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BANKRUPTCY, FINANCIAL REORGANIZATION & CREDITORS' RIGHTS

FISKER DECISION FURTHER DEMONSTRATES THAT SECTION 510(b) SUBORDINATION OF INVESTOR CLAIMS IS NOT ABSOLUTE

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When a company files for bankruptcy protection, it is often the case that insufficient value is realized to satisfy all claims against the company. Because the creditors of a bankrupt company generally must be paid in full before its equity holders recover at all, shareholders typically receive no distribution on account of their equity interests in the bankrupt company. Even further, section 510(b) of the Bankruptcy Code provides that certain equity-related claims — specifically, claims for damages arising from the purchase of a security of the debtor or of an affiliate of the debtor — are subject to mandatory subordination and are thus treated like equity for purposes of distribution. Accordingly, for investors asserting securities fraud claims against a bankrupt company, mandatory subordination is the inevitable kiss of death in the bankruptcy claims distribution process. However, the Delaware Bankruptcy Court's recent decision in *Fisker* demonstrates that certain investor-related bankruptcy claims do not get swept up by section 510(b).[2]

In the bankruptcy proceedings of Fisker Automotive Holdings, Inc. ("Fisker"), a group of funds (the "Funds") filed proofs of claim (the "Claims") for investment losses in connection with their purchase of membership interests in a special purpose vehicle that itself purchased Fisker preferred stock. The Funds maintain that their purchase of these membership units was induced by Fisker's conduct and its false and misleading statements and omissions.

Fisker and its liquidating trustee objected to the Funds' Claims, arguing that the Claims were based on damages arising from the purchase of a security "of the debtor or of an affiliate of debtor," and therefore, subject to mandatory subordination under Bankruptcy Code section 510(b). Several Funds conceded that their claims were subject to mandatory subordination because they *directly* purchased preferred stock from Fisker. The investors who purchased the membership units, however, were in a different position.

In connection with its 2011 offering, Fisker engaged Advanced Equities, Inc. ("AEI") to assist in raising equity capital. Under the placement agreement, Fisker granted AEI a warrant to purchase a number of shares of Fisker preferred stock, and gave AEI the right to transfer the warrant to sub-agents engaged by AEI. Shortly thereafter, AEI executed a sub-placement agreement with Middlebury Securities LLC ("Middlebury"). Middlebury circulated a private placement memorandum soliciting qualified investors to purchase membership units in a related special purpose vehicle, Middlebury Ventures II ("Middlebury II"). The second group of claimants subject to the trustee's claim objection purchased membership units of Middlebury II, which purchased Fisker preferred stock.

The parties agreed that the membership units purchased by the Funds were "securities" and that the claims were for "damages arising from the purchase or sale of a security." Thus, the main issue before the court was whether the investors purchased (i) securities "of the debtor" or (ii) securities "of an affiliate of the debtor."

First, the court found that the membership units purchased by the Funds were not securities "of the debtor." Judge Gross explained that the relevant case law provides that a security "of" a debtor must be a *direct* security of a debtor in order to subordinate the security holder's claim for damages. The court decided that the securities at issue were not direct securities of Fisker, but rather, were securities of Middlebury II as issuer. The court further reasoned that the membership units were not securities of the debtor since they do not appear within the debtor's capital structure.

Second, the court rejected the liquidating trustee's argument that the Middlebury special purpose vehicles were affiliates of the debtor under Bankruptcy Code section 101(2)(C) as "person[s] whose business is operated under a lease or operating agreement by a debtor, or person[s] substantially all of whose property is operated under an operating agreement with the debtor." 11 U.S.C. § 101(2)(C). Judge Gross pointed out that case law interpreting the phrases "agreement

by a debtor" and "agreement with a debtor" under section 101(2)(C) provides that the threshold requirement for establishing an affiliate relationship is the existence of an operating agreement between the debtor and its alleged affiliate.

The liquidating trustee argued that by virtue of being designated AEI's sub-agent based on the language in the placement agreement, Middlebury became a party to the original placement agreement between Fisker and AEI. Judge Gross rejected this argument, explaining, simply, that although the liquidating trustee asserted there was a contract between Fisker and AEI (the placement agreement) and another contract between AEI and Middlebury (the sub-placement agreement), this was insufficient to establish the existence of an operating agreement between Fisker and Middlebury.

Accordingly, since the Funds' Claims were not based on their purchase of securities "of the debtor or of an affiliate of the debtor," their Claims were not subject to subordination under section 510(b) of the Bankruptcy Code. The liquidating trustee has appealed Judge Gross's ruling to the Delaware District Court, where the appeal remains pending.

The *Fisker* decision makes clear, as did the prior decisions in *WaMu*[3] and *SemCrude*,[4] that where a debtor engages in creative engineering to raise equity capital, it may engineer itself beyond the reach of section 510(b). Thus, where an investor's claim against a debtor is challenged under section 510(b) of the Bankruptcy Code, investors must be cognizant of whether they purchased securities directly from the debtor or an affiliate of the debtor, or from an entity unrelated to the debtor in terms of the debtor's capital structure. Where the latter is true, the *Fisker* decision is clear authority that the claims will rank with general unsecured claims rather than be relegated to equity with little if any prospect of recovery.

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[2] *In re FAH Liquidating Corp.*, 563 B.R. 160 (Bankr. D. Del. 2017).

[3] *In re Washington Mut., Inc.*, 462 B.R. 137 (Bankr. D. Del. 2011).

[4] *In re SemCrude, L.P.*, 436 B.R. 317 (Bankr. D. Del. 2010).

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