

Clients & Friends Memo

American Home Court Denies Bank's Deficiency Claim by Accepting Discounted Cash Flow Valuation of Mortgage Loan Portfolio Subject to Repurchase Agreement¹

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A Delaware bankruptcy court recently delivered the first decision applying section 562 of the Bankruptcy Code to a claim based on the termination of a repurchase agreement. *In re American Home Mortgage Corp.*, Bankr. Case no. 07-1104, Dkt. no. 8021 (Bankr. D. Del. Sept. 8, 2009). The court's ruling creates additional uncertainty in the calculation of bankruptcy claims, not only with respect to repurchase agreements but also with respect to other safe harbored financial contracts.

Added to the Code in 2005, section 562 provides that claims based on the termination of a safe-harbored trading contract, such as a repurchase agreement, must be measured as of the termination date. Section 562 goes on to say that if there are no "commercially reasonable determinants of value" as of the termination date, damages are to be measured as of the earliest subsequent date on which there are commercially reasonable determinants of value. Unable to find a market for the assets on the termination date, the nondefaulting party submitted a claim based on a subsequent market valuation. The Debtor, however, asserted that a discounted cash flow valuation as of the termination date was commercially reasonable. This position was accepted by the Court, resulting in a finding that the nondefaulting party suffered no damages from the termination.

Certain unique aspects of the ruling may limit its applicability. At a minimum, a careful party could avoid some of the questions the decision presents.

Factual Background

On November 21, 2006, certain American Home entities and Calyon New York Branch ("Calyon") entered into a repurchase agreement pursuant to which Calyon purchased certain mortgage loans

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from American Home. Pursuant to the terms of the repurchase agreement, Calyon terminated and accelerated the Repurchase Agreement on August 1, 2007 (the "Acceleration Date"), thereby requiring American Home to immediately repurchase the loans for a price of approximately \$1.144 billion (the "Repurchase Price"). Five days later, on August 6, 2007, American Home filed for chapter 11 bankruptcy protection.

Earlier in these cases, the court held that Calyon's contract with the Debtor was a "repurchase agreement" within the meaning of section 559 of the Bankruptcy Code. Based on the section 559 safe harbor, the acceleration and termination of the repurchase agreement did not violate the automatic stay of section 362. Further, the subsequent sale by Calyon of the mortgage loan portfolio would not violate the automatic stay.²

On January 10, 2008, Calyon filed claims ("Claims") in the total amount of approximately \$1.155 billion. On January 9, 2009, American Home objected to the Claims, seeking either to disallow the Claims, or to reduce them to an amount determined by the court.

Analysis By The Court

At issue were the timing and method of valuation of the mortgage loan portfolio subject to Calyon's repurchase agreements. Section 562 of the Bankruptcy Code governs these issues. This provision addresses the timing for the measurement of damages resulting from the rejection or termination of repurchase agreements and other financial contracts. Section 562(a) states that if a trustee (or debtor in possession) rejects a repurchase agreement or other safe harbored financial contract, or if a repo participant or other qualified financial contract counterparty liquidates, terminates or accelerates such an agreement, damages shall be measured as of the earlier of the rejection date or the date of such liquidation, termination or acceleration. Section 562(b) applies if there are no "commercially reasonable determinants of value" as of the operative date. Under those conditions, damages are to be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.³

The Debtors contended that section 562(a) applied because, according to at least two valuation methodologies, a DCF analysis or a market analysis that existed outside the litigation context, damages could be measured on the Acceleration Date.⁴ If the Debtors were correct, they would owe no deficiency or damages claim to Calyon, because, according to these methods, the market

² See M. Ellenberg & L. Chervokas, "American Home Court Excludes Servicing From Safe Harbors" (Client & Friends Memo, January 2008).

³ 11 U.S.C. § 562.

⁴ Opinion at 5.

value of the loan portfolio exceeded the Repurchase Price on that date. Calyon, by contrast, argued that no “commercially reasonable determinants of value” existed on the Acceleration Date, because the assets were unable to be sold due to the instability in the financial marketplace. Therefore, section 562(b) of the Bankruptcy Code should apply, and the court should measure damages on the earliest date on which a commercially reasonable determinant existed -- August 15, 2008.⁵

Judge Sontchi acknowledged the ambiguity of the phrase “commercially reasonable determinants of value” and considered the parties’ competing interpretations of this language.⁶ Calyon argued that the phrase meant “what one could buy or sell the assets for in the market place” and that the only relevant “determinants” are “those that provide evidence of the asset’s market price, such as the price actually received in a sale, the price available from a generally recognized source, the most recent bid quotation from that source, or expert testimony regarding the market price.”⁷ The Debtors countered that Calyon’s definition was too narrow in light of the broad language used by Congress. Moreover, by using the plural word “determinants”, Congress clearly intended that “more than one valuation methodology may constitute a ‘commercially reasonable determinant’ of an asset’s value.”⁸ Further, Congress’ use of the word “value” rather than “market value” suggests that Congress intended for the “use of multiple methodologies to determine value, including those that do not rely on the existence of a functional market.”⁹

The Court’s Decision

The bankruptcy court, after considering the sparse legislative history behind section 562 of the Bankruptcy Code and its apparent purpose, adopted the Debtor’s view. The court held that section 562’s reference to “commercially reasonable determinants of value” is not limited to the market or sale value of an asset. The court went on to conclude that the DCF method of valuing the loan portfolio, an “income-producing asset,” was commercially reasonable. The court noted that Calyon had failed to demonstrate that the DCF valuation method, which actually had been used internally by the bank itself, was not commercially reasonable. As a result, Calyon’s arguments about why it could not obtain a market value for the loan portfolio on the Acceleration Date – disputes over ownership and loan servicing rights, in addition to frozen markets and uncertain delinquency rates – were irrelevant. Since the portfolio’s DCF value exceeded that of the Repurchase Price, Calyon had no deficiency claim against the debtors’ estates.

⁵ Opinion at 4 and 17.

⁶ Opinion at 12.

⁷ Opinion at 9.

⁸ Id.

⁹ Id.

Implications

The court's ruling creates additional uncertainty in the calculation of bankruptcy claims relating to the termination of safe harbored contracts. In this respect, it bears emphasis that section 562 applies to all safe harbored contracts, not just repurchase agreements. There are some possible limitations on the ruling. First, Calyon chose to assert that commercially reasonable determinants of value were not available on the termination date. In most cases, parties liquidating a repurchase agreement for mortgage loans would conduct a commercially reasonable auction of the assets. That auction should constitute a reasonably commercial determinant of value, whatever its results. In addition, standard repurchase agreements generally provide the nondefaulting party with considerable flexibility in valuing the assets. It is not clear to what extent section 562 overrides these contractual provisions, that were freely entered into by sophisticated parties prior to the bankruptcy. Finally, the court's decision raises a question as to when a commercially reasonable determinant of value would not exist. In most, if not all cases, a DCF or other non-market based valuation could always be calculated. Thus, the Court's decision seems to render section 562(b) mere surplusage.

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