

Delaware Bankruptcy Court Severs Servicing Rights from Safe Harbored Repo

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Transferee under mortgage repurchase agreement can terminate the agreement upon transferor's bankruptcy filing, but mortgage loan servicing rights can be severed from the repurchase agreement, court rules.

Congress enacted amendments to the United States Bankruptcy Code in 2005 designed to increase certainty in the marketplace for mortgage loan repurchase agreements and other financial contracts.¹ The contours — and limits — of these amendments were recently explored by the Delaware bankruptcy court in *Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage Holdings, Inc.)*.² In *Calyon*, the court held that the 2005 amendments permit a transferee under a mortgage repurchase agreement to terminate the agreement upon the bankruptcy filing of the transferor, but that mortgage loan servicing rights could be severed from the repurchase agreement that fell within applicable safe harbors of the Bankruptcy Code, and, accord-

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ingly, constituted an estate asset protected against termination by the automatic stay.

In reaching his decision, Bankruptcy Judge Sontchi held that under the plain language of the Bankruptcy Code, the repurchase agreement satisfied the criteria necessary to qualify for the “securities contract” and “repurchase agreement” safe harbors of Sections 555 and 559 of the Bankruptcy Code. The court rejected the debtor’s argument that a “true” repurchase agreement required additional features not specified in the statute.

However, the court also ruled that the servicing rights were not subject to any safe harbor. Instead, applying New York law, the court determined that the servicing rights in question could be severed from the rest of the agreement because the repo seller (now the debtor in bankruptcy) had bargained for a “servicing retained” agreement.

This decision leaves open the possibility that repurchase agreements providing for the transfer of mortgages “servicing released” would not be covered by the decision. In fact, in considering an earlier motion for a preliminary injunction filed in the same bankruptcy case by another repurchase agreement transferee, Judge Sontchi indicated that he would not sever the servicing rights. In that motion, the transferee argued that the repurchase agreement fell within the safe harbor, and sought immediate transfer of servicing rights to its designee, in addition to immediate possession of the mortgage loan records and asset files. Although the court denied that motion,³ the court suggested that the servicing rights appeared to be part of a single, integrated repurchase agreement, particularly because the repurchase agreement did not provide for any separate consideration to be paid to the seller or its affiliates for servicing.⁴

SUMMARY OF DECISION

Prior to American Home’s bankruptcy filing on August 6, 2007 (the “Petition Date”), Calyon New York Branch (“Calyon”), as administrative agent, and American Home Mortgage Corp. and certain affiliates (“American Home”) entered into a whole loan repurchase agreement that expressly provided that the loans were transferred to Calyon “servicing

retained,” *i.e.*, American Home Mortgage Servicing Inc. (“AHMS”) would service the mortgages and would be paid a servicing fee during the term of the repurchase agreement. The agreement also provided, however, that Calyon could designate a new servicer following an event of default by the servicer under the repurchase agreement.

American Home subsequently defaulted under the repurchase agreement and on August 1, 2007, Calyon provided it with a formal notice of default demanding “that the Debtors immediately repurchase all of the mortgage loans in the Purchasers’ possession under the repurchase agreement.”⁵ American Home sent a separate servicer notice of default to AHMS. It designated JPMorgan Chase Bank, N.A. as servicer for certain mortgage loans but permitted AHMS to retain servicing of other “purchaser option adjustable rate” mortgages through August 29, 2007. On August 28, Calyon sent further notice terminating the services of AHMS as loan servicer for the purchaser option adjustable rate loans and demanding that American Home take all actions necessary to transfer the servicing of those mortgage loans to their newly designated servicer, Cenlar FSB.

Also on August 28, Calyon filed an adversary proceeding against the debtors seeking a declaratory judgment that the repurchase agreement was a “repurchase agreement” under Section 101(47) of the Bankruptcy Code that was covered by the safe harbor provision of Sections 555 and 559 of the Bankruptcy Code. The debtors counterclaimed that the repurchase agreement in reality constituted a secured financing and Calyon was prohibited from exercising its rights by the automatic stay of Section 362 of the Bankruptcy Code. The debtors also argued that the servicing rights applicable to the mortgage loans were not subject to the safe harbor. The Debtors disputed Calyon’s rights to exercise its remedies under the repurchase agreement and refused to repurchase the mortgage loans or transfer servicing to Calyon’s designee.

RULING

In reaching its decision, the court decided three issues. The first issue was whether the repurchase agreement fell under either Section 559

(repurchase agreement safe harbor) or Section 555 (securities contract safe harbor) of the Bankruptcy Code. These safe harbor provisions, among other things, permit the non-debtor party to terminate and close out covered agreements, notwithstanding the automatic stay. The second question decided was whether the portion of the agreement providing for servicing of the mortgages was covered by the safe harbor provisions, or constituted a separate, severable contract. The third question was whether the court should order specific performance of American Home's obligation to transfer servicing to a servicer designated by Calyon upon American Home's default.

REPURCHASE AGREEMENT/ SECURITIES CONTRACT SAFE HARBORS

In deciding that Section 559 of the Bankruptcy Code applied to the repurchase agreement, the court concluded that it needed only to apply the plain meaning of Section 101(47) of the Bankruptcy Code, which defines "repurchase agreement." Under that section, an "agreement, including related terms," is a repurchase agreement if it:

- (i) provides for the transfer of one or more mortgage loans or interests in mortgage related securities or mortgage loans;
- (ii) provides for the transfer of funds by the transferee of such mortgage loans or interests in mortgage related securities or mortgage loans;
- (iii) contains a simultaneous agreement by such transferee to transfer the assets back to the transferor;
- (iv) provides that the obligation to transfer back occur on a date certain not later than one year after such transfer or on demand; and
- (v) provides for the transfer of funds from the transferor to the transferee on the retransfer date.

The court concluded that on its face, the Calyon agreement met each of these requirements such that Section 559 of the Bankruptcy Code applied. The court rejected American Home's assertion that additional

criteria of liquidity and alienability were essential to qualify an agreement as a repurchase agreement for protection under Section 559.

The court applied a similar plain language analysis to find that Section 555 of the Bankruptcy Code applied to the Calyon agreement. That section permits a financial institution to exercise its rights under a “securities contract” as defined under Section 741(7)⁶ to terminate, close out and net amounts due under the contract, outside of the operation of the automatic stay. The court determined that as a subsidiary of Credit Agricole CIB, Calyon was a financial institution under Section 101(22) of the Bankruptcy Code entitled to exercise its rights under the repurchase agreement. In addition, the court noted that “repurchase agreements” had been expressly added to the definition of “securities contract” under the 2005 amendments.

SERVICING NOT PROTECTED BY ANY SAFE HARBORS

Although the court upheld the applicability of the Sections 555 and 559 safe harbors to the agreement, the court refused to apply them to the right to service the mortgages. Applying New York law, the court concluded that the servicing rights were severable from the repo agreement under state law, emphasizing that mortgage loans commonly are sold both “servicing released” and “servicing retained,” and that loans sold “servicing released” commanded a premium. In the court’s view, Calyon had not paid the “servicing released” premium as part of the initial transaction, and, thus, would receive a windfall if permitted to change the servicer. Moreover, the windfall would be at the debtors’ expense, since it would deprive the debtors of valuable property of their estates.

The court noted that under New York law a “contract is severable when by its terms, nature and purpose, it is susceptible of division and apportionment.”⁷ According to Judge Sontchi, a repurchase agreement’s terms, nature and purpose differed substantially from those of a servicing arrangement in that the repurchase agreement established terms of a financing transaction, while servicing comprised collection and other asset protection activities. Moreover, (i) the repurchase agreement “severs the owner of the mortgage loans [the repo buyer] from the party with

the right to designate the servicer [the repo seller]. This is, in and of itself, strong evidence of the parties' intent to sever the servicing...from the sale and repurchase of the mortgage loans."⁸ In addition, the court mentioned that the consideration for servicing the loans was "readily apportioned from the other consideration flowing under the [repurchase agreement]."⁹ Extrinsic evidence also established that according to industry standards, mortgage servicing was a "separate asset and that asset is traded separately and accorded distinct accounting treatment."¹⁰ Further, by sending separate notices of default to each of the repo seller and the servicer, Calyon implicitly acknowledged that there were two different functions covered by the agreement. The court rejected Calyon's argument that the purpose of the repurchase agreement would be frustrated by the severance of the mortgage loans, finding that the facts supported their separation.

In addition, the court considered whether the servicing portion of the repurchase agreement could stand alone as a separate "repurchase agreement" or "securities contract" under the Bankruptcy Code. It dismissed this argument because servicing rights do not constitute a "mortgage loan" and do not pertain to "ownership of an interest in a mortgage loan" under Sections 101(47) or 741(7) of the Bankruptcy Code. The court reasoned that because Section 541(d) expressly referred to a debtor's retention of title in order to service both mortgages and interests in mortgages, it would be irrational to conclude that the terms "mortgages" and "interests in a mortgage loan" included servicing rights.

The court also considered whether servicing rights and the right to designate the servicer fell within the language of Section 101(47) of the Bankruptcy Code that defines a repurchase agreement to be "an agreement, *including related terms*."¹¹ The court concluded that the servicing rights and the right to designate the servicer "are not 'related terms' to those portions of the Contract that constitute the repurchase agreement."¹² The court found that servicing rights were a separate asset that were unrelated to the purchase and sale transaction. This conclusion was further supported by the "fact that many repurchase agreements do not address servicing, and separate agreements may govern servicing exclusively."¹³ In a somewhat strained interpretation of the Bankruptcy Code, the court reasoned that because the phrase "related terms" existed prior to BAPCA's

addition of “mortgage loans and interest in mortgage loans” to the definition of repurchase agreement, “related terms”...“could not have meant the right to service because, at that time, [i.e., prior to the 2005 amendments], the repurchase agreement definition included only securities with respect to which there were no servicing rights...[.]”¹⁴ Although the phrase “related terms” existed earlier and applied only to assets such as certificates of deposit, however, it does not necessarily follow that the legislature intended to exclude servicing rights from the “related terms” of a repurchase agreement.

Accordingly, the court held that the portion of the repurchase agreement relating to servicing of the mortgage loans could not, by itself, be subject to the safe harbor provisions of Sections 555 and 559 of the Bankruptcy Code, and Calyon could not exercise its contractual right to designate a new servicer.

SPECIFIC PERFORMANCE

Finally, the court declined to order American Home to transfer servicing to a new servicer designated by Calyon. The court reasoned that, absent applicability of a safe harbor to the servicing portion of the agreement, Calyon was not entitled to specific performance.

ANALYSIS OF THE DECISION

This decision turned upon the particular facts of the repurchase agreement in question, particularly the court’s determination that the loans were transferred “servicing retained,” and that, consequently, the purchaser had not bargained for the right to control servicing. This suggests that careful drafting of repurchase agreements could lead to a different result.

Indeed, the same court reached a different conclusion in an earlier motion for injunctive relief sought by a repurchase agreement transferee. There, the transferee of mortgage loans had sought to compel the debtors to turn over mortgage files and relinquish servicing. To counter that motion, the debtors argued that the master repurchase agreement actually constituted two separate agreements — a repurchase agreement and a servicing agreement.¹⁵ The debtors further argued that the servicing agree-

ment was an executory contract subject to assumption or rejection under Section 365 of the Bankruptcy Code, and could not be terminated without violating the automatic stay. Credit Suisse First Boston Mortgage Capital LLC (“Credit Suisse”), the transferee, countered that the master repurchase agreement was a “single integrated contract,” and argued that because the debtors did not receive any consideration for servicing, it would be “absurd to argue that the servicing rights somehow constitute a separate agreement that would be subject to assumption or assignment under Section 365 of the Bankruptcy Code.”¹⁶

Although the court did not grant Credit Suisse’s motion, it found “particularly persuasive” Credit Suisse’s argument that the repurchase and servicing rights were one integrated agreement and decided that Credit Suisse had established a prima facie case that the master repurchase agreement was a “repurchase agreement” under the Bankruptcy Code. Confining its remarks to the Credit Suisse agreement at hand, the court explained:

Congress recently added mortgage-related securities, mortgage loans and interests in mortgage-related securities or mortgage loans to the definition of repurchase agreement under section 101(47) of the Bankruptcy Code. It is of no moment that warehouse lenders reacted to the change in law by reconstituting their relationships with companies such as the Debtors to repurchase agreements. Moreover, the servicing issues that relate to any mortgage-related instrument are non-sufficient on their own to exclude that agreement from the definition of a repurchase agreement....If the servicing issues, such as those in the [master repurchase agreement], were sufficient to make an agreement such as the [master repurchase agreement] not a repurchase agreement, Congress’s amendment would have had little or no effect on virtually all mortgage-related purchase agreements.¹⁷

The court added “In short, the [master repurchase agreement] is titled a repurchase agreement, it contains normal provisions of a repurchase agreement and it does not contain any provisions that would exclude it from the definition of a repurchase agreement.”¹⁸ Thus, in this ruling, the

court was sympathetic to the argument that servicing rights were not severable from the repurchase agreement under consideration.

CONCLUSION

Accordingly, with careful drafting, repurchase agreements and other financial contracts should be able to be clarified to reflect the parties' intent, including with respect to repo agreements that servicing rights follow the mortgage loans upon termination of a safe harbored repurchase agreement.

NOTES

¹ See Bankruptcy Abuse & Consumer Protection Act of 2005, Pub. L. 109-8 (2005) ("BAPCA") which, among other things, expanded the carveouts from the automatic stay of 11 U.S.C. § 362 applicable to swaps, repos and other financial contracts and permitted cross-netting among various types of contracts in order to reduce systemic risk.

² Adv. Proc. No. 07-51704 (CSS), 2008 Bankr. Lexis 10 (Bankr. D. Del. Jan. 4, 2008).

³ See Order Denying Credit Suisse First Boston Mortgage Capital LLC's Motion for a Temporary Restraining Order and Declaratory Relief, *Credit Suisse First Boston Mortgage Capital LLC v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Holdings, Inc.)*, Adv. Proc. No. 07-51684 (CSS) (Aug. 24, 2007) (Docket No. 32).

⁴ See Transcript of Proceedings, *Credit Suisse First Boston Mortgage Capital LLC v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Holdings, Inc.)*, Adv. Proc. No. 07-51684 (CSS) (Aug. 17, 2007) ("8/17/07 Transcript"). Ultimately, the parties entered into a global settlement of this proceeding which provided among other things, for the transfer of mortgage servicing to Credit Suisse or its designee. See Order Pursuant to Bankruptcy Rule 9019 Approving Global Settlement Agreement with Credit Suisse First Boston Mortgage Capital LLC, Credit Suisse Securities (USA) LLC and DLJ Mortgage Capital Inc., *Credit Suisse First Boston Mortgage Capital LLC v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Holdings, Inc.)*, Adv. Proc. No. 07-51684 (CSS) (Nov. 21, 2007) (Docket No. 73).

⁵ *Calyon*, 2008 Bankr. LEXIS 10, at *11.

⁶ Section 741(7)(a)(i) of the Bankruptcy Code defines “securities contract” as a “contract for the purchase, sale, or loan of a...mortgage loan [or] any interest in a mortgage loan...and including any repurchase or reverse repurchase transaction on any such...mortgage loan, [or] interest...(whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement” as defined in Section 101.)” *Id.* at *34 (quoting 11 U.S.C. § 741). Because Section 741 of the Bankruptcy Code includes any repurchase agreements as defined under Section 101(47) of the Bankruptcy Code, the repurchase agreement is a securities contract.

⁷ *Id.* at *38.

⁸ *Id.* at *40-41.

⁹ *Id.* at *41.

¹⁰ *Id.*

¹¹ *Id.* at *43.

¹² *Id.* at *46.

¹³ *Id.*

¹⁴ *Id.* at *46-47.

¹⁵ *See* 8/17/07 Transcript at 100.

¹⁶ *Id.*

¹⁷ *Id.* at 101-102.

¹⁸ *Id.* at 102.