reviewing a break-up fee request, courts should apply the general standard used for granting or denying other administrative expenses — i.e., whether the expense was necessary to preserve the value of the estate.

While the Kelson court acknowledged that getting a stalking horse bid may be necessary to preserve the value of the estate, it noted that break-up fees may not be necessary to entice a stalking horse bidder, particularly where it is clear that the bidder would have bid even without the fee.

Here, Kelson did not condition its bid upon the assurance of a break-up fee. Rather, the break-up fee in Kelson's bid was conditioned upon subsequent Bankruptcy Court approval.

In the Kelson court's view, parties who submit full and complete bids without the assurance of a break-up fee will not generally abandon their efforts to obtain an asset if a break-up fee ultimately is not approved. As a result, the break-up fee is not viewed as necessary to induce the bid, and therefore does not, in and of itself, satisfy the requirements of section 503(b).

The Kelson court also considered whether bankruptcy courts should consider the absence of objections to a proposed break-up fee by debtors or other parties in interest.

On this score, the court reaffirmed prior rulings that break-up fees — like other requests for the payment of administrative expenses — should be awarded or denied in accordance with the dictates of section 503(b) of the Bankruptcy Code, and not on the basis of a debtor's business judgment or the fundamental fairness to the creditor of allowing such expenses in bankruptcy.

Kelson signals the Third Circuit's continuing commitment to critically reviewing break-up fees in strict adherence with the requirements of section 503(b) of the Bankruptcy Code, and raises the idea that parties may need to identify creative alternatives to break-up fees to entice a stalking horse bidder.

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