## Legal Updates & News

**Bulletins**

# Delaware Bankruptcy Court Applies "Safe Harbor" Protections to Repurchase Agreement; Article 9 Deemed Inapplicable

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**Delaware Bankruptcy Court Applies "Safe Harbor" Protections to Repurchase Agreement; Article 9 Deemed Inapplicable**

A standard repurchase agreement, commonly referred to as a "repo," typically consists of a two-part transaction.[i] The first part involves the transfer of specified securities by one party, the dealer, to another party, the purchaser, in exchange for cash. The second part consists of a contemporaneous agreement by the dealer to repurchase the securities at the original price, plus an agreed-upon additional amount on a specified future date.[ii] Generally, the "safe harbor" provisions of the Bankruptcy Code are designed to permit a non-debtor party to terminate and close out a repo (as well as other derivative contracts) notwithstanding the automatic stay.[iii] Without these special protections, or "safe harbors," the bankruptcy of a counterparty to a repurchase agreement "would impair the liquidity of the repurchase agreement and possibly lead to the bankruptcy of the non-debtor counterparties."[iv]

The amendments to the Bankruptcy Code implemented by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Amendments"), strengthened several of the safe harbor provisions. Notably, the 2005 Amendments significantly expanded the definition of "repurchase agreement" to include a much wider category of securities and derivative agreements, including "mortgage related securities, (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans."[v] The 2005 Amendments broadened Section 559 of the Bankruptcy Code (specifically addressing the liquidation of repos) by amending it to include the termination or acceleration of repos, and expanded the definition of "contractual right." Similarly, the 2005 Amendments amended Section 555 of the Bankruptcy Code (specifically addressing securities contracts) by broadening it to cover the termination or acceleration of a securities contract, and expanding the definition of "contractual right".

For the second time this year, Judge Christopher Sontchi, applying the 2005 Amendments, held that an agreement involving the debtor in possession, American Home Mortgage Investment Corp. ("AHMIC"),[vi] was a "repurchase agreement," finding that the repo satisfied the "repurchase agreement" and "securities contract" safe harbor provisions under sections 559 and 555 of the Bankruptcy Code.[vii] As a result, Lehman Brothers Inc. ("LBI", along with Lehman Commercial Paper Inc., "Lehman") was found not to be in violation of the automatic stay when it foreclosed on and/or liquidated the underlying subordinated notes.[viii]

In addition, the court held that the repo fell outside the scope of Article 9 of the New York Uniform Commercial Code, thereby defeating AMHIC's effort to impose Article 9's "commercial reasonableness" standards upon LBI's enforcement actions.[ix]

**Summary of the Court's Decision**

The dispute in *Lehman* arose out of a complaint filed by AHMIC, the bulk of which was ultimately dismissed by the court.[x] The case arose out of a master repurchase agreement ("MRA") between AMHIC and Lehman, in which Lehman agreed to finance certain subordinated note purchases made by AHMIC — a transaction that was integral to AHMIC's loan origination business. In July 2007, AHMIC and Lehman entered into a transaction under the MRA (the "Subordinated Notes Transaction"), under which AHMIC sold two series of notes (the "Subordinated Notes") to Lehman pursuant to the MRA.[xi]

After the initial sale of the Subordinated Notes, the MRA entitled Lehman to make margin calls when the market value of the Subordinated Notes fell below a certain amount. In late July 2007, Lehman issued two margin calls, the second of which AHMIC failed to satisfy. On August 1, 2007, Lehman provided AHMIC with a formal notice of default. On August 6, 2007, AHMIC filed for protection under chapter 11 of the Bankruptcy Code. Subsequently, on August 27, 2007, Lehman issued a foreclosure notice, terminating the MRA and foreclosing on the Subordinated Notes in lieu of selling them to a third party.

On October 24, 2007, AHMIC filed an adversary proceeding against Lehman, seeking, among other relief, a declaratory judgment that the MRA was not a "repurchase agreement" within the purview of section 101(47) of the Bankruptcy Code and accordingly, that the safe harbor provisions did not apply. Consequently, AHMIC requested a declaration that Lehman had violated the automatic stay by terminating the MRA. Failing those requests, AHMIC sought a declaration that Article 9 of the UCC applied to the MRA and as a result, Lehman was subject to Article 9's commercial reasonableness standard. AHMIC sought remuneration for damages incurred as a consequence of Lehman's failure to comport with UCC Article 9. In response, Lehman moved to dismiss most of the adversary complaint.

**Ruling**

In reaching its decision, the court decided three issues. The first issue was whether the MRA fell under section 559 (repurchase agreement safe harbor) of the Bankruptcy Code. The second issue was whether the MRA fell under section 555 (securities contract safe harbor) of the Bankruptcy Code. The third issue was whether Article 9 of the UCC applied to the repurchase agreement.

**Repo Safe Harbor**

The court adopted a two-part inquiry in determining whether section 559 of the Bankruptcy Code applied.[xii] First, the court considered whether the Subordinated Notes qualified as one of the four types of financial instruments included within the definition of "repurchase agreement" under section 101(47) of the Bankruptcy Code, those being:[xiii] (i) mortgage related securities, (ii) mortgage loans, (iii) interests in mortgage related securities, or (iv) interests in mortgage loans. Second, finding that the Subordinated Notes constituted one of the financial instruments contemplated by section 101(47), the court analyzed whether the structure of the MRA followed the structure of a "repurchase agreement" as defined by section 101(47).

The court resolved the first question by concluding that the Subordinated Notes qualified as an interest in mortgage loans based on a plain language reading of that term.[xiv] The court, relying on the Bankruptcy Code's definitions of "security interest"[xv] and "lien,"[xvi] concluded that the Subordinated Notes were a payment obligation secured by a mortgage loan, thus providing a lien or security interest in the mortgage loans owned by a third party.

The court resolved the second question by finding that the MRA followed the structure of a "repurchase agreement" as it met the five elements identified in section 101(47). Specifically, the MRA (i) provided for the transfer of one or more interests in mortgage loans; (ii) provided that the transfer of one or more interests in mortgage loans from AHMIC to Lehman was against the transfer of funds from Lehman to AHMIC; (iii) contained a simultaneous agreement by Lehman to transfer the interests in the mortgage loans to AHMIC; (iv) provided that the obligation to transfer the interests in mortgage loans from Lehman to AHMIC occur on a date certain or on demand; and (v) provided that the transfer of the interests in mortgage loans from Lehman to AHMIC would be against the transfer of funds from AHMIC to Lehman. On its face, the MRA qualified as the sale and repurchase of the Subordinated Notes within the ambit of section 101(47) such that section 559 of the Bankruptcy Code applied. Accordingly, the court held that Lehman's enforcement of its termination rights under the *ipso facto* clause of the MRA was not prohibited by section 365(e) or section 362(a) of the Bankruptcy Code.

**Securities Contract Safe Harbor**

Next, the court looked to extrinsic evidence in determining that the securities contract safe harbor provisions applied to the Subordinated Notes Transaction. That section permits a "stockbroker, financial institution, financial participant or securities clearing agency" to exercise its rights under a securities contract as defined under section 741(7) outside of the operation of the automatic stay.[xvii] First, the court concluded that the MRA fell squarely within the Bankruptcy Code's definition of a "securities contract"[xviii] because it qualified as a "repurchase agreement" of and "interest in mortgage loans." Second, the court considered extrinsic evidence "integral to or explicitly relied upon in the complaint"[xix] to determine that LBI was the sole counterparty to the Subordinated Notes Transaction and that it was a "stockbroker" under section 101(53A) of the Bankruptcy Code entitled to exercise its rights under the MRA.[xx] In particular, the court considered trading confirmations showing that LBI was the sole counterparty to the relevant transactions and Lehman's Form 10-Q filing to

determine that as a U.S. registered broker-dealer, LBI qualified as a "stockbroker" under section 741 of the Code. Accordingly, the court declared that the securities contract safe harbor provision of section 555 of the Bankruptcy Code allowed Lehman to foreclose on and/or liquidate the Subordinate Notes, despite the automatic stay.

**Article 9 and "Commercial Reasonableness"**

In an effort to subject Lehman to a "commercial reasonableness" standard in connection with its foreclosure and liquidation of the Subordinated Notes, AHMIC asserted that Article 9 of the Uniform Commercial Code (the "UCC") applied to the MRA, and specifically, those provisions of the UCC dealing with post-default remedies. AHMIC contended that irrespective of the parties' intent, pursuant to section 9-109(a)(1) of the UCC, Article 9 applied to the MRA because the MRA created a security interest in the Subordinated Notes. Section 9-109(a)(1) of the UCC provides that Article 9 applies to a transaction "regardless of its form, that creates a security interest in personal property or fixtures by contract,"[xxi] Specifically, AHMIC relied on the "savings clause" contained in Section 6 of the MRA entitled "security interest" which provided that although the parties intended that all the transactions subject to the MRA were sales and purchases and not loans, to the extent they were deemed to be loans, AHMIC would be deemed to have granted a security interest in the Subordinated Notes to Lehman.[xxii] Citing to both New York law contract principles and the official comments to Article 9, the court rejected AHMIC's position that the parties' intent was irrelevant. Based upon the parties' expressed intent as reflected in the express terms of the MRA and the "operative provisions" of the MRA, the court found that the MRA was a purchase and sale agreement and not a secured loan. Indeed, the court held that the fact that the MRA may contain a security interest contingent upon a court declaring the underlying transactions to be a loan, the "existence of [such] a 'contingent' security interest, whether or not the contingency ever occurs, also does not give rise to Article 9 applicability."[xxiii]

In the alternative, AHMIC argued that even if the MRA was found to be purchase and sale agreement, Article 9 applied to the transactions at issue because the Subordinated Notes constituted both a "promissory note" and "payment intangible" and Article 9 applies to the sale of promissory notes and payment intangibles. The court, citing to section 9-601(g) of the UCC, summarily rejected AHMIC's position. The court held that pursuant to section 9-601(g), the UCC's commercial reasonableness standard does not apply to the purchase of promissory notes or payment intangibles.[xxiv]

**Conclusion**

*Lehman*, like *Calyon*, represents a court's willingness to protect the non-debtor counter-party to a repo by giving effect to the 2005 Amendments through a plain language reading of the applicable safe harbor provisions. Courts adopting Judge Sontchi's analysis (particularly those in the Third Circuit) will not only look to the plain language of the Bankruptcy Code and the Securities Exchange Act of 1934,[xxv] but also may consider extrinsic evidence in circumstances where such evidence is "integral or explicitly relied upon in the complaint"[xxvii] — such as a non-debtor counterparty's 10-Q filing[xxvi] — in determining whether the safe harbor protections ought to apply.

Repo counterparties can also take comfort in the court's refusal to import the commercial reasonableness standard of Article 9 into the transactions underlying the repo.

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**Footnotes**

[i] The authors wish to thank summer associate Jeremy Merkelson for his assistance in helping draft this article.
[ii] *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer S&L Ass'n (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.)*, 878 F.2d 742, 743 (3d Cir. 1989)(citations omitted).
[iii] Sections 362(b)(6) and 362(b)(7) of the Bankruptcy Code specifically provide an exception to the automatic stay for the exercise of certain contractual rights by certain non-debtor counterparties to a commodity contract, forward contract or securities contract, and repurchase agreement. *See also*, 11 U.S.C. §559 (addressing contractual rights of repo participants and *ipso facto* clauses); 11 U.S.C. §555 addressing contractual rights of certain parties to a securities contract and *ipso facto* clauses); 11 U.S.C. §556 (addressing contractual rights of certain parties to a commodities contract or forward contract and *ipso facto* clauses).
[iv] *See generally Calyon New York Branch v. American Home Mortgage Corp. (In re American Home Mortgage Holdings, Inc.)*, 370 B.R. 503, 512-13 (Bankr. D. Del. 2008) (Sontchi, J.).
[v] 11 U.S.C. §101(47).
[vi] *See Calyon*, 379 B.R. at 519-20 (finding agreement to be a repo and a securities contract, but severing servicing provisions and holding such provisions were not protected under safe harbor). The relevant parties who signed the repo agreement at issue in *Calyon* were American Home Mortgage Corp., American Home Mortgage Acceptance, Inc., American Home Mortgage Servicing, Inc., and American Home Mortgage

Investment Corp. *Id.* at 508.
[vii] *See American Home Mortgage Inv. Corp. v. Lehman Bros. Inc. (In re American Home Mortgage Holdings, Inc.)*, No. 07-11047, Adv. Proc. No. 07-51739, 2008 WL 2156323, at **7-9, 21(Bankr. D. Del. May 23, 2008) (hereinafter "Lehman").
[viii] *Id.* at *11.
[ix] N.Y.U.C.C. § 901, *et seq*.; *Lehman*, 2008 WL 2156323 at *14-15.
[x] Although the court dismissed the bulk of AHMIC's claims for declaratory judgment, the court dismissed without prejudice AHMIC's pre-petition breach of contract claims against Lehman, allowing it an opportunity to plead with more specificity its claim of damages. Because the court did not make a determination on this cause of action, the breach of contract claim is not specifically examined in this article.
[xi] The MRA contained an *ipso facto* clause, declaring an "Event of Default" to include the voluntary commencement of a [counterparty's] chapter 11 proceeding.
[xii] *Id*. at *5.
[xiii] Section 101(47) of the Bankruptcy Code, in relevant part, defines "repurchase agreement" as:

> [A]n agreement, including related terms, which provides for the transfer of one or more . . . mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities or mortgage loans . . . against the transfer of funds by the transferee of such ... mortgage loans, or interests, with a simultaneous agreement by such transferee to transfer to the transferor thereof . . . mortgage loans, or interests of the kind as described in this clause, at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds.

[xiv] The court cited the United States Supreme Court's decision in *Hartford Underwriters Ins. Co v. Union Planters Bank* for the proposition that "when a statute's language is plain, the sole function of the courts, at least where the disposition by the text is not absurd, is to enforce it according to its terms." *Lehman*, 2008 WL 2156323 at *6 (citing *Hartford Underwriters*, 530 U.S. 1, 6 (2000)).
[xv] 11 U.S.C. §101(51).
[xvi] 11 U.S.C. §101(37).
[xvii] Section 555 of the Bankruptcy Code provides, in relevant part:

> The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 365 (e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding.

[xviii] Section 741(7)(A)(i), in relevant part, defines "securities contract" as:

> [A] contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein (including an interest therein or based on the value thereof), or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement,' as defined in section 101).

[xix] The court cited *Pension Benefit Guar. Corp. v. White Consol. Ind., Inc.*, for the proposition that, when evaluating a motion to dismiss, Third Circuit courts "may consider a document which is not part of the complaint if that document is integral to or explicitly relied upon in the complaint." *Pension Benefit*, 998 F.2d 1192, 1196 (3d Cir. 1993).
[xx] Both LBI and Lehman Commercial Paper Inc. were parties to the MRA with AHMIC, and AHMIC had argued that the securities contract safe harbor was thus inapplicable because the termination rights asserted under the MRA were not exercised by "a stockbroker, financial institution, financial participant or securities clearing agency" as required by section 555 of the Bankruptcy Code.
[xxi] N.Y. U.C.C. Rev. §9-109(a)(1) (McKinney 2001).
[xxii] *Id.* at *12.
[xxiii] *Id.* at *13.
[xxiv] *Id.* at *15.
[xxv] Securities and Exchange Act of 1934, 15 U.S.C. §78c.
[xxvi] *See Lehman*, 2008 WL 2156323 at *8 (discussing Third Circuit standard for evaluating extrinsic evidence in the context of a motion to dismiss).
[xxvii] *Id.* at *10 (considering Lehman Brothers Holdings, Inc. Form 10-Q in determining whether such party was a "stockbroker").