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The **Price** of Terminating a Mortgage Loan Repurchase Agreement

Third Circuit approves discounted cash flow analysis under Code §562.

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ON FEB. 16, 2011, the U.S. Court of Appeals for the Third Circuit ruled that a discounted cash flow (DCF) analysis constituted "a commercially reasonable determinant[] of value" for purposes of §562(a) of the U.S. Bankruptcy Code.[1]

In so doing, the court upheld the U.S. Bankruptcy Court for the District of Delaware decision sustaining the objection of American Home Mortgage Holdings Inc. and its affiliated debtors (collectively, the "debtors") to the $478.5 million claim of Calyon New York Branch for damages related to the termination of a mortgage loan repurchase agreement.[2] Specifically, at issue was the timing and method for valuing the mortgage loan portfolio for purposes of calculating Calyon's deficiency claim against the debtors pursuant to §562 of the Bankruptcy Code.

Section 562 was enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) to set the exact date for measuring damages under repurchase agreements and other safe-harbored contracts in the event of liquidation, termination, or acceleration thereunder.

Section 562(a) provides that, for the purposes of measuring damages under repurchase and other safe-harbored contracts, "damages shall be measured as of the earlier of—(1) the date of such rejection" of the contract or agreement; or (2) the date or dates of "liquidation, termination, or acceleration" of the relevant contract or agreement.[3] Under §562(b), "[i]f there are not any commercially reasonable determinants of value as of" the date of rejection or the date of liquidation, termination or acceleration, "damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value."[4]

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Calyon had taken the position that no "commercially reasonable determinants of value" existed on the termination date of the repo agreement so, instead, in reliance on §562(b) of the Code, calculated its claim based on the "market value" of the specific loans at issue one year after the termination date.[5]

Ultimately, the Third Circuit rejected Calyon's valuation methodology and held that §562(a) of the Bankruptcy Code permitted the debtors to calculate damages on the basis of any "commercially reasonable determinant of value," particularly at a time when the market was "dysfunctional," rendering market price impractical and inaccurate.[6] The Circuit held that if Congress had intended §562 to be limited solely to market or sale price, as Calyon had contended, it would have expressly said so, as it did in Code §559.[7]

Although the Third Circuit's decision may be limited to its unique set of facts, the decision begs the question of the import of Bankruptcy Code §562(b). For one, a DCF valuation methodology, which the Third Circuit held to be a so-called "commercially reasonable determinant of value" (or other non-market based valuation test), could always be applied to measure damages under a repo agreement on the liquidation, termination or acceleration date pursuant to §562(a), regardless of the liquidity in the marketplace at the time.

Further, a repo counterparty liquidating a repurchase agreement for mortgage loans could promptly conduct a commercially reasonable auction of the purchased assets covered by the repurchase agreement, and then use the auction results, whatever they may be, to value the assets on the termination date under §562(a).

These means for valuing assets as of the termination date, under §562(a), are seemingly always available, even in a completely illiquid or dislocated market, and thus, raise the question of when §562(b) would apply.

Background

Calyon and the debtors were parties to a 2006 repurchase agreement covering

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a portfolio of 5,700 mortgage loans with an original unpaid principal balance of approximately $1.2 billion.[8]

The debtors defaulted on their obligations under the repurchase agreement and Calyon served them with a notice of default. On Aug. 1, 2007 (the "acceleration date"), Calyon accelerated the repurchase agreement.[9] Five days later, the debtors filed for bankruptcy.

As a result of the debtors' defaults under the repurchase agreement, Calyon filed proofs of claim against the debtors totaling $478.5 million. One year later, the debtors objected to Calyon's claims, arguing that the claims should either be disallowed or reduced when calculated under §562 of the Bankruptcy Code.[10]

The debtors and Calyon "vigorously disagree[d] as to the methodology for the measurement of damages, and consequently to the amount of damages."[11] Calyon argued that market and sale value were the only appropriate valuation methodologies prescribed by §562(a) of the Code.

Because, as Calyon determined, the "mortgage market was dysfunctional on the Acceleration Date,"[12] Calyon took the position that damages should be measured using market value as of a date subsequent to the acceleration date, pursuant to §562(b), which permits calculation as of the first date for which there are commercially reasonable determinants of value.

Calyon argued Aug. 15, 2008 (more than a year after the acceleration date) was the first date on which a commercially reasonable sale of the portfolio was possible.[13] Applying this methodology, Calyon calculated a $478.5 million deficiency claim against the debtors.[14]

The debtors agreed with Calyon that the market was dysfunctional on the acceleration date. However, the debtors took the position that a "commercially reasonable determinant of value" had in fact existed as of the acceleration date under §562(a)(2): specifically, the DCF method.

The debtors thus used a DCF valuation to fix Calyon's damages as of the acceleration date under §562(a). Applying this methodology, the debtors argued that Calyon's claims should be expunged because their value exceeded the underlying repurchase price obligation under the repo agreement.

After a two-day evidentiary hearing, the bankruptcy court sustained the debtors' objections to Calyon's claims. In pertinent part, the bankruptcy court held that, while "market price should be used to determine an asset's value when the market is functioning properly," when the "market is dysfunctional and the market price does not reflect an asset's worth" other determinants of value may be used to evidence damages under §562(a), namely, the DCF.[15]

Because the value of an asset is its "material or monetary worth, i.e., 'the amount of money, goods, etc., for which a thing can be exchanged and traded,'" in an illiquid and dysfunctional market, "markets may not fairly estimate the potential sale price of an asset."[16]

Although the legislative history behind §562 is sparse, the bankruptcy court's rationale comports with the statutory construction of §562, which does not impose any express limitations on what may constitute a commercially reasonable determinant of value. As the Third Circuit stated, if Congress had intended §562 to be limited to only certain determinants (namely, sale or market value) as Calyon asserted, "it would have said so."[17]

Section 562 was **enacted** as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of **2005**, and although the legislative history behind it is sparse, the bankruptcy court's rationale in 'American Home' comports with the statutory construction of §562, which **does not impose** any express **limitations** on what may constitute a commercially reasonable determinant of value.

Appeal to the Third Circuit

Calyon fared no better on appeal to the Third Circuit. The key issue was whether the bankruptcy court erred in interpreting the phrase "commercially reasonable determinants of value" from §562(a) to mean that any commercially reasonable valuation methodology may be used, and not just market or sale price.[18]

Honing in on the dysfunctionality of the secondary mortgage market on the acceleration date, the Third Circuit agreed that market value was not the proper method for valuation under those circumstances, and instead accepted the debtors' proposed DCF method as a commercially reasonable determinant under §562(a).

The Circuit gave consideration to the testimony proffered by the debtors in the bankruptcy court as to the appropriateness of a DCF valuation, regardless of market condition, because it focuses on valuing the particular asset's cash flow.

Notably, the debtors' expert testified that "[u]nless there is something very, very strange going on in the market, the market value of the assets and the discounted cash flow value of the assets will be very, very similar…."[19] As such, "the DCF valuation methodology is a particularly apt methodology for valuing debt instruments such as mortgage loans where the owner is receiving the cash flows" because the assets "are held for the cash flow, not for the distress sale in the market."[20]

Interestingly, Calyon never attacked the methodology applied by the debtors' expert in calculating the DCF.[21] Rather, Calyon's challenges were directed at the alleged deficiencies in the quality of the loan portfolio at issue and "the problems [Calyon] saw with the loans, such as the dispute regarding the ownership of the loans, the direction of the proceeds, and questions regarding the servicing."[22]

The Third Circuit agreed with the bankruptcy court, however, that "these problems relate[d] to the difficulties that would affect the market price or sale price of the Loan Portfolio, were it placed on the market for sale," but were "irrelevant" to the issue of whether "commercially reasonable determinants of value" existed on the Acceleration Date.[23]

Of particular import was the significant evidence that Calyon had intended to retain the loan portfolio and the income stream generated by the mortgages (i.e., the "cash flow" from the assets). At no point did Calyon make any effort to sell the mortgage loans to either recoup value or, at least, market test the assets.

As recognized by Judge Marjorie Rendell in her concurring opinion, "Calyon clearly ha[d] determined that it [would] maximize its value by retaining the mortgages, preferring to receive the cash flow over time, rather than selling them."[24] The DCF methodology was therefore deemed a particularly reasonable determinant of value for purposes of measuring Calyon's damages under §562(a), and the testimony presented by Calyon regarding the issues with the income-generating portfolio, and the variables that might have had an impact on sale price, were considered inapposite.

Further, the Third Circuit agreed with the bankruptcy court that "Calyon's interpretation [of section 562] involve[d] a moral hazard that is counter to the policy of preserving liquidity."[25] When considering Congress' seeming intent in enacting §562, the bankruptcy court observed that the purpose of the Bankruptcy Code provisions

relating to repurchase agreements was to "preserve liquidity in the relevant assets, including mortgage loans and interests in mortgage loans."[26]

The Third Circuit agreed with the bankruptcy court that §562 "'align[s] the risks and rewards associated with an investment in those assets,' and prevents the 'moral hazard' that would result if damages were measured at a date other than the date of termination, acceleration, or liquidation, such that 'the repo participant [here Calyon] could hold the asset at little or no risk. This would make the debtor an insurer of the repo participant's investment even though the debtor has no control over the management of the asset—thus, the moral hazard.'"[27]

After all, it can take a long time for a market to rebound and, in turn, for a repo participant to sit and wait for a once marketable asset to become marketable again.

The Third Circuit thus concluded that "market price should be used to determine an asset's value when the market is functioning properly."[28] However, when the market fails to function and market price does not provide the most accurate measure of value, courts should look to other commercially reasonable determinants of value to calculate repo damages as of the termination date.[29]

Conclusions

Having only been enacted in 2005 as part of BAPCPA, case law interpreting §562, and §562(b) in particular, is relatively scarce.

The legislative history to §562 makes clear that Congress "expected that in most circumstances damages would be measured as of the date or dates of either rejection or liquidation, termination or acceleration" pursuant to §562(a), and that "in certain unusual circumstances, *such as dysfunctional markets* or liquidation of very large portfolios, there may be no commercially reasonable determinants of value of liquidating any such agreements or contracts or for liquidating all such agreements and contracts in a large portfolio on a single day"—hence §562(b).[30]

The Third Circuit's recent decision, however, raises a number of questions.

First, when does a market cross from depressed to dysfunctional? Because Calyon, itself, started from the proposition that the market was dysfunctional (the acceleration date coincided with the unprecedented market collapse), the Third Circuit did not need to grapple with this issue.

Second, the debtors' arguments in favor of a DCF valuation may prove too much. The Third Circuit and the bankruptcy court both relied on the fact that the word "determinants" was plural in the Bankruptcy Code to conclude that §562(a) was not limited to market price and that any methodology could be used to determine value, so long as it was commercially reasonable.

But, as a general proposition, it is almost always possible to calculate a DCF, meaning that there will almost always be a way to measure damages on a repo termination date under §562(a). This would avoid the need for reliance on §562(b). The Third Circuit's decision thus raises a question as to when a commercially reasonable determinant of value does not exist as of the termination date and, more specifically, under what circumstances, if any, would a DCF valuation not be considered a commercially reasonable determinant.

In that regard, the Third Circuit's decision also, of course, rekindles the long-standing debate about appraisal values versus actual transaction values. Where there is no market demand for an asset, or a class of assets, could a DCF really represent a commercially reasonable determinant of value?

Indeed, the DCF method calculates present value of an underlying asset by forecasting future cash flows on the underlying asset and then applying a discount rate to account for the default risk. At some level, the market would seem to be conveying a view of risk concerning the assets that the DCF may not adequately capture.

Similarly, in most cases a repo counterparty will initiate a commercially reasonable auction of the purchased assets immediately after termination of the repo agreement. (The auction itself may not occur on the termination date; the nature of the assets may require a short diligence period for the auction to be commercially reasonable). In such cases, the auction result, regardless of outcome, would provide a way to value the assets as of the termination date, pursuant to §562(a).

Again, the repo counterparty would not need to rely on §562(b), which, as noted, is triggered only "[i]f there are not any commercially reasonable determinants of value" on the termination date. This seems consistent with the Third Circuit's conclusion that the market is generally the best indicator of value.

Moreover, were the non-defaulting repo counterparty to sit back in an illiquid market and perpetuate the "moral hazard" of trying to measure its damages as of a more promising future date under §562(b), §562(c) of the Bankruptcy Code would kick in. Section 562(c) provides that if the date for measuring damages under §562(b) is objected to, the burden shifts to the non-defaulting party determining damages to prove that no commercially reasonable determinant for calculating value existed as of the earlier dates specified in §562(a) (i.e., the date of rejection, liquidation, termination or acceleration).

Section 562(c) thus could be viewed as Congress' way of circumscribing the valuation date, and ensuring that a repo party cannot game the system by "sit[ting] back and monitor[ing] market conditions while being protected, at least in part, from market losses by its potential deficiency claim against the debtor."[31]

In the aftermath of the Third Circuit's decision holding that a DCF was a commercially reasonable determinant of value notwithstanding the dysfunctionality of the market at the time, it remains to be seen when a court will find that DCF is not in fact commercially reasonable (such as when the underlying asset is not generating cash, for instance).

That issue remains for future judges. But in the absence of any such determination, is Bankruptcy Code §562(b)'s practical import even more narrow than Congress intended?

1. 11 U.S.C. §562.
2. As of Feb. 7, 2010, Calyon became Crédit Agricole Corporate and Investment Bank, New York Branch.
3. 11 U.S.C. §562(a).
4. 11 U.S.C. §562(b).
5. *Crédit Agricole Corporate & Inv. Bank N.Y. Branch v. Am. Home Mortg. Holdings Inc. (In re Am. Home Mortg. Holdings Inc.)*, No. 09-4295, 2011 U.S. App. LEXIS 2992, at *32 (3d Cir. Del. Feb. 16, 2011).
6. 11 U.S.C. §562.
7. *In re Am. Home Mortg. Holdings Inc.*, 2011 U.S. App. LEXIS 2992, at *32.
8. Id. at *4.
9. Id.
10. Id.
11. Id. at *6.
12. Id. at *7.
13. Id.
14. Id.
15. Id. at *31.
16. Id. at *20 (quoting *In re Am. Home Mortg. Holdings Inc.*, 411 B.R. 181, 191 (Bankr. D. Del. 2009)).
17. Id. at *32.
18. Id. at *23.
19. Id. at *12.
20. Id. at *29 (internal quotations omitted).
21. Id. at *10.
22. Id. at *29-30.
23. Id. at *30.
24. Id. at *36.
25. Id. at *32.
26. Id. at *19.
27. Id. at *19-20 (quoting *In re Am. Home Mortg. Holdings Inc.*, 411 B.R. at 191).
28. Id. at *31.
29. Id.
30. 5 COLLIER, BANKRUPTCY ¶562.L.H at 562-7 (16th ed. 2010) (emphasis added).
31. *In re Am. Home Mortg. Holdings Inc.*, 411 B.R. 193.

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