DCF Analysis: A "Commercially Reasonable Determinant" of Value for Liquidation of Mortgage Loans in Repo Transaction

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In a case of first impression, the Third Circuit Court of Appeals in *In re American Home Mortg. Holdings, Inc.*, 637 F.3d 246 (3d Cir. 2011), held that, for purposes of section 562 of the Bankruptcy Code, a discounted cash flow analysis was a "commercially reasonable determinant" of value for the liquidation of mortgage loans in a repurchase transaction.

Repurchase, or "repo," agreements have long been an important mechanism for investing in U.S. government and agency securities, mortgage-related instruments, commodities, and money market instruments. Though these transactions can be complicated, the basic structure of a repo agreement is simple: one party sells assets to a purchaser in exchange for cash, and the purchaser promises to sell those assets back at an agreed-upon time or upon demand.

Repurchase Agreements in Bankruptcy

Repurchase transactions are potentially beneficial to both parties. On the one hand, the party supplying the funds can invest its idle cash, and one attractive feature of many repos is that the party supplying the funds can make such an investment in a manner that is sufficiently short and flexible to meet its cash flow needs. On the other, the party receiving the funds uses the transaction as a form of financing. In fact, certain types of large institutions typically rely on repo transactions as an essential means of financing their securities or other portfolios. As a result of these benefits, the total amounts invested in repo transactions are staggering.

Recognizing the importance and interrelatedness of repo transactions, in the 1980s Congress began to express concerns that the bankruptcy of a major financial player could cause a chain reaction in the markets. The fear in the repo market, which was fueled in part by a decision in the *Lombard-Wall* bankruptcy, was that the bankrupt entity's automatic stay would prohibit the other party from closing out its repo position, thereby exposing the nondebtor party to open-ended market risk. In response to these concerns, Congress added certain provisions to the Bankruptcy Code to address repo transactions. Since the 1980s, these provisions were amended and refined, and provisions dealing with other types of financial contracts, such as swap agreements, were added as well.

Among the provisions dealing with repo transactions is section 559 of the Bankruptcy Code, which allows a nondebtor party to exercise its contractual right to terminate, liquidate, or accelerate a repurchase agreement based on a so-called *ipso facto* clause, notwithstanding the automatic stay. This provision, which was enacted in 1984 and subsequently amended, was designed to address the *Lombard-Wall* problem. That is, a counterparty could cut off the feared open-ended market risk by promptly liquidating the contract upon bankruptcy.

In the interest of fairness to the debtor's estate, however, section 559 of the Bankruptcy Code provides that, upon liquidation, "any excess of the market prices received on liquidation of such assets . . . over the sum of the stated repurchase prices and all expenses in connection with the liquidation of such repurchase agreements shall be deemed property of the estate." In other

words, if the counterparty liquidates the assets in the repo transaction, the counterparty must return to the debtor any excess over the market prices received.

Another provision relevant to repo agreements is section 562 of the Bankruptcy Code, which was enacted in 2005. That section addresses the appropriate date or dates for measuring damages arising from a debtor's or trustee's rejection or a counterparty's liquidation, termination, or acceleration of repo and derivatives instruments. Section 562 sets forth the rule that damages for such contracts are generally measured as of the earlier of either: (a) the date of termination, liquidation, or acceleration of the contract; or (b) the date of the rejection of the contract, pursuant to section 365 of the Bankruptcy Code. That general rule, however, gives way where a party can prove that on the applicable date there were no "commercially reasonable determinants" of value. Under those circumstances, damages are then measured as of the earliest subsequent date or dates on which commercially reasonable determinants exist.

American Home

With the onset of the mortgage and housing-market crisis, many lenders were forced to seek the refuge of bankruptcy court protection. In August 2007, American Home Mortgage Investment Corp. ("American Home"), one of the largest home lenders at the time, filed for chapter 11 in Delaware. Prior to filing, American Home's business primarily involved the origination, servicing, and sale of mortgage loans, as well as investments in mortgage loans and mortgage-backed securities. To fund the origination of mortgage loans, American Home was party to a repurchase agreement.

Under the agreement, when American Home originated a mortgage loan, it would immediately transfer the loan to a repo purchaser. American Home would then undertake to dispose finally of the loan to a private investor or securitization vehicle. Once it made arrangements to dispose of the loan, American Home would repurchase the mortgage from the repo purchaser. The repo purchaser received a spread based on the number of days it held the loan, and American Home received funds that enabled it to keep originating mortgages.

Around the time of the bankruptcy, Calyon New York Branch ("Calyon"), as administrative agent under a repurchase agreement, served American Home with a notice of default and accelerated the repo. As a result of the notice, American Home was obligated to repurchase the mortgage loans. On the basis of this repurchase obligation, Calyon filed claims in the bankruptcy that alleged a deficiency between the value of the mortgages transferred to Calyon and the repurchase obligation owed to it by American Home. In other words, Calyon alleged it was undercollateralized and sought an unsecured deficiency claim against the debtor. American Home objected to the claims, arguing that Calyon's valuation was incorrect and seeking to disallow or reduce the claims under section 562 of the Bankruptcy Code.

Bankruptcy Court Decision

In the bankruptcy court, American Home argued that the appropriate date for measuring damages in connection with the Calyon repurchase agreement was the date of acceleration, while Calyon argued that a later date should apply. Both parties agreed that the secondary market for mortgage loans was dysfunctional on the acceleration date because of the onset of the housing and mortgage crisis. The parties disagreed over the significance of that fact, however.

Calyon argued that a market or sale value of the mortgage loans was the *only* appropriate valuation methodology. According to Calyon, because the markets were admittedly dysfunctional on the acceleration date, such values could not be appropriately used, and consequently, section 562 mandated the application of a different date for measuring damages—that is, the date when the markets became functional again. In contrast, American Home argued that, though use of a market value was inappropriate because of the dysfunction of the markets on the acceleration date, other commercially reasonable determinants of value existed on that date. In particular, American Home asserted that the court could appropriately measure damages under section 562 by relying on a discounted cash flow analysis or certain market analyses that Calyon had obtained outside the context of the litigation.

The bankruptcy court resolved the dispute in favor of American Home in *In re American Home Mortg. Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), ruling that the discounted cash flow analysis (but not the market analyses) was a commercially reasonable determinant of value on the acceleration date. The court determined that section 562 was ambiguous in this regard, partly on the basis of a conflict with section 559. It then observed that the repo provisions of the Bankruptcy Code were designed to preserve liquidity in repo assets and that section 562 was designed to "align the risks and rewards associated with an investment in those assets." Section 562, according to the court, prevented the "moral hazard" that would result if damages were measured on a date other than the date of termination, acceleration, or liquidation. For example, by measuring damages as of a later date, the nondebtor could capture the benefits of price increases (up to the amount of the repurchase obligation), while being compensated for any price decreases in the form of a larger deficiency claim.

The court also observed, “There is nothing in section 562 that would imply a limitation on any methodology used to determine value, provided it is commercially reasonable.” Indeed, the court continued, “the use of the word *determinants* suggests just the opposite—that *any* commercially reasonable valuation may be used.” Also pertinent to the court’s ruling was the finding that American Home’s expert witness was credible and that Calyon’s expert was not. Further, the court found that, even if Calyon’s evidence were credited, it would not change the analysis because such testimony might have impacted the loan portfolio’s sale price but was not relevant since Calyon intended to hold the loans.

Applying the discounted cash flow analysis, the court determined that the value of the mortgage loans exceeded the repurchase obligation and that Calyon therefore had no deficiency claim.

Third Circuit Decision

On direct appeal, the Third Circuit Court of Appeals affirmed the bankruptcy court’s decision. But it did not agree with the bankruptcy court’s reasoning in full. Specifically, the court of appeals rejected the lower court’s suggestion that section 562 was ambiguous in light of a perceived conflict with section 559. The Third Circuit explained that these provisions address different circumstances: “Section 559 applies only in the event that a repurchase agreement is liquidated, and the liquidation results in excess proceeds . . . [, while section 562] applies when the contract is liquidated, terminated, or accelerated, and results in *damages* rather than excess proceeds.”

The appellate court agreed, however, with the bankruptcy court's conclusion that market price is not the only commercially reasonable determinant of value under section 562. The Third Circuit noted the bankruptcy court's finding that Calyon had no intention of selling the loans, as well as the testimony below that a discounted cash flow was particularly appropriate where the owner holds the mortgage loans and is receiving the cash flows. The court of appeals also found persuasive the bankruptcy court's analysis that market price should be used when the market is functioning well and that a court should look to other determinants only when the market is dysfunctional.

Accordingly, the Third Circuit found the bankruptcy court's findings and conclusions persuasive and supported by the evidence, and it rejected Calyon's argument that only market price should be considered. Circuit judge Rendell concurred in the court's opinion and succinctly noted three reasons why the result was correct in her view: First, the statute uses the plural—"determinants." Second, the phrase "commercially reasonable" implicates a fact-intensive inquiry that depends on the totality of the circumstances (which may not include a sale of the assets). Third, Calyon retained the mortgage loans instead of selling them and thus received the cash flows.

Outlook

The *American Home* decision appears to be the first opinion to address these issues at the circuit level. Indeed, precious few courts have discussed either the repurchase provisions or section 562 of the Bankruptcy Code at all. Accordingly, how that body of case law will develop remains to be seen. However, at least for those courts within the Third Circuit, the phrase "commercially reasonable determinants" encompasses more methodologies than market price alone.