International Corporate Rescue

ChaseCambria

3-4 SOUTH SQUARE
BARRISTERS

UCL
UCL LAW FACULTY
CENTRE FOR COMMERCIAL LAW

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2008 (6 issues)
Print or electronic access:
EUR 665.00 / USD 799.00 / GBP 465.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 114 255 9040 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

Calyon New York Branch v American Home Mortgage, Corp. (In re American Home Mortgage, Inc.): Bankruptcy Court Identifies Limits of Safe Harbour Provisions Applicable to Mortgage Loan Repurchase Agreements

Scott C. Shelley, Counsel, Bankruptcy & Reorganization Group, Shearman & Sterling LLP, New York, USA

Introduction

In a recent ruling, the US Bankruptcy Court for the District of Delaware (the 'Court') held that mortgage servicing rights and mortgage loan repurchase obligations contained in a single agreement could be severed for purposes of applying the 'safe harbour' provisions of the Bankruptcy Code.[1] The Court concluded that while the repurchase obligations fell within the safe harbour provisions of Bankruptcy Code sections 555 and 559, which permit the liquidation, termination or acceleration of repurchase agreements upon the bankruptcy filing of the counterparty, the mortgage servicing rights did not. As a result, while the non-debtor counterparty to the contract was permitted to exercise rights and remedies in respect of the repurchase obligations that would have been prohibited but for the safe harbour, it was not permitted to take action to reclaim the servicing rights. In a case of first impression, the Court's ruling in *In re American Home Mortgage, Inc.*[2] adheres to the plain meaning of the applicable Bankruptcy Code provisions, and reaches a conclusion that should guide other courts during the rising wave of mortgage-related insolvencies.

The automatic stay and safe harbours

The automatic stay is one of the fundamental protections afforded to debtors under the Bankruptcy Code. The stay arises immediately upon the filing of a bankruptcy petition and generally applies to any act to obtain possession of, or exercise control over, property of a debtor's bankruptcy estate, as well as to the commencement or continuation of most legal and administrative proceedings against the debtor. The automatic stay is subject to a number of exceptions, as set forth in Bankruptcy Code section 362(b). For example, the automatic stay does not apply to the exercise by a governmental unit of its police or regulatory powers, such as the commencement or continuation of criminal proceedings.

In enacting the Bankruptcy Code, Congress also recognised the specialised needs of the financial markets and created certain 'safe harbours' for enforcing rights under, or terminating, certain types of financial contracts notwithstanding the automatic stay. Specifically, Congress excepted these contracts from the automatic stay restrictions on setting off mutual claims. In addition, although Bankruptcy Code section 365(e)(1) generally prohibits the termination or modification of a contract based upon a provision that is conditioned on the solvency or financial condition of the debtor, or the occurrence of an insolvency event such as a bankruptcy filing (such provisions being generally referred to as *ipso facto* provisions), the safe harbour provisions expressly permit certain protected persons to exercise *ipso facto* rights with respect to certain financial contracts.

These safe harbours, which were first added to the Bankruptcy Code in 1982 and expanded as part of extensive amendments in 2005, are currently found in Bankruptcy Code sections 555 (applicable to securities contracts), 556 (commodities contracts and forward contracts), 559 (repurchase agreements), 560 (swap agreements) and 561 (master netting agreements). In addition, Bankruptcy Code section 562 sets forth procedures for determining the measure of damages under a financial contract that has been liquidated, terminated or accelerated by the non-debtor party under the safe harbour provisions, or that has been rejected by the debtor.

Perhaps the broadest and most significant of the 'safe harbour' provisions is section 555, which establishes

Notes

1 As used herein, the term 'Bankruptcy Code' refers to Title 11 of the United States Code. Unless otherwise noted, references herein to a 'section' are references to a section of the Bankruptcy Code.

2 *Calyon N.Y. Branch v American Home Mortgage, Corp. (In re American Home Mortgage, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008).

the right of certain protected parties (namely, a stockbroker, financial institution, financial participant or securities clearing agency) to enforce their rights under a securities contract. The term 'securities contract', defined in Bankruptcy Code section 741(7), includes

> 'a contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in section 101).'[3]

Assuming that a contract meets the requirements of section 741(7), a protected person would be entitled to the protections under section 555, which provides, in relevant part:

> 'The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title [subject to certain limited exceptions].'[4]

Thus, section 555 permits a protected person (i.e., a stockbroker, financial institution, financial participant or securities clearing agency) to cause the liquidation, termination or acceleration of a securities contract based upon a contract provision triggered by the occurrence of an *ipso facto* event (insolvency or bankruptcy filing), and the exercise of rights by the protected person with respect to the securities contract may not be stayed by an order from any court or administrative agency.

As noted above, other 'safe harbour' provisions provide similar protections with respect to commodities contracts and forward contracts, repurchase agreements, swap agreements and master netting agreements. By way of example, section 559 provides in relevant part:

> 'The exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title [subject to certain limited exceptions].'[5]

As with section 555, the availability of 'safe harbour' protections under section 559 (and the other related provisions) is dependent on strict compliance with the specific requirements of the statute.

Background of the *American Home Mortgage* dispute

American Home Mortgage Corp. and certain of its affiliates (collectively, the 'Debtors') were engaged in the business of originating, servicing and selling mortgage loans. The Debtors also made investments in mortgage loans and mortgage-backed securities issued in connection with the securitisation of residential mortgage loans. To provide the Debtors with liquidity to fund their business, the Debtors and Calyon New York Branch (in its capacity as a bank, Managing Agent and Administrative Agent) entered into a Repurchase Agreement, dated as of 21 November 2006 (the 'Contract'). Under the Contract, various banks and security issuers (collectively, the 'Purchasers') transferred funds to the Debtors in exchange for mortgage loans or interests in mortgage loans. The Contract also provided that within 180 days of the initial transfer, the Purchasers would return the mortgage loans or mortgage loan interests to the Debtors in exchange for a sum of cash, specifically, the original purchase price plus a per diem amount. The mortgage loans repurchased by the Debtors were immediately transferred to a private investor or a securitisation trust.

In addition to the sale and repurchase of mortgage loans, the Contract also governed another important aspect of transactions in the mortgage loan industry, namely, the right to service or designate a servicer for the mortgage loans subject to the Contract. Mortgage loan servicing includes collecting payments from the borrower, administering tax and insurance escrows and responding to inquiries from the borrower. A mortgage loan servicer generally receives a fee for these services, typically calculated as a small percentage of the unpaid principal balance of the mortgage loan.

Notes

3 11 USC § 741(7).
4 11 USC § 559.
5 11 USC § 555.

Under the Contract, the Debtors sold mortgage loans to the Purchasers but continued to perform mortgage loan servicing duties. One of the Debtors, American Home Mortgage Servicing, Inc. ('AHM Servicing'), was designated as the servicer of the mortgage loans and was entitled to a monthly servicing fee.

By July 2007, the Debtors were experiencing financial distress. The turmoil in the global credit markets had resulted in a substantial write-down of the Debtors' security and loan portfolios, which led to margin calls aggregating hundreds of millions of dollars. The Debtors' lenders began exercising remedies, which impaired the Debtors' ability to originate new loans and led to a severe liquidity crisis. On 1 August 2007, Calyon transmitted two default notices to the Debtors. The first, styled a 'Notice of Event of Default', alleged that the Debtors were in default under the Contract and demanded that the Debtors repurchase all the mortgage loans under the Contract then held by the Purchasers. The second, entitled 'Notice of Event of Default to Servicer', also asserted a default and demanded repurchase of the relevant mortgages. The second notice designated AHM Servicing as 'interim servicer' of Contract mortgage loans pending transfer of the mortgage servicing duties to Calyon's new designated servicer.

As a result of these events, the Debtors were forced to terminate their loan origination businesses, and on 6 August 2007, the Debtors filed for bankruptcy protection. The bankruptcy filing was an event of default under the Contract. On 28 August 2007, Calyon terminated AHM Servicing's duties as the interim servicer, directed the Debtors to transfer the servicing operations to Calyon's new designees, and filed a complaint against the Debtors seeking (i) a declaratory judgment that the Contract was a 'repurchase agreement' with the meaning of the Bankruptcy Code, such that Calyon was not restricted in its ability to enforce its rights thereunder, and (ii) injunctive relief directing the Debtors to transfer the mortgage servicing duties as directed by Calyon.

The Debtors responded to the complaint by filing an answer denying that the Contract was a repurchase agreement, accompanied by a counterclaim seeking a declaratory judgment that the Contract was a secured financing. The answer also asserted, in the alternative, that the provisions of the Contract dealing with mortgage loan servicing (as contrasted to the provisions dealing with the mortgage loan repurchases) were not subject to the safe harbour protections of the Bankruptcy Code.

The Bankruptcy Court's decision

At the outset of its ruling, the Court identified three key issues requiring adjudication:

1. Whether the sale and repurchase of mortgage loans under the Contract were transactions made pursuant to a 'repurchase agreement' within the meaning of Bankruptcy Code section 101(47) and thus were entitled to the safe harbour protections of Bankruptcy Code sections 362(b)(7), 555 and 559?
2. Whether the entirety of the Contract was a 're-purchase agreement', entitling Calyon to obtain control over servicing rights attendant to the mortgage loans in question?
3. Whether the Court should order the Debtors to transfer the servicing rights to Calyon?

The Court then outlined some of the basic legal precepts applicable to safe harbour contracts, including the ability of a party to liquidate, terminate or accelerate a repurchase agreement, or exercise setoff rights in respect thereof, notwithstanding the automatic stay, and the protection afforded to these contracts permitting the exercise of rights triggered by an *ipso facto* clause. The Court next noted that, as part of the 2005 amendments to the Bankruptcy Code, Congress had broadened the definition of 'repurchase agreement' to encompass any transfer of 'mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans'.[6] Observing that the Contract contained an *ipso facto* clause, the Court stated that if the sale and repurchase of mortgage loans thereunder constituted a repurchase agreement, the rights of Calyon in respect thereof would not be stayed, avoided or otherwise limited by operation of any Bankruptcy Code provision.

Addressing the first of the three key issues above, the Court began by reciting the Supreme Court directive for cases involving statutory interpretation: '[W]hen a statute's language is plain, the sole function of the courts, at least where the disposition by the text is not absurd, is to enforce it according to its terms.'[7] Notwithstanding this directive, the Court explained, if a statute contains ambiguity, other canons of statutory construction will be implicated, and reference to the relevant legislative history may be necessary, in order to determine Congressional intent underlying the statute.

Applying the plain meaning of the Bankruptcy Code to the terms of the Contract, the Court noted, was an easy task, as the Contract easily satisfied the

Notes

6 *American Home Mortgage*, 379 B.R. at 513 (quoting 11 USC § 101(47)).
7 *Id.* at 514 (quoting *Hartford Underwriters Ins. Co. v Union Planters Bank, N.A.*, 530 U.S. 1, 7 (2000)).

requirements of a 'repurchase agreement'. The Court concluded that the Contract (i) provided for the transfer of mortgage loans to the Purchasers, (ii) in exchange for payments from the Purchasers, (iii) included a contemporaneous agreement by the Purchasers to transfer the mortgage loans back to the Debtors, (iv) with such transfer to occur within 180 days, (v) in exchange for payments from the Debtors. Because the terms of the Contract were 'clear and unambiguous', the Court held that consideration of extrinsic evidence regarding the parties' intent was inappropriate. Utilising the plain meaning of the Contract and the Bankruptcy Code, the Court concluded that Contract was a repurchase agreement that implicated the protections of section 559. As a result, notwithstanding the Debtors' bankruptcy filing, the Purchasers were entitled to enforce their rights under the Contract.

The Court next shifted its analysis to section 555 of the Bankruptcy Code, and examined whether the Contract fulfilled the criteria of a 'securities contract', and whether Calyon met the requirements of a 'financial institution' entitled to the protections of section 555. With respect to the latter question, the Court noted that the definition of the term 'financial institution' included commercial banks, and that Calyon was a commercial bank. With respect to the former question, the Court explained that the definition of the term 'securities contract' included 'a contract for the purchase, sale, or loan of a ... mortgage loan, [or] any interest in a mortgage loan ... and including any repurchase or reverse repurchase transaction on any such ... mortgage loan, [or] interest'.[8] Based upon the prior conclusion that the Contract was a 'repurchase agreement', the Court readily concluded that it was also a 'securities contract' entitled to the protections of section 555. Accordingly, based on defaults under the Contract, and despite the Debtors' bankruptcy filing, the Purchasers were entitled to enforce their rights under the Contract.[9]

Turning to the second key issue (whether the portion of the Contract governing mortgage loan servicing is covered by the safe harbour protections in section 555 and 559), the Court observed that the mortgage loans sold under the Contract were sold on a 'servicing retained' basis, whereby the Debtors retained the right to service the loans and to collect a monthly servicing fee of 50 basis points on the unpaid principal balance of the loans in question. Whether this aspect of the Contract was severable from the repurchase aspect, the Court explained, was dependent on the parties' intent, which was to be gleaned from the terms of the agreement. The Court noted that under the Contract, because the mortgage loans were sold to the Purchasers on a 'servicing retained' basis, it was clear that the parties' intent was that the servicing aspect was severable from the repurchase aspect. In addition, the Court found the fact that Calyon had sent two separate default notices to the Debtors (one notice relating solely to mortgage repurchase obligations and one dealing also with servicing rights) on the same day to be indicative of the parties' intent to treat the servicing rights separately.[10]

The Court next stated that although the servicing rights were severable, it remained a possibility that the portion of the Contract governing those rights might qualify for safe harbour protection under either section 555 or section 559. The Court quickly rejected that notion, however, and concluded that the servicing aspects of the Contract failed to meet the requirements of a repurchase agreement or a securities contract. Parsing closely the relevant Bankruptcy Code provisions, the Court noted that although the definition of 'repurchase agreement' included agreements involving the transfer of 'mortgage loans [or] interests in mortgage related securities or mortgage loans', the servicing rights, while related to the mortgage loans, did not meet this definition. In support, the Court referenced Bankruptcy Code section 541(d), which, the Court noted, 'refers to *servicing both* mortgages and *interests in mortgages*';[11] if servicing rights fell within the definition of 'interests in mortgages', then section 541(d) would refer to 'servicing servicing rights', an absurd result at odds with sound principles of statutory construction. Accordingly, the Court held that the portions of the Contract dealing with servicing rights failed to qualify for the safe harbour protections of sections 555 and 559.

Moving to the third and final key issue, the Court concluded that Calyon was not entitled to specific performance in respect of its demand that the Debtors transfer mortgage loan servicing rights to Calyon. The Contract provisions dealing with servicing rights, the Court reiterated, did not fall within any of the Bankruptcy Code safe harbour provisions. As such, enforcement of rights in respect of those provisions were subject to the automatic stay, and the Court could divine no basis for requiring the Debtors to transfer the servicing rights to Calyon. Thus, the Court denied such relief.

Conclusion

In *American Home Mortgage*, the Court became the first to weigh in on what may become a common issue as the wave of sub-prime-related insolvencies begins

Notes

8 *Id.* at 519 (quoting 11 USC § 741(7)).
9 *Id.* at 520.
10 *Id.* at 520-521.
11 *Id.* at 523.

to crest: the treatment of mortgage servicing rights contained in a multi-faceted agreement, portions of which fall within the Bankruptcy Code safe harbour provisions, and portions of which arguably do not. In reaching the conclusion that mortgage loan servicing rights did not fall within the safe harbour provisions, the Court appears to have faithfully applied the plain meaning of the relevant statutes to the plain meaning of the Contract terms, and reached a sensible outcome. An alternative ruling, in which the Court refused to sever the servicing rights from the distinct repurchase provisions of the Contract, might have served as an improper catalyst encouraging parties to overload repurchase agreements with a multitude of ancillary matters, with the hope of gaining the benefits of safe harbour protection. The Court's ruling should discourage that tactic.

One dubious aspect of the Court's ruling – and an aspect that is central to the Court's holding – is the conclusion that the mortgage loans transferred under the Contract were transferred on a 'servicing retained' basis. Under the Contract (a copy of which was filed as an exhibit to the complaint and is available on the Court's electronic docket), it appears that all 'general intangibles' – including mortgage loan servicing rights – related to the purchased mortgage loans were transferred to the Purchasers. The Contract also provides, however, that AHM Servicing is to provide all mortgage loan servicing unless and until the Purchasers, following a default or event of default, opt to designate a substitute servicer. It is therefore somewhat unclear whether the Contract envisioned the servicing rights (i) being transferred to the Purchasers, then immediately transferred back to AHM Servicing, subject to future termination upon a default or event of default, or (ii) simply being retained by the Debtors (in particular, AHM Servicing). In either case, the Court could nonetheless find the servicing rights severable from the repurchase obligations, although such a finding would be incrementally more difficult for 'servicing released' mortgage loans.

It is interesting to note that Calyon's own actions – specifically, the fact that Calyon sent separate notices of events of default for the (a) mortgage repurchase obligations and (b) the servicing obligations – support the conclusion that the servicing rights were viewed by the parties as severable from the repurchase obligations. Depending on the terms of the specific contracts in question, litigants in future cases situated as Calyon was in *American Home Mortgage* will likely be better served by delivery of a single default notice. This approach will help litigants avoid inadvertently supporting the severability of the contract in question, which would compromise the very rights they are trying to uphold.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com