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By By Karen Gelernt, David A. Wender and Jonathan T. Edwards

A Must-Read for 'Repo' Counterparties

Few courts have construed the meaning of “repurchase agreement” as used in the Bankruptcy Code, so the recent HomeBanc[1] case out of the United States Bankruptcy Court for the District of Delaware is a must-read for “repo” counterparties.

The principal issue in HomeBanc was whether several zero purchase price repo transactions under the parties’ contract for the sale and repurchase of mortgage-backed securities fell within the definition of a “repurchase agreement” in Section 101(47) of the Bankruptcy Code. The HomeBanc court also weighed in on (1) whether Article 9 of the Uniform Commercial Code’s “commercial reasonableness” standard applies to repo participants’ disposition of securities and (2) the appropriate valuation method to use in valuing securities when the market is dysfunctional.

Repurchase Agreements and the Bankruptcy Code

Under Section 101(47), a repurchase agreement is “an agreement ... which provides for the transfer of one or more ... mortgage related securities ... against the transfer of funds by the transferee of such ... securities ... with a simultaneous agreement by such transferee to transfer to the transferor thereof ... securities ... at a date certain not later than 1 year after such transfer or on demand, against the transfer of funds.”[2]

In other words, a repo is the sale of securities with a simultaneous agreement by which the repo seller agrees to buy back the securities at a later date at a price greater than, or equal to, the original sale price. The spread between the selling price and the repurchase price effectively represents interest, also known as the price differential.

Repurchase agreements are uniquely treated in bankruptcy cases because repo counterparties enjoy protection under the safe harbor in Section 559 of the Bankruptcy Code. Section 559 of the Bankruptcy Code provides: “The exercise of a contractual right of a repo participant ... to cause the liquidation, termination or acceleration of a repurchase agreement ... shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court.”[3]

This safe harbor is an important protection for repo counterparties.

Facts

HomeBanc and the Bear Stearns defendants had entered into two “master repurchase agreements” in 2005. Between 2005 and 2007, HomeBanc obtained significant financing (approximately $200 million) from the Bear defendants through numerous repurchase transactions. In August 2007, HomeBanc was unable to meet certain obligations under the repurchase agreements, and after HomeBanc failed to pay the amounts due under the repurchase agreements in August 2007, the Bear defendants notified

HomeBanc of its various defaults. The litigation before the court involved 10 transactions under the master repurchase agreements, which had a zero purchase price and were payable on demand.

The HomeBanc trustee argued that the transactions could not qualify as repurchase agreements under the Bankruptcy Code because each "confirmation"[4] for the securities at issue had a purchase price of zero. Thus, the HomeBanc trustee argued that "there is no such thing as a zero purchase price repo" because the securities must be transferred in exchange for funds, relying on the definition of repurchase agreement in Section 101(47) of the Bankruptcy Code.

HomeBanc argued that the Bear defendants did not lend any monies to HomeBanc against the securities, but that the securities were transferred to the Bear Defendants and held for future lending transactions. HomeBanc also argued that, even if the zero purchase price repurchase agreements qualified as repurchase agreements under the Bankruptcy Code, the Bear Defendants' auction of the securities at a time when the markets were highly dysfunctional was neither commercially reasonable under Article 9 of the UCC ("Article 9") nor conducted in good faith. Specifically, to support its argument that a discounted cash flow valuation is an appropriate — and the best — method to value securities in a dysfunctional market, HomeBanc relied heavily on the decision in Calyon II.[5] The Bear defendants, on the other hand, used their discretion to determine the net value of the securities as of the default valuation time.

Court's Holding

The court held that the securities at issue satisfied the definition of "repurchase agreement" in Section 101(47) of the Bankruptcy Code, adopting the Bear defendants' so-called "bucket theory."

Under the applicable master agreement, the Bear defendants' "bucket theory" was that each repo transaction was deemed consideration for every other transaction under that master agreement. As such, each transaction with a purchase price greater than zero provided adequate consideration to satisfy the Bankruptcy Code's reference to "transfer of funds," even for the securities with a zero purchase price.

The court's holding hinged on the contractual language in the master agreement, which stated that "payments, deliveries and other transfers made by either [party] in respect of any Transaction shall be deemed to have been made in consideration of payments, deliveries and other transfers in respect of any other Transactions hereunder."

Moreover, the court alternatively held that the zero purchase price transactions satisfied the "catchall provision" of the Bankruptcy Code definition of repurchase agreements, which provides, in pertinent part, that a "repurchase agreement" means any security agreement or arrangement or other credit enhancement related to any agreement or transaction referred to in clause (i), (ii), (iii) or (iv) ..."

Because the zero purchase price transactions qualified as repurchase agreements under the Bear defendants' "bucket theory," as well as under the plain language of the catchall "credit enhancement"provision in the Bankruptcy Code, the Bear defendants were protected by the safe harbor in Section 559 and did not violate the automatic stay when they exercised their rights under the master agreement.

The court also disagreed with HomeBanc's assertion that the court should adopt Article 9's commercial reasonableness standard — an objective test — in judging the Bear defendants' auction of the securities. In doing so, the court followed the Lehman and Granite Partners cases.[6]

Instead of applying the commercial reasonableness standard, the court construed the contractual language in the master repurchase agreement requiring "reasonableness" to invoke a "rationality test." According to the court, the cornerstone of the rationality test is that it effectively places the resolution of the parties' conflicting interests in the hands of the party exercising discretion. So long as the decision maker acts in a way that is not arbitrary, capricious, perverse and irrational, the exercise of direction can be said to be reasonable.

Further, the court considered HomeBanc's assertion that the Bear Defendants acted in bad faith by valuing the securities using a "market" value in August 2007 when the market was in turmoil. The HomeBanc trustee relied heavily on Calyon II. The HomeBanc court, however, found Calyon II inapposite, reasoning that, in that case, both the debtor and the repo participant (Calyon) asked the Calyon II court to determine Calyon's deficiency damage claim under Bankruptcy Code § 562, which provides that a repo participant's "damages shall be measured as of the earlier of ... the date or dates of such liquidation, termination or acceleration."

In HomeBanc, the court distinguished Calyon II, stating that "the Bear defendants are not seeking damages under Bankruptcy Code § 562 and the reasoning of Calyon II is not applicable." The Bear defendants' liquidation of the securities at issue by auction pursuant to Section 559 requires a different analysis than the damages question of Section 562.

Section 559 does not use the phrase "commercially reasonable determinants of value" and does not require the backward-looking analysis found in Section 562 that Calyon II required. Instead, Section 559 specifically permits disposing of assets by liquidation at "market prices." Accordingly, the court concluded that it would be inappropriate to use hindsight to declare the Bear defendants' decision to liquidate the securities in August 2007 as irrational due to the market's "dysfunctional" status at that time. In short, the court afforded the Bear defendants discretion in making the decision to sell.

Takeaway

Examine your master agreements. The bankruptcy court did not focus on the transactions in isolation, but in light of the provisions of the master agreement, which contained favorable language for zero price confirmations. Repo participants should ensure their master contracts contain language preserving the "bucket theory" argument. Given that few courts have construed the definition of "repurchase agreements," this case is a welcome addition to this particular area of the law. Finally, the court's interpretation of the reasonableness requirement in the master repurchase agreement to amount to a "rationality test" should provide repo participants some comfort when exercising their remedies following an event of default.