

# Recourse to Seller Upheld in Claims Trading: The *Longacre* Case

A recent decision by the U.S. Court of Appeals for the Second Circuit should reassure purchasers of bankruptcy claims that recourse protections commonly negotiated into claim transfer agreements are enforceable. In *Longacre Master Fund v. ATS Automation*,<sup>1</sup> the Second Circuit vacated a decision by the District Court for the Southern District of New York in which the District Court declined to enforce a provision in the agreement permitting the buyer to put the claim back to the seller if the debtor objected to the claim. The District Court reasoned that because the claim objection was without merit, it did not trigger the put right. On appeal, the Second Circuit looked at the plain language of the transfer agreement and concluded that there was no requirement that a debtor's claim objection be meritorious to trigger the put right.

## Background

Longacre Master Fund, Ltd. and Longacre Capital Partners L.P. (together, "Longacre") entered into a claim transfer agreement (the "Agreement") with ATS Automation Tooling Systems Inc. ("ATS") pursuant to which ATS sold to Longacre certain claims it held against Delphi Automotive Systems (the "Debtor"). The Agreement provided Longacre with a put option, requiring ATS to take back the claims and refund the purchase amount, plus interest, if the claims were subject to "Impairment" or a "Possible Impairment" that was not resolved within 180 days. Any objections to the claims would constitute "Impairment" as defined in the Agreement.

Subsequent to the Agreement taking effect, the Debtor filed an omnibus objection to preserve its rights with respect to certain claims pending the resolution of various avoidance actions it had commenced. The Debtor had filed hundreds of preference complaints, under seal, whereby it sought to avoid and recover payments made to creditors in the 90-day period prior to its petition date. ATS was the subject of such an avoidance action, and therefore, the claim it had sold to Longacre was subject to the omnibus objection.

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<sup>1</sup> 2012 WL 4040176 (C.A.2 (N.Y.)).

The Bankruptcy Court entered an order preserving the objection pending the resolution of the avoidance actions. The preference actions were subsequently unsealed and served on the defendants. ATS filed a motion to dismiss the preference complaint, and the Bankruptcy Court granted the motion, dismissing the complaint without prejudice. The Debtor subsequently filed a motion to amend its complaint but the parties settled before the Bankruptcy Court ruled on that motion. Shortly thereafter, the Debtor withdrew its objection against ATS and the Bankruptcy Court dismissed the preference complaint with prejudice. The period from the date of the omnibus objection to the date it was withdrawn was more than 180 days.

## The District Court Opinion

Longacre commenced an action against ATS demanding payment on the grounds that the Debtor's claim objection and ATS's failure to resolve the objection within 180 days triggered an obligation of ATS under the Agreement to take back the claim and refund the purchase price amount, with interest, pending resolution of the objection.<sup>2</sup> While Longacre conceded that it would have had to take back the claim and return the refunded purchase price to ATS once the objection was resolved, it sought payment of the interest due on the purchase price amount from the date the parties entered into the Agreement in December 2006 through to the date the claim was finally resolved in March 2011.

The District Court granted summary judgment to ATS on all counts and denied Longacre's cross-motions for summary judgment. In its decision, the District Court did not rule on whether ATS had met the requirement to resolve the claim within 180 days or "a reasonable time thereafter" under the terms of the Agreement. Instead, the District Court assessed the merits of the claim objection itself under the controversial and widely criticized opinion in *Enron v. Springfield Associates*.<sup>3</sup> In *Enron*, the U.S. District Court for the Southern District of New York held that the plain language of Bankruptcy Code section 502(d) was directed at the claimant, as opposed to the claim, which led the Court to conclude that disallowance is a personal disability of a claimant and not an attribute of the claim itself. The *Enron* Court also distinguished between assignments and sales, finding that disabilities can attach to the assignments, but not to the sales of claims.

In *Longacre*, the District Court held that because the claim objection lacked merit, the recourse provisions in the Agreement were not triggered. Specifically, the District Court held that the Debtor's objection was not an "Impairment" or "Possible Impairment" as defined in the Agreement because the Debtor's objection only preserved its right to object to the claim and because, under *Enron*, section 502(d) objections attach to the claimant and not to the claim itself.<sup>4</sup>

The District Court also held that Longacre had not shown that ATS had knowledge of any impairments when it sold the claim and thus that ATS breached its warranty that the claim was not subject to disallowance or possible impairment. Lastly, the District Court held that because ATS had not breached any of its obligations, indemnification was not warranted.

## The Second Circuit Opinion

On appeal, the Second Circuit vacated and remanded the District Court's decision, finding that the plain language of the Agreement did not require that the objection be meritorious to trigger the contractually agreed upon recourse provisions.<sup>5</sup> The Court held that the terms of the Agreement called "for at least a temporary return of the purchase price when there is an unresolved 'Possible Impairment'" and that the Debtor's objection to the claim qualified as such.<sup>6</sup> Accordingly, the Debtor's

<sup>2</sup> *Longacre Master Fund, Ltd., Long Acre Capital Partners (QP) L.P. v. ATS Automation Tooling Systems Inc. (Longacre)*, 456 B.R. 633 (S.D.N.Y. 2011), *vacated and remanded*, Longacre, No. 11-3414-cv, sum order, (2d Cir. Sept. 14, 2012).

<sup>3</sup> *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007).

<sup>4</sup> 2012 WL 4040176 (C.A.2 (N.Y.)) at \*2.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

objection and the order of the Bankruptcy Court preserving the objection were sufficient to trigger Longacre's put right.

The Second Circuit also vacated the District Court's finding that there was no reasonable issue of fact regarding whether ATS breached its warranty and had knowledge of any impairments when it sold the claim. Because the parties did not dispute that the Debtor made a payment to ATS in the 90-day preference period prior filing its chapter 11 petition, there was at least a question of whether ATS knew the claim was subject to disallowance or possible impairment. The Court also vacated the District Court's judgment with respect to indemnification.

## Conclusion

The Second Circuit's decision should reassure secondary market claims purchasers that they can enforce a put right if a debtor objects to a purchased claim without having to evaluate the merits of the objection. It should be noted that the purchasers in *Longacre* engaged in extensive litigation. Accordingly, buyers should be certain that any triggers for recourse provisions in claim transfer agreements are explicit and cover all scenarios – from a pleading that merely preserves the debtor's right to object to a final order reducing or disallowing the claim. Claims purchasers also should ensure that their sellers provide unlimited and unqualified representations, warranties, and indemnification with respect to the validity, status, and treatment of the claims. And where payments are made to the seller during the preference period, sellers should seek acknowledgements from buyers and carve-outs from representations to avoid allegations that they breached representations because they knew the claim was subject to possible impairment.

While this decision is favorable to bankruptcy claims purchasers, the uncertainties raised by *Enron* remain. There was some hope that the Second Circuit would address these lingering uncertainties. Instead, the Second Circuit decided *Longacre* using a straightforward reading of the Agreement with only a brief mention of *Enron*.

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