ALERTS

Second Circuit Decision Reassures Bankruptcy Claim Purchasers on Enforceability of Recourse Against Sellers

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The United States Court of Appeals for the Second Circuit recently vacated a decision by the District Court for the Southern District of New York, which had declined to enforce the contractual allocation of claim impairment risk between a bankruptcy claim buyer and its seller.[1] Relying on the plain language of the documents, the Second Circuit held in *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc. (Longacre)* that the debtors' objection to the claims had triggered the seller's repurchase obligation. The District Court had granted summary judgment to ATS, the seller of certain bankruptcy claims, in a suit brought by two Longacre funds, the buyers of the claims.[2] In the suit, Longacre was seeking to enforce provisions of the claims purchase documents that required ATS to repurchase the claims because the debtors had filed an objection to the claims under section 502(d) of the Bankruptcy Code (claim disallowance when creditor received preference) and/or breached its representation and warranties concerning the claim. Rather than enforce the plain language of the claims purchase documents, the District Court had found against Longacre, reasoning that the debtors' objection under section 502(d) were not substantive objections to the merits of a claim. The District Court also determined that ATS had not breached its representations and warranties regarding the absence of potential preference actions because it had no knowledge of potential preference actions. The District Court's decision challenged the bankruptcy claims market's expectations that claims buyers will be able

to exercise any agreed upon contractual "put right" when a debtor objects to a purchased claim. The Second Circuit's decision will go a long way to reassure the bankruptcy claims market and reduce unnecessary uncertainty as to the enforceability of common risk allocation provisions in bankruptcy claims purchase documents.

Background: Risk Allocation in the Secondary Market for Bankruptcy Claims

Buyers of bankruptcy claims have to address at least three types of risk when purchasing a bankruptcy claim: recovery risk, notional amount risk and counterparty credit risk. Recovery risk is the risk that the amount and timing of distributions on the face amount of the claim changes (e.g., the debtor pays 30 cents in notes instead of 80 cents in cash per dollar of the claim's face amount). Notional amount risk is the risk, often overlooked, that the face amount of the claim is reduced and/or subordinated to other claims (e.g., a $100,000 claim is allowed as only a $70,000 claim reducing the total recovery on the claim, even if the recovery percentage is as expected). Finally, counterparty credit risk becomes a factor to the extent the claim purchase documents allow a buyer to look to its seller for recourse or indemnification for an impairment of the claim's notional amount.

Unlike recovery risk and counterparty credit risk, which can be mitigated through pre-trade diligence, notional amount risk is allocated between buyers and sellers in the claims purchase documents. The bankruptcy claims trading market has coalesced around three types of documentation structures allocating this notional amount risk. In so-called "recourse" claims purchase documents, the buyer is granted a put right, i.e., the right to require the seller to repurchase the claim, if the notional or face amount of the claim is impaired or, in some cases, becomes subject to a potential impairment which can include the claim simply having been objected to by the debtor, any creditors' committee or other third party. In "non-recourse" claims purchase documents, there is no direct put right, but the seller will generally indemnify the buyer for any breaches of representations and warranties, including those covering the risk of an impairment of the claim. The seller's indemnification and the scope of the heavily negotiated representations and warranties often allow the buyer, through litigation, to end up in the same economic position as in a "recourse" claim purchase document. Lastly, in "as-is" purchase documents, the buyer generally takes on the full amount of

notional risk, as the seller is not providing any put right, and only limited representations and warranties, which are often knowledge qualified. For claims with very uncertain notional amounts and where neither buyer nor seller is willing to take on this large notional risk, the parties often agree to a holdback of the purchase price until part or the entire claim amount is crystallized.

District Court Decision in *Longacre*

Delphi Automotive Systems and certain of its affiliates (collectively, the "Debtors") filed for voluntary Chapter 11 petitions on Oct. 8 and 14, 2005 in the Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court").[3] On Dec. 14, 2006, Longacre Master Fund Ltd. and Longacre Capital Partners (QP) LP (collectively "Longacre") purchased bankruptcy claims (the "Claims") against the Debtors from ATS Automation Tooling Systems Inc. ("ATS") at 89 percent of the Claims' face amounts.[4]

On Feb. 3, 2010, the Debtors filed their Forty-Fourth Omnibus Claims Objection (the "Omnibus Objection"), which included an objection to the Claims.[5] The Omnibus Objection served to preserve the Debtors' right under section 502(d) of the Bankruptcy Code to object to claim subject to a preference action,[6] and in particular sought to "object to each Preference-Related Claim pending the conclusion of the Avoidance Action related to such Claim," and to "obtain 'entry of an order preserving the Reorganized Debtor's objection to the Preference-Related Claims.'"[7] The Bankruptcy Court entered such an order on April 5, 2010, recognizing the objections and providing that the objection to each such claim "is hereby deemed preserved pending the conclusion of the Avoidance Action related to such Preference-Related Claim."[8] Subsequently, the Debtors served a complaint (the "Complaint") on ATS seeking to recover alleged preferential payments made to ATS in the 90 days prior to the Debtors' petition date.[9]

The claims purchase documents between ATS and Longacre (the "Agreement") was structured as a "recourse" agreement.[10] The Agreement provided Longacre with the option to require ATS to refund the purchase price and pay interest at 10 percent on the amount from the date of the Agreement to the date the refund is paid, in the event of an "Impairment" under Paragraph 7 of the Agreement,[11] and in the event of a "Possible Impairment" not resolved within 180 days under Paragraph 16

of the Agreement.[12] In addition, the Agreement required ATS to resolve any "Possible Impairments" within 180 days.[13]

ATS was not able to resolve the Complaint until March 30, 2011, when the Debtors withdrew the Omnibus Objection.[14] In the meantime, on Aug. 25, 2010, Longacre had notified ATS that it had not fully resolved the Complaint and the possible impairment of the Claims within the required 180 days (i.e., by Aug. 9, 2010).[15] However, ATS did not refund the purchase price as demanded by Longacre. Accordingly, Longacre sued ATS asserting various causes of action for breach of contract, seeking recovery of the interest owed on the purchase price from the date of the Agreement until the Claims were allowed.[16] Both ATS and Longacre filed motions for summary judgment.[17] The District Court granted ATS' motion for summary judgment and denied Longacre's motion.[18] As Longacre only appealed the dismissal of counts one, six and seven, none of the other counts were at issue before the Second Circuit.[19]

Longacre's complaint count one alleged that the Debtors' objection constituted an "Impairment" under paragraph 7 of the Agreement.[20] That paragraph provides that a claim is impaired when "all or any part of the Claim is . . . objected to . . . for any reason whatsoever, pursuant to an order of the Bankruptcy Court."[21] The District Court granted summary judgment to ATS on count one because in the District Court's interpretation, the Debtors' objection was not an "Impairment" or "Possible Impairment" as defined in the Agreement, as the Omnibus Objection was only a preservation of the Debtors' right to objection. Moreover, objections under section 502(d) of the Bankruptcy Code do not contest the validity or amount of, and is not a lien or encumbrance on, the claim.[22]

Longacre's count six alleged that ATS breached its warranty in paragraph 4 of the Agreement that "to the best of ATS's knowledge, the Claim is not subject to any defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action."[23] The District Court granted summary judgment to ATS on count six because Longacre had failed to show that ATS had knowledge at the time of the sale of any impairments to the claim.[24] The representation that the claim was not subject to any "defenses, claims, rights to set-off, avoidance, or disallowance" was knowledge qualified and Longacre failed to prove that ATS had knowledge of the possibility of a 502(d) objection to the claims. The district court was not willing to find at the summary

judgment stage that the contract unambiguously required representations and warranties to be satisfied after the date of the Agreement.[25] Lastly, Longacre's count seven sought indemnification based on the breaches described in the other counts, including counts one and six.[26]

Second Circuit Decision Vacates District Court

The Second Circuit vacated the District Court's judgment on each of the appealed dismissed counts. Specifically, with respect to Longacre's count one, the Second Circuit held that "nothing in the language of Paragraph 7 [of the Agreement] requires that the objection be meritorious" and Paragraph 16 requires the temporary return of the purchase price when there is an unresolved "Possible Impairment." Moreover, the Second Circuit held that ATS's obligation to repurchase the claims was triggered when the Debtors filed their Omnibus Objection "stating they were 'objecting to' the [Claims], and the Bankruptcy Court issued an order stating that the 'Objection' was preserved," regardless if the "objection" constituted a reservation of rights.[27]

The Second Circuit also vacated the District Court's finding that there was no reasonable issue of fact as to the knowledge of ATS that the Claims "[are] not subject to any . . . impairment . . . or preference action, in whole or in part, whether on contractual, legal, or equitable grounds, that have been or may be asserted by or on behalf of the Debtors or other party to reduce the amount of the Claim[s] or affect its validity, priority or enforceability".[28] The Second Circuit found that it was undisputed that the Debtors made a payment to ATS within the 90 days period before its filing for bankruptcy so ATS could have known that it was possible that the Debtors could bring a preference action that might impair the Claims.[29] Accordingly, the Second Circuit found that there was a material issue of fact as to whether ATS had knowledge of the possibility of a preference action and related objection.[30]

Takeaways

While it appears that Longacre may ultimately be able to enforce its contract, it had to go through the time and expense of litigation and an appeal to get to the result it likely thought the Agreement provided for on its terms. Thus, despite this reassuring clarification by the Second Circuit,

it remains crucial for buyers who want their sellers to take on notional amount risk that the trigger for the put right or the forward looking nature of the representations and warranties in the purchase agreement is unambiguous.

As a result, the trigger for any put right should be broad enough to cover not only existing, but also possible, impairments that have been or may be asserted in the case which affect or could affect the buyer's ability to receive a timely distribution on the claim. Additionally, the forward looking nature of a seller's representations and warranties in connection with a recourse transaction could be clarified to provide a guarantee with respect to the validity of the notional amount of the claim both on *and* after the effective date of a claim purchase.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc. (Longacre)*, No. 11-3414-cv, sum. order, (2d Cir. Spt. 14, 2012).

[2] *Longacre Master Fund, Ltd. v. ATS Automation Tooling Systems Inc.* (*ATS*), 456 B.R. 633 (S.D.N.Y. 2011), *vacated* and *remanded*, Longacre, No. 11-3414-cv, sum. order, (2d Cir. Spt. 14, 2012).

[3] *ATS*, 456 B.R. at 635.

[4] *Id.* at 636.

[5] *Longacre*, at *2.

[6] Under section 502 of the Bankruptcy Code, "the court shall disallow any claim of any entity" that is a transferee of a transfer avoidable under section 547.

[7] *Longacre*, at *2.

[8] *Id.*

[9] *ATS*, 456 B.R. at 637.

[10] *SeeATS*, 456 B.R. at 636-37.

[11] Paragraph 7 of the Agreements reads as follows: "Subject to paragraph 16 below, in the event all or any part of the Claim is ... offset, objected to, disallowed, subordinated, in whole or in part, in the Case for any reason whatsoever, pursuant to an order of the Bankruptcy Court (whether or not such order is appealed) ... (collectively, an "Impairment"), Seller agrees to immediately repay, within 5 business days on demand of Buyers (which demand shall be made at Buyers' sole option), an amount equal to the portion of the Minimum Claim Amount subject to the Impairment multiplied by the Purchase Rate ..., plus interest thereon at 10 percent per annum from the date hereof to the date of repayment." *ATS*, 456 B.R. at 637.

[12] Paragraph 16 of the Agreement reads as follows: "[I]n the event a possible Impairment is raised against the Claim in the Case and actually received by Buyers (a "Possible Impairment"), Buyers shall promptly notify Seller.... If at any time after the 180th calendar day following the day on which the Possible Impairment was filed against the Claim or otherwise formally commenced (herein, the "Limitation Day"), Seller's opposition and/or defense against the Possible Impairment has not been fully resolved and is not likely to be fully resolved within a reasonable period of time, then Seller must immediately repay an amount calculated in accordance with paragraph 7, as if there were an Impairment in respect of all or part of the Claim and Buyers had made a demand under paragraph 7. If after the Limitation Day Seller is subsequently successful (wholly or partly) in opposing or defending against such Possible Impairment, Buyers agree to promptly pay, on demand of Seller, an amount equal to the portion of the Claim subject to the Possible Impairment that was successfully opposed or defended and to which a repayment previously was made under this paragraph 16 multiplied by the Purchase Rate, plus interest thereon at 10% per annum from the date of repayment by Seller under this paragraph 16 to the date the payment is made by Buyers." *Id.*

[13] *Id.*

[14] *Id.* at 639.

[15] *Id.* at 638-39.

[16] *Id.* at 639. Longacre was, however, not seeking repayment of the purchase price, as the objections to the claim had been dismissed and resolved. The total interest Longacre was seeking was $817,037.17. *Id.*

[17] *Id.* at 635 (while ATS had initially filed a 12(b)(6) motion to dismiss, it later converted it to a motion for summary judgment).

[18] *Id.* at 644.

[19] *Longacre*, at *3. Note that Longacre did not appeal the dismissal of its second (i.e., the claim was "Impaired" due to offset), third (i.e., breach of "valid claim" representations), fourth (i.e., breach of representation that seller has no liability or obligation as to the claim), and fifth (i.e., breach of representation that the claim is free from lien, encumbrances and set-offs) causes of actions. Thus, these dismissals were not reviewed by the Second Circuit.

[20] *Id.*

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *ATS*, 456 B.R. at 642-643 ("The representations and warranties were made as of Dec. 14, 2006 (the 'Effective Date'), the date the Agreement was fully executed, and do not purport to serve as a guarantee of the future.").

[26] *Longacre*, at *3.

[27] *Id.* at *4.

[28] *Id.* at *5.

[29] *Id.*

[30] *Id.*

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