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THE DELAWARE BANKRUPTCY COURT CLARIFIES STANDARDS FOR EVALUATING WHETHER CERTAIN TRANSACTIONS CONSTITUTE "REPURCHASE AGREEMENTS" UNDER THE BANKRUPTCY CODE AND HOLDS THE COMMERCIAL REASONABLENESS STANDARD OF UCC ARTICLE 9 DOES NOT APPLY TO A FORECLOSURE OF NOTES UNDER A REPURCHASE AGREEMENT

On May 23, 2008, the Delaware Bankruptcy Court, in *American Home Mortgage Investment Corp. v. Lehman Brothers Inc., et al.*, Adv. Proc-No. 07-51739 (CSS), held that: (i) the master repurchase agreement (the "MRA") in question is a "repurchase agreement" under the Bankruptcy Code and therefore the "safe harbor" provisions of sections 559 and 555 of the Bankruptcy Code are applicable; (ii) Lehman did not violate the automatic stay when it exercised its rights under an "*ipso facto* clause" that permitted Lehman to terminate the MRA based on the debtor's bankruptcy filing and foreclose on the subordinated notes it had purchased under the MRA; and (iii) Lehman was not constrained by the commercial reasonableness standard contained in Article 9 of the Uniform Commercial Code when it exercised its rights under the repurchase agreement to liquidate and/or foreclose on the subordinated notes.

Prior to its bankruptcy filing, American Home Mortgage Investment Corp. ("AHMIC") was engaged in the business of originating residential mortgage loans. AHMIC would sell these mortgage loans to special-purpose entities that issued commercial paper and subordinated debt in order to raise funds to purchase the mortgage loans from AHMIC. In June 2005 and July 2007, AHMIC purchased certain subordinated notes from Lehman, under the terms of the MRA. AHMIC and Lehman then entered into a separate transaction under the MRA in which AHMIC sold these same subordinated notes back to Lehman in accordance with the terms of the MRA. On July 26, 2007, Lehman made a margin call in connection with that transaction, which AHMIC failed to satisfy. On August 1, 2007, five days prior to AHMIC's Chapter 11 bankruptcy filing, Lehman sent a notice to AHMIC, declaring an event of default under the MRA. On August 27, 2007, Lehman notified AHMIC that it had terminated the MRA and that it had foreclosed or intended to foreclose on the subordinated notes, instead of selling them to a third party. Following these events, AHMIC filed a complaint against Lehman in which it sought, among other things, certain declaratory relief. A summary of the Court's legal discussion is below.

The MRA is a "repurchase agreement" under the Bankruptcy Code and the "safe harbor" provisions of sections 559 and 555 of the Bankruptcy Code are applicable.

In this portion of its decision, the Court discussed certain background relating to the market for repurchase agreements and the special protections provided by the Bankruptcy Code to protect the liquidity of repurchase agreements. The Court outlined the two-part inquiry it must make in order to determine whether the MRA is a "repurchase agreement." First, the Court said that it must determine if the subordinated notes qualify as either mortgage related securities, mortgage loans, interests in mortgage related securities, or interests in mortgage loans. Being that the term "mortgage related securities" is the only one of those terms defined by the Bankruptcy Code, the Court started with that definition. The Court noted that the subordinated notes are not "mortgage related securities" because neither Standard and Poor's nor Moody's gave the subordinated notes one of their highest ratings. Guided by its conclusion that the subordinated notes are not "mortgage related securities," the Court quickly determined that they are not "interests in mortgage related securities." The Court found that the mortgage loans securing the

subordinated notes qualified as "mortgage loans," as that term is used in section 101(47)(A) of the Bankruptcy Code. As a result, the Court determined that "a holder of the subordinated notes holds an interest in the mortgage loans owned by [the SPE], or, more simply put, an interest in the mortgage loans."

For the second part of the two-part inquiry, the Court said that it must determine if the structure of the MRA follows the structure of a "repurchase agreement," as defined by section 101(47) of the Bankruptcy Code. The Court then found that the MRA satisfied all of the necessary structural elements. As a result of this two-part inquiry, the Court concluded that the MRA falls within the definition of a "repurchase agreement" under the Bankruptcy Code, triggering the applicability of the safe harbors contained in section 559 of the Bankruptcy Code. In addition, the Court determined that the MRA fits within the definition of a "securities contract" under the Bankruptcy Code because the MRA is a "repurchase agreement," the subordinated notes are "interests in mortgage loans," and Lehman is a "stockbroker," as these terms are used in the Bankruptcy Code. Thus, the Court also found that the safe harbor provision of section 555 of the Bankruptcy Code applies to the MRA.

Lehman did not violate the automatic stay imposed by section 362(a) of the Bankruptcy Code when it exercised its rights under an *ipso facto* clause.

Having determined that the safe harbor protections of sections 559 and 555 of the Bankruptcy Code apply to the MRA, the Court then looked to see whether Lehman was permitted to exercise its rights under an *ipso facto* clause contained in the MRA. The Court observed that although the Bankruptcy Code generally prohibits non-debtor counterparties from enforcing *ipso facto* clauses, the safe harbor provisions of sections 559 and 555 provide an exception to this general rule and allow non-debtor counterparties to exercise contractual rights to liquidate, terminate or accelerate a repurchase agreement or securities contract. Because the safe harbor provisions apply to the MRA, the Court held that Lehman's enforcement of its rights under the *ipso facto* clause in the MRA was not prohibited by section 365(e) or section 362(a) of the Bankruptcy Code. Accordingly, the Court found that Lehman was permitted to enforce its rights under the MRA by foreclosing on and/or liquidating the subordinated notes.

UCC Article 9's commercial reasonableness standard did not constrain Lehman's exercise of its foreclosure rights under the MRA.

For what appears to be the first time following the amendments to the Bankruptcy Code made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the Court addressed the issue of whether the commercial reasonableness standard contained in Article 9 applies to repurchase agreements. In deciding this issue, the Court first observed that the MRA expressly states that the parties' intent was "that all Transactions hereunder be sales and purchases and not loans." However, the Court also observed that the MRA further states that "in the event any such Transactions are deemed to be loans, Seller shall be deemed . . . to have granted to Buyer a security interest in all of the Purchased Securities with respect to all Transactions hereunder and all Income thereon and other proceeds thereof." Based upon these provisions, the Court stated that the only situation in which AHMIC will be deemed to have granted Lehman a security interest is if the Court determined that the subordinated notes transaction is a loan. The Court then considered the operative provisions of the MRA, which included terms such as "Buyer," "Seller," "Purchased Securities," and "Purchase Price." After completing its review of both the stated intent of the parties and the operative provisions of the MRA, the Court concluded that the MRA was a purchase and sale agreement and, therefore, the provisions of the MRA concerning the creation of a contingent security interest did not come into play.

The Court went on to observe that Article 9 nevertheless applies to certain purchase and sale agreements, including the sale of accounts, chattel paper, payment intangibles, and promissory notes. AHMIC had argued that the subordinated notes qualify as both "promissory notes" and "payment intangibles." The Court recognized that the Article 9 commercial reasonableness standard that AHMIC sought to impose on Lehman is limited in that context. Specifically, the Court pointed out that although section 9-610 of the UCC outlines the standards applicable to post-default collateral dispositions, including commercial reasonableness, section 9-601(g) of the UCC provides that "this part imposes no duties upon a secured party that is a . . . buyer of . . . payment intangibles, or promissory notes." Given that the MRA is a purchase and sale agreement and the commercial reasonableness standard of Article 9 does not apply to the subordinated notes as either "promissory notes" or "payment intangibles," the Court held that Lehman's foreclosure and/or liquidation of the subordinated notes is not governed by Article 9 and the commercial reasonableness standard it contains.

The Court's decision may be read as holding that if property subject to a valid repurchase agreement is the sale of accounts, chattel paper, payment intangibles, and promissory notes, the buyer has no duty to comply with the commercial reasonableness standard contained in section 9-610 of the UCC in exercising its foreclosure/liquidation rights.