Hughes Hubbard & Reed

Bankruptcy Court Decision Illustrates Limits of Section 510(b) Subordination of Claims

Client Advisories

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

February 6, 2017 - A recent decision in the Bankruptcy Court for the District of Delaware explored the limits of mandatory subordination under section 510(b) of the Bankruptcy Code. In I*n re FAH Liquidating Corp.*, No. 13-13087(KG), 2017 WL 95115 (Bankr. D. Del. Jan. 10, 2017), Judge Kevin Gross ruled that membership units in special purpose vehicles that held securities of a debtor were outside the scope of section 510(b) because they were neither "securit[ies] of the debtor" nor securities of "an affiliate of the debtor." Because the claimants invested in special purpose vehicles that were insulated from the debtor, their securities law claims against the debtor were indirect and therefore not subject to mandatory subordination.

Prior to the Petition Date, the debtor's predecessor, Fisker Automotive Holdings, Inc. ("Fisker"), issued preferred stock. Fisker engaged Advanced Equities, Inc. ("AEI") to aid in raising private capital. As memorialized in a Placement Agreement, AEI would receive, among other things, warrants that it could transfer to other broker-dealers that it designated as sub-agents. One such sub-agent, Middlebury Securities LLC ("Middlebury Securities"), entered into a Sub-Placement Agreement with AEI. Middlebury Securities solicited qualified investors for purchase of Membership Units in one or more[1] Special Purpose Vehicles, affiliated with Middlebury Securities, that themselves purchased or held Fisker's preferred shares. Notably, however, there was no direct contractual relationship between Fisker and Middlebury Securities; rather, each contracted separately with AEI.

Two sets of plaintiffs commenced securities lawsuits against controlling shareholders and current and former officers and directors of Fisker, and filed proofs of claim on account of securities law claims against Fisker. One set of plaintiffs had purchased Fisker's preferred stock (the "Direct Purchasers"), while the other plaintiffs had purchased membership units in one or more of the Special Purpose Vehicles (the "Membership Unit Purchasers").

The parties and the Bankruptcy Court agreed that the Direct Purchasers' claims against Fisker were subject to mandatory subordination under section 510(b) of the Bankruptcy Code, which subordinates any "claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages

arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim."[2]

The parties also agreed that the Membership Units were "securities" and that the plaintiffs' claims arose from the purchase or sale of securities. However, the parties disputed the application of section 510(b) to the claims of the Membership Unit Purchasers.

Although the Membership Units did not represent direct interests in Fisker, the Liquidating Trustee argued that purchases of Fisker securities were "part of the causal link leading to" the alleged injuries, and thus the Membership Unit Purchasers' claims *arose from* the purchase or sale of a debtor's securities. The Liquidating Trustee further argued that there was a "complete identity of economic interest" between the Membership Units and Fisker's securities.

In the alternative, the Liquidating Trustee argued that the Membership Unit Purchasers' claims arose from the purchase or sale of securities of "an affiliate of the debtor" because Middlebury Securities acted as an intermediary between Fisker and investors for purposes of raising capital for Fisker. In the Liquidating Trustee's view, the Special Purpose Vehicles were "affiliates" of Fisker because they were operated under the Placement Agreement between Fisker and AEI, pursuant to which AEI designated Middlebury Securities as its sub-agent.

The Bankruptcy Court first rejected the Liquidating Trustee's argument that the Membership Units were securities "of the debtor." The Bankruptcy Court noted that the Membership Units were distanced and insulated from Fisker due to the Special Purpose Vehicles: the Special Purpose Vehicles were not debtors, the Membership Units were not part of Fisker's capital structure, and the Membership Unit Purchasers did not have actual ownership interests in Fisker.

The Bankruptcy Court next addressed the Liquidating Trustee's contention that the Membership Units were the securities of Fisker's affiliates. Section 101(2) of the Bankruptcy Code defines an "affiliate" as, among other things, a "person whose business is operated under a lease or operating agreement by a debtor, or [a] person substantially all of whose property is operated under an operating agreement with the debtor."[3] Focusing on that definition, the Bankruptcy Court emphasized that there was no contract between Fisker and Middlebury Securities. The Placement Agreement was between Fisker and AEI; AEI separately contracted with Middlebury Securities as sub-agent to sell Membership Units. The Special Purpose Vehicles thus fell outside the scope of section 101(2)(C): they were not "operat[ing] under an operating agreement *with the debtor*" (emphasis added).

The Bankruptcy Court further noted that the Fifth Circuit has applied a more expansive view of section 101(2)(C) where a debtor is "in full control" of another entity. However, the Bankruptcy Court found that the Debtors did not exert sufficient control to make the Special Purpose Vehicle entities mere "shell conduit[s] between [the] debtor and [the] entity." AEI acted as an independent contractor, and it used its own authority to contract with Middlebury Securities. In fact, Fisker's agreement with AEI even prohibited Fisker from communicating directly with sub-agents (like Middlebury Securities) without AEI's authority.

The Bankruptcy Court's decision shows that even the broad terms of section 510(b) have limits. Where a special purpose entity is sufficiently insulated from the debtor whose securities it holds, an investor in the special purpose entity may be able to maintain unsubordinated claims against the debtor (or the debtors' directors and officers). Purchasers of securities should be aware that claims against debtors on account of purchases of membership interests in unaffiliated special purpose vehicles may potentially be due a higher priority than claims on account of direct purchases of the debtor's securities. For their part, debtors and trustees should be aware that they may not be able to rely on section 510(b) in defending against such claims.

Footnotes

[1]. The decision notes that only one Special Purpose Entity— Middlebury Ventures II— was identified by name on the record, although the term was used in the plural by the Plaintiffs. *Id.* at *5-6. Thus, it was "unclear from the record whether [Middlebury Ventures II] is the only Special Purpose Vehicle that issued the Membership Units." *Id.* at *7.

[2]. 11 U.S.C. § 510(b).

[3]. 11 U.S.C. § 101(2)(C).

Related Areas of Focus

Corporate Reorganization & Bankruptcy