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MARCH 23, 2020

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The HomeBanc Case – Implications for Repurchase Agreements

On December 24, 2019, the United States Court of Appeals for the Third Circuit (the "Third Circuit") issued an important ruling in *In re HomeBanc Mortgage Corp., et. al.*[1] that clarified several issues which frequently arise in repurchase agreements[2]:

1. Do assets that have a zero-dollar purchase price constitute repurchase transactions that are protected from the automatic stay upon a debtor's bankruptcy?

The Third Circuit ruled that assets with a zero-dollar purchase price are credit enhancements and not repurchase transactions. However, since credit enhancement is part of the definition of "repurchase agreement," it receives the protection of Section 559 of the Bankruptcy Code and the exemption from the automatic stay.

2. What valuation standards must a purchaser follow in liquidating assets after default?

The Third Circuit paid deference to the standard set forth in the repurchase agreements at issue, holding that a liquidation will not be subject to the automatic stay if, as provided in these repurchase agreements, there is a good faith valuation of the assets.

3. What are "damages" under Section 562 of the Bankruptcy Code, and must a non-breaching party bring a claim for them? Does the restriction under Section 562 of the Bankruptcy Code limit when credit enhancements can be liquidated?[3]

The Third Circuit held that "damages" as used in Section 562 of the Bankruptcy Code refers to a legal claim (as opposed to a loss, deficiency or shortfall). For Section 562 of the Bankruptcy Code to be implicated, a deficiency claim must be brought. Further, due to pragmatic considerations involved in liquidating securities, Section 562 does not limit when credit enhancements can be liquidated.

4. Do the liquidation provisions of Section 559 of the Bankruptcy Code apply when no excess is realized from the liquidation of assets?

The Third Circuit held there is no requirement that any excess be realized for Section 559 of the Bankruptcy Code to be applied.

SUMMARY OF THE CASE

HomeBanc Corp. ("HomeBanc") was in the business of operating, securitizing, and servicing residential mortgage loans. From 2005 through 2007, it obtained financing for mortgage backed securities from Bear Stearns & Co., Inc. and Bear Stearns International Ltd. ("Bear Stearns") pursuant to two repurchase agreements. Pursuant to these agreements, HomeBanc transferred securities to Bear Stearns, including nine (the securities at issue, "SAI") that required repurchase on demand and had a purchase price of zero. The repurchase date for the securities (including the SAI) was August 7, 2007 (the "Repurchase Date"), and the repurchase price was around $64 million. Bear Stearns was concerned about HomeBanc's ability to repurchase all of the securities and offered to extend the Repurchase Date if HomeBanc paid down the transactions by $27 million. Alternatively, Bear Stearns offered to buy all of the securities for around $60.5 million. HomeBanc rejected both of these offers and failed to repurchase the securities on the Repurchase Date, thereby defaulting on its obligations under the repurchase agreements. Bear Stearns made a demand for payment followed by a formal default notice on August 9, 2007 and on that same day HomeBanc filed for Chapter 11 bankruptcy.

Under the terms of the repurchase agreements, Bear Stearns was required to determine the value of the securities upon a default. Bear Stearns, claiming that they owned the securities, decided to assess their fair market value[4] via an auction. Bear Stearns sent bid solicitations over a period of around 4 days to approximately 200 different entities, including to multiple individuals within the same entity. They also sought bids from their mortgage trading desk and put safeguards in place to guard against the desk having any insider advantages. The auction ultimately only yielded two bids, one was for $2.2 million for two of the securities and the other and successful bid, from the Bear Stearns trading desk, was for $60.5 million for all of the securities (other than one which JP Morgan had previously bid on but was later sold via auction to Bear Stearns for a higher price). The securities were ultimately transferred to the Bear Stearns trading desk.

HomeBanc's bankruptcy filing was subsequently converted to a Chapter 7 liquidation proceeding and the trustee for the HomeBanc estate brought several claims against Bear Stearns including for (i) conversion for selling the SAI (which HomeBanc claimed they had superior title to), (ii) violating the automatic stay for the SAI and (iii) breach of contract for improperly valuing the SAI. The Bankruptcy Court determined that the SAI (i) were repurchase transactions subject to Section 559 of the Bankruptcy Code and thus could be liquidated, (ii) were not subject to the automatic stay, and (iii) were required, per the terms of the applicable repurchase agreement, to be rationally appraised in good faith and that Bear Stearns' method of utilizing an auction was typical industry practice and complied with the applicable repurchase agreement. On appeal, the District Court affirmed the determination that the Section 559 safe harbor applied but on slightly different grounds. The District Court found that the SAI were credit enhancements under Section 101(47)(A)(v) of the Bankruptcy Code, and not repurchase agreements under Section 101(47)(A)(i) of the Bankruptcy Code[5]. However, since the credit enhancements were part of the repo transactions, the SAI were still subject to the protections of the Section 559 safe harbor provisions. The District Court remanded two issues to the Bankruptcy Court: (i) did Bear Stearns act in good faith in valuing the SAI, and (ii) was the auction conducted in a way to dissuade additional bidders. On remand, the Bankruptcy Court held that Bear Stearns acted in good faith in determining value by auction. It noted that although the residential mortgage backed security market was in turmoil at the time of the auction, it was still functioning and there was no indication as to when it would stabilize. Therefore, it was reasonable for Bear Stearns to utilize the auction process to liquidate the collateral. The Bankruptcy Court ruled that (i) the auction process was conducted in a reasonable manner with sufficient time and with many potential buyers and safeguards to prevent the Bear Stearns bid from having an unfair advantage and (ii) the auction valuation was a good faith determination of the fair market value of the SAI.

During a subsequent appeal to the District Court, HomeBanc argued, among other things, that since the SAI were credit enhancements and not repurchase agreements under Section 101(47)(A)(i) of the Bankruptcy Code, they were subject to the damage limitation under Section 562 of the Bankruptcy Code; namely that the credit enhancement not exceed the damages in connection with the transaction. HomeBanc also challenged the auction process, questioning whether a good faith effort was made by Bear Stearns (who was the purchaser at the auction and the sole bidder for the SAI) to determine the fair market value of the securities. In particular, HomeBanc reasserted that a functioning market for mortgaged-backed securities did not exist at the time the auction was conducted. The District Court disagreed with HomeBanc and held that Section 562 of the Bankruptcy Code was inapplicable since Bear Stearns never asserted a claim for damages. Instead, rather the broader protections of Section 559 of the Bankruptcy Code were operative. The HomeBanc trustee then appealed to the Third Circuit.

The pertinent issues before the Third Circuit were: (i) whether "damages" under Section 101(47)(A)(v) of the Bankruptcy Code requires the non-breaching party to bring a claim for damages in order to trigger the damages limitation in Section 562 of the Bankruptcy Code; (ii) whether the Section 559 safe harbor protection can apply to a non-breaching party that has no excess proceeds after the auction; and (iii) whether a reasonable opinion of the securities "fair market value" was obtained in the auction.

As to the first point, the Third Circuit concluded that damages under Section 101(47)(A)(v) necessitates the filing of a deficiency claim prior to triggering the limitations imposed by Section 562 of the Bankruptcy Code. The court looked to the plain meaning of the term "damages"[6] and other sections of the Bankruptcy Code for contextual support. It also considered the practical problems that would arise for differentiating between "credit enhancements" and "repurchase agreements" for any "loss", "shortfall" or "deficiency." As to the second point, the court held that a creditor may exercise rights under Section 559 of the Bankruptcy Code irrespective of whether any "excess" proceeds are generated from the auction (rather, if there are any excess proceeds they must got the bankruptcy estate). Finally, the Third Circuit reaffirmed that the market for mortgage backed securities, while in turmoil, was still functioning and Bear Stearns acted in good faith in determining a fair market value of the securities by utilizing an auction even though the only bid for all of the securities and the ultimate sale was to its trading desk.

CONCLUSION

The HomeBanc ruling has practical implications that are important for both buyers and seller to keep in mind in negotiating and carrying out the terms of repurchase agreements:

5. It is possible to assign a zero dollar purchase price to an asset for "credit enhancement" purposes and still maintain rights under Section 559 of the Bankruptcy Code to liquidate those assets in a default scenario without being subject to the automatic stay.
6. A court will likely defer to the negotiated language in the applicable repurchase agreement as to what standard the non-defaulting party must use to value the assets. Using words like "reasonable", "fair market value" and "sole discretion" in the valuation standard provisions may play a key role in litigation regarding determinations of value in liquidation scenarios.
7. It is not necessary to first incur "damages" in order to liquidate "credit enhancement" assets.
8. The language in Section 559 of the Bankruptcy Code regarding excess proceeds does not require that an excess be realized in connection with the liquidation, rather it means that excess must be given to the bankruptcy estate.

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[1] *In re HomeBanc Mortgage Corp.*, 945 F.3d 801 (3d Cir. 2019).
[2] For a background on mortgage loan repurchase agreements, please see here.
[3] Section 559 of the Code generally permits a non-defaulting party to liquidate collateral, according to the terms of the relevant repurchase agreement, without seeking court approval. Section 562 of the Code also provides a safe harbor, though it requires that “damages” be measured at a certain time and using a “commercially reasonable determinant of value.”
[4] Bear Stearns (under the repurchase agreement which was governed under English law) had to reach a “reasonable opinion” regarding the securities’ “fair market value, having regard to such pricing sources and methods…as [it]…consider[ed] appropriate.” *In re HomeBanc*, 945 F.3d at 806 (quoting from J.A. 1038).
[5] The Bankruptcy Code does not define the term “credit enhancement,” but the term encompasses various ways that a borrower may improve its credit standing and reassure lenders that it will honor its debt obligations. The SAI were held to be a credit enhancement, and not a repurchase agreement covered by Section 101(47)(A)(i), because they had a zero dollar repurchase price and therefore could not be transferred back “…against the transfer of funds…”.
[6] Black’s Law dictionary defines Damages as “[m]oney claimed by, or ordered to be paid to, a person as compensation for loss injury.” Black’s Law Dictionary (11th ed. 2019). The Third Circuit focused on the term “claimed” as support for its ultimate ruling that damages in this context means more than a loss but a volitional act by the non-breaching party to collect on that loss.