

American Home Mortgage, Holdings, Inc. v. Lehman Brothers Inc.

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The derivatives provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) amendments greatly enlarged the scope of the financial contracts that are shielded from traditional bankruptcy limitations such as the automatic stay and the prohibition on *ipso facto* clauses. Those exceptions were reaffirmed in a strong anti-debtor opinion in *Am. Home Mortg. Inv. Corp. v. Lehman Bros. (In re Am. Home Mortg. Holdings, Inc.)*, 388 B.R. 69 (Bankr. D. Del 2008). Although Lehman may now regret its victory since it is a debtor in its own bankruptcy case, it succeeded in defeating a number of theories that might have limited the scope of the exceptions. In an opinion relying in part on the market protection policy reflected by the exceptions, the Delaware Bankruptcy Court adopted a liberal definition of “repurchase agreement” that turned mostly on the intention of the parties as stated in the four corners of their agreement. Thus, providing greater protection to non-defaulting parties to Master Repurchase Agreements (“MRAs”).

This memo begins with a concise overview of the relevant facts of *American Home*. Next, it briefly reviews the pertinent amendments made to the Bankruptcy Code by BAPCPA. It then considers in detail the decision in *American Home* and its relevancy on future Bankruptcy proceedings involving Master Repurchase Agreements. It also examines *Calyon New York Branch v. American Home Mortgage Corp. (In re Am. Home Mortg. Holdings, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008), a case related to *American Home*, in which the Court adopted a

similar interpretation of the definition of repurchase agreements. The article concludes with a short discussion of the importance of the decision in *American Home* and the impact it will have on our financial future in this tough economic climate.

The dispute in *American Home* arose from a structured financing agreement between the parties that ultimately lead to the Defendant's bankruptcy filing. American Home Mortgage Investment Corp. ("AHMIC") was in the "business of originating residential mortgage loans." *In re Am. Home*, 388 B.R. at 75. In order to finance its operations, AHMIC sold mortgage loans to special-purpose entities ("SPEs"), one of which was Broadhollow Funding LLC ("Broadhollow"). Broadhollow, after receiving the mortgage loans, issued commercial paper in the form of subordinated notes to investors, which were "secured by liens in the mortgage loans it purchased from AHMIC." *Id.* A portion of these subordinated notes, known as Series 2004-A and Series 2005-A Notes, were acquired by Lehman and then resold to AHMIC. *Id.* Lehman, agreed to finance these Notes for AHMIC within the terms of the parties' pre-existing MRA. *Id.*

The MRA entitled Lehman to make margin calls when the market value of the Notes fell below a certain amount as "determined by a 'generally recognized source.'" *Id.* at 76 (citing Compl. ¶ 20). Furthermore, the MRA contained an *ipso facto* clause, which in case of default permits the non-defaulting party to terminate the contract, irrespective of whether either party has filed for bankruptcy. In July 2007, Lehman notified AHMIC that the market value of the Notes had dropped to 91 percent of their market value, AHMIC satisfied that the margin call. *In re Am. Home*, 388 B.R. at 76. However, shortly thereafter Lehman made a second margin call and AHMIC failed to post margin. *Id.* When AHMIC failed to meet the margin calls as was required under the MRA, Lehman sent a Pre-Petition Default Notice to AHMIC stating that "[AHMIC's] failure to pay the latest margin constituted an event of default and that Lehman

reserved all of its rights under the MRA.” *Id.* at 76. In its notice Lehman informed AHMIC of its intention to “terminate[] the MRA” and “foreclose on the [Notes].” *Id.* at 76–77. Subsequently, AHMIC filed for Bankruptcy and sought protection under the Automatic Stay Provisions of Bankruptcy Law. Lehman argued that such provisions did not extend to the MRA under the 2005 BAPCA amendments and rather the *ipso facto* clause was enforceable under the safe harbor provisions provided by Section 559 and Section 555 of the Bankruptcy Code. These safe harbor provisions would allow Lehman to terminate and close out the MRA notwithstanding the automatic stay. On the other hand, AHMIC argued that the MRA was not a repurchase agreement because the Notes did not constitute mortgage related securities due to their low rating-by-rating agencies. *See In re Am. Home*, at 79 (citing Compl., Exh. A, p. 16).

I. 2005 BAPCPA Amendments to the Bankruptcy Code

The 2005 BAPCPA amendments to the Bankruptcy Code strengthened and expanded several of the existing safe harbor provisions. One of the most significant changes made to the Bankruptcy Code by BAPCPA was the expansion of the definition of “repurchase agreement.” By enlarging the scope of the definition, BAPCPA allowed a much larger category of securities and derivative agreements to be considered “repurchase agreements.” 11 U.S.C. § 101(47) (2006) (redefining repurchase agreements to include “mortgage related securities . . . mortgage loans, interests in mortgage related securities or mortgage loans”). Thus, in effect the Bankruptcy Code now provides its special protection provisions to a much broader range of security agreements.

Although financial derivative contracts were given special treatment under prior law, BAPCPA provided a greater shield for participants in such transactions with parties who file for

bankruptcy protection. The Court in *American Home* recognized that in order “[t]o protect the liquidity of repurchase agreements, the Bankruptcy Code provides special protections to non-debtor counterparties.” *Id.* at 78. Within these special protections are *ipso facto* clauses, like the one in the MRA agreement between the parties in *American Home*.

Generally, the Bankruptcy Code prohibits the enforcement of such clauses, however section 555 and section 559 provide exceptions to the general rule. *See* 11 U.S.C. § 365(e). By broadening Section 559 of the Bankruptcy Code, BAPCPA “allows a non-debtor counterparty to a ‘repurchase agreement’ (as defined by section 101(47) of the Bankruptcy Code) to exercise its contractual rights under an *ipso facto* clause to liquidate, terminate or accelerate the repurchase agreement.” *In re Am. Home*, 388 B.R. at 78 (citing 11 U.S.C. § 559 (“[t]he exercise of a contractual right of a repo participant . . . to cause the liquidation, termination, or acceleration of a repurchase agreement because of [an ipso facto condition] shall not be stayed, avoided, or otherwise limited”)). Furthermore, the BAPCPA amendments made to section 555 of the Code “provides a similar protection for the non-debtor counterparty to a ‘securities contract’ (as defined by section 741 of the Bankruptcy Code).” *In re Am. Home*, 388 B.R. at 78 (citing 11 U.S.C. § 555 (“[t]he 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 . . . shall not be stayed, avoided, or otherwise limited.”)).

By expanding the definition of a repurchase agreement, BAPCPA extended protection to a much larger range of repurchase agreements by permitting *ipso facto* clauses that terminate the contract upon a bankruptcy filing, 11 U.S.C. § 559 (2006), and by exempting from the section 362 automatic stay the exercise of setoff remedies on default. *See* 11 U.S.C. § 362(b)(7) (2006) (providing that a non-debtor party in a repurchase agreement is excluded from the automatic stay

provision in Section 362(a) of the Bankruptcy Code). Therefore if the Court determines that the MRA is either a repurchase agreement or a securities contract, Lehman would be entitled to exercise its right under the *ipso facto* clause and be protected by the safe harbor provisions.

II. Broad Interpretation of Repurchase Agreements in *American Home*

In relying on the decision in *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer S&L Ass'n* (*In re Bevill, Bresler & Schulman Asset Mgmt. Corp.*) 878 F.2d 742 (3d Cir. 1989), the Court in *American Home* adopted a broad interpretation of the scope of repurchase agreements entitled to the safe harbor protections to include a MRA. *In re Am. Home, Inc.*, 388 B.R. at 82. In *Bevill*, the Court identified repurchase agreements as a two step process where “[t]he first part is the transfer of specified securities by one party, the dealer, to another party, the purchaser, in exchange for cash [and] [t]he 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.” *In re Bevill*, at 743.

In deciding if the MRA would be entitled to the safe harbor protections the Court looked at whether the MRA qualified as a repurchase agreement as defined in section 101(47) of the Bankruptcy Code which states

[a]n agreement, including related terms, which provides for the transfer of one or more . . . 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 . . . against the transfer of funds by the transferee of such . . . mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof . . . mortgage loans, or interests of the kind as described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds

A. Application of Two-Part Test to Determine Whether MRA Qualified as Repurchase Agreement

The Court adopted a two-part test for its application. *In re Am. Home*, 388 B.R. at 79. First, the *American Home* Court determined whether the Notes qualified as “mortgage related securities, mortgage loans, interests in mortgage related securities or interests in mortgage loans.” *Id.* Second, the Court determined whether “the structure of the MRA follows the structure of a “repurchase agreement” as defined by the Bankruptcy Code.” *Id.*

In applying the first step, the Court found that these Notes did not qualify as mortgage related securities since they had not received a high enough rating-by-rating agencies. *Id.* at 80 (citing Securities and Exchange Act of 1934, 15 U.S.C. § 78(c)) (finding that mortgage related securities are defined as “a security that is rated in one of the two highest rating categories by at least one nationally recognized statistical rating organization...”) (internal quotations omitted). However, the fact that the Notes were secured by mortgage loans meant that they qualified as “interests in mortgage loans.” *Id.* The Court reasoned that the term “interest” did not require that the Notes themselves be mortgage loans and that the lien on the underlying mortgage loans was an “interest” in mortgage loans to qualify. *Id.*

B. Codification of Five Elements to Determine Whether the Parties’ MRA Met the Structure of a Repurchase Agreements under Section 101(47)

Next the Court codified five elements that must be met in order to satisfy the structure of a repurchase agreement under Section 101(47) of the Bankruptcy Code:

- (i) provides for the transfer of one or more interests in mortgage loans;
- (ii) against the transfer of funds by the transferee of such interests in mortgage loans;
- (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof interests in mortgage loans;

- (iv) at a date certain not later than 1 year after such transfer or on demand; and
- (v) against the transfer of funds.

In re American Home, at 82. Relying primarily on the intention of the parties as expressed in the four corners of their agreement, the Court found that the MRA was a repurchase agreement and thus entitled to the safe harbor provisions. *In re Am. Home*, 388 B.R. at 88. The Court also rejected the argument that the agreement was a traditional UCC Article 9 security interest rather than a repurchase agreement.

III. Examination of *Calyon*: A Similar Case Adopting a Broad Interpretation to of Repurchase Agreements

The decision in *American Home* was not the first time that a Bankruptcy Court favored protecting the non-debtor party in a repurchase agreement and thus entitling them to the safe harbor provisions provided in the Bankruptcy Code. In a similar case decided only four months prior to the *American Home* decision, the Delaware Bankruptcy Court also found that a contract for the sale and repurchase of mortgage loans was a repurchase agreement as defined under Section 101(47) of the Bankruptcy Code. *Calyon*, 379 B.R. at 507–08 (citing 11 U.S.C. § 107(47)). However, in that case, the Court severed the agreement into its component servicing rights and repurchase provisions and refused to extend the financial contract protections to the servicing rights aspects of the agreement.

Similarly to the discussion in *American Home*, the Court in *Calyon* focused largely on the economic implications that would ensue if these repurchase agreements are not excluded from the automatic stay provisions under the Bankruptcy Code. *Calyon*, at 512. Discussing the impact that these repurchase agreements have on both US and global markets, the Court found it

essential to enforce their liquidity and exclude them from the automatic stay provision in order to protect the financial markets from the risk that the debtor's default might cause a cascading series of counter-party bankruptcies if the counter-parties were unable to promptly liquidate the contracts. *Id.*; see also *In re Am. Home*, at 78 (“Without these special protections, or safe harbors as they are known, the bankruptcy of a counterparty to a repurchase agreement would impair the liquidity of the repurchase agreement and possibly lead to the bankruptcy of the non-debtor counterparties.”). The Court asserted that without liquidity “the repurchase agreement would not serve the function that it now does.” *Id.* at 513 (quoting *In re Bevill*, 878 F.2d at 746 (citation omitted)).

IV. Conclusion

The *American Home* decision is a crucial stepping-stone in the wake of the financial markets today. The outcome of this decision has prevented or at least postponed the failures of many more financial institutions. Had the Court found that the MRA did not qualify for the safe harbor protections afforded to repurchase agreements, bankrupt mortgage companies would be able to freeze these assets thus causing a domino effect which would lead to the deterioration of many more businesses.