

Bankruptcy Court Rules That Repurchase Agreements Involving Mortgage Loans Are Safe Harbored Under the Bankruptcy Code, But That Servicing Rights Are Not

New York
January 14, 2008

On January 4, 2008, the United States Bankruptcy Court for the District of Delaware issued an opinion in the adversary proceeding brought by Calyon New York Branch (“Calyon”) against American Home Mortgage Corp. (“AHM”) and certain of its subsidiaries (the “Debtors”). In an opinion by Judge Sontchi, the Court found that the safe harbor provisions of the Bankruptcy Code (as amended in 2005)¹ applied to a repurchase agreement entered into by Calyon and the Debtors. However, the Court also held that the portion of the repurchase agreement relating to the servicing of the mortgage loans was not protected under the safe harbor provisions and refused to force AHM’s servicing affiliate, American Home Mortgage Servicing, Inc., (“AHM Servicing”) to transfer servicing rights to Calyon as a result of the Debtors’ default on the repurchase agreement. In re American Home Mortgage, Inc., et al., Adv. No. 07-51704, 2008 WL 60292 (Bankr. D. Del. January 4, 2008).

The key facts in this case are as follows: Calyon and the Debtors are parties to a Repurchase Agreement (the “Contract”) which provides for the transfer of mortgage loans or interests therein from the Debtors to certain Purchasers, including Calyon (also the administrative agent under the Contract) in exchange for the transfer of funds from the Purchasers to the Debtors, and for the later resale of the mortgage loans by the Purchasers to the Debtors in exchange for the transfer of funds from the Debtors to the Purchasers. Five days before the Debtors filed for bankruptcy, Calyon notified the Debtors that they were in default under the Contract and demanded immediate repurchase of the mortgage loans in the Purchasers’ possession and transfer of the servicing of those loans. The Debtors did not respond to Calyon’s demands. On August 28, 2007, two weeks after the Debtors filed for bankruptcy, Calyon terminated AHM Servicing as servicer, demanded that the Debtors

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

transfer the servicing of the mortgage loans under the Contract to newly designated servicers, and commenced the adversary proceeding. The Debtors denied that the Contract is a “repurchase agreement” as defined in section 101(47) of the Bankruptcy Code or a “securities contract” as defined in section 741(7) of the Bankruptcy Code. Instead, the Debtors argued that the Contract constituted a secured financing, and thus disputed Calyon’s right to exercise its default remedies under the Contract post-petition pursuant to the safe harbor provisions of the Bankruptcy Code.

Contracts for Sale and Repurchase of Mortgage Loans are Repurchase Agreements and Securities Contracts: The Court found that, under the plain meaning of section 101(47), the Bankruptcy Code definition of “repurchase agreement,” the Contract is a repurchase agreement and Calyon may exercise close-out remedies pursuant to section 559 of the Bankruptcy Code. The Court also found that because the Contract constitutes a repurchase agreement under the Bankruptcy Code, it also constitutes a “securities contract” under section 741(7). Therefore, because Calyon is a financial institution and the Contract is a securities contract, the Court ruled that Calyon also could exercise its close-out rights pursuant to section 555 of the Bankruptcy Code.

The Court rejected the Debtors’ argument that the Court should look beyond the Code’s definition of “repurchase agreement” and examine the substance of the Contract to determine whether it was a “true” repurchase agreement or a “disguised secured financing.” Instead, the Court held that if the Contract satisfied the statutory definition of “repurchase agreement”, then the safe harbor provisions are applicable to the Contract. The Court drew support for this conclusion from both the plain meaning of the statute and the legislative history to the 2005 Bankruptcy Code amendments, which clarifies that:

The reference to “repurchase and reverse repurchase transactions” is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. Repurchase and reverse repurchase transactions meeting certain criteria are already covered under the definition of “repurchase agreement” in the Bankruptcy Code. H.R. Rep. No. 109-31, pt. 1, at 130 (2005).

Furthermore, the Court found that even if the Contract only provides for the creation of a lien in the mortgage loans, it still constitutes a “transfer” for the purpose of determining whether the sale and repurchase of mortgage loans and interests therein under the Contract constitutes a repurchase agreement. The Court’s decision is particularly significant given that the documentation for the Contract was not on a standard industry form.

Servicing Rights Related to Mortgage Loans are not Protected by Safe-Harbor Provisions: The Court held that the portion of the Contract providing for the servicing of

mortgage loans is not protected under the safe harbor provisions of the Bankruptcy Code because (i) the portion of the contract relating to mortgage loan servicing is severable from the sale and repurchase portion of the Contract; and (ii) the servicing portion of the contract is neither a “repurchase agreement” nor a “securities contract” under the Bankruptcy Code. Because the servicing portion of the Contract is not subject to the safe harbor provisions, the Court found no basis to require the Debtors to transfer the mortgage loan servicing rights, part of the Debtors’ bankruptcy estate, to Calyon solely based on the bankruptcy filing.

With regard to the severability of the servicing portion of the Contract from the sale and repurchase portion of the Contract, the Court found that the unambiguous language of the Contract showed that the terms, nature and purpose of the two portions of the Contract were different and thus severable. In particular, the Court found that the mortgage loans were sold on a servicing retained basis (as AHM Servicing had the right to service until an event of default) and that AHM Servicing was, pursuant to the Contract, to be paid a separate servicing fee. In addition, Calyon had issued two separate notices of default (one specifically directed to servicing). It would also seem significant that the servicer – AHM Servicing – is an entity distinct from some of the sellers under the Contract. The Court did not express an opinion as to whether the Bankruptcy Code safe harbors would apply to the servicing provisions of repurchase agreements that provide for the sale and repurchase of mortgage loans on a servicing released basis.

* * *

If you have any questions concerning this alert memorandum, please contact Seth Grosshandler at 212-225-2542 (sgrosshandler@cgsh.com) or Lisa M. Schweitzer at 212-225-2629 (lschweitzer@cgsh.com).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

NEW YORK

One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON

2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS

12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS

Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON

City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW

Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT

Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE

Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME

Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN

Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG

Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING

Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax