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Bankruptcy Court Rules that Repurchase Agreements Involving Subordinated Notes Secured by Mortgage Loans Are Safe Harbored Under the Bankruptcy Code, and That Disposition of The Notes Is Not Subject to Article 9 of the UCC

New York
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On May 23, 2008, the United States Bankruptcy Court for the District of Delaware issued an opinion in the adversary proceeding brought by American Home Mortgage Investment Corp. (the "Debtor") against Lehman Brothers Inc. and Lehman Commercial Paper Inc. ("Lehman"). In an opinion by Judge Sontchi dismissing the bulk of the complaint against Lehman, the Court found that the safe harbor protections of Sections 559 and 555 of the Bankruptcy Code (as amended in 2005)[1] applied to a repurchase agreement entered into by the parties. American Home Mortgage Investment Corp. v. Lehman Bros. (In re American Home Mortgage Holdings, Inc.), Adv. No. 07-51739, 2008 WL 2156323 (Bankr. D. Del. May 23, 2008).

The key facts in this case were as follows: Lehman and the Debtor were parties to a Master Repurchase Agreement documented under the SIFMA New York law-governed standard form (the "MRA"). The MRA contained an *ipso facto* clause permitting Lehman to terminate the MRA if the Debtor filed for bankruptcy. Although *ipso facto* clauses are generally not enforceable against debtors, the safe harbor provisions of Section 559 of the Bankruptcy Code provide that a non-debtor counterparty to a repurchase agreement is entitled to exercise its rights under an *ipso facto* clause. Section 555 of the Bankruptcy Code, another safe harbor provision, separately provides that a non-debtor counterparty to a "securities contract" may enforce an *ipso facto* clause, as long as the non-debtor counterparty is a "stockbroker," "financial institution," "financial participant," or "securities clearing agency," as such terms are defined in the Bankruptcy Code.

In July 2007, the parties entered into a transaction under the MRA. Under that transaction, the Debtor sold two series of subordinated notes (the "Notes") to Lehman. On August 6, 2007, the Debtor sought bankruptcy protection. On August 27, 2007, Lehman

[1] Cleary Gottlieb represented the Securities Industry and Financial Markets Association in connection with the 2005 and 2006 amendments to the Bankruptcy Code.

notified the Debtor that it had terminated the MRA, and that it "either had foreclosed or intended to foreclose" on the Notes under the MRA.

The Debtor denied that the MRA was a Repurchase Agreement under the Bankruptcy Code because the Notes, rated BBB and Baa2 by Standard & Poor's & Moody's, were not mortgage related securities, or interests therein, within the meaning of the Bankruptcy Code, making the transaction ineligible for Section 559 safe harbor protection. The Debtor also argued that the MRA was not a "securities contract" entitling Lehman to safe harbor protection under Section 555. The Debtor also asked the Court to declare that Article 9 of the New York Uniform Commercial Code ("NY UCC") should govern Lehman's disposition of the Notes.

Section 559 Safe Harbor Protection Applies to Repurchase Agreements for BBB and Baa2-rated Securities Secured by Mortgage Loans. To determine whether the MRA was a Repurchase Agreement, the Court had to decide whether the Notes qualified as at least one of the following: i) "mortgage related securities," ii) "interests in mortgage related securities," iii) "mortgage loans," or iv) "interests in mortgage loans." The Court agreed with Debtor that the Notes were not "mortgage related securities" or "interests in mortgage related securities" because the Notes were not given one of the two highest ratings by Standard & Poor's or Moody's, as required by the Bankruptcy Code and the Securities Exchange Act of 1934. However, the Court agreed with Lehman that the Notes were "interests in mortgage loans" because they constituted a payment obligation secured by mortgage loans, regardless of their rating. Because the MRA otherwise clearly satisfied the elements of a "repurchase agreement" under the Code, the Court concluded that the MRA was a repurchase agreement and that Section 559 of the Bankruptcy Code was applicable.

Section 555 Safe Harbor Protection Applies to Repurchase Agreements. The Debtor argued that Lehman was not entitled to Section 555 safe harbor protection because the Lehman entity that was the counterparty to the MRA and the relevant Notes transactions was not a "stockbroker" under the Bankruptcy Code. The Court disagreed and held that Lehman Brothers Inc. was the sole counterparty to the Notes transaction, and that as a registered-broker dealer in the business of effecting securities transactions, Lehman Brothers Inc. was indeed a "stockbroker" as defined by the Code. The Court also stated that, as a repurchase agreement, the MRA was a "securities contract" entitled to Section 555 protection.

The Court concluded that Lehman did not violate the automatic stay imposed by the Bankruptcy Code when it exercised its rights under the MRA's *ipso facto* clause because the safe harbor protections of Sections 559 and 555 applied to the MRA.

The Foreclosure and Liquidation of Notes Bought and Sold Pursuant to a Repurchase Agreement is Not Governed by the "Commercial Reasonableness" Standard of Article 9 of the UCC. The Debtor argued that Lehman's disposition of the

Notes is governed by Article 9 of the NY UCC, and that Lehman therefore was required to act in a "commercially reasonable" manner at all times. The Debtor argued that the MRA created a "security interest" in the Notes, such that Article 9 was applicable.

The Court did not accept the Debtor's argument that Article 9 applies regardless of the whether the parties actually intended to create a "security interest" in the Notes by entering into the MRA. The Court held that under NY UCC Section 9-109(a)(1), the intention of the contracting parties continues to be relevant to interpreting the contract. The Court next turned to the MRA to determine whether the parties had intended to create a "security interest" in the Notes. The Court stated that the parties had clearly expressed their intent that "all Transactions hereunder be sales and purchases and not loans." However, the MRA further stated that "in the event any such transactions are deemed to be loans, Seller shall be deemed to have granted to Buyer a security interest in all of the Purchased Securities with respect to all Transactions hereunder and All Income thereon and other proceeds thereof." The Court interpreted this language to mean that only if the Notes transaction is a loan will the Buyer be deemed to have granted the Seller a security interest in the Notes. The Court examined the language of the MRA and concluded that the Notes transaction was intended to be a sale and purchase agreement and not a loan, because (i) the MRA denominated the parties "Buyer" and "Seller," rather than lender and borrower or secured creditor and debtor; (ii) the terms of the MRA provided that the Seller agreed to transfer to the Buyer securities or other assets against the transfer of funds by the Buyer; (iii) the MRA defined the securities or other assets as "Purchased Securities"; and (iv) the MRA contained such terminology as "Purchase Date," "Purchase Price," "Repurchase Price," and "Repurchase Date." The Court also concluded that application of the Article 9 commercial reasonableness standard does not apply to repurchase agreements such as the MRA, even though other aspects of Article 9 apply to sales of notes.

In addition to the above holdings, the Court also dismissed the Debtor's claims against Lehman for breach of contract, turnover of property, conversion, and unjust enrichment.

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