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LEGAL & REGULATORY CONSIDERATIONS

Mortgage repo redux: will the Code's broadened protections be broad enough

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With the enactment of the Bankruptcy Code in 1978 and its early amendments, Congress demonstrated its concern about the volatile nature of the financial markets by including certain protections to prevent the insolvency of one player from spreading to others, threatening the collapse of an entire market. For example. Sections 546(e), (f) and (g) shield certain types of payments made by or to certain market participants, including commodity brokers, forward contract merchants, stockbrokers, financial institutions, securities clearing agencies and repo participants (each, a 'Protected Party') in connection with certain market transactions, such as forward contracts, securities contracts, commodity contracts, repurchase agreements or swap agreements (each, a 'Protected Contract'), from most of the debtor's avoidance powers. Sections 362(b)(6), (b)(7) and (b)(17) exempt from the automatic stay the post-petition exercise of a Protected Party's contractual rights under a Protected Contract. Also, Sections 555, 559 and 560 allow Protected Parties to liquidate and terminate their Protected Contracts after a bankruptcy filing. Recognising the evolving nature of our complex financial markets, Congress increased the category of Protected Parties and the types of Protected Contracts, and further curtailed the bankruptcy court's ability to interfere with the exercise of these parties' post-petition remedies, with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) and the technical amendments incorporated in the Financial Netting Improvements Act (FNIA, together with BAPCPA, the 'Amendments'), which took effect on 12 December 2006.

More recently, a Delaware bankruptcy court reinforced, and arguably expanded, the protections of Section 546(e) in *Official Committee of Unsecured Creditors of the IT Croup vs. Acres of Diamonds (In re: IT Group),* Adv. Pro. No. 04 51311(MFW)(Bank. D. Del. Dec. 29, 2006.

While these welcome developments are encouraging, recent Chapter 11 filings in the heavily securitised subprime mortgage industry may test the newly broadened provisions. In particular, several subprime mortgage lenders, who generally lend to borrowers with poor credit, have recently filed for bankruptcy protection. The safe harbour protections in the Bankruptcy Code are of particular significance to the financial institutions that purchase loans from and extend credit to mortgage companies based on the belief that their contractual remedies and pre-and post-bankruptcy transfers would be insulated from attack because of the Amendments. If these protections are not available, the ripple effect of these defaults through the financial system could be dramatic.

The safe harbour provisions

The safe harbour provisions are designed to, among other things, limit the application of two basic principals of American bankruptcy law: the imposition of the automatic stay and the concept of equitable distribution among creditors. In that regard, several provisions of the Bankruptcy Code limit non-debtor parties' contractual rights upon the debtor's bankruptcy filing and are designed to force a party to return certain types of payments received from the debtor prior to the filing. For example, Section 362 imposes a stay prohibiting the counterparty from exercising its rights and remedies post-petition, including its contractual right to set off or foreclose upon its collateral, and Title 5 of the Bankruptcy Code allows the debtor to recapture avoidable payments generally made within 90 days (for preferential transfers) or two years (for fraudulent conveyances) of the bankruptcy filing. Where, however, the subject contract is a Protected Contract, and where the non-debtor party is a Protected Party, that Protected Party may exercise its contractual remedies under a Protected Contract as if the bankruptcy case had not been filed, and will be shielded from the debtor's avoidance powers.

The recent amendments

Prior to BAPCPA, the definition of a Protected Contract was significantly more limited and the range of Protected Parties more circumscribed. Among the more significant changes are: the expansion of the definition of swap agreements to include almost every type of derivatives contract; the addition of master netting agreements to the list of Protected Contracts and the addition of Section 362(b)(27) of the Bankruptcy Code to exempt such agreements from the automatic stay; and the addition of Section 362(o) of the Bankruptcy Code, which enjoins the bankruptcy court from interfering with a Protected Party's right to exercise its contractual remedies under the applicable subsections of Section 362(b).

Of particular relevance to the mortgage financing industry are: the amendments to the definitions of 'repurchase agreement' and 'securities contract' to expressly include such agreements relating to mortgage loans; the expansion of the definition of 'repo participant' to include any party that had an outstanding repurchase agreement with the debtor at any time prior to the bankruptcy filing, and the addition of 'financial participant' to the list of Protected Parties. 'Financial participant' includes any entity who, at the time it entered into a Protected Contract or as of the bankruptcy filing, was a party to other Protected Contracts that had (i) a total gross dollar value of at least $1bn in notional or actual principal amount outstanding or (ii) gross mark-to-market positions of not less than $100m, on any day during the 15-month period preceding the bankruptcy filing.

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Even more directly relevant is the recent enactment of FNIA, in which Congress further amended Sections 362(b)(7) and (b)(6) to expand the rights previously available to Protected Parties under the prior version of the statute. H.R. Rep. 109-648, 109th Cong. 2d Sess. (2006). In relevant part, these amendments expanded the earlier protections of Protected Parties by permitting the exercise of any remedy available under or in connection with the Protected Contract, despite the imposition of the automatic stay, and doing away with the requirement that a payment be a 'settlement payment' to qualify for protection. Moreover, the amendments also appear to dispose of any challenge to a Protected Party's setoff based upon lack of mutuality, by eliminating the concept from the statute and instead permitting a Protected Party to exercise any contractual right.

As is evident from the foregoing, and as the legislative history confirms, the Amendments significantly expanded the protections available to shelter financial markets from systemic collapse when parties to these transactions file bankruptcy.

IT Group

In *IT Group,* the debtor's subsidiary had purchased certain unlisted shares from the defendant, making payment by a wire transfer through the debtor's account at Citibank. Plaintiff (the litigation trustee for the debtor's estate) argued that the payment was not a true 'settlement payment' and should not be protected by the safe harbour provisions of Section 546(e). Defendant's summary judgement motion included a one page argument contending that Section 546(e) did apply and the transfer could NOT be avoided because the payment to complete the sale was made on account of the purchase of a security (the unlisted shares) by a financial institution (the wire from Citibank). Plaintiff argued that the technical reading of a 'settlement payment' was inapplicable because the transaction did not involve a public stock market, a clearing or settlement agency or any other financial intermediary that had a beneficial interest in the stock.

Judge Walrath agreed with the defendant. Citing Third Circuit precedent, she ruled that the transfer was protected. It was irrelevant whether the sale was made privately rather than on a public stock market. This decision reflects how powerful the protections of these sections may be, not just for financial institutions, but even for parties who simply effectuate sales of securities through such institutions.

Financial participants in the subprime mortgage market

Financial institutions provide 'warehouse financing' through 'master repurchase agreements' with mortgage loan originators (i.e, the subprime lenders) who transfer the mortgage loans in exchange for the transfer of funds, with a simultaneous agreement by the warehouse provider to transfer back (or re-sell) such mortgage loans to the originator against the transfer of funds (typically called the 'repurchase price') at the request of the originator. During this interim period, the warehouse provider is deemed the owner of the mortgage loans and is generally permitted to treat the loans as its property to, among other things, enter into its own repurchase transactions involving the mortgage loans. At the same time, the originator attempts to package these mortgage loans for sale to other financial institutions through 'master purchase agreements,' after which the mortgages are generally packaged into securitisations. Once a buyer is found, the originator buys back the mortgage loans from the warehouse provider and then sells the loans.

Based upon the foregoing, it would appear that these warehouse facilities should qualify as 'repurchase agreements' (and possibly securities contracts) and the warehouse providers should qualify as 'repo participants' and, if they are large enough, 'financial participants'. That is because the master *repurchase* agreements provide for (i) the transfer of mortgage loans (ii) against the payment of cash (i.e., the purchase price) to the debtor, and (iii) simultaneous agreement to re-transfer such mortgage loans to the debtor within on demand (and usually within 1 year) against (iv) the payment of cash. 11 U.S.C. § 101(47)(A)(i). 'Master' repurchase agreements qualify as repurchase agreements by definition. 11 U.S.C. § 101(47)(A)(iv)

It would further appear that master *purchase* agreements also constitute 'securities contracts'. That is because such agreements are contracts for the purchase or sale of mortgage loans. 11 U.S.C. § 741(7). Prior to BAPCPA, the definition of securities contract did not include a contract for the purchase or sale of mortgage loans.

Because these agreements appear to be Protected Contracts, the financial institutions that provide warehouse financing and purchase the originators' mortgage loans should be protected by the Amendments. Moreover, most Wall Street firms that are active in this industry operate through multiple entities, with one subsidiary acting as a warehouse lender while another buys the mortgage loans for syndication. Those separate entities should also be able to take advantage of the 'cross netting' provisions of the Amendments to offset their respective claims against and obligations to a debtor, notwithstanding the general requirement of 'mutuality' for exercising such rights.

It is therefore probable that financial institutions will continue to provide financing to loan originators and supply the necessary liquidity for the mortgage market. On the other hand, the impact on the financial markets could be significant if the applicability of the Amendments to these agreements is challenged. Because the provisions of BAPCPA and FNIA discussed in this article have yet to be tested, it still remains to be seen if the Amendments will have their intended results. ■

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