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## The Treatment of Mortgage Loan Repurchase Agreements in Chapter 11 Bankruptcy

In a recent case of first impression, a bankruptcy court held that a contract for, among other things, the sale and repurchase of mortgage loans was a "repurchase agreement" as defined in Section 101(47) of the Bankruptcy Code, and the amended "safe harbor" provisions of Sections 555 and 559 of the Bankruptcy Code were applicable; however, the safe harbor provisions did not apply to the servicing rights for the mortgage loans.

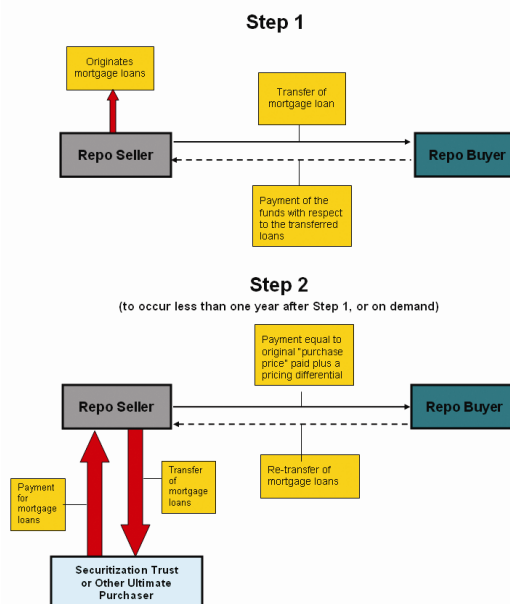
*In Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage, Inc.),*<sup>1</sup> the U.S. Bankruptcy Court for the District of Delaware recently held that a contract providing for, among other things, the sale and repurchase of mortgage loans was a "repurchase agreement" as defined in Section 101(47) of the Bankruptcy Code and, as such, these provisions of the contract were entitled to the protections afforded by the amended "safe harbor" provisions of Sections 555 and 559 of the Bankruptcy Code. The court also held, however, that the provisions of the contract relating to the servicing rights of such loans were not protected by the safe harbor provisions.

### Mortgage Loan Repurchase Agreements

A common mortgage loan repurchase agreement provides a means by which a finance provider (a "repo buyer") can supply a loan originator (a "repo seller") with the funds necessary to originate mortgage loans. In exchange for providing these funds, the repo seller agrees to sell the loans to the repo buyer for an interim period during which the repo seller may seek to arrange for a final disposition of the mortgage loans by way of a securitization or other means. The repo seller will

then re-purchase such loans from the repo buyer in exchange for the transfer of funds from the repo seller to the repo buyer.

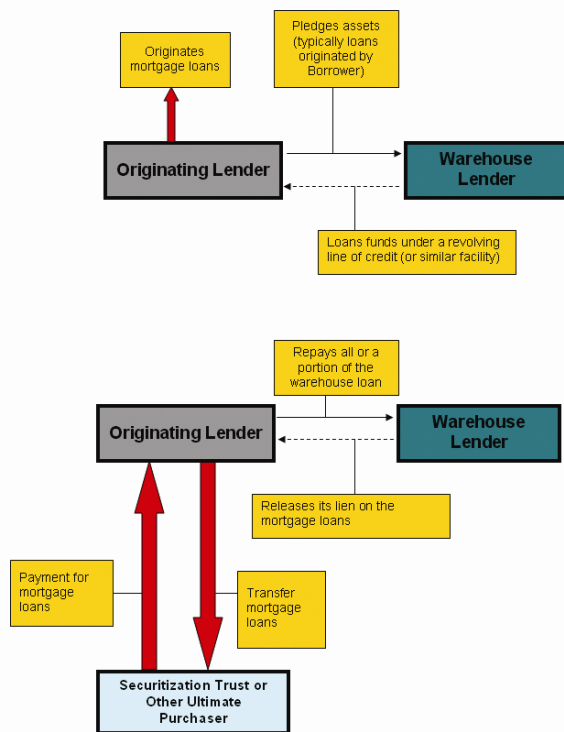
The repo buyer's re-transfer of the mortgage loans or the interests in mortgage loans to the repo seller should occur no later than one year after the initial transfer<sup>2</sup> in exchange for the transfer of funds from the repo seller. The re-purchase price paid by the repo seller would consist of the original purchase price paid to the repo seller plus a premium to compensate the repo buyer for both the time value of its money and the risk associated with the transaction. The repo seller may then sell these mortgage loans to a securitization trust or other ultimate purchaser. The following diagram illustrates an example of such a structure:



<sup>1</sup> 379 B.R. 503 (Bankr. D. Del. 2008).

<sup>2</sup> See 11 U.S.C. § 101(47)(A)(i) (2005).

A repurchase agreement can be contrasted with a secured debt warehouse financing. While these transactions may appear similar, the treatment a secured debt warehouse financing receives in a bankruptcy proceeding is vastly different. In a secured financing, a loan originator (the “originating lender”) will seek financing by which to originate loans. The originating lender will pledge, rather than sell, assets (typically the loans it originates) to a lender (the “warehouse lender”) in exchange for loan funds under a revolving line of credit or other similar facility. The originating lender may then sell these mortgage loans to a securitization trust or other ultimate purchaser. The originating lender likely would use the proceeds from any such sale to repay the warehouse facility and, in return, the warehouse lender will release its lien on such loans. The following diagram illustrates this structure:



Although a repurchase agreement and a secured debt financing have similar economic benefits, a creditor in a secured debt financing is not entitled to any of the “safe harbor” provisions discussed in greater detail below. Thus, creditors in a secured debtor financing are subject to, among other things, the automatic stay under Section 362(a) of the Bankruptcy Code.

## Safe Harbor and Related Bankruptcy Code Provisions

In 2005, Congress enacted amendments to the Bankruptcy Code.<sup>3</sup> These amendments expanded the definition of both a “repurchase agreement”<sup>4</sup> and a “securities contract,”<sup>5</sup> and exempted repurchase agreements from the obligations and restrictions imposed by the following provisions of the Bankruptcy Code:

- the automatic stay under Section 362(a), which stays the post-petition exercise of the right to terminate the agreement, accelerate obligations of the parties, sell or recover the underlying securities, and set off the remaining mutual debts and claims under the agreement;
- the opportunity for the debtor to assume or reject repurchase agreements under Section 365;
- the avoidance of pre-petition payments or transfers by the debtor as “preferences” under Sections 547 and 550; and
- the prohibition against *ipso facto* clauses under Section 365(e)(1).

Under Section 362(a) of the Bankruptcy Code, a debtor filing for protection under any chapter of the Bankruptcy Code triggers an injunction or “automatic stay” against, *inter alia*, the continuance of any action by any creditor against the debtor or the debtor’s property. Section 559 of the Bankruptcy Code, however, exempts “repurchase agreements” from the automatic stay. Section 559 provides, in pertinent part, that the “exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination or acceleration of a

<sup>3</sup> See Bankruptcy Abuse & Consumer Protection Act of 2005, Pub. L. 109-8 (2005).

<sup>4</sup> Section 101(47) of the Bankruptcy Code now defines “repurchase agreement” to include mortgage-related securities, mortgage loans, and interests in mortgage-related securities or mortgage loans.

<sup>5</sup> Section 741(7) of the Bankruptcy Code now defines “securities contract” to include mortgage loans and any interests in mortgage loans, including repurchase transactions.

repurchase agreement” under an *ipso facto* clause “shall not be stayed, avoided or otherwise limited by operation of any provision of [the Bankruptcy Code].” In essence, Section 559 allows a party protected by a repurchase agreement to enforce the termination provisions of the agreement as a result of a bankruptcy filing by the other party. Section 555 of the Bankruptcy Code provides the same exemption for “securities contracts.” Moreover, Section 362(b)(7) of the Bankruptcy Code exempts setoffs under repurchase agreements from the automatic stay and enables a repo buyer to recoup its losses by selling the mortgage loans serving as collateral.

Pursuant to Section 365 of the Bankruptcy Code, a bankrupt debtor may assume or reject any executory contract<sup>6</sup> or unexpired lease. As executory contracts and unexpired leases are regarded as property of the bankruptcy estate, a non-debtor party is prohibited from unilaterally terminating a contract or lease with the debtor, absent relief from the automatic stay. This is significant for a repo participant because it would prevent the non-bankrupt party from terminating the repurchase agreement and selling the mortgage loans under Section 365 of the Bankruptcy Code. Bankruptcy Code Section 559, however, exempts repurchase agreements from this obligation and allows repo participants to exercise their contractual rights to cause the acceleration, termination, or liquidation of a repurchase agreement. As such, a repo participant may terminate the repo agreement and sell the collateral mortgage loans in the event of a repo seller bankruptcy without fear of violating the requirements of Section 365.

Section 547 of the Bankruptcy Code provides that a bankrupt debtor may avoid or recover (for the estate) certain pre-petition transfers as a “preference” payment. Bankruptcy Code Section 548 permits the recovery of certain pre-petition transfers for which the debtors received less than “fair value.” The policy underlying these provisions is to ensure that all unsecured creditors are fairly treated. Sections 547 and 548 of the Bankruptcy Code are of concern for

repo participants as a bankruptcy court could seek to undo certain transfers required under a repurchase agreement as “preference” payments or “fraudulent transfers” if such transfers occurred prior to repo seller’s bankruptcy petition. Section 559 of the Bankruptcy Code, however, exempts repurchase agreements from this obligation and allows repo participants to exercise their contractual rights without risk of having them “unwound.”

## Factual Background of the Case

On November 21, 2006, American Home Mortgage, Inc. (“American Home”) and a group of financial institutions, for whom Calyon New York Branch (“Calyon”) served as administrative agent, entered into an agreement (the “Agreement”). American Home was in the business of originating, selling, and servicing mortgage loans. Calyon financed American Home’s operations via the Agreement pursuant to which Calyon would provide American Home with the funds necessary to originate the mortgage loans. In return, American Home would sell the loans to Calyon for an interim period during which American Home would seek to arrange for a final disposition of the mortgage loans by way of a securitization or other means. Once American Home was prepared to sell the mortgage loans, it would repurchase the same from the Calyon in exchange for the transfer of funds from American Home to Calyon. Calyon would then have to return the mortgage loans or the interests in mortgage loans to American Home no later than 180 days after the initial transfer in exchange for the transfer of funds from American Home. The repurchase price paid by American Home would consist of the original purchase price paid to American Home plus the “pricing differential,” a *per diem* “pricing rate” multiplied by the number of days the mortgage loans were in the possession of Calyon.

Additionally, the Agreement provided for the servicing of the mortgage loans. Specifically, the Agreement provided that the underlying mortgage loans were to be transferred to Calyon (as administrative agent) on a “servicing retained” basis. In a servicing retained sale of a mortgage loan, the repo seller retains the right to designate the mortgage loan servicer. Conversely, in a “servicing released” sale of a mortgage loan, the repo buyer purchases both the mortgage loan and the right to designate the mortgage loan servicer. Typically, a buyer will pay a greater price in a servicing released transaction

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<sup>6</sup> The Bankruptcy Code contains no definition of “executory contract.” The majority view, however, is that an executory contract is a contract between a debtor and another party under which both parties have significant performance commitments, such that if either side failed to complete its performance obligations under the contract, it would excuse performance by the other party.

because it is purchasing both the mortgage loan and the right to receive the payments for servicing the loan. In this case, American Home Mortgage Servicing, Inc. (an affiliate of American Home) had the right to service the mortgages and was entitled to a servicing fee during the term of the Agreement. Pursuant to other provisions of the Agreement, however, Calyon could designate a new servicer upon the occurrence of an event of default by the incumbent servicer.

Finally, the Agreement contained an *ipso facto* clause that allowed either party to the Agreement to terminate and/or liquidate for cause if the other party became insolvent, failed to follow the conditions articulated in the Agreement, or declared bankruptcy.

## The Bankruptcy Court's Analysis and Holding

In deciding the case, the court was called upon to rule on four issues:

- whether the Agreement was a repurchase agreement as defined in Section 101(47) of the Bankruptcy Code;
- whether such a repurchase agreement was protected by the amended "safe harbor" provisions of Sections 555 and 559 of the Bankruptcy Code;
- whether the provisions of the Agreement addressing the servicing of the mortgage loans were protected by the aforementioned "safe harbor" provisions or were severable from the rest of the Agreement; and
- whether the court should order specific performance of American Home's obligation to transfer servicing rights to Calyon upon an event of default by American Home Mortgage Servicing.

### Is the Agreement a Repurchase Agreement?

The court began its analysis by describing the nature of a repurchase agreement. The court looked to the U.S. Court of Appeals for the Third Circuit, which in *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer*

*S&L Ass'n*<sup>7</sup> characterized a repurchase agreement as a two-step transaction. The first step entails a transfer of specified securities by one party (the "repo seller") to another party (the "repo buyer") in exchange for cash. The second step is a contemporaneous agreement by the repo seller to repurchase the securities from the repo buyer at the original price plus an agreed upon additional amount on a specified future date.

The bankruptcy court went on to articulate the specific factors that identify and distinguish a repurchase agreement from a secured financing transaction. The court looked to the plain meaning of Section 101(47) of the Bankruptcy Code, and stated that an agreement will be considered a repurchase agreement if it:

- (i) provides for the transfer of one or more mortgage loans or interests in mortgage related securities or mortgage loans;
- (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage related securities or mortgage loans;
- (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests in mortgage related securities or mortgage loans;
- (iv) at a date certain not later than one year after such transfer or on demand; and
- (v) against the transfer of funds.

The court then analyzed whether the Agreement fulfilled each of these factors.

The court found the first factor fulfilled as the Agreement provided for the transfer of multiple mortgage loans or interests in mortgage loans. The court noted that even if the Agreement provided for the creation of a lien on the mortgage loans, it would still constitute a "transfer" under 11 U.S.C. § 101(54). With respect to the second factor, the court determined the transfer of the mortgage loans from American Home to Calyon to be against the transfer of funds from Calyon to American Home. Additionally, the Agreement contained a concurrent agreement by

<sup>7</sup> 878 F.2d 742 (3d Cir. 1989).

Calyon to transfer the mortgage loans to American Home that, according to the court, fulfilled the third factor. The court concluded the fourth factor was satisfied as the transfer of the mortgage loans from Calyon to American Home was to occur within 180 days of the original transfer—well before the one-year deadline. Finally, as the transfer of the mortgage loans from Calyon to American Home was against the transfer of funds by American Home to the Calyon, the final factor was fulfilled. Thus, the court held that the sale and repurchase of the mortgage loans under the Agreement was a repurchase agreement.

### **Are the Amended “Safe Harbor” Provisions of Sections 555 and 559 of the Bankruptcy Code Applicable?**

As the sale and repurchase of the loans under the Agreement was a repurchase agreement, the court held that the “safe harbor” provisions of Sections 559 and 555 of the Bankruptcy Code were applicable. As noted above, these sections protect the exercise of certain contractual rights to liquidate, terminate, and accelerate repurchase agreements from the automatic stay, and other bankruptcy limitations.

In reaching this conclusion, the court determined that it need only apply the “plain meaning” of the Section 101(47) definition of “repurchase agreement.” As the Agreement was a repurchase agreement, and because both Calyon and American Home were “repo participants,” Section 559 of the Bankruptcy Code was applicable. The court rejected American Home’s argument that additional criteria were required to find an agreement to be a repurchase agreement. Thus, the court held that Calyon’s rights (as the non-debtor party) relating to the sale and repurchase of mortgage loans were not stayed, avoided, or otherwise limited by the operation of any provision of the Bankruptcy Code.

### **Are the Servicing Rights also Protected by the “Safe Harbor” Provisions?**

With respect to the servicing of the mortgage loans under the Agreement, however, the court found that the safe harbor provisions were inapplicable. Applying New York law, the court reached this conclusion for two reasons: (i) the portion of the Agreement that provided for the servicing of the mortgage loans was severable from the portion of the Agreement providing for the sale and repurchase of the mortgage loans; and (ii) the portion of the Agreement providing for the servicing of the mortgage loans was neither a

“repurchase agreement” (under 11 U.S.C. § 101(47)) nor a “securities contract” (under 11 U.S.C. § 741(7)(a)(i)). Based on this finding, the court held that the provisions of the repurchase agreement relating to servicing the mortgage loans were severable from the rest of the Agreement and were thus not protected by the “safe harbor” provisions of the Bankruptcy Code.

### **Is Specific Performance of American Home’s Obligation to Transfer Servicing Rights to Calyon Appropriate?**

The court refused to grant specific performance, reasoning that absent an applicable “safe harbor” for the servicing portion of the Agreement, Calyon was not entitled to specific performance.

### **Significance of the Decision**

*American Home* is significant in that it is a case of first impression regarding the applicability of the amended “safe harbor” provisions of Sections 555 and 559 of the Bankruptcy Code to a repurchase agreement involving mortgage loans. Participants in a repurchase agreement should take some comfort from the court’s holding that the portion of the agreement providing for the sale and repurchase of mortgage loans fell within the plain meaning of the Bankruptcy Code’s definitions of a “repurchase agreement” and a “securities contract.” This enables repo participants to receive the protections for which they bargained through the application of the amended “safe harbor” provisions.

Of note, however, is the court’s finding that the portion of the agreement providing for the servicing of the mortgage loans was not protected under the amended “safe harbor” provisions of the Bankruptcy Code because that portion of the agreement was neither a repurchase agreement nor a securities contract. As a bankrupt repo seller is unlikely to have the funds necessary to buy back its loans, a repo buyer may have to liquidate collateral loans by sales to third-party buyers. The price a repo buyer could realize from such a sale, however, may be reduced if the repo buyer must sell the mortgage loans subject to the bankrupt repo seller’s servicing rights.

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This update was authored by Katherine A. Burroughs (+1 860 524 3953; [katherine.burroughs@dechert.com](mailto:katherine.burroughs@dechert.com)) and Jonathan F. Tross (+1 860 524 3932; [jonathan.tross@dechert.com](mailto:jonathan.tross@dechert.com)).

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## Practice group contacts

If you have questions regarding the information in this legal update, please contact the authors or the Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/finance&realestate](http://www.dechert.com/finance&realestate).

**Katherine A. Burroughs**  
Hartford  
+1 860 524.3953  
[katherine.burroughs@dechert.com](mailto:katherine.burroughs@dechert.com)

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