

**ALERTS**

## Energy Future Holdings: Third Circuit Authorizes Potential Administrative Claim for Losing Stalking Horse Bidder

**June 1, 2021**

The Third Circuit recently held, in a case from the *Energy Future Holdings* bankruptcy, that a losing stalking horse bidder can provide sufficient value to the debtor's estate to receive an administrative claim for a break-up fee and expenses. *In re Energy Future Holdings Corp.*, 990 F.3d 728, 748 (3rd Cir. 2021). This represents an expansive view of potential administrative claims related to those costs, providing bidders significant potential protections for their bids. The Third Circuit ruling ensures the enforcement of breakup fees and enables debtors to rely on their ability to attract stalking horse bids. The Bankruptcy Court for the District of Delaware will decide on remand whether the bidder's work conferred an actual benefit on the estate that would entitle the bidder to payment. *Id.*

### Key Points

- A stalking horse bidder can benefit the estate and potentially recover termination fees and out-of-pocket expenses with administrative expense priority — even when the ultimate winning bid is lower than the stalking horse bid.
- Courts will consider the terms and conditions in the various proposals, along with the final purchase price, to determine whether the estate benefitted from the stalking horse's efforts.
- Stalking horse bidders should argue that expenses incurred in a bid ultimately stymied by regulatory concerns still benefit the estate — and

thus may be entitled to administrative priority.

## **Facts and Procedural History**

Energy Future Holdings filed for Chapter 11 relief in April 2014. EFH entered into merger negotiations with NextEra, culminating in the Bankruptcy Court's approval of a Merger Agreement providing for NextEra's acquisition of the Oncor power facility in exchange for paying EFH's debt.

NextEra made consummation of the Merger Agreement subject to the removal of a regulatory "ring fence" in place around Oncor. The ring fence prohibited NextEra from appointing or replacing Oncor board members and prevented Oncor from making distributions to NextEra.

On April 13, 2017, the Public Utility Commission of Texas denied NextEra's request to remove the ring fence. The Merger Agreement provided for a \$275-million Termination Fee that would be payable to NextEra if EFH terminated the Agreement. NextEra appealed the PUCT decision to a Texas state court, and EFH terminated the Merger Agreement while NextEra's appeal was pending.

Upon a creditor's motion for reconsideration, the Bankruptcy Court modified the Termination Fee provision in the NextEra Merger Agreement after noting "that under no foreseeable circumstances would NextEra terminate the Merger Agreement if the PUCT declined to approve the NextEra Transaction." The Bankruptcy Court entered an order modifying the Termination Fee provisions and denying recovery of a Termination Fee.

The Bankruptcy Court eventually approved a merger between EFH and Sempra Energy for several hundred million dollars less than what NextEra had agreed to pay. The Sempra Merger allowed the ring fence to stay in place.

Subsequently, NextEra filed an Expense Application under Section 503(b)(1)(A) to recover costs "incurred in its efforts to complete the transaction, obtain the requisite regulatory approvals, and complete the acquisition of [EFH's] Oncor assets from the time the Merger Agreement was executed until [EFH] gave notice of termination." One of EFH's creditors, along with the indentured trustee, opposed NextEra's Expense Application.

The Bankruptcy Court did not permit payment of NextEra's costs. The court emphasized the absence of a "competitive bidding process," noting that EFH "eventually closed a transaction with Sempra for substantially less value." The court also rejected NextEra's argument that its efforts provided a "roadmap" for the Sempra deal, concluding that, because EFH "[was] forced ... to find an alternative transaction at far less value," there was no benefit to the estate.

The Bankruptcy Court also denied payment based on language in the Merger Agreement providing that each party pays its own expenses, except for those fees recounted in "specifically enumerated sections of the Merger Agreement or are administrative expenses addressed in [EFH's] bankruptcy plan." The Delaware District Court affirmed the Bankruptcy Court, and NextEra appealed from this decision to the Third Circuit Court of Appeals.

## **Analysis**

The Third Circuit addressed two issues on appeal: (1) whether the Merger Agreement barred NextEra from recovering expenses and (2) whether NextEra "plausibly alleged" that its expenses conferred an actual benefit on the estate.

### **1. Section 6.7 of the Agreement's Did Not Bar Payment of Fees**

The Third Circuit first addressed whether Section 6.7 of the Merger Agreement precluded NextEra from recovering general administrative fees, holding that it did not and reversing the Bankruptcy Court's granting of summary judgment. Section 6.7 of the Merger Agreement provided that: *"Except ... any administrative expenses of the Debtors' estates addressed in the Plan of Reorganization, whether or not the Merger is consummated, all costs and expenses incurred in connection with this Agreement and the Closing Date Transactions and the other transactions contemplated by this Agreement shall be paid by the party incurring such expense."* (emphasis added).

The Third Circuit found that the "unambiguous meaning of Section 6.7 ... is that administrative expenses of the Debtors' estates are allowed under the Plan of Reorganization ... if determined by the Bankruptcy Court to be expenses that were "actual and necessary" to preserving the Debtors' estates." Because the Plan allowed for payment of valid administrative expenses, the Third Circuit "enforce[d] the plain text of the Merger

Agreement and the Plan” by reviewing the merits of NextEra’s administrative expense claims.

### 1. NextEra Plausibly Alleged that it Benefitted the Estate

The Third Circuit held that NextEra plausibly alleged that it benefitted the estate “by providing valuable information, and accepting certain risks, that paved the way for the later Sempra deal.” In reversing the Bankruptcy Court, the Third Circuit noted that, at the motion to dismiss stage, the inquiry “is not whether NextEra *actually* benefitted the estate, but whether it *plausibly alleged* that it did so.” *Id.* at 747 (emphasis added).

#### *Defining and Determining “Benefit” to the Estate*

The Third Circuit emphasized that the benefit “does not have to be substantial” and that “less readily calculable benefits, such as the ability to conduct business as usual, can qualify.” The Court found that promoting more competitive bidding by inducing an initial bid, along with encouraging prospective bidders to do their due diligence and “research[ing] the value of the debtor and convert[ing] that value to a dollar figure on which other bidders can rely” can qualify as a “benefit.”

#### *The Plausibility of NextEra’s Alleged Benefits*

NextEra articulated two arguments that it benefitted the bankruptcy estate: (1) it acted as a “stalking horse” whose bid encouraged later, higher bidders; and (2) it created “a roadmap” that “assisted in and sped up the approval of the Sempra merger.”

*Stalking Horse Theory.* The Third Circuit noted that “NextEra was not a prototypical stalking horse” because its bid was the sole offer. Additionally, NextEra’s alleged stalking horse bid did not attract higher offers, because EFH agreed to the Sempra Merger with a significant price deduction. *Id.* For this reason, the Court gave more consideration to NextEra’s “roadmap” theory. *Id.*

*Roadmap Theory.* The Third Circuit agreed that NextEra plausibly alleged that its labor in drafting the Merger Agreement and Plan (which were relied on in the later Sempra deal), settling creditor objections to the proposed merger, and “proving to future bidders that Debtor’s interest would necessarily have the [ring fence] attached saved Debtors from reinventing the wheel even after the deal with NextEra fell through.”

Notwithstanding EFH's acceptance of a substantially lower price, the Third Circuit observed that the Sempra bid "was for Oncor with the undesirable ring fence intact and was, therefore, a bid on a different bag of goods." NextEra's unsuccessful efforts towards consummating the merger without the ring fence "provided future bidders with the necessary information to place informed bids, with the understanding that the ring fence would remain." Therefore, NextEra plausibly alleged that it benefited the estate through its "due diligence" in pursuing PUOT approval of the sale without the ring fence attached, since this "increase[d] the likelihood that the price at which the debtor[']s asset] is sold will reflect its true worth."

## Next Steps

The Bankruptcy Court will consider whether NextEra's efforts "actually benefitted" the estate. The court will ascertain the value of the benefits NextEra conferred, as well as any costs NextEra allegedly imposed, on the estate during merger negotiations. To minimize alleged costs, bidders would be wise to avoid pursuing expensive regulatory appeals that a court, in hindsight, may consider detrimental to the estate.

The Bankruptcy Court "ought to consider in its balancing, the fairness — or lack thereof — of NextEra being induced by the assurance of a Termination Fee to make the substantial outlays it did, only, when all was said and done, to lose out not only on the deal but also on the Termination Fee." *Id.* at n. 8. However, because Termination Fees are "meant to account for the risk of mergers rather than be an accurate valuation of merger-related services," bidders should not rely on the Termination Fee alone as evidence of the value of the benefit to the estate. *Id.* at n. 13.

The Third Circuit made clear that NextEra is not estopped from arguing that pursuing PUOT approval of a merger without the ring fence benefitted the estate, although a different panel on the Third Circuit affirmed a determination that the Termination Fee did not benefit the estate. *Id.* at n. 9. The question of "whether [a] Termination Fee, if correctly understood at the time it was approved, produced a benefit to the estate" is wholly independent from the inquiry on remand — whether NextEra's efforts taken to consummate the merger "provided a benefit worthy of administrative expense reimbursement *wholly apart* from any Termination Fee." *Id.* (emphasis added).

*Authored by Douglas Mintz.*

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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