

Clients & Friends Memo

Third Circuit Upholds Use of Discounted Cash Flow Method Under Bankruptcy Code Section 562 in *In re American Home Mortgage Holdings, Inc., et al.*

March 2, 2011

On February 16, 2011, the United States Court of Appeals for the Third Circuit ruled that a discounted cash flow analysis constituted “a commercially reasonable determinant[] of value” for purposes of section 562(a) of the United States Bankruptcy Code.¹ In so doing, the court upheld the United States Bankruptcy Court for the District of Delaware decision sustaining the objection of American Home Mortgage Holdings, Inc. (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 Calyon had taken the position that no commercially reasonable determinants of value existed on the termination date, and, in reliance on section 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.³

The decision may be limited to its unique set of facts. In particular, a repo counterparty that promptly conducted a commercially reasonable auction of the purchased assets covered by the repurchase agreement would be able to use the auction result to value the assets on the termination date. This would avoid any need for reliance on section 562(b).

Background

Calyon and the Debtors were parties to a 2006 Repurchase Agreement covering a portfolio of 5,700 mortgage loans with an original unpaid principal balance of approximately \$1.2 billion.⁴ The Debtors defaulted on their obligations under the Repurchase Agreement and Calyon served the Debtors with a notice of default. On August 1, 2007 (the “Acceleration Date”), Calyon accelerated

¹ 11 U.S.C. § 562.

² As of February 7, 2010, Calyon became Crédit Agricole Corporate and Investment Bank, New York Branch.

³ *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).

⁴ *Id.* at *4.

the Repurchase Agreement.⁵ 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. The Debtors objected to Calyon's claims, arguing that the claims should either be disallowed or reduced when calculated under section 562 of the Bankruptcy Code.⁶

Section 562(a) of the Bankruptcy Code 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.⁷ Under section 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."⁸

Calyon determined that the "mortgage market was dysfunctional on the Acceleration Date."⁹ Accordingly, Calyon took the position that the Bankruptcy Court should measure damages using market value as of a date subsequent to the Acceleration Date, pursuant to section 562(b). Calyon argued August 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.¹⁰

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 date of acceleration under section 562(a)(2) – specifically, the Discounted Cash Flow method. The Debtors used a DCF valuation to fix Calyon's damages as of the Acceleration Date under section 562(a) of the Bankruptcy Code. Applying this methodology, the Debtors argued that Calyon's claims should be expunged because their value exceeded the underlying repurchase price obligation.

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

⁵ *Id.*

⁶ *Id.*

⁷ 11 U.S.C. § 562(a).

⁸ 11 U.S.C. § 562(b).

⁹ *Am. Home Mortg. Holdings, Inc.*, 2011 U.S. App. LEXIS 2992, at *7.

¹⁰ *Id.*

dysfunctional and the market price does not reflect an asset's worth" other determinants of value may be used to evidence damages under section 562(a) of the Bankruptcy Code.¹¹ 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."¹² The Bankruptcy Court's rationale comports with the statutory construction of section 562, which imposes no express limitations on what may constitute a commercially reasonable determinant. Indeed, as the Third Circuit stated, if Congress had intended section 562 to be limited to only certain determinants (namely, sale or market value), "it would have said so."¹³

Appeal to the Third Circuit

The key issue on appeal was whether the Bankruptcy Court erred in interpreting the phrase "commercially reasonable determinants of value" from section 562(a) of the Bankruptcy Code to mean that *any* commercially reasonable valuation methodology may be used -- and not just the market or sale price.¹⁴ 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 section 562.

The Third Circuit gave consideration to the testimony proffered by the Debtors in the Bankruptcy Court that "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."¹⁵ In the instant case, there was substantial evidence that Calyon had intended to retain the loan portfolio (and the income stream generated by the mortgages in the portfolio). Calyon did not make any effort to sell the loans either to recoup value or, at least, market test the assets. Therefore, the Third Circuit considered inapposite the testimony presented by Calyon regarding the issues with the loan portfolio and the variables that might have had an impact on sale price.¹⁶

¹¹ *Id.* at *31.

¹² *Id.* at *20 (quoting *In re Am. Home Mortg. Holdings, Inc.*, 411 B.R. 181, 191 (Bankr. D. Del. 2009)).

¹³ *Id.* at *32.

¹⁴ *Id.* at *23.

¹⁵ *Id.* at *29 (internal quotations omitted).

¹⁶ *Id.* at *31.

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.”¹⁷ Specifically, in attempting to determine Congress’s intent, the Bankruptcy Court examined the purpose of the Bankruptcy Code provisions relating to repurchase agreements and observed that such purpose was to “preserve liquidity in the relevant assets, including mortgage loans and interests in mortgage loans.”¹⁸ The Third Circuit agreed with the Bankruptcy Court that section 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.’”¹⁹

The Third Circuit thus concluded that “market price should be used to determine an asset’s value when the market is functioning properly.” However, when the market fails to function, courts should look to other determinants of value to calculate damages.²⁰

Conclusion

The Third Circuit’s decision raises a number of questions. First, of course, the decision 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? At some level, the market would seem to be conveying a view of risk concerning the assets that the DCF would not adequately capture. Further, when does a market cross from depressed to dysfunctional? Because Calyon, itself, started from the proposition that the market was dysfunctional, 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 “determinants” was plural to conclude that section 562(a) was not limited to market prices. But, it is always possible to calculate a DCF, meaning that there will always be a commercially reasonable determinant of value on the termination date. This begs the question of when section 562(b) would apply. As noted, section 562(b) is triggered only “[i]f there are not any commercially reasonable determinants of value” on the termination date.

¹⁷ *Id.*

¹⁸ *Id.* at *19.

¹⁹ *Id.* at *19-20 (quoting *In re Am. Home Mortg. Holdings, Inc.*, 411 B.R. at 191).

²⁰ *Id.* at *31.

Last, but hardly least, it is not clear to what extent the decision will apply beyond its somewhat unique facts. In most cases, a repo counterparty will initiate a commercially reasonable auction of the purchased assets immediately after termination. (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 would provide a termination date value for the assets. The repo counterparty, thus, would not need to rely on section 562(b). This seems consistent with the Third Circuit's conclusion that the market is generally the best indicator of value. Thus, parties closing out repurchase agreements in the future would be well advised to engage in a prompt auction of the assets.

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