Repurchase agreement redux: Mortgage loan originator bankruptcies are back

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The reasons may be different, but mortgage loan originator bankruptcies are making headlines for the first time since the run-up to the 2008 financial crisis. Climbing interest rates on top of high home values have resulted in a sharp drop in origination volume on the heels of rapid growth and expansion, creating financial distress and uncertainty. At least one residential mortgage lender has filed for bankruptcy, while several others have ceased operations or announced massive layoffs.

Over a decade ago, courts first examined whether certain Bankruptcy Code amendments provided a path for parties providing liquidity to mortgage loan originators, traditionally called "warehouse providers," to exercise their contractual rights despite an originator's bankruptcy filing. Although some courts ultimately blessed the applicability of these amendments, continued difficulties likely can be expected — at least as a practical matter — in the enforcement of rights under covered agreements.

Rise of the repo in mortgage loan warehouse lending

During the subprime mortgage lending boom prior to the financial crisis, forward-thinking warehouse providers to mortgage loan originators structured their agreements as repurchase agreements, or "repos," rather than secured credit facilities. The choice was made in anticipation of amendments to the Bankruptcy Code, which, as expected, extended certain "safe harbors" from protections afforded debtors in bankruptcy, such as the Bankruptcy Code's automatic stay, to mortgage loan repos.

Pursuant to these repo arrangements, a warehouse provider, in this context often called a "repo buyer," would purchase mortgage loans subject to the seller/originator's obligation to buy back the loans within specified timing and pricing terms. In practice, the loans generally were put out for bid and a third-party investor would pay the proceeds of sale to the repo buyer, satisfying the originator's obligations. If the originator defaulted, the repo buyer generally could liquidate the collateral or determine the market value of the collateral and apply it to the unpaid repurchase price.

With the anticipated Bankruptcy amendments, mortgage loan repo buyers appeared to have a clear path to enforcement, regardless of an originator's bankruptcy filing. Then the securitization market froze. The housing market crashed. Investor demand disappeared. Without investors to buy the mortgage loans, originators were unable to satisfy their repurchase obligations and sought protection from bankruptcy courts.

What was a repo buyer to do — put the safe harbors to the test and exercise its remedies under the repo, potentially violating the automatic stay, or more conservatively, act as a secured lender and foreclose on collateral under the UCC? The latter would mean seeking relief from the automatic stay and complying with time-consuming public notice and auction requirements. Every day of delay meant a decline in collateral value.

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It was only a matter of time that an originator would challenge a repo buyer's right to act unimpeded by the automatic stay.

A repo, is a repo, is a repo

In 2008, such a challenge was raised in the bankruptcy case of American Home Mortgage Corp. (*In re American Home Mortgage Holdings, Inc.*) The presiding judge, Judge Christopher S. Sontchi of the Delaware Bankruptcy Court, determined that mortgage loan repos were in fact entitled to the safe harbors in sections 559 and 555 of the Bankruptcy Code.

In so holding, the Court relied on the plain meaning of the definition of "repurchase agreement" in Section 101(47) of the Bankruptcy Code ("Succinctly stated, if the definition of 'repurchase agreement' is met, the section 559 safe harbor provisions apply, period."). The Court further found, however, that servicing rights attendant to the agreement were severable and not afforded the protections of the safe harbors.

Later in 2008, the issue came up again in American Home Mortgage's bankruptcy, this time with respect to different mortgage loan repos. Judge Sontchi again found the repos at issue were "repurchase agreements" for purposes of the safe harbor provisions. He stated that without these safe harbors, "the bankruptcy of a counterparty to a repurchase agreement would impair the liquidity of the repurchase agreement and possibly lead to the bankruptcy of the non-debtor counterparties."

Despite that safe harbor protections appear safe as a legal matter, at least in the 3rd Circuit, there still remain practical challenges to the unfettered exercise of rights.

Seemingly feeling constrained by the language of the safe harbors, Judge Sontchi later voiced disapproval of the broad protections accorded to repo counterparties. Specifically, in March of 2014, he argued against the application of safe harbors to mortgage loan repos in a congressional hearing for chapter 11 reform based on the practical options and conduct of repo buyers during the crisis.

Despite the criticism and debate, which may reignite as market conditions create hardships for mortgage originators, the safe harbors remain in place and courts — predominantly 3rd Circuit courts — have largely declined to narrow their scope.

For example, years later in 2019, in the bankruptcy case of Homebanc Mortgage Corp., the 3rd U.S. Circuit Court of Appeals rejected the argument that mortgage-related securities with a purchase price of zero did not meet the definition of "repurchase agreement" and, consequently, found no violation of the automatic stay when the repo buyer there, Bear Sterns, liquidated the securities. (*In re Homebanc Mortgage Corp.*)

FGMC: a case study

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On June 30, 2022, First Guaranty Mortgage Corporation (FGMC), a mortgage originator, filed a chapter 11 bankruptcy petition in the U.S. Bankruptcy Court in Delaware after ceasing operations. It listed several warehouse agreements it used to fund its origination business, identifying three as repos. (*In re First Guaranty Mortgage Corp., et al.*)

Customers Bank (Customers), a warehouse provider for FGMC, faced practical challenges in enforcing its safe harbor rights. Specifically, despite the relatively settled state of the law, Customers reported being "hamstrung" by third parties in exercising its rights and remedies under its repo. Accordingly, several weeks after the bankruptcy filing, Customers asked the court by motion to confirm the applicability of the Section 559 safe harbor, arguing confirmation was needed to obtain third-party compliance.

In its motion, Customers alleged that subservicer Rushmore Loan Management Services LLC (Rushmore) was refusing to comply with Customer's demand that it remit mortgage payments to Customers going forward, instead of to FGMC. Customers also raised having at least some initial difficulties securing compliance from the custodian on the deal, Deutsche Bank.

In defense of its refusal to comply with Customers' demand, Rushmore cited the "complexities associated with this process" and the "absence of clear direction from FGMC." In fact, at the outset of the bankruptcy, and over the objection of Customers, the court entered an interim cash management order that prohibited banks from "offsetting, affecting, freezing, or otherwise impeding the Debtors' use of any funds," which Customers argued would restrict its safe harbor rights.

Whether or not Rushmore's noncompliance resulted from the entry of the interim order, it seems reasonable for a party to be hesitant to alter payment terms in response to a bankruptcy filing where there is concern that the court could find that the funds have been improperly diverted.

Ultimately, the court granted the cash management motion with language expressly authorizing Customers to exercise its rights under the repo. In addition, the bankruptcy court provided the comfort order confirming applicability of the safe harbor as Customers requested. While maybe all is well that ends well, the need for third-party compliance resulted in the preparation of motions, an objection, and otherwise active participation in the bankruptcy case — all in the name of relief that it may have been entitled to by operation of law.

Conclusion

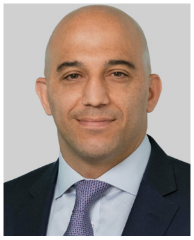
Litigation in the wake of the 2008 housing crisis has provided repo buyers with relative assurance that the automatic stay and other Bankruptcy Code provisions should not prevent them from enforcing their rights under repurchase agreements. However, the exercise of rights included in the safe harbors may not play out seamlessly in practice.

In anticipation of these enforcement issues, repo buyers may consider other contractual protections, such as a lien on the repo collection account, together with a control agreement with the depository bank. However, practically, even if the repo had control of the account, the depository bank may refuse to follow the repo buyer's direction, fearing violations of the automatic stay and improper diversion of estate assets.

Accordingly, to minimize expenditure of resources and delay, repo buyers may wish to file a comfort order at the outset of the originator's bankruptcy case confirming the applicability of a safe harbor to its agreement.

Joseph Cioffi is a regular contributing columnist on consumer and commercial financing for Reuters Legal News and Westlaw Today.

About the authors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