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What Does "Commercially Reasonable Determinants of Value" Mean Under Section 562 of the Bankruptcy Code?

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As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Congress added Section 562 to the Bankruptcy Code. Section 562 governs the timing of damage measurements with respect to swap agreements, securities contracts, forward contracts, commodity contracts, repurchase agreements, and master netting agreements that are rejected or terminated in connection with a bankruptcy case. Section 562 provides, in relevant part, that:

- a) If the trustee rejects a . . . repurchase agreement, . . . or if a . . . repo participant . . . liquidates, terminates, or accelerates such contract or agreement, damages shall be measured as of the earlier of –
 - (1) the date of such rejection; or
 - (2) the date or dates of such liquidation, termination, or acceleration
- (b) If there are not any commercially reasonable determinants of value as of any date referred to in paragraph (1) or (2) of subsection (a), damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.

Accordingly, damages are measured as of the earlier of the date of the debtor's rejection of the contract or the date of the eligible party's liquidation, termination, or acceleration of the contract. See In re Enron Corp., 354 B.R. 652 (S.D.N.Y. 2006). If commercially reasonable valuation data is not available as of that date, then Section 562(b) of the

Bankruptcy Code requires that damages be measured as of the earliest subsequent date for which data is available. Realizing that such a valuation system could lead to parties attempting to improve their position by valuing the qualified contract in the future, Congress added a deterrent – if the damages are not measured as of the dates provided in Section 562(a), and either the trustee or the protected party objects to the timing of the measurement of damages, the burden falls on the non-objecting party to prove that there was no commercially reasonable method of calculating the value of the derivative as of the dates specified in subparts (1) or (2). See 11 U.S.C. § 562(c).

In conjunction with adding Section 562, Congress also added Section 502(g)(2) to the Bankruptcy Code, which provides that any claim for damages arising from the post-petition rejection, liquidation, termination or acceleration of a qualified contract under Section 562 shall be treated as a prepetition claim. See 11 U.S.C. §§ 502(g)(2) and 562.

In the approximately 5 years since BAPCPA, there has been very little case law interpreting Sections 562 and 502(g)(2) of the Bankruptcy Code. Recently, a Delaware bankruptcy court delivered the first decision applying Section 562 to a claim based on the termination of a repurchase agreement. See In re American Home Mortgage Corp., 411 B.R. 181 (Bankr. D. Del. 2009). In that case, certain American Home entities and Calyon New York Branch (“Calyon”) entered into a repurchase agreement pursuant to which Calyon purchased certain mortgage loans from American Home. Following American Home’s default, Calyon accelerated the repurchase agreement in accordance with its terms, thereby requiring American Home to repurchase the loans immediately for a price of approximately \$1.14 billion (the “Repurchase Price”). Shortly thereafter, American Home filed for Chapter 11 bankruptcy protection. Calyon submitted a claim slightly in excess of the Repurchase Price. Calyon contended that it could not have obtained a “commercially reasonable price” for the loan portfolio on the acceleration date because, among other things, the market was distressed and, therefore, the only proper valuation methodology for its claim was the market or sale value. Therefore, Calyon measured its claim based on a subsequent market valuation. American Home argued, in turn, that Calyon could not prove that no “commercially reasonable determinants of value” existed on the acceleration date. Rather, Calyon’s claim should be

measured based on a discounted cash flow valuation as of the acceleration date.

The Bankruptcy Court found that the phrase “commercially reasonable determinants of value” in Section 562 was ambiguous, and looked to legislative history for guidance. The Court remarked that the legislative history contains “an acknowledgement that the size of the portfolio or a dysfunctional market would make reliance upon the market price on a specific day unreasonable. . . . Thus, where the market is dysfunctional it may be difficult or impossible to use a market price to assign value to an entire asset or asset pool on a single date – either because the nature of the market mandates that the asset be broken up and sold off in multiple pieces on multiple dates (thereby making it impossible to measure damages on a single date) or because the nature of the market at given time would result in having to sell or liquidate the asset in a commercially unreasonable manner.”

The Court then analyzed the purpose and intent of Section 562 and noted that the common thread for repurchase agreements in the Bankruptcy Code is liquidity: “the primary purpose of the Code provisions relating to repurchase agreements is to preserve the liquidity in the relevant assets, including mortgage loans and interests in mortgage loans. Section 562 serves to align the risk and rewards associated with an investment in those assets.”

The Court ultimately did not find significant assistance from the legislative history or purpose of Section 562, and returned to the fundamental inquiry of assessing an asset’s value. The Court agreed with Calyon that “commercially reasonable determinants of value” means evidence regarding what an asset could be bought or sold for in the marketplace. The Court disagreed, however, that the only pertinent determinants of value are “those that provide evidence of the asset’s actual market price.” Such a reading of Section 562, the Court concluded, was too narrow. The Court reasoned that nothing in Section 562 suggests a limitation on any particular methodology used to determine value, as long as it is commercially reasonable. Furthermore, waiting for the asset to become saleable and/or the market to correct itself might take a long time. In fact, in the case at issue, Calyon took more than a year before selling the asset. The Court opined that “[t]his creates exactly the moral hazard that section 562 was designed to

prevent. In such an instance, the repo participant can sit back and monitor market conditions while being protected, at least in part, from market losses by its potential deficiency claim against the debtor.”

In sum, the Court held that the phrase “commercially reasonable determinants of value” is not circumscribed to the actual sale or market value of an asset, and that a discounted cash flow valuation is a valid method for determining the value of the loan portfolio at issue, which was an income-producing asset. Therefore, Calyon suffered no damages from the termination of the repurchase agreement.

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