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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 bankruptcy 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 secured creditor immediately appealed to the district court. As a procedural matter, the secured creditor had an absolute right to have its appeal heard only if the bankruptcy court's ruling was considered a "final order." If it was not a "final order," then the district court had discretion to hear the merits of the appeal. On Feb. 7, 2014, the district court determined that the bankruptcy court order was not final, and declined to hear the appeal. In doing so, however, the district court made sweeping statements regarding the bankruptcy court's authority to limit or otherwise deny a secured creditor the right to credit bid. Eleven days later, the bankruptcy court approved the sale of the debtors' assets to a third party. The secured creditor has since consented to the sale and withdrawn its appeal.

While the bankruptcy court has stated that its decision is non-precedential, it serves as a cautionary tale for secured lenders who may want to credit bid to acquire a debtor's assets.

Facts

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. Fisker defaulted under the Loan and, in 2012, retained an investment banker to explore strategic alternatives and a potential sale, which efforts were unsuccessful.

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. Hybrid was the successful bidder at the auction, purchasing the Loan for $25 million. At the time of the sale, there was $168 million in principal amount outstanding under the Loan.

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, without further marketing or an auction, for: 1) $75 million in the form of a credit bid of a portion of the Loan; 2) a waiver of a portion of the DIP Loan; 3) the assumption by Hybrid of certain liabilities; and 4) 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.

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 Hybrid should not be allowed to credit bid because: 1) Wanxiang, which had lost the auction for the Loan, had made a superior unsolicited offer for Fisker's assets, 2) denying Hybrid the right to credit bid would foster a competitive bidding environment, and 3) there was a dispute as to the validity of Hybrid's liens on a portion of its collateral. The Committee asserted that that the existence of a dispute regarding the validity of Hybrid's liens on a portion of its collateral constituted "cause" to prevent Hybrid from credit bidding. To justify its alternative argument to cap Hybrid's credit bid, the Committee introduced expert testimony that concluded, among other things, that the $25 million Hybrid paid for the Loan reflected a fair, reasonable and market-tested valuation of the collateral. The Committee also sought standing to commence an adversary proceeding against Hybrid seeking to equitably subordinate its secured claim asserting that Hybrid, an insider, should be precluded from credit bidding because its principals had engaged in self-dealing and breached fiduciary duties owed to Fisker.

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 bankruptcy 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.

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

After hearing the parties, the bankruptcy 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." *See* Transcript of Jan. 10, 2014 Hearing 136:22-25. The bankruptcy court supplemented its bench ruling on Jan. 17 with a written decision.

The bankruptcy 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. 11 U.S.C. § 363(k) (emphasis added). The bankruptcy court concluded that "cause" existed to limit the credit bid because, among other things: 1) absent a cap on Hybrid's credit bid, Wanxiang would withdraw its bid and refuse to participate in the auction; and 2) the extent of Hybrid's liens on some of its collateral had not yet been determined. In support of its ruling, the Bankruptcy 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."

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Philadelphia Newspapers, 599 F.3d 298, 315-16 fn. 14 (3d Cir. 2010) (affirmed the denial of a right to credit bid for a sale of assets under plan, as opposed to a sale under section 363).

The bankruptcy court left open the possibility that the cap on Hybrid's credit bid could be modified after the bankruptcy court determined how much of Hybrid's claim would be allowed as a secured claim.

Hybrid's Appeals to the District Court

Hybrid sought leave to appeal to the extent the bankruptcy court's credit bid order was deemed interlocutory (*i.e.*, not final) and for certification for direct appeal to the Third Circuit. Hybrid argued that the bankruptcy court's decision to cap its right to credit bid in order to encourage competitive bidding was inconsistent with controlling Third Circuit and U.S. Supreme Court precedent, citing *SubMicron Sys. Corp.*,432 F.3d 449, 459 (3d Cir. 2006) and *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012) for the proposition that a secured creditor had a right to credit bid the full amount of its claim. According to Hybrid, the bankruptcy court's reliance on the Third Circuit's *Philadelphia Newspapers* decision was flawed because two of the three judges in that case declined to adopt the portion of the opinion with the footnote the bankruptcy court had relied upon. Thus, Hybrid asserted the premise that a court can limit a credit bid to foster competitive bidding was mere *dicta*. In any event, Hybrid contended that the *Philadelphia Newspaper*s decision was later overruled by the United States Supreme Court in *RadLAX*.

Hybrid also argued that only its lien on a portion of the collateral was in dispute. Thus, its right to credit bid for collateral that was indisputably secured by its liens could not be limited merely because the Committee disputed Hybrid's lien on other portions of the collateral. In sum, Hybrid argued it had the right to credit bid the full amount of its claim for those assets as to which there was no dispute as to the validity of its liens. Hybrid contended that because its appeal involved the auction process itself and the preservation of its rights as a secured creditor, it would be left without a remedy if it were not permitted to credit bid at the auction.

The District Court's Decisions

On Feb. 7, 2014, the district court determined that the bankruptcy court order was not final and declined to hear the appeal. The district court found that there was no "controlling question of law as to which there exists substantial grounds for a difference of opinion" because the bankruptcy court's ruling was supported by the "plain text of 363(k)," which permits a bankruptcy court to limit credit bidding for "cause," and "relevant legal precedent." The district court effectively adopted the bankruptcy court's rationale that "cause" to cap a credit bid incudes fostering a competitive bidding environment.

The district court also dismissed Hybrid's argument that it would be without a remedy if the auction occurred while its credit bid was capped at $25 million. The district court noted that Hybrid could credit bid $25 million and continue bidding with cash. In that context, Hybrid could effectively "round-trip" the cash component to the extent of its allowed secured claim about $25 million. If a third-party bidder won the auction, Hybrid would receive its entitlement from the sale proceeds.

Five days later, on Feb. 12, the district court issued a second opinion denying Hybrid's motion for a direct appeal to the Third Circuit. Further addressing the merits of Hybrid's argument, the district court held that the "for cause" exception of 363(k) was within a bankruptcy court's discretion. The district court also disputed Hybrid's assertion that the "for cause" exception set forth in the *Philadelphia Newspapers* decision was mere *dicta*, stating that it was, in fact, "essential to its holding and was a majority ruling."

The Auction

After an 18-round auction that lasted two days, Wanxiang was selected as the winner with a $149.2 million bid. Hybrid stated shortly after the auction that it would not seek further review of the bankruptcy court's credit bid decision and did not object to the selection of Wanxiang as the highest bid pursuant to the bankruptcy court's bidding procedures. Hybrid did reserve its rights with respect to a number of disputes, including the allocation of the sale proceeds. On Feb. 18, the bankruptcy court approved the sale to Wanxiang.

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 secured creditor of its right to credit bid by disputing the validity or enforceability of all or any portion of 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: 1) 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; 2) developing an expedited process to resolve simple lien disputes; and 3) 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 effect will be especially felt by strategic buyers who acquire secured debt with a view toward 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 designated 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. *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). 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.

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." *RadLAX*, 132 S. Ct. at 2070 n.2.

Because Hybrid will not prosecute its appeal of the bankruptcy court decision, the issue of what constitutes "cause" to cap or eliminate a credit bid will continue to be hotly contested.

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