Subprime turmoil will provide quick test of Code amendments

By David Curry and Richard Ziegler, Mayer, Brown LLP

The Bankruptcy Code has long provided safe harbors for certain financial contracts — repurchase agreements (Section 559), securities contracts (Section 555), swap agreements (Section 560), commodity contracts and forward contracts (Section 556). The protections given to these contracts were significantly expanded in the BAPCPA. One change in particular immediately caught the attention of the capital markets — the expansion of the definition of repurchase agreements and securities contracts to include transactions involving mortgage loans and mortgage backed securities. The recent bankruptcies of numerous subprime lenders have illustrated the effectiveness of these provisions, and also some of the limitations on the protections in the context of financing against pools of mortgage loans.

The free pass

The Bankruptcy Code came close to providing qualifying parties to these protected contracts with a free pass from the bankruptcy of their counterparty. They are exempted from the Bankruptcy Code's invalidation of *ipso facto* clauses and they may exercise their rights to close out protected contracts free from the automatic stay. Protected parties are also exempt from almost all of the trustee's avoidance powers with respect to pre-bankruptcy transfers made to them under the protected contracts, the one notable exception being transfers made with actual intent to hinder, delay or defraud creditors.

Improving on the free pass

The BAPCPA expanded the protections in several significant ways. First, it clarified that a protected party's right to close out the contract upon the bankruptcy of its counterparty extends to the right to cause the "liquidation, termination or acceleration" of the contract. Thus, the BAPCPA makes it clear that the remedies protected by the Bankruptcy Code are consistent with the remedies exercised in the marketplace: protected contracts typically provide that upon a counterparty's bankruptcy the other party's remedies include terminating the contract, accelerating the due date of the obligation, and liquidating the assets held pursuant to the contract and applying the proceeds in accordance with the agreement.

Second, the BAPCPA created the concept of "financial participants," which includes large participants in the capital market who hold significant positions in protected contracts. For example, a party with protected contracts with a total gross mark to market positions of not less than $100 million or not less than $1 billion in notional amount of such contracts is a financial participant. This expansion of protected parties allows large financial institutions, such as hedge funds, to qualify for protected status under security contracts. Before the BAPCPA, the qualifying counterparties for securities contracts were more limited, with entities such as stockbrokers and securities clearing agencies being the typical protected party.

Third, the BAPCPA resolves any doubt about the ability to net across products. In other words, a party that has different types of protected contracts with a debtor may take into account the termination positions with respect to all of the contracts in netting out the various positions. To accomplish this, the BAPCPA adds to the Bankruptcy Code, Section 561, which provides protection to master netting agreements. Although not conclusively resolved by the BAPCPA, the new provisions make possible an argument for triangular netting involving parties other than the debtor and the counterparty, such as guarantors.

Fourth, BAPCPA expanded the definitions of the contracts that are protected. Most significantly in light of recent developments in the subprime lending market, the definitions of repurchase agreement and securities contract were expanded to include mortgage loans, mortgage related securities, or interests in mortgage loans or mortgage securities. Other examples include the definition of swap agreements, which was significantly expanded with the intent to match market practices. For example, "weather swap" and "total return swap" are now included in the definition of swap agreement. Finally, Section 562 has been added to the Bankruptcy Code to provide rules for the timing and measurement of the protected party's damages when it exercises close-out rights.

BAPCPA in Action

Quick Exits.

The recent bankruptcies of numerous subprime lenders have provided early evidence that the special protections afforded to protected contracts can indeed provide protected parties with a quick departure from the bankruptcy proceedings. Many financial institutions are now taking advantage of the amendments in the BAPCPA by structuring

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their financings of mortgage loans and mortgage related securities as repurchase agreements. For example, in the recent bankruptcy filing by **HomeBanc Corp.**, the debtor listed 11 of its 20 largest creditors as parties under repurchase agreements. Repurchase agreements, as defined by the BAPCPA, must have a term of no longer than one year. Thus, repurchase agreements are particularly well-suited for mortgage warehouse lending — short term loans to fund a mortgage lender's acquisition of mortgage loans prior to securitization. Experience from cases such as **New Century Financial** indicates that the protected contract provisions have generally worked as designed, enabling lenders to close out repurchase agreements and sell the mortgage loans backing the debtor's repurchase obligations free from the automatic stay. In filings with the bankruptcy court, New Century disclosed that it had over $7 billion in indebtedness under repos and that by the time of the filing, numerous repo participants had exercised their remedies. For the bankruptcy practitioner, this phenomenon necessitated rapid liquidations in which the primary activity has been sale of any remaining assets, such as servicing platforms or disputes regarding the repurchase agreements.

Potential for Entanglements.

Recent experience has also brought to light some of the significant differences between a repo involving a pool of mortgage loans and a traditional repo involving U.S. Government securities. Government securities are held and can be readily liquidated without much effort by the repo buyer. Mortgage loans, on the other hand, require much greater hands-on management — they must be actively serviced for the repo buyer. Under a typical repurchase agreement, the seller (debtor) usually acts as servicer and is therefore collecting payments under the mortgages, and often has possession of documentation related to the mortgages. Upon the filing of bankruptcy by the debtor, the counterparty may be free to terminate the repurchase agreement and sell the mortgages. However, prospective buyers of the mortgage loans are likely to want certainty about ongoing servicing and may insist on having immediate possession of the documentation necessary to enable it to service the mortgages or to transfer servicing duties to another servicer. As long as the buyer is fully cooperative, these requirements may not present much problem to the repo buyer. However, if the debtor is unwilling or unable to facilitate these matters, the repo buyer will face some difficulties. While the remedies under the BAPCPA are broad, they are largely in the nature of self-help. If the exercise of a remedy necessary to close-out the contract requires action by the debtor, and the debtor is unwilling to take that action, the protected party is forced to resort to seeking relief from the bankruptcy court.

Recent experience suggests that there may be some delays for protected parties in obtaining full vindication of their rights. For example, in the recent bankruptcy case of **People's Choice Home Loan Inc.**, a repo participant had to seek relief from the bankruptcy court for protection in connection with the transfer of mortgage documentation from the debtor. In that case, the repo participant was also concerned that the debtor would fail to continue to service the mortgages during the transition.

Similarly, in the New Century case, the debtor alleged that it had commingled the mortgage collections of numerous repo participants with its own funds and that there were no accounting procedures in place to allow for identification of the funds. The debtor's motion led to the entry of an adequate protection order for the affected repo participants, which provided for, among other things, accounting procedures, an escrow of cash to pay potential repo claimants, and an adequate protection lien.

This recent and ongoing experience illustrates the benefit of structuring mortgage lending arrangements as repurchase agreements. It also provides a forewarning of some of the pitfalls that may occur as a result of the differences between mortgages and the types of securities that are normally the subject of repurchase agreements. ■

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