Safe Harbor or Adrift in Bankruptcy: Treatment of Mortgage "Repurchase Agreements" and Servicing Rights in Bankruptcy Court

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The subprime mortgage crisis of 2007 has led to the bankruptcy filings of numerous mortgage companies. Before bankruptcy, some of those mortgage companies not only originated and sold mortgage loans, but also functioned as the "servicer" of the mortgage loans over the life of the loan. Within these bankruptcy cases, the debtors, the creditors' committees, the warehouse lenders and others have battled over their respective rights with regard to the mortgage loans and the servicing business. A recent decision in the *American Home Mortgage, Inc*. Chapter 11 case from the United States Bankruptcy Court for the District of Delaware provides some guidance on these critically important issues. See *Calyon New York Branch v. Am. Home Mortgage Corp. (In re Am. Home Mortgage Inc.),* 379 B.R. 503 (Bankr. D. Del. 2008).

The *American Home* court held that a contract between the debtor-mortgage company and a purchaser for the sale and repurchase by the debtor of mortgage loans constituted a "repurchase agreement" under the Bankruptcy Code, thereby invoking various "safe-harbor" provisions. Under those provisions, the purchaser's rights under the contract that related to the sale and repurchase of mortgage loans were not stayed or otherwise limited by operation of the Bankruptcy Code. The purchaser could thus take immediate action to terminate the repurchase agreement and sell the underlying loans to third parties, eliminating the debtor's interest therein.

The court also held, however, that the portion of the contract that addressed the "servicing" of the loans was severable from the sale and repurchase provisions. Because the servicing portion of the contract did not independently satisfy the definition of a "repurchase agreement," the purchaser could not take advantage of the safe harbors or affect the debtor's exercise of its rights concerning the servicing of the mortgage loans. Rather, the debtor retained its servicing business as an asset of its estate for possible future sale.

Facts

American Home Mortgage Corp. and certain of its affiliates (the Debtors) engaged in the business of originating, servicing and selling mortgage loans. To fund their business, the Debtors entered into a contract (the Contract) with Calyon New York Branch (Calyon) and other institutions (collectively, the Purchasers) pursuant to which the Purchasers would provide funds to the Debtors to originate mortgage loans. Immediately upon origination, the Debtors would transfer the loans to the Purchasers on an interim basis while they arranged for final disposition of the loans, either through a sale to a private investor or placement in a securitization trust. Once those arrangements were in place, the Debtors "repurchased" the loans from the Purchasers at the original purchase price plus a "Price Differential"--in essence, the Purchasers' gross profit component. Upon repurchase, the Debtors immediately transferred the loans to the ultimate purchasers (the investor or the securitization vehicle).

The Contract also provided for servicing of the mortgage loans. Servicing encompasses collecting the mortgage payments, administering tax and insurance escrows, responding to borrower inquiries, and the like. The servicer collects a fee, usually based upon the amount of unpaid principal of the serviced loans.

Under the Contract, the Debtors sold the mortgage loans on a "servicing retained" basis, meaning that the Debtors retained the right to designate the servicer under the loans. By contrast, a contract could provide for the sale of mortgage loans on a "servicing released" basis, where the purchaser (not the mortgage originator) would have the right to designate the servicer. Here, the Debtors retained that right, and designated one of their entities, American Home Mortgage Servicing, Inc. (AHM Servicing), as the servicer.

In the weeks leading to their bankruptcy filing, the Debtors experienced a severe liquidity crisis, forcing them to discontinue their indirect loan origination business. As a result, Calyon sent to the Debtors a notice of default, demanding that the Debtors immediately repurchase all of the mortgage loans in Calyon's possession under the Contract. Calyon also sent a separate "Notice of Default to Servicer," in which it again asserted an event of default under the Contract, sought to designate a new servicer with respect to the mortgage loans and stated that AHM Servicing would function only as the "interim servicer" pending transfer to the new servicer. Five days later, the Debtors (including AHM Servicing) filed bankruptcy.

During the bankruptcy case, Calyon purported to terminate AHM Servicing as interim servicer and demanded that the servicing duties be transferred to a servicer of Calyon's designation. Calyon also filed a complaint against the Debtors in the bankruptcy court presiding over the Debtors' bankruptcy cases, seeking that court's judgment that its Contract with the Debtors constituted a "repurchase agreement" under the Bankruptcy Code and, as such, Calyon's rights under the Contract were not stayed or otherwise limited by any Bankruptcy Code provision. Additionally, Calyon requested that the court order the Debtors to transfer the servicing rights under the Contract to its designee.

The "Repurchase Agreement" Analysis

The use of repurchase agreements is widely recognized as a critical component of not only the US capital markets, but also global capital markets. Accordingly, to prevent disruption caused by insolvencies from rippling through those markets, Congress has provided certain safe harbors in the Bankruptcy Code for the benefit of parties to a "repurchase agreement" when their counterparty has filed for bankruptcy. Under those safe harbors, the purchaser--the non-debtor party--may immediately take action to close out the repurchase agreement and liquidate the underlying securities, notwithstanding the automatic stay that generally prevents similar action by most other creditors.

- Sections 555 and 559 protect the enforceability of certain contractual rights to liquidate, terminate and accelerate repurchase agreements based on contractual *ipso facto* clauses--clauses excusing a solvent party from performance of a contract when the other party becomes insolvent or otherwise suffers certain benchmarks of financial distress.
- Under sections 362(b)(7) and 362(o), the automatic stay is made inapplicable to any rights of setoff under the repurchase agreement and the realization against the underlying loans.
- Sections 546(f) and 548(d) provide exemptions from the preference and fraudulent transfer avoidance powers for settlement and margin payments made with respect to repurchase agreements.

To implicate these safe harbors, however, a contract must satisfy the definition of a "repurchase agreement." A standard repurchase agreement provides for a two-part transaction: First, the dealer transfers specified securities to the purchaser in exchange for cash. Second, the dealer contemporaneously agrees to repurchase the securities at the original price plus an agreed upon additional amount at a specified future date not later than one year after such transfer.

Applying that standard, the *American Home* court concluded that the portion of the Contract providing for the sale and repurchase of mortgage loans constituted a repurchase agreement. Specifically, the Debtors, as the dealer, agreed to transfer mortgage loans to Calyon, the purchaser, in exchange for funds, with the contemporaneous agreement that the Debtors would repurchase the mortgage loans from Calyon for the price Calyon paid the Debtors plus the agreed upon "Price Differential" within 180 days of the original transfer. Because the Contract constituted a repurchase agreement, Calyon was not stayed from immediately exercising its rights to close out the Contract and enforcing its rights against the underlying mortgage loans.

In reaching its conclusions, the bankruptcy court rejected the Debtors' invitation to look beyond the four corners of the Contract and recharacterize the Contract as a secured financing. "[I]f the criteria established in the statute are [met] the contract is a repurchase agreement. No further inquiry or consideration of other contractual provisions is required." *Id.* at 516. Indeed, the court stated that Congress intended the Bankruptcy Code to eliminate any inquiry concerning whether a transaction is a purchase and sale, or a secured financing.

Transfer of the Loan Servicing Provisions

The court next considered whether the loan servicing provisions of the Contract were severable from the portion of the Contract that provided for the sale and repurchase of mortgage loans. The issue was whether the loan servicing provisions were part and parcel of the repurchase agreement and thereby entitled to the benefit of the safe harbors, or whether they were a separate contract, which would be treated in bankruptcy separately--and perhaps differently--than the repurchase agreement. To resolve this inquiry, the court turned to New York state law, the applicable law of the contract. Under New York law, severability is a question of the parties' intent. Specifically, "a contract is severable when by its terms, nature and purpose, it is susceptible of division and apportionment." *Id.* at 521 (internal quotations omitted).

Applying that standard, the court found that the provisions concerning the servicing of the mortgage loans were severable from the sale and repurchase provisions. Of critical importance, the Contract provided that the mortgage loans were bought and sold on a "servicing retained" basis, as opposed to a "servicing released" basis, which demonstrated that the Contract itself severed the right to designate the servicer from the underlying mortgage loan. Moreover, the court touched on the economics of this distinction: "All things being equal, a buyer will pay a higher price in a servicing released transaction because the buyer is purchasing the underlying mortgage loan and the right to receive the payments for servicing the loan (which presumably generate a profit for the servicer)." *Id.* at 522. Since Calyon had presumably paid less in this case for a "servicing retained" contract, the court was unwilling to give it rights that it had not purchased.

The court also found the following factors relevant:

- The sale and repurchase provisions concerned accessing financing through the repo market, whereas the servicing functions concerned collecting money, paying expenses and otherwise attending to administrative aspects of the loans.
- The consideration for the servicing functions was "readily apportioned from the other consideration flowing under the Contract." Id. at 521.
- Calyon itself recognized the distinct nature of the two agreements by issuing two separate notices of default on the same day--one to the sellers of the mortgage loans and another to the servicer.

The court then considered how to treat the servicing provisions, given that it now viewed them as a separate contract. It applied the definitions of "repurchase agreement" and "securities contract" to those provisions, and easily concluded that they met neither. Because no Bankruptcy Code safe harbors applied, the court found no basis to require the Debtors to transfer estate property, *i.e.,* the servicing business, to Calyon's designee.

The Bottom Line

Unless overturned on appeal, the *American Home* opinion signifies recognition that agreements in the mortgage loan industry for the sale and repurchase of mortgage loans can meet the Bankruptcy Code's definition of a repurchase agreement. The purchaser may thereby avail itself of the Bankruptcy Code's safe harbors permitting it immediately to take action to close out the repurchase agreement and liquidate the underlying securities, notwithstanding the automatic stay that would otherwise prevent such action. In that regard, purchasers under repurchase agreements should enjoy significant protections when the dealer files for bankruptcy.

Where the contract between the parties also addresses the servicing rights for those mortgage loans, however, the servicing rights may not be protected by the Bankruptcy Code's safe harbors. If the mortgage loans were sold on a "servicing retained" basis, as opposed to a "servicing released" basis, or if the terms of the contract and the parties' intent otherwise allow the servicing provisions to be severed from the repurchase provisions of the contract, then the servicing rights may not fall within the safe harbors. Rather, the servicing rights may be an asset of the debtor's estate, to be sold or otherwise administered in the course of the debtor's bankruptcy case in accordance with the provisions of general bankruptcy law.

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