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Divided Third Circuit Panel Affirms Bankruptcy Court's Reconsideration of $275 Million Termination Fee

The United States Court of Appeals for the Third Circuit recently issued a 2–1 decision affirming the ruling of the Bankruptcy Court for the District of Delaware, which reconsidered its prior approval of a $275 million termination fee in connection with a proposed merger. *In re Energy Future Holdings Corp.*, No. 18-1109, 2018 WL 4354741, at *14 (3d Cir. Sept. 13, 2018). The Third Circuit noted that the case was "anomalous" and that reconsideration was warranted only because the Bankruptcy Court failed to discern a critical fact that profoundly altered its initial decision to approve the termination fee.

Background

Shortly after filing chapter 11 cases, Energy Future Holdings Corp. and Energy Future Intermediate Holding Company LLC began marketing their economic interest in the rate-regulated business of Oncor Electric Delivery Co. LLC, an electricity transmission and distribution system. On July 29, 2016, the debtors entered into a merger agreement with NextEra Energy, Inc. under which NextEra would acquire Oncor. The merger agreement included a provision which obligated the debtors to pay NextEra a $275 million termination fee under certain circumstances. The default rule was that the fee would be triggered if NextEra did not acquire Oncor and the debtors either sold Oncor to someone else or otherwise emerged from bankruptcy; however, it was subject to certain exceptions. Notably, the fee obligation would ***not*** be triggered if the agreement was terminated ***by NextEra*** and approval of the merger by the Public Utility Commission of Texas (the "PUCT") was the only outstanding condition to closing. It was silent as to whether the fee would be owed if the PUCT rejected the merger and, as a result, ***the debtors*** terminated the agreement. Under those circumstances, the default rule applied.

The scope of the debtors' termination fee obligation was the subject of confusion at the hearing to approve the merger agreement. The debtors' financial advisor testified that if the debtors entered into another transaction, even following the PUCT's rejection of the NextEra transaction, the fee would be payable. Counsel for the debtors, however, contradicted that testimony, stating that: "Suffice to say there's no break-up fee if the PUC[T] just denies—outright denies approval. But if the PUC[T] imposes the burdensome condition which is a significant hurdle . . . a break-up fee is triggered." In fact, as the Third Circuit later noted, the termination fee obligation did not turn on whether the PUCT outright rejected the merger or imposed a "burdensome condition." Rather, it hinged on who terminated the agreement—the debtors or NextEra. If the PUCT rejected the merger, the fee would be payable so long as it was the debtors who terminated. The confusing record was not corrected during the hearing, though, and the Bankruptcy Court ultimately entered an order approving the merger agreement.

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After the hearing, the debtors and NextEra submitted a joint letter to the Bankruptcy Court seeking to clarify the terms of the termination fee provision. The letter did not address "what would happen if the PUCT rejected the merger or approved it with burdensome conditions and NextEra did not terminate."

The PUCT subsequently rejected the NextEra transaction. While the merger was "clearly dead," NextEra made it "clear that [it] would appeal the PUCT's decision to all levels of review, leaving the Debtors no choice but to terminate the Merger Agreement and risk triggering the Termination Fee or else incur months or years of continued interest and fee obligations." In July 2017, the debtors terminated the agreement and entered into a new merger agreement with another party. A few weeks later, certain creditors of the debtors (the "Movants"), filed a motion with the Bankruptcy Court to reconsider its prior approval of the termination fee.

The Bankruptcy Court ultimately granted the Movants' motion, explaining that it had "fundamentally misapprehended the facts as to whether the Termination Fee would be payable if the PUCT failed to approve the NextEra Transaction." The Bankruptcy Court insisted that no one "focused the Court on a critical fact: the Merger Agreement did not set a date by which approval by the [PUCT] had to be obtained [to avoid automatic termination of the agreement]." "Consequently," the Bankruptcy Court wrote, no party made it aware "that if the PUCT did not approve the NextEra Transaction, the Debtors could eventually be required to terminate the Merger Agreement and trigger the Termination Fee unless NextEra terminated first of its own volition." The Bankruptcy Court noted that "under no foreseeable circumstances would NextEra terminate the Merger Agreement . . . [b]ecause NextEra had the ability to hold out . . . until the Debtors were forced by economic circumstances to terminate." The Bankruptcy Court stated that had it understood this critical fact, it could not, and would not, have approved the termination fee.

The Majority Decision

In affirming the Bankruptcy Court's ruling, the Third Circuit primarily focused on (i) whether the Bankruptcy Court misapprehended the facts when it approved the termination fee (because it didn't appreciate that the merger agreement did not include a PUCT approval deadline) and (ii) whether such misapprehension was central to the Bankruptcy Court's legal calculus in approving the merger agreement.

With respect to the first issue, the parties agreed that the merger agreement did not include a PUCT approval deadline and, thus, the principal question for the Third Circuit was whether the Bankruptcy Court understood that fact when it approved the agreement. The Bankruptcy Court stated that it had not. The Third Circuit held that it was bound to "accept the Bankruptcy Court's factual conclusions regarding its own subjective understanding unless they are clearly erroneous." It found nothing in the record that suggested that the Bankruptcy Court knew the agreement lacked a PUCT approval deadline. While NextEra argued that the Bankruptcy Court *should have* recognized that the agreement lacked a PUCT deadline based on the record, the Third Circuit held that the relevant question was whether the

Bankruptcy Court *actually* misapprehended the facts—not whether it was justified in doing so. The Third Circuit concluded that, based on the record, the Bankruptcy Court's findings were not clearly erroneous.

Next, the Third Circuit considered whether the Bankruptcy Court's misapprehension of the facts was central to its legal determination regarding the permissibility of the termination fee under the standard set forth in *In re O'Brien Environmental Energy, Inc.* (O'Brien), 181 F.3d 527, 532 (3d Cir. 1999). In *O'Brian*, the court held that termination fees can be approved only if they constitute "actual, necessary costs and expenses of preserving the estate." *See O'Brien*, 181 F.3d at 535. Bankruptcy courts have discretion to approve or deny a termination fee based on the totality of the circumstances – that is, "to make . . . a judgment call about whether the proposed fee's potential benefits to the estate outweigh any potential harms, such that the fee is 'actually necessary to preserve the value of the estate.'"

In the view of the Third Circuit, the Bankruptcy Court's "error led the court to fundamentally misjudge the likelihood that the [fee] would be harmful to the estates." The Bankruptcy Court failed to appreciate that the debtors had essentially gambled on PUCT approval and, thus, the Bankruptcy Court did not initially correctly weigh the fee's potential benefits against its potential harms. Thus, the Third Circuit concluded that the Bankruptcy Court did not abuse its discretion by reconsidering its prior approval of the termination fee and denying the fee.

The Third Circuit emphasized that reconsideration "remains a form of relief generally reserved for 'extraordinary circumstances,'" noting that the fact "[t]hat the heightened standard [employed by the Bankruptcy Court] was satisfied here is in and of itself proof that this case is anomalous."

The Dissent

Judge Rendell dissented, calling reconsideration of the fee "uncalled for." In the dissent's view, there was no legal or factual error—just "a failure to appreciate a particular set of potential consequences which became apparent in the light of day." The dissent maintained that "hindsight cannot justify nullifying a material term of the deal that was struck with all of the facts on the table" and insisted that:

> The reconsideration of a previously approved term of a deal, based on a bankruptcy court's failure to appreciate all of the potential ramifications of the term, sets a troubling—if not dangerous—precedent. Parties to commercial transactions present the terms of the deal to the court for approval and, once approved, are entitled to rely on the court's order, which is based on a thoughtful, well-reasoned analysis. Here, that should have been the guiding principle, and the grant of reconsideration so as to nullify the previously approved Fee when there was no clear error of fact or law was an abuse of discretion.

Conclusion

The Third Circuit's decision highlights the importance of establishing a clear and unequivocal record in seeking court approval of large and complex transactions. Counsel should consider correcting any misstatements, even by opposing counsel, lest they mislead the court.

While the decision explicitly limits its application to "anomalous" cases, it may provide an opening for parties seeking to revisit previously approved fee arrangements or other commercial terms. It remains to be seen whether (and under what circumstances) courts will be receptive to motions for reconsideration of such provisions. NextEra has filed a petition for rehearing or rehearing *en banc*, so this may not be the last word on this topic.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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