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RESTRUCTURING, BANKRUPTCY & INSOLVENCY/ SECURITIZATION UPDATE

Another Victory for the Mortgage Loan Repo Market

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In a decision issued on May 23, 2008, the mortgage loan repo market scored its second important victory in the American Home Mortgage bankruptcy case.[1] In its first victory, a prior decision[2] in the case, the Delaware Bankruptcy Court affirmed that the mortgage loan repos at issue were entitled to the benefits of the Bankruptcy Code's "safe harbor" provisions. The May 23 decision (hereafter, "*American Home Two*") dismissed the debtor's law suit against two Lehman entities (collectively, "Lehman") that were involved in a different pre-petition repo.

The suit challenged the safe harbors from multiple angles, but without success. Among the court's important holdings:

- A repo of subordinated notes secured by mortgage loans is entitled to the benefit of the repo and securities contract safe harbors; and
- Commercial reasonableness standards imposed on secured lenders by Article 9 of the Uniform Commercial Code (the "UCC") do not apply to the exercise of remedies by a repo lender in closing out a repo after default.

While the application of the repo and securities contract safe harbors to transactions involving mortgage loans has not yet been tested at the appellate level, the two *American Home* decisions from the Delaware Bankruptcy Court could hardly have been more supportive of the safe harbors.

Brief Background on the Safe Harbors

Although they are economically similar to short-term secured loans, repurchase agreements (commonly referred to as "repos") involving specified types of financial collateral enjoy a panoply of safe harbors that protect and enhance a repo lender's access to the collateral upon the bankruptcy of the repo seller, as compared to the rights of a conventional secured lender against similar collateral. Most importantly, a repo lender:

- May exercise its contractual rights to liquidate, terminate or accelerate the repo (and the repo'd collateral) upon its counterparty's bankruptcy filing, without violating the automatic stay and regardless of the fact that remedies triggered by the filing might otherwise by unenforceable as "*ipso facto*" clauses; and
- Is broadly protected from the Bankruptcy Code's provisions allowing recovery of fraudulent conveyances (assuming no actual fraud) and voidable preferences.

Mortgage loans were added to the list of qualifying financial collateral by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, as were "mortgage related securities" and "interests in mortgage related securities or mortgage loans." We refer to these various types of mortgage-related assets below as "mortgage collateral." The Bankruptcy Code limits the repo safe harbors to repurchase agreements that involve mortgage collateral (and a few other qualifying assets such as US government securities) and that meet other specified terms (including a maturity of not more than one year, or on demand).

Repos of mortgage collateral may also qualify as "securities contracts," as the definition of "securities contract" includes any contract "for the purchase or sale" of mortgage collateral. Securities contracts also expressly include "repurchase or reverse repurchase transactions," without subjecting those transactions to the maturity limit and other terms in the Bankruptcy Code's definition of repurchase agreement. However, for securities contracts, the Bankruptcy Code limits the universe of protected counterparties to stockbrokers, financial institutions, financial participants (essentially large players in the financial markets) or securities clearing agencies, which is a more limited set than the "repo participants" (essentially anyone who is party to a repo) that benefit from the repo safe harbors.

American Home Two

The repo'd securities involved in the repo at issue in *American Home Two* were subordinated notes issued by a special purpose entity, which notes were secured by mortgage loans.[3] One way the debtor attacked the transaction was by arguing that the subordinated notes were not qualifying collateral for the repo safe harbor. The court disagreed, holding that the subordinated notes were "interests in mortgage loans" (one of the qualifying categories), because they were secured by mortgage loans. As a result of this finding and a further finding that the Lehman entity involved was a "stockbroker," the court also held that the subject repurchase agreement was a securities contract.

Because the repo was a repurchase agreement and a securities contract, the court held that Lehman's action in exercising its contractual right to liquidate and close out the repo (by retaining the subordinated notes) was not subject to the automatic stay and survived the Code's general provision rendering *ipso facto* clauses unenforceable. Importantly, the repo did not have to be both a repurchase agreement and a securities contract in order for Lehman's actions to be permitted. Either one would have been enough without the other, but this particular repo fell within both protected categories.

The debtor also claimed that Lehman's exercise of remedies had violated a commercial reasonableness requirement that Article 9 of the UCC imposes on secured parties. The court disagreed. Although some sales of receivables are treated like security interests for parts of Article 9, the commercial reasonableness requirement in the remedies section of the Article does not apply to "true buyers."[4] Based on expressions of intent in the master repurchase agreement governing the Lehman repo, the court held that the

master repurchase agreement was "a purchase and sale agreement," and, therefore, the commercial reasonableness requirement did not apply. As a result, according to the court, Lehman was entitled to exercise the default remedies set out in the contract (in particular, the right to retain the repo'd securities free of the debtor's interests), and Lehman was not required to conduct a UCC-type foreclosure sale or otherwise to comply with the UCC's commercially reasonable standard.

The debtor made several other claims, including that Lehman had breached contractual obligations, was guilty of conversion[5] or had been unjustly enriched through the transaction. However, all of the counts of the complaint were dismissed, although the court left room for the debtor to refile its claim that Lehman's actions breached the terms of the master repurchase agreement.

Endnotes

1 *Am. Home Mortgage Inv. Corp. v. Lehman Bros. Inc.* (*In re Am. Home Mortgage Holdings, Inc.*), Adv. No. 07-51739 (CSS), -- B.R. --, 2008 WL 2156323, *__ (Bankr. D. Del. May 23, 2008).

2 In *re American Home Mortgage Inc.*, 379 B.R. 503 (Bankr. D. Del. 2008) (hereinafter referred to as "*American Home One*"). For more detail about *American Home One*, mortgage loan repos and the repo safe harbors, see Curry & Tougas, *The Mortgage Loan Repo Survives its First Big Test (With One Hitch)*, BNA BANKRUPTCY LAW REPORTER, Vol. 20., No. 16 (April 17, 2008), available at http://mayerbrown.com/publications/article.asp?id=4452&nid=6.

3 The secured notes were not "mortgage related securities" (another qualifying category) because they did not meet a minimum credit rating requirement applicable to that category.

4 See Official Comment 9 to N.Y. UCC Section 9-601, which the court cited in *American Home Two*.

5 As the court noted, under New York law, the tort of conversion is the "exercise of unauthorized dominion over the property of another in interference with a plaintiff's legal title or superior right of possession." (*citing Briarpatch LTD. L.P. v. Geisler Roberdeau, Inc.*, 148 F.Supp.2d 321, 328 (S.D.N.Y. 2001) (quoting *Lopresti v. Terwilliger*, 126 F.3d 34, 41 (2d Cir. 1997)).

If you have any questions relating to the American Home *decisions or repo or securities contract safe harbors, please feel free to contact any of the following attorneys, or the member of the Restructuring, Bankruptcy & Insolvency practice or Securitization practice with whom you regularly work.*

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