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Subprime financiers take note: BAPCPA may not save the day for repurchase agreement participants

BY WALTER H. CURCHACK

It has been estimated that over $200bn of subprime mortgage loans will default over the next year. Within the last 18 months, over 100 mortgage companies have closed, filed for bankruptcy, or sold their businesses, including 15 of the top 25 subprime lenders. The 2007 vintage of subprime loans is already defaulting at a higher rate than 2006, with over 6 percent of securitised loans suffering 'serious loan delinquencies' within the first three months, compared with a rate of 4 percent for 2006. Given the likelihood that the majority of the adjustable rate subprime mortgages written in 2006 will be restating their below-market, initial rates during 2008, there likely will be an ever increasing number of delinquencies ahead. The economic consequence of these defaults will be magnified as a result of the growth of and changes in the financial markets. For example, more than a quarter of the collateralised debt obligations issued in the last year consist of subprime collateral. In fact, the overall market for such derivatives now dwarfs the value of the underlying assets.

Balanced against these troubling developments, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) has significantly changed bankruptcy practice in the US, making restructuring harder to accomplish. BAPCPA also was intended to provide additional protections for financial participants, such as issuers of the structured financial products that provide the principal financing to today's subprime mortgage lenders. As the subprime market collapses, however, the effectiveness of these protections is being tested. It is not at all clear that they will be up to the challenge.

The Bankruptcy Code includes several, now expanded, 'safe harbour' provisions. These allow protected counterparties to certain types of financial contracts, such as mortgage loan repurchase agreements, to exercise their contractual rights to terminate, liquidate or accelerate such contracts with a debtor and set off or net out their obligations without having to contend with the automatic stay and other provisions of the Code. The rationale behind the enactment of the safe harbour provisions is that absent such protections, non-debtor counterparties would be harmed by the bankrupt debtor's default and, as a result, be unable to meet their other market commitments, which could, in turn, cause their counterparties to fail to meet their commitments, creating a domino effect which could undermine the entire market.

Though BAPCPA is still relatively new, a number of cases have already started to address these issues. For example, one recent case (not involving mortgages) has challenged the broad definition of a 'swap' in the recent Bankruptcy Code amendments, holding that a contract to provide natural gas, even though couched as a 'swap', is not necessarily a futures contract, and therefore not entitled to the safe harbour protections.

In the Chapter 11 proceedings of one subprime mortgage company, the debtor has commenced discovery against the pre-petition lenders who financed the debtor's loan origination business through what they thought would be protected 'repurchase agreements', seeking evidence to challenge whether the underlying transactions in fact qualify as 'repos' or other financial contracts entitled to the protection of the recent amendments to the Code.

Warehouse lenders and repo counterparties generally have the right under their repo documentation to replace the debtor as servicer of the underlying mortgages. However, the debtor (or its unsecured creditors) will likely view such a change as an attempt to deprive the estate of an asset (i.e., the servicing revenue) without having provided sufficient consideration. Whether such rights are severable from the 'repo' itself has already been raised as an issue and will be hotly contested. A somewhat related issue has arisen in cases where the debtor proposes the sale of its servicing platform. The counterparties have challenged the sales (generally without success) on the theory that the proposed assignee of the servicing rights must the meet the higher standards required under their financing documents rather than the typical Bankruptcy Code standard of adequate assurance of future performance required in connection with the assignment of an executory contract.

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While many aspects of unwinding repos and similar agreements are addressed in the Code, many more are not. For example, it seems clear that a repo participant can liquidate its collateral. But what if the collateral is, for whatever reason, not in the creditor's possession at the time of the filing? The Bankruptcy Code is silent on that point and a number of lenders have asserted possessory rights in so-called 'wet' loans or 'scratch and dent' loans where for one reason or another the actual mortgage file may be incomplete or not in the lender's possession. Thus, even though a creditor in possession of the files can act, the Code may not authorise the turnover of files still in the possession of the debtor. In fact, one bankruptcy court has so held, refusing to order the debtor to turn over ▸▸

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such files to repo participants who had purchased the loans, and sought to enforce their rights under the safe harbour provisions.

Another issue *not* adequately resolved by BAPCPA is when and how the debtor and its counterparty will value any deficiency or dispose of the collateral, including whether or not the standards of Article 9 of the Uniform Commercial Code (UCC) apply. Under Bankruptcy Code Section 562, damages with respect to the termination of a financial contract arise either upon rejection of the contract or when the counterparty exercises its default rights. While the most likely date for measuring such damages is the date the counterparty asserts its rights under the contract, section 562(b) of the Code permits damages to be measured at a later date in the event there is no commercially reasonable measure of collateral value on the earlier date. The correct date may also shift depending on whether the collateral is of a type which is sold in a 'recognised market', an issue likely to be in dispute since the standard discussed in the commentary to the latest standard industry form contradicts the Official Comments to the UCC.

While the outcome of these challenges will most likely depend on the specific language of particular contracts, the decisions rendered in the first few cases will significantly alter the balance of power in negotiations over similar provisions going forward.

It comes as no surprise, then, that many of the skirmishes over these issues to date have been resolved by negotiated stipulations. However, in many cases those stipulations 'reserve' all parties' rights and once the liquidation (or sale) of the debtor is complete, it is likely that litigations will be brought by the successors to the debtors against the pre-petition counterparties.

BAPCPA also has not done anything to resolve the many traditional 'lender liability' causes of action that are also likely to be brought against repo counterparties as a result of the subprime meltdown. These include, for example, breach of express or implied contract. An implied contract is one whose existence and terms are manifested from the conduct of the parties. An implied contract can be found if both parties intended to be bound and the intent of the parties can be inferred from their conduct or other facts and circumstances. Given the rapid growth of the subprime mortgage industry, and the accepted custom of dealing on unsigned 'trade confirms', there are likely to be many transactions where the parties' agreements will need to be 'imputed'. Interestingly, the Bankruptcy Code sections that address the termination, liquidation and acceleration of financial contracts specifically state that a counterparty's contractual rights include, inter alia, "a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice" (emphasis added).

Equitable subordination will also likely be raised as a challenge to the claims of the major banks and brokerage houses that financed the subprime mortgage companies. Under this theory, a creditor's claims against the debtor can be subordinated to the claims of some or all of the other creditors in a case. Establishing equitable subordination requires three findings: (i) that the claimant engaged in some type of inequitable conduct, (ii) that the misconduct injured creditors or conferred an unfair advantage on the claimant, and (iii) that subordination would not be inconsistent with the Bankruptcy Code. There are generally three situations where courts will apply the equitable subordination doctrine: (i) when a fiduciary of the debtor misuses its position to the disadvantage of others, (ii) when a third party dominates or controls the debtor to the disadvantage of others, or (iii) when a third party defrauds other creditors.

In one recent case, a Wall Street lender successfully defeated an attempt to subordinate its secured claim. The trustee in the First Alliance bankruptcy sought to equitably subordinate the claim on the theory that by aiding and abetting First Alliance's fraud, the lender's actions increased the amount of unsecured claims, thus depleting the pro rata share that each unsecured creditor would have of the remaining assets. The Ninth Circuit Court of Appeals, however, determined that the lender's knowledge of the fraudulent actions of First Alliance, and even its substantial assistance in those actions, did not constitute inequitable conduct sufficient to equitably subordinate its bankruptcy claims. The court noted, among other things, that the lender's conduct was not a contributing factor to bringing about the bankruptcy, that the lender did nothing to improve its status as a creditor at the expense of other creditors, that the lender's conduct did not deplete or otherwise adversely impact First Alliance's assets, and that its conduct was not related to the acquisition or the assertion of its secured claim.

In another recent case, a major Wall Street firm was sued for WARN Act damages by the employees of a mortgage originator and packager, which was forced to shut down when the firm stopped providing funding. The Court of Appeals for the Second Circuit held that the issue was whether the creditor exercised control beyond what was necessary to recoup some or all of what it was owed and, in effect, was operating the debtor as the 'defacto' owner of the business. The court went on to say that a creditor may exercise very substantial control in an effort to stabilise a debtor and/or even seek a buyer in an effort to recover its loan or security. Significantly, though, the court stated that when such an exercise of control goes beyond that reasonably related to 'collection' and amounts to the operation of the debtor as an ongoing business without any apparent debt protection scenario, liability could be found.

Thus, despite the changes introduced by BAPCPA, there are likely to be a number of issues litigated between subprime lenders and their former financiers in the coming months and years. ■

Author's note: This article only addresses issues relating to the relationship between insolvent mortgage lenders and their counterparties in the financial markets. In doing so, we do not mean to ignore the fact that millions of homeowners may be displaced as a result of this crisis nor the negative impact of recent changes to the Bankruptcy Code on individual debtors.

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