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Break-up Fees in Bankruptcy

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In recent years, purchasers of assets/businesses in Chapter 11 cases have frequently sought certain protections that are common in the corporate takeover world such as "break-up fees" or "topping fees," expense reimbursement, non-solicitation or "window shop" clauses, bid increment limitations, and various other bidding or lock-up type protections. Courts addressing these matters have focused primarily on break-up fee arrangements. [1] Outside of the bankruptcy context, break-up fee arrangements are presumptively valid under the business judgment rule.[2] In a bankruptcy case, bidding incentives such as break-up fees and bid increment limitations are carefully scrutinized in asset sales to ensure that the debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.[3]

Courts have justified the use of break-up fees and other incentives as necessary and appropriate, under certain circumstances, in order to further the goal of maximizing the value of the assets sold by obtaining the highest price or greatest overall benefit possible for the estate.[4] In *In re Integrated Resources, Inc.*, the district court identified three questions for courts to consider when evaluating break-up fees in a Chapter 11 case:

1. Is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation?
2. Does the fee hamper rather than encourage, bidding?
3. Is the amount of the fee unreasonable relative to the proposed purchase price?[5]

The usual rule is that if the break-up fee encourages bidding, it will be approved; if it stifles bidding, it will not be approved [6].

In examining whether the break-up fee encouraged bidding, the district court in *In re Integrated Resources, Inc.*, stated that the court should examine whether the break-up fee served any of three possible useful functions:

1. 1. To attract or retain a potentially successful bid
2. To establish a bid standard or minimum for other bidders to follow; or
3. To attract additional bidders. [7]

Other courts have identified a more detailed (but very similar) list of significant factors to be considered in determining the propriety of allowing break-up fee provisions including the following:

1. Whether the fee requested correlates with a maximization of value to the debtor's estate;

2. Whether the underlying negotiated agreement is an arms-length transaction between the debtor's estate and a negotiating inquirer;
3. Whether the principal secured creditors and the official unsecured creditors' committee are supportive of the concession;
4. Whether the subject break-up fee constitutes a fair and reasonable percentage with the proposed purchase price;
5. Whether the dollar amount of the break-up fee is so substantial that it provides a "chilling effect" on other potential bidders;
6. The existence of available safeguards beneficial to the debtor's estate; and
7. Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee. [8]

While most courts which have addressed these issues are motivated to approve break-up fees and other bidder protections, under certain circumstances, based on the belief that these imports from non-bankruptcy transactions will assist in maximizing values, some commentators disagree. One commentator recently contended that although the stated purpose of break-up fees is permissible in theory, the purpose fails to materialize in practice and that, accordingly, break-up fees represent unnecessary payments of estate funds.[9] moreover, in a very recent decision in *In re America West Airlines, Inc.*, the bankruptcy court disapproved a proposed break-up fee in the range of $4 million to $6 million depending on the timing of certain occurrences.[10] The court rejected the application of the business judgment rule to consideration of break-up fees as applied by both the bankruptcy court and the district court in *In re Integrated Resources, Inc.* and adopted and approved of the reasoning set forth in a law review article by the commentator referenced above against the application of break-up fees in bankruptcy cases.[11]

The court in *In re America West Airlines, Inc.*, stated that "the standard is not whether a break-up fee is within the diverse business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders alike.' "[12] In *In re America West Airlines, Inc.*, the court held that the applicable analysis must include a determination that all aspects of the transaction are in the best interest of all concerned, including the debtor's bankruptcy estate, its creditors, bond holders and shareholders. The court found that the proposed break-up fee:

1. Was not in the best interest of the estate, creditors or equity holders,
2. Was not economically reasonable where the debtor had been operating profitably over the last three quarters,
3. Unnecessarily chilled bidding when the debtor had been thoroughly marketed and when there was no need to induce bidding, and
4. Potentially depleted estate assets that could be better utilized to fund a plan of reorganization and continue to provide funds for professionals, attorneys, accountants, and consultants to that end.[13]
5.

1. See *In re Integrated Resources, Inc*., 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992)("A 'break-up fee' is a fee paid to a potential acquirer of a business, or certain assets, by the seller, in the event that the transaction contemplated fails to be consummated and certain criteria in the purchase agreement are met. The condition most commonly given rise to the payment of a break-up fee is the seller's acceptance of a later bid. Break-up fees may take the form of paying the out-of-pocket expenses incurred in arranging the deal, including due diligence expenses, or break-up fees may be wholly independent of the transaction costs. For example, a break-up fee may include compensation for a bidder's lost opportunity cost.").
2. *In re Integrated Resources, Inc.*, 147 B.R. 630,657(S.D.N.Y.1992), *citing Cottle v. Storer Communications, Inc.*, 849 F.2d 570 (11th Cir. 1988). ("Outside of bankruptcy, the business judgment rule generally bars judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes.") *In re Hupp Industries, Inc.*, 140 B.R. 191,195 (Bankr. N.D. Ohio 1992), *quoting Revlon, Inc. v MacAndrews & Forbes Holding, Inc*., 506 A.2nd 173(Del. Sup. 1985).
3. *In re Hupp Industries, Inc.*, 140 B.R. at 195-196.
4. *In re Integrated Resources, Inc.*, 135 B.R. at 750 and *In re Integrated Resources, Inc.*, 147 B.R. at 650.
5. *In re Integrated Resources, Inc.*, 147 B.R. at 657.
6. *In re Integrated Resources, Inc.*, 135 B.R. at 750; *In re Integrated Resources, Inc.*, 147 B.R. at 650.
7. *In re Integrated resources, Inc.*, 147 B.R. at 661-662.
8. *In re Hupp Industries, Inc.* 140 B.R. at 194; *In re Twenver, Inc.*, 149 B.R. at 954,956 (Bankr. D. Colo. 1992).
9. Bruce A. Markell, *The case Against Breakup Fees In Bankruptcy*, 66 Am. Bankr. L.J. 349 (Fall 1992).
10. *In re America West Airlines, Inc.*, 166 B.R. 908 (Bankr. D. Ariz. 1994).
11. *Id. at* 912; see *In re Integrated Resources, Inc.*, 135 B.R. 746 and *In re Integrated Resources, Inc.*, 147 B.R. 630 and Bruce A. Markell, The Case Against Breakup Fees In Bankruptcy, 66 A. Bank. L.J. 349 (Fall, 1992).
12. *In re America West Airlines, Inc., citing In re Lionel Corp.,* 722 F.2d at 1071.
13. *In re America West Airlines, Inc.*, at 913. The court found that the parties viewed the proposed break-up fee as liquidated damages and held that liquidated damages could not be paid as an administrative expense because 11 U.S.C. § 503(b) only allows payment of administrative expense claims incurred that were beneficial to the debtor's estate, *citing In re Hupp*, 140B.R. at 196. The court concluded that "[a]s liquidated damages, the proposed break-up fee does not meet the standard of Section 503 because it is not correlated to any transactional cost or expense incurred by the negotiating bidder." *In re America West Airlines, Inc.*, at 912-913. In denying approval of the proposed break-up fee, the court found that a proposed reimbursement provision allowed significant and fair treatment of a third party bidder by providing for reimbursement of expenses in the amount of #250,000 per month, up to $3 million, subject to court approval. The court further found and concluded that all other sections of the proposed "Interim Procedures Agreement"

except those dealing with break-up fees were in the best interest of the estate and could be approved. *Id.*