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Alert

Credit Bid Buyers Beware: Delaware Bankruptcy Court Caps Credit Bid

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On Jan. 10, 2014, the United States Bankruptcy Court for the District of Delaware (the "Court") in *In re Fisker Automotive Holdings, Inc., et al.*, capped a secured creditor's right to credit bid its $168 million claim at only $25 million (the amount it paid to purchase the claim). The decision is on appeal. While the Court stated that its decision is non-precedential, it serves as a cautionary tale for secured lenders who also are potential acquirers of a debtor's assets in bankruptcy sales.

Facts

Loan to Fisker
Fisker Automotive Holdings, Inc. and Fisker Automotive, Inc. (collectively, "Fisker") developed and sold luxury plug-in hybrid electric cars. To finance its business, Fisker obtained a $530 million loan commitment (the "Loan") from the Department of Energy ("DOE"). The Loan was secured by liens on substantially all of Fisker's assets.[1] Fisker defaulted under the Loan, and, in 2012, retained an investment banker to explore strategic alternatives and a potential sale, efforts which were unsuccessful.

DOE Sells Loan to Hybrid in Auction
The DOE decided to sell the Loan in the secondary market and hired a nationally recognized financial adviser to run an auction sale process. In October 2013, after extensive marketing efforts, five bids were submitted, including one by Wanxiang America Corporation ("Wanxiang") and another by Hybrid Tech Holdings, Inc. ("Hybrid"), a Fisker affiliate.[2] Hybrid was the successful bidder at the auction, purchasing the Loan for $25 million.[3] At the time of the sale, there was $168 million in principal amount outstanding under the Loan.

Fisker Chapter 11 and Contested Credit Bid Sale to Hybrid
Fisker filed for Chapter 11 relief on Nov. 22, 2013. It immediately sought approval of a private sale of its assets to Hybrid and approval of debtor-in-possession financing (the "DIP Loan") from Hybrid. The sale motion sought authority to sell Fisker's assets to Hybrid for: (a) $75 million in the form of a credit bid of a portion of the Loan; (b) a waiver of a portion of the DIP Loan; (c) the assumption by Hybrid of certain

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[1] *See Declaration of Marc Beilinson in Support of First Day Motions*, ¶ 26 [Case No. 13-13087-KG; Docket No. 2].

[2] *Id*.

[3] *See Declaration of J.P. Hanson in Connection with Motion of Debtors for Entry of: (I) an Order (A) Approving Form and Manner of Notices and (B) Scheduling a Sale Hearing and Establishing Dates and Deadlines Related Thereto; and (II) an Order (A) Authorizing the Sale of Substantially all of the Debtors' Assets Free and Clear of Liens, Claims, Encumbrances, and Other Interests, (B) Granting the Purchaser the Protections Afforded to a Good Faith Purchaser, and (C) Granting Related Relief* [Docket No. 294].

liabilities; and (d) certain cash payments, a portion of which (approximately $500,000) would be left behind for unsecured creditors. Fisker also filed a plan of liquidation to address the administration of the remainder of its assets.

Creditors' Committee Opposes Sale to Hybrid

The creditors' committee (the "Committee") was appointed in December 2013, and began litigating with Hybrid on several fronts. The Committee objected to Fisker's sale to Hybrid arguing, among other things, that: (a) Hybrid, an insider, should be precluded from credit bidding because its principals had engaged in self-dealing and breached fiduciary duties owed to Fisker;[4] and (b) Wanxiang, which had lost the auction for the Loan, made a superior offer for Fisker's assets.[5] The Committee also sought standing to commence an adversary proceeding against Hybrid seeking to equitably subordinate its secured claim. On Jan. 10, the Bankruptcy Court held a hearing to consider the Committee's objection. At the hearing, the Committee and Fisker agreed to limit the issue before the court to a determination of whether Hybrid could credit bid its secured claim and, if so, whether cause existed to cap Hybrid's right to credit bid in order to create a more competitive auction.

Court's Ruling: Credit Bid Capped at $25 Million

After hearing the parties, the Court ordered (in an oral ruling from the bench) that "there ought to be an auction and that the only way for there to be an auction was to…place a cap on the credit bidding."[6] The Court supplemented its bench ruling on Jan. 17 with a written decision.[7]

The Court began its analysis with the text of Section 363(k) of the Bankruptcy Code, which provides that "unless the court for cause orders otherwise," a secured creditor may credit bid (i.e., offset its secured claim against the purchase price) in a sale of its collateral. The Court found "cause" existed to cap Hybrid's credit bid at $25 million because, if left uncapped, bidding would not just be chilled, it would be "frozen," and there would be no auction. By capping Hybrid's right to credit bid the Court believed that a robust auction likely would ensue. In support of its ruling, the Court cited the Third Circuit's *Philadelphia Newspapers* decision where, in a footnote, the Third Circuit stated that "[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the [Bankruptcy] Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."[8]

Two additional facts appear to have influenced the Court. First, the Court was disturbed by the sale process, calling the proposed sale timetable "troublesome."[9] The Court noted that the schedule, which straddled the Thanksgiving and December holidays, provided only 24 days for parties to challenge the

[4] *See The Official Committee of Unsecured Creditors' Omnibus Objection to (I) the Debtors' (A) Sale Motion, (B) DIP Financing Motion, (C) Plan of Liquidation and (D) Disclosure Statement and (II) the Allowance of Claims of Hybrid Against the Debtor* [Docket No. 264] (the "Committee Obj."), at 4. While ultimately not considered by the Court in reaching its decision, the Committee asserted that the proposed sale of Fisker's assets to Hybrid was engineered by a director and insider of Fisker who "participated in all board meetings discussing the sale of Fisker's assets and the sale of the Loan, all the while working with the other principals of Hybrid to implement its own plan to acquire the Loan and Fisker's assets."

[5] Wanxiang's bid is $35.25 million in cash and a 20 percent equity stake in the acquired assets, whereas Hybrid's current bid was $30 million in cash and a $25 million credit bid (reduced from $75 million set forth in the sale motion given the Court's ruling).

[6] *See* Transcript of Jan. 10, 2014 Hearing ("Tr.") 136:22-25.

[7] A copy of the Court's Memorandum Opinion [Docket No. 483] ("Memo Op.") can be found here.

[8] *See* Memo Op., at 9 (citing *Philadelphia Newspapers*, 599 F.3d 298, 315-16 fn. 14 (3d Cir. 2010).

[9] Memo Op., at 10.

sale motion and even less time for the Committee to represent the interests of unsecured creditors.[10] The Court pointed out that neither Fisker nor Hybrid ever provided a satisfactory reason why the sale of the non-operating assets required such speed, and that Hybrid's drop dead date to purchase the assets was "pure fabrication, designed to place maximum pressure on the creditors and the Court."[11] In sum, the Court held that Hybrid "insisted on an unfair process, i.e., a hurried process, and the validity of its secured status has not been determined."[12]

Additionally, the Court was concerned because the validity of Hybrid's liens on certain of Fisker's assets is the subject of an ongoing dispute. At the start of the hearing, the Committee and Fisker agreed that Hybrid's $168 million claim is "partially secured, partially unsecured and of uncertain status for the remainder."[13] The Committee argued that "cause" existed to: (i) bar Hybrid from credit bidding because its lien was in dispute;[14] or, alternatively (ii) limit the amount of Hybrid's credit bid to the $25 million that it paid for the Loan, which represented the market-tested value of the assets securing the Loan collateral.[15]

In response, Hybrid argued that: (i) even if there were unencumbered or disputed assets, the existence of such assets did not constitute "cause" to deny a creditor the right to credit bid for its undisputed collateral;[16] and (ii) governing Third Circuit case law prohibited capping its credit bid at the value of the underlying collateral (i.e., the price it paid for the loan) and required that Hybrid be permitted to credit bid the full amount of its claim.[17]

The Court took the middle road, limiting Hybrid's credit bid to $25 million because the extent of its lien was disputed and "[n]o one knows how much of the claim that Hybrid purchased from DOE will be *allowed* as a secured claim."[18] In doing so, the Court did not provide a reason for capping Hybrid's credit bid at the price it paid for the Loan.[19]

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[10] *Id*.

[11] Memo Op., at 10, n.4.

[12] Memo Op., at 11.

[13] Memo Op., at 10. Despite Fisker's stipulation at the beginning of the hearing that there is a dispute regarding the validity or perfection of Hybrid's liens on certain of Fisker's "material" assets, Fisker's attorney later argued to the court that these assets were not very valuable or critical to the operating business. For example, Fisker's attorney stated that Chapter 5 causes of action and commercial tort claims were not being sold and the D&O policy would remain with the estate. Fisker's attorney characterized the disputed assets as: (i) foreign intellectual property; (ii) six certificated vehicles; and (iii) "certain inventories sitting in a foreign port." Tr. 112:19-24. Fisker's attorney went on to argue that a fundamental assumption in the committee's value proposition is that Hybrid's claims will ultimately be disallowed or avoided. Tr 113:21-114:2.

[14] Committee Obj., ¶ 41.

[15] Committee Obj., ¶ 33.

[16] Tr. 70:25-73:17. Hybrid further argued that it had provided adequate additional value (in the form of a waiver of a portion of its secured claims, additional cash, and an agreement to share proceeds from the sale of certain intellectual property) for the unencumbered and disputed assets.

[17] Limited Objection of Hybrid to Committee Obj. [Docket No. 297], ¶ 6-9 (citing *Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Systems Corp)*, 432 F.3d 448 (3d Cir. 2006) (held, although secured debt had no actual economic value, secured creditor was nonetheless entitled to credit bid its entire secured claim.).

[18] *Id.* (emphasis in original).

[19] The Court distinguished *SubMicron* stating that the validity of the claim in that case was clear, whereas here, the Court did not know how much of Hybrid's claim was actually secured. *See* Mem. Op., at 11.

Observations

Even though the decision is supposedly non-precedential, secured creditors should be concerned about this decision because it could be used as a litigation tactic by committees and other parties in interest to deprive a creditor of its right to credit bid by disputing the creditor's lien (especially in fast moving cases). Secured creditors should work with counsel early in a bankruptcy case (even before a debtor files) to consider creative and practical solutions to these potential attacks, such as: (i) providing debtor in possession financing to obtain a lien on unencumbered assets or assets that are subject to dispute as to the validity of the creditor's prepetition liens; (ii) developing an expedited process to resolve simple lien disputes; and (iii) using non-credit bid currency to acquire unencumbered assets, such as cash or the assumption of prepetition liabilities.

This decision may have a chilling effect on future secured claim auctions and could have broader implications for the claims trading markets generally. This chilling effect will be especially felt by strategic buyers who acquire secured debt with a view towards using that debt as acquisition currency in so-called "loan to own" strategies. Compounding this effect is a small but relevant body of case law in which courts have not counted a secured creditor's votes on a plan of reorganization when the creditor is found to have purchased the debt to obtain control of the debtor or to gain a competitive advantage.[20] This decision also may give pause to any purchaser of secured claims who intends to credit bid, who could fear that their claims would be valued at what they paid for them rather than the face amount of the claim.[21]

The Court's reliance on the footnote from the *Philadelphia Newspapers* decision appears to be results oriented. While fostering "a competitive bidding environment" may be a legitimate policy objective, capping a credit bid also tramples the important policy objective of protecting a secured creditor's property interest. One of the chief protections afforded to a secured creditor is the statutory right to credit bid. As stated by the Supreme Court, "the ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price. It enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."[22]

Without a decision from a higher court — ultimately the Third Circuit or Supreme Court — the issue of what constitutes "cause" to cap or eliminate a credit bid will remain a hotly contested issue.

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[20] *See, e.g., In re DBSD N. Am., Inc.*, 421 B.R. 133, 141-142 (Bankr. S.D.N.Y. 2009) (designating vote of secured creditor who had purchased debt as means of advancing its "strategic investment interests wholly apart from maximizing recoveries" on its claims) (aff'd *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 627 F.3d 496 (2d Cir. 2010).

[21] The Court also expressed concern about the Loan auction. The Court noted that it did not "take great comfort" that the Loan was auctioned pre-bankruptcy because the Court had no oversight of that process. The Court stated that a bankruptcy auction would help it to determine whether the price paid for the Loan was "fair and reasonable and in the best interests of the debtors' estates." Tr. 137:6-138:4. This is somewhat surprising because secured claims often are sold in private transactions for less than par without the ostensible protections afforded by the auction of the Loan, which was conducted after an extensive marketing process by an experienced financial advisor. In sum, the Court appeared troubled that the auction of the Loan effectively determined that there would not be a bankruptcy auction and thus, the outcome of Fisker's bankruptcy case.

[22] *RadLAX,* 132 S. Ct. at 2070 n.2.

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