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Recent Decisions Impacting Chapter 11 Sales: Limitations on Secured Creditor's Right to Credit Bid and Non-Bidder's Right to Challenge Confirmation of a Sale

Recent decisions by the Bankruptcy Court for the District of Delaware and the United States Court of Appeals for the Seventh Circuit address two significant issues relating to chapter 11 asset sales: whether a secured creditor's right to credit bid purchased debt may be capped at the discounted price paid for such debt to facilitate an auction, *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D. Del. Jan. 17, 2014) ("*Fisker*") and whether an entity that fails to qualify for an auction has standing to oppose confirmation of a sale to the winning bidder, *In re New Energy Corporation*, 2014 WL 145274 (7th Cir. Jan. 15, 2014) ("*New Energy*"). Both decisions highlight potential risks parties may face if they purchase secured debt as part of a larger acquisition strategy or do not bid or play by the rules of an auction.

In re Fisker Automotive Holdings, Inc.

We turn first to *Fisker,* where Delaware Bankruptcy Judge Kevin Gross held that a bidder could credit bid secured debt purchased shortly before the chapter 11 filing but limited the credit bid amount "for cause" to $25 million (the discounted purchase price for the debt).

Background

The debtors, Fisker Automotive Holdings, Inc. and its affiliates, made premium hybrid electric vehicles in the United States but they encountered a series of setbacks impairing their ability to operate. In 2011, the United States Department of Energy (the "DOE") advised them it would cease funding and not permit further disbursements under the debtors' senior secured loan facility. In October 2013, Hybrid Tech Holdings, LLC ("Hybrid") bought at auction the DOE's $168.5 million loan under that facility for $25 million.

Hybrid and various Fisker entities signed an asset purchase agreement for the private sale of substantially all of the Fisker assets to Hybrid for consideration that included $75 million in the form of a credit bid. 2014 WL 210593, at *2. On November 22, 2013, the debtors filed their chapter 11 cases to sell substantially all of their assets to Hybrid. In their motion to approve the sale, the debtors submitted that the cost and delay of a competitive auction process or a sale to a different entity would be unlikely to result in increased value for the estates. *Id.* The debtors insisted that the hearing on the sale motion occur no later than January 3, 2014 (Hybrid's supposed "drop dead" date). *Id.*, at *5.

The Official Committee of Unsecured Creditors—appointed on December 5, 2013—opposed the sale and instead sought approval of bidding procedures for an auction with another entity, Wanxiang America Corporation, as lead bidder. The Committee opposed Hybrid's right to credit bid or, in the alternatively, sought to cap the credit bid at $25 million. *Id.*

The Sale Motion Hearing

At the hearing to consider the debtors' sale motion and the Committee's bidding procedures motion, the debtors and the Committee stipulated, among other things, that:

- if Hybrid was not permitted to credit bid or its credit bid was capped at $25 million, there was a strong likelihood that an auction would create material value for the estate above Hybrid's present bid;
- if Hybrid's ability to credit bid was not capped, there was no realistic possibility of an auction; and
- as for Hybrid's collateral, there were (i) material assets constituting properly perfected collateral, (ii) material assets not subject to Hybrid's liens and (iii) material assets where there was dispute as to whether Hybrid's lien was properly perfected. However, the debtors and the Committee did not agree on how to allocate value between these groups. *Id.*, at *2-3.

Analysis

The Bankruptcy Court concluded that Hybrid could credit bid its claim but capped the credit bid amount at $25 million. *Id.*, at *4.

Judge Gross recognized that under section 363(k) of the Bankruptcy Code, a secured creditor can credit bid its allowed claim unless the court "for cause orders otherwise." 11 U.S.C. § 363(k). The Bankruptcy Court cited the Third Circuit's decision *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 315-16 n.14 (3d Cir. 2010) for the proposition that the "for cause" exception to a secured creditor's right to credit bid is not limited to situations of inequitable conduct alone.[1] Instead, the Third Circuit noted: "This argument has no basis in the statute. A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." 2014 WL 210593, at *4-5 (quoting *Philadelphia Newspapers*, 500 F.3d at 315-16 n.14).

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[1] The stipulations made at the sale motion hearing by the debtors and the Committee specified the bases for limiting the credit bid. *Fisker*, 2014 WL 210593, at *2-3. The Committee advised the court at the hearing that it was not seeking to limit Hybrid's right to credit bid based on any other basis, including alleged misconduct by the debtors or any other party. *Id.*, at *3; *see also* Sale Motion Hearing Tr. at 19.

The Bankruptcy Court held that "cause" existed to limit Hybrid's credit bid because bidding would be frozen without the cap. 2014 WL 210593, at *5. It noted that "[t]he evidence in this case is express and unrebutted that there will be *no* bidding—not just the chilling of bidding—if the Court does not limit the credit bid." *Id.* (emphasis in original). Judge Gross also seemed concerned about the potential loss of the Wanxiang bid. He characterized Wanxiang as a highly attractive—and capable—participant that had recently purchased at auction the lithium ion battery, the primary component in Fisker's electric cars. *Id.*

The Bankruptcy Court noted that Hybrid's conduct "might well have frozen out other suitors for Fisker's assets," particularly because the accelerated timeline from petition date to approval of the sale motion provided parties only 24 business days to challenge the sale motion. *Id.* It noted that the unjustified rush was "inconsistent with the notions of fairness in the bankruptcy process." *Id.* (For example, the Bankruptcy Court characterized the January 3, 2014 deadline for the sale motion hearing as "pure fabrication, designed to place maximum pressure on the creditors and the Court.") *Id.*, at *5 n.4.

Judge Gross also observed that the validity of Hybrid's secured status had not been determined. *Id.*, at *5. The debtors and the Committee had stipulated that Hybrid's claim was "partially secured, partially unsecured and of uncertain status for the remainder." *Id.*, at *3. While Hybrid contended that under Third Circuit law it nonetheless could credit bid its entire claim, Judge Gross was not persuaded. He observed that "[t]he law leaves no doubt that the holder of a lien the validity of which has not been determined, as here, may not bid its liens." *Id.*, at *5.

Accordingly, the Bankruptcy Court limited for cause Hybrid's credit to $25 million to avoid a bidding freeze. *Id.* Notably, it made no effort to justify or explain why it capped the credit bid at the $25 million purchase price.

Conclusion

Fisker's effect on crediting bidding—and the acquisition of secured debt for strategic purposes—remains to be seen. Hybrid has appealed the decision to the district court, as well as moved for a direct appeal to the United States Court of Appeals for the Third Circuit. At a minimum, *Fisker* means that bidders should proceed with caution in acquiring secured debt as a purchasing tool on the eve of a chapter 11 filing and assess the wisdom of pressing for a private sale on an aggressive timeline, particularly when confronted with bankruptcy court unease.

In re New Energy Corporation

In *New Energy*, an appeal by Natural Chem Holdings ("Natural Chem") from an order approving an asset sale, the Seventh Circuit held that Natural Chem—an entity that was neither a qualified bidder in the auction nor a creditor of New Energy—lacked standing to challenge approval of the sale.

Background

The debtor, New Energy Corporation, operated an ethanol plant in Indiana and after entering bankruptcy, proposed to sell most of its assets by auction. 2014 WL 145274, at *1. To qualify for the auction, a potential bidder had to post a $250,000 bond and submit a proposed asset purchase agreement; the terms of the auction required bidders to pay cash upfront for the assets. *Id.* While before the auction Natural Chem expressed interest in bidding, the structure of its proposed offer (a lease with an option to buy) did not conform to the cash upfront requirement. *In re New Energy Corp.*, 2013 Bankr. LEXIS 3665, at *2 (Bankr. N.D. Ind. Feb. 26, 2013). Natural Chem's proposed bid was also submitted without (a) the required bond and (b) the required asset purchase agreement proposal. *Id.*, at *2-3. Accordingly, Natural Chem's bid was rejected, and Natural Chem did not qualify to participate in the auction. *Id.*

After the auction, the debtor and successful joint venture requested bankruptcy court approval of the sale. 2014 WL 145274, at *1. The sale was supported by the United States Trustee and the Depeartment of Energy, the debtor's largest single creditor. *Id.* Although neither a creditor nor a qualified bidder, Natural Chem opposed approval of the sale, arguing that the joint venture was the byproduct of collusion that spoiled the auction. *Id.*, at *2.

The bankruptcy court approved the sale, holding that Natural Chem could not have been harmed because it had not participated in the auction. *Id.*, at *1. Natural Chem did not seek a stay of the sale's closing, but appealed the bankruptcy court's decision to the district court. *Id.* When the district court affirmed the bankruptcy court's decision, Natural Chem appealed to the Seventh Circuit. *Id.*

Analysis

The Seventh Circuit first considered whether Natural Chem had standing to appeal, which required Natural Chem to have "suffered a redressable injury" as a result of the auction. *Id.* The Seventh Circuit affirmed the lower courts' holding that Natural Chem did not have standing and that Natural Chem could not have been injured as a bidder, because, having failed to post the bond required to qualify as a bidder, Natural Chem could not have prevailed in the auction regardless of other bidders' conduct. *Id.*[2] The Seventh Circuit further noted that joint ventures "have the potential to improve productivity," and that Natural Chem's arguments to the contrary fell short of establishing forbidden collusion. *Id.*, at *2. The Seventh Circuit observed that Natural Chem would have been helped rather than harmed by any collusion, as the result "would have made it *easier* for Natural Chem to have prevailed at auction." *Id.* (emphasis in original).

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[2] The Seventh Circuit also noted that Natural Chem could not have been injured as a creditor on the basis that it would receive a reduced payout, since Natural Chem is not one the debtor's creditors. *Id.*, at *1.

Finally, the Seventh Circuit held that, even if Natural Chem had standing to appeal, its appeal would not succeed. Under section 363(m) of the Bankruptcy Code, the reversal of a sale order "does not affect the validity of a sale . . . to an entity that purchased . . . in good faith . . . unless such sale . . . [was] stayed pending appeal." The sale was not stayed and the Seventh Circuit held that the Bankruptcy Court did not abuse its discretion when it found the winning bidders acted in good faith. *Id.*

Conclusion

The Seventh Circuit's decision in *New Energy* confirms that a party's ability to object to the outcome of an auction requires meeting standing requirements, either as an auction participant[3] or as a creditor. A party that elects not to participate in an auction (or to comply with its rules) will likely have little ability to challenge a sale after the auction is completed.

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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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[3] Except in certain situations not present here, unsuccessful bidders generally lack standing to challenge a bankruptcy court's approval of a sale of a bankruptcy estate's assets. *See, e.g.*, *In re Farmland Indus., Inc.*, 639 F.3d 402, 405 (8th Cir. 2011); *In re Gucci*, 126 F.3d 380, 388 (2d Cir. 1997); *In re Gulf States Steel, Inc. of Ala.*, 258 B.R. 739, 742 (Bankr. N.D. Ala. 2002).