

SELECTED ISSUES REGARDING REPO BUYER'S ENFORCEMENT RIGHTS

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I. Introduction

When a repo seller defaults under a repurchase agreement and the repo buyer exercises its rights and remedies, the consequences to the repo seller can be devastating. As discussed in preceding materials, an attempt to fend off the repo buyer by seeking relief in bankruptcy is not likely to succeed due to the “safe harbor” provisions of the Bankruptcy Code affording special privileges to counterparties to repurchase agreements, including exceptions to the automatic stay.

After a repo buyer exercises its rights and remedies against the repo securities, the repo seller may wish to complain about the manner by which the repo buyer exercised its rights. In at least one case, the repo seller, after filing for Chapter 11 relief, brought suit against the repo buyer seeking relief, including significant damages, for among other things, the repo buyer's alleged failure to sell the repo securities in a commercially reasonable manner. *See American Home Mortgage Inv. Corp. v. Lehman Bros., Inc. (In re American Home Mortgage)*, Adv. Proc. No. 07-51739 (CSS) (May 23, 2008, Bankr. D. Del.) (“*American Home Mortgage*”). Before turning to the Court's decision dismissing most of the debtor's counts for failure to state a claim for which relief can be granted, some background is in order.

II. Enforcement Provisions under the Standard Master Repurchase Agreement

A. Upon an event of default by a repo seller, the standard Master Repurchase Agreement, promulgated by The Bond Market Association (September 1996 version)¹, gives the repo buyer certain foreclosure rights. If the repo seller fails to repurchase the securities on the required repurchase date or to meet margin calls, the repo buyer has the right, without prior written notice to the repo seller, to:

- (i) as to Transactions in which the defaulting party is acting as Seller, (A) immediately sell, in a recognized market (or otherwise in a commercially reasonable manner) at such a price or prices as the nondefaulting party may reasonably deem satisfactory, any or all Purchased Securities subject to such Transactions and apply the proceeds thereof to the aggregate unpaid Repurchase Prices and any other amounts owing by the defaulting party hereunder; or (B) in its sole discretion elect, in lieu of selling all or a portion of such

¹ This was the form Agreement at issue in *American Home Mortgage*.

Purchased Securities, to give the defaulting party credit for such Purchased Securities in an amount equal to the price therefor on such date, obtained from a generally recognized source or the most recent closing bid quotation from such a source, against the aggregate unpaid Repurchase Prices and any other amounts owing by the defaulting party hereunder

Master Repurchase Agreement at § 11(d)(1).

B. The repo buyer thus has the option either to (1) sell the securities or (2) keep the securities and give the repo seller credit for the current value of the securities. In either event, the agreement provides that the repo seller is responsible for the difference between the sale price or shortfall price, as applicable, plus consequential damages and interest, to the extent allowed by state law.

C. If the repo buyer decides to sell the securities, it must do so in a recognized market (or otherwise in a commercially reasonable manner), but the repo buyer has the discretion to sell the securities at a price the repo buyer may reasonably deem satisfactory. If the repo buyer decides to keep the securities rather than sell them, the repo buyer is simply required to give the repo seller credit for the value of the securities on the date of foreclosure.

III. American Home Mortgage Inv. Corp. v. Lehman Bros., Inc.

A. The Facts

In *American Home Mortgage*, the debtor (“American Home”) filed an adversary proceeding against Lehman Brothers, Inc. (“Lehman Brothers”), seeking damages for breach of contract, turnover, conversion and unjust enrichment, as well as declaratory relief. American Home and Lehman Brothers were parties to a master repurchase agreement, under which American Home was the repo seller and Lehman Brothers was the repo buyer of subordinated mortgage notes. American Home funded a portion of their mortgage origination by selling mortgage notes to Lehman Brothers under the repurchase agreement.

The repurchase agreement contained the typical provisions entitling Lehman Brothers to make “margin calls” in the event the market value of the notes fell below the original market value on the purchase date. American Home was required to satisfy the margin calls to make up the deficiency between the current market value and the original market value of the notes. In the event of a failure by American Homes to meet a margin call, the repurchase agreement allowed Lehman Brothers to call an event of default and to foreclose on the notes by selling them or keeping them and giving American Home credit for the market value of the notes on the date of foreclosure.

Lehman Brothers made margin calls on July 23, 2007 and July 26, 2007 of \$3,785,625 and \$6,940,313, respectively. American Home satisfied the first margin call, despite contesting the appropriateness of the call, but did not have the funds to satisfy the second margin call. American Home subsequently filed for relief under Chapter 11 of the Bankruptcy Code. After

the bankruptcy filing, Lehman Brothers foreclosed on the notes. American Home filed a complaint against Lehman Brothers, asking the bankruptcy court to recharacterize the repurchase agreement as a secured transaction and to award American Home substantial damages under a variety of legal theories.

B. American Home's Complaint

American Home's complaint alleged that Lehman Brothers fabricated the margin calls, knowing that the market value of the notes did not depreciate, and that the notes were near "money good," in a scheme to take advantage of American Home's liquidity problems and to foreclose on the valuable notes to make a quick profit. Specifically, American Home alleged that Lehman Brothers breached the repurchase agreement by not acting in good faith or in a commercially reasonable manner, and that Lehman Brothers should be required to turn over either the notes or, if the Bankruptcy Code's safe harbor provisions apply, the debt owed by Lehman for damages arising from Lehman Brothers' termination of the repurchase agreement and foreclosure on the notes. American Home also sought damages for conversion and unjust enrichment, and sought declaratory judgments from the bankruptcy court that:

- (1) Lehman Brothers violated the automatic stay by foreclosing on the notes after the petition date;
- (2) the Master Repurchase Agreement is not a "repurchase agreement" as defined in Section 101(47) of the Bankruptcy Code;
- (3) Lehman Brothers is not entitled to the "securities contract" safe harbor of Section 555 of the Bankruptcy Code, because in the transaction with American Home, Lehman Brothers is not a "stockbroker, financial institution, financial participant, or securities clearing agency;"
- (4) Lehman Brothers' foreclosure and/or liquidation of the notes is governed by Article 9, at all times Lehman Brothers was required to act in a commercially reasonable manner, and any damages resulting from Lehman Brothers' failure to comply with those standards and Article 9 shall be determined in accordance with Section 562 of the Bankruptcy Code; and
- (5) even if the Master Repurchase Agreement is a "repurchase agreement" as defined in Section 101(47), or Lehman Brothers is entitled to the "securities" safe harbor of Section 555, the determination of damages must be made pursuant to Section 562, because commercially reasonable determinants of value do not exist.

The discussion following will focus solely on American Home's fourth and fifth requests for declaratory relief, which concern the standard of conduct applicable to a foreclosure under a repurchase agreement and the timing of the calculation of damages under Section 562 of the Bankruptcy Code after a foreclosure.

C. The Standard of Conduct for Enforcement by the Repo Buyer

American Home argued that the repurchase agreement was an Article 9 secured loan because it wanted the bankruptcy court to adopt the standard of conduct applicable to Article 9

transactions; specifically, Section 9-610(b) of the U.C.C. requires that all aspects of the foreclosure or liquidation be conducted in a commercially reasonable manner.

Although not mentioned in the pleadings, Article 9 if applied to foreclosure of repurchase securities, would have a broader effect on Lehman Brothers' foreclosure rights than just the standard of conduct. Notwithstanding the provisions of the repurchase agreement, if Article 9 were to apply Lehman Brothers, as the repo seller, it could have been required to satisfy other requirements of Article 9 including: (1) all aspects of the sale would have to be conducted in a commercially reasonable manner (§ 9-610(b)); (2) reasonable notice to the repo seller would have to be given, with 10 days' notice being *per se* reasonable (§ 9-611); (3) the notification would have to sufficiently describe the disposition of collateral (§ 9-613); (4) the repo buyer would have to adequately describe the calculation of a deficiency or surplus (§§ 9-615(f) and 9-616); and (5) the repo buyer would have to give the repo seller a right to redeem the collateral (§9-623). In the event of a repo buyer's failure to comply with Article 9, the repo buyer could be liable for damages (§ 9-625) and could lose any deficiency claim it may have against the repo seller (§ 9-626). Because Article 9 requires certain notice to the debtor prior to foreclosure, a finding that Article 9 applied might render Lehman Brothers' foreclosure *per se* invalid, and expose it to damages in favor of American Homes and a forfeiture of any deficiency claim against American Homes, notwithstanding whether it satisfied the standard of conduct applicable to Article 9 transactions.

If Article 9 does not apply to the repurchase agreement, or if Article 9 applied in certain respects but, as Lehman Brothers argued, the commercial reasonableness standards did not apply to the foreclosure of the notes, American Home would not be able to rely on Section 9-610(b) of the U.C.C., which requires that all actions with respect to the foreclosure on collateral be "commercially reasonable." Instead, the standard of conduct in the repurchase agreement would govern. Lehman Brothers moved to dismiss the complaint, and American Home responded by arguing that the parties agreed that commercially reasonableness standards would apply to Lehman Brothers' liquidation of the notes. The commercial reasonableness standard in the repurchase agreement, however, is limited to situations where the repo buyer decides to sell the securities other than in a recognized market. It does not, by its terms, apply to the sale of securities as a remedy upon foreclosure in a recognized market, or the alternative remedy of keeping the securities and giving the repo seller credit for the current market value of the securities.

In a dispute over whether a repo buyer appropriately foreclosed on securities under a repurchase agreement, possible issues that could be raised include:

1. What constitutes a "recognized market" for purposes of determining whether the repo buyer properly exercised its right to foreclose on securities?
2. If the repo buyer sells the securities in a "recognized market," does that eliminate all grounds for challenging the repo buyer's method of sale?

3. If the repo buyer sells the securities in a market that is not considered a “recognized market,” what would constitute an otherwise “commercially reasonable” sale in the industry?

4. If the repo buyer decides to keep the securities rather than sell them, what constitutes a “generally recognized source” as it relates to the price obtained for securities for the purpose of calculating the credit due to the repo seller?

D. Arguments Relating to Damages

The parties in *American Home* appeared to agree that Section 562 of the Bankruptcy Code applied. The effect of its applicability, however, was hotly contested. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amended the Bankruptcy Code to include Section 562, which governs the timing of damage measurement in connection with swap agreements, securities contracts, forward contracts, commodities contracts, repurchase agreement, and master netting agreements.

Section 562 provides, in part:

(a) If the trustee rejects a swap agreement, securities contract (as defined in section 741), forward contract, commodity contract (as defined in section 761), repurchase agreement, or master netting agreement pursuant to section 365(a), or if a forward contract merchant, stockbroker, financial institution, securities clearing agency, repo participant, financial participant, master netting agreement participant, or swap participant liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of--

(1) the date of such rejection; or

(2) the date or dates of such liquidation, termination, or acceleration.

(b) If there are not any commercially reasonable determinants of value as of any date referred to in paragraph (1) or (2) of subsection (a), damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.

Section 562 was adopted to pinpoint the exact date by which damages should be measured in the event the debtor rejects, or the repo buyer exercises rights to liquidate, terminate or accelerate, the repurchase agreement. In the event of such rejection by the debtor, or liquidation, termination or acceleration by the repo buyer, Section 562(a) provides that the damages shall be measured on the earlier of the rejection date or the date or dates of such liquidation, termination or acceleration, as long as there is a “commercially reasonable determinate of value” as of that date. If not, Section 562(b) provides that damages are measured as of the earliest subsequent date or dates on where there are commercially reasonable determinants of value.

Although American Home and Lehman Brothers agreed that Section 562 generally applied, they each argued that under Section 562 it was entitled to damages for the other party's conduct. Section 562 does not give the debtor, as repo seller, or the nondebtor, as repo buyer, an independent right to recover damages; rather, the section simply provides the date by which damages should be measured, to the extent damages are allowed under the agreement or applicable law.

An issue of contention under Section 562, however, appears to be the determination of what constitutes a "commercially reasonable determinate of value." American Home argued that "commercially reasonable determinates of value" do not exist. What constitutes a "commercially reasonable determinate of value" under Section 562 remains open to future judicial determination.

E. The Court's Opinion

1. In a case of first impression regarding the interpretation of a repo buyer's enforcement rights after BAPCPA, Judge Sontchi first held that the transaction at issue was a repurchase agreement under BAPCPA, and that the safe harbor provisions of Sections 559 and 555 of the Bankruptcy Code applied. Most relevant to the enforcement issues, the Court found that Lehman Brothers was not subject to the requirements of Article 9 of the U.C.C. when it exercised its rights to foreclose.

2. In rejecting American Home's arguments that Article 9 standards of conduct should apply, the Court concluded that because the repurchase agreement was a purchase and sale agreement, and not a loan, Article 9 did not apply and neither did the commercial reasonableness standard of Article 9.

3. The Court also rejected American Home's unjust enrichment argument. In the Court's view, an event of default indisputably occurred, and Lehman Brothers properly exercised its rights under the repurchase agreement, and therefore could not be deemed unjustly enriched by its foreclosure of the repurchase securities.

4. In short, while a repurchase transaction may in substance bear a distinct resemblance to a secured transaction, the Bankruptcy Court does not appear to offer the repo buyer any relief from the harsh consequences of a default under a repurchase agreement.