

OUTLINE REGARDING RECHARACTERIZATION AND REPURCHASE AGREEMENTS

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1. Power of Bankruptcy Court to Recharacterize
 - (a) Section 105
 - (b) Majority Position -- Bankruptcy Court Has Power to Recharacterize:
Dornier Aviation (4th Cir.), *Herby's Foods* (5th Cir.), *Autostyle Plastics* (6th Cir.), *Hedged Investments Associates* (10th Cir.), *Submicron Systems* (3d Cir.)
 - (c) Minority Position -- Bankruptcy Court Lacks Power to Recharacterize:
Pacific Express (BAP 9th Cir.), *Pinetree Partners* (Bankr. N.D. Ohio)
2. Some say “characterize” rather than “recharacterize”
 - (a) *Georgetown Building Associates* (Bankr. D. D.C.), *Cold Harbor Associates* (Bankr. E.D. Va.)
3. Common Types of Recharacterization
 - (a) Debt vs. Equity
 - (b) Sale vs. Secured Financing
 - (c) Lease vs. Secured Financing
4. Some Courts Use Factors
 - (a) In the debt v. equity context, factors may include:
 - the names given to the instruments;
 - the presence or absence of fixed maturity date and schedule of payments;
 - the presence or absence of a fixed interest rate and interest payments schedule;
 - the source of repayments;
 - the adequacy or inadequacy of capitalization;

- the identity of interests between holders of purported debt and stockholders;
- whether there is security for repayment of the obligation;
- the borrower's ability to obtain financing from lenders;
- the extent to which the financing was subordinated to other creditors;
- the extent to which the financing was used to acquire capital assets; and
- the presence or absence of a sinking fund to provide repayments.

Roth Steel Tube (6th Cir.).

(b) In the lease recharacterization context, factors may include:

- whether the present value of the future rent payments is equal to the fair market value of the goods at the time the purported lease is entered into;
- which party assumes the risk of loss;
- whether the rent appears to be calculated as loan interest;
- whether the lessee pays with respect to the leased property taxes, insurance, service or maintenance costs and other expenses;
- the terms of a purchase option in favor of the lessee, and whether rent is credited against an option purchase price;
- whether the lessee has the right to extend the lease term to or beyond the useful life of the leased property;
- whether the equipment is custom-made such that it has no value to anyone other than the lessee;
- any requirements relating to return condition; and
- the stated intention of the parties.

5. What is a Repurchase Agreement?

“A standard repurchase agreement, commonly called a ‘repo,’ consists of a two-part transaction. The first part is the transfer of specified securities by one party, the dealer, to another party, the purchaser, in exchange for cash. The second part consists of a contemporaneous agreement by the dealer to repurchase the securities at the original price, plus an agreed upon additional amount on a specified future date. A "reverse repo" is the identical transaction viewed from the perspective of the dealer who purchases securities with an agreement to resell.” *Bevill, Bresler & Schulman Asset Mgmt. Corp. v.*

Spencer S&L Ass'n. (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.), 878 F.2d 742, 743 (3d Cir. 1989).

Bankruptcy Code Repurchase Agreement Definition

The term “repurchase agreement” (which definition also applies to a reverse repurchase agreement)

(A) means—

(i) an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans, eligible bankers’ acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers’ acceptances, securities, mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers’ acceptance, securities, mortgage loans, or interests of the kind described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds;

(ii) any combination of agreements or transactions referred to in clauses (i) and (iii);

(iii) an option to enter into an agreement or transaction referred to in clause (i) or (ii);

(iv) a master agreement that provides for an agreement or transaction referred to in clause (i), (ii), or (iii), together with all supplements to any such master agreement, without regard to whether such master agreement provides for an agreement or transaction that is not a repurchase agreement under this paragraph, except that such master agreement shall be considered to be a repurchase agreement under this paragraph only with respect to each agreement or transaction under the master agreement that is referred to in clause (i), (ii), or (iii); or

(v) any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii), or (iv), including any guarantee or reimbursement obligation by or to a repo participant or financial participant in connection with any agreement or transaction referred to in any such clause, but not to exceed the damages in connection with any such agreement or transaction, measured in accordance with section 562 of this title; and

(B) does not include a repurchase obligation under a participation in a commercial mortgage loan.

11 U.S.C. 101(47) (amended in 2005)

6. In Substance, a Repo is Very Similar to Secured Financing

“The distinction between a repurchase transaction and a secured lending, while critical to an issue in this bankruptcy case, is virtually without meaning as to the practical effects of the transaction and the purposes for which it is made. It is clearly an effort by the industry of creditors dealing in this type of transaction to avoid potential unfavorable treatment that a security interest might receive in bankruptcy.” *In re CRIIMI MAE*, 251 B.R. 796, 800 (Bankr. D. Md. 2000) (citing J. Schroeder, *Repo Madness: The Characterization of Repurchase Agreements Under the Bankruptcy Code and the U.C.C.*, 46 *Syracuse L.Rev.* 999, 1010 (1996)).

7. Advantages Given to Repo Counterparty Over Secured Lender in Bankruptcy
 - (a) 559 (and 555) -- protects right of repo (and “securities contract”) counterparties to liquidate, terminate and accelerate repos upon a bankruptcy filing without regard to the automatic stay and certain other limitations.
 - (b) 362(b)(7) and 362(o) -- exempts from the automatic stay, *inter alia*, realization against collateral for repurchase agreements and offsets among repurchase agreements.
 - (c) Other provisions (*e.g.*, 546(f), 548(d)(2)(C), limiting the ability to avoid repo settlement payments or margin payments).
8. Relevant 2005 BAPCPA Amendments
 - (a) Broadened the definition of “repurchase agreement,” including specific references to mortgages and mortgage related securities.
 - (b) Expanded protections under §§ 555 and 559.
 - (c) Expanded the definition of “securities contract” under §741(7).
9. American Home Decision
 - (a) Held that the counterparty to a mortgage loan repurchase agreement that met the applicable statutory definition was entitled to the statutory “safe harbor” protections for repos and securities contracts, without regard to extrinsic evidence.
 - (b) Also held that the servicing rights were not part of the repurchase agreement, but instead were severable under traditional contract severability principles.
10. Debtor’s Main Arguments as to Why this Repurchase Should be Recharacterized as Secured Debt Were:
 - (a) The purchaser/lender was obligated to return to the seller/borrower the exact same mortgages (rather than simply equivalent mortgages), so it seems like the mortgages were collateral rather than actually sold to the purchaser/lender.

- (b) The seller/borrower retained an interest in the mortgage proceeds, until an event of default; if the mortgages were really sold rather than pledged, the purchaser/lender would have full ownership rights to the proceeds.

11. Other Decisions have Recognized Possible Arguments for Characterizing Certain Purported Repurchase Agreements as Secured Loans

(a) CRIIMI MAE -- Debtors' plan proposed to sell securities that were subject to a purported repurchase agreement. The counterparty ("buyer") objected on the basis that it owned the securities and the Debtors could therefore not sell them. The Debtors responded that the repo was intended to be, and should be characterized as, a secured loan. Court held that ambiguities in the repurchase agreement document created material question of fact.

- (i) Repo contained a "loan to value" requirement;

- (ii) Seller was entitled to retain income earned on the purportedly sold securities prior to default;

- (iii) Language concerning the "sale" of the securities was in some respects ambiguous;

- (iv) Repo buyer was required to return the identical securities to seller and was not permitted to return equivalent securities;

- (v) It was not clear that this repo fell within the statutory definition, at the time the case was decided.

(b) Orange County -- "master repurchase agreement" characterized by the parties as assignment for security where buyer was required to resell the exact same securities conveyed by seller, and had no right to re-sell those securities (but no court decision on this issue).

(c) Other cases, in upholding repos, have relied upon factors that are not present in all repos, perhaps leaving room for a recharacterization argument where these factors are not present. *See, e.g., Granite Partners*, 17 F.Supp. 2d 275 (S.D.N.Y. 1998) (upholding repo based on buyer's right to engage in repurchase transactions, sell or pledge the purchased securities, suggesting that the initial repo was a true sale); *SEC v. Drysdale Securities*, 785 F.2d 38 (2d Cir. 1986) ("a most significant difference between repos and standard collateralized loans" is that in the case of a secured loan "the lender holds pledged collateral for security and may not sell it in the absence of a default. In contrast, repo 'lenders' take title to the securities received and can trade, sell or pledge them. The repo merely imposes a contractual obligation to deliver identical securities on the settlement date..."); *Bevill, Bresler & Schulman*, 67 B.R. 557, 569-70 (D. N.J. 1986) ("There is no question that retention of principal and/or interest payments by a seller/borrower is a common feature of collateralized loans.").