

# The Next Strain of Repo Litigation

*Joseph Cioffi and Joel Melendez\**

The authors of this article discuss a case that is worth examining for its echoes of the past and some important lessons going forward for real estate investment trusts regarding the valuation of collateral and enforcement of rights under repurchase agreements.

As the economic crisis continues to impair the value of commercial mortgage-backed securities (“CMBS”) that collateralize loans to real estate investment trusts (“REITs”) to finance their investments, there is the prospect of increased margin calls, requiring REITs to provide additional funds to make up shortfalls in value. The case of *AG MIT CMO, LLC et al. v. Royal Bank of Canada et al.*,<sup>1</sup> which settled at the outset of the crisis, is worth examining for its echoes of the past and some important lessons going forward for REITs regarding the valuation of collateral and enforcement of rights under repurchase agreements.

## Current Distress in the CMBS Market

Since the start of the COVID-19 crisis, more than a thousand CMBS loans totaling approximately \$40 billion have been transferred to special servicing, according to Fitch.<sup>2</sup> The vast majority of those transfers - more than 900 loans totaling nearly \$36 billion - occurred in the second quarter of 2020.<sup>3</sup> Overall, CMBS conduit delinquencies have seen a “dramatic increase” due to the coronavirus,

with 30-day delinquencies jumping significantly in recent months.<sup>4</sup> The rating agency anticipated delinquency rates to rise to between 8.25 percent and 8.75 percent by the end of the third quarter of 2020.<sup>5</sup> Retail and lodging, which have been particularly hard-hit by temporary closures, have seen the worst concentration of delinquencies.<sup>6</sup>

These troubles have permeated the secondary market. Increased loss expectations resulting from the ongoing economic turmoil have triggered a considerable number of rating actions on CMBS deals. For example, since the beginning of March, Kroll Bond Rating Agency (“KBRA”) has downgraded 113 classes across 34 CMBS conduit transactions and has placed many more on Watch Downgrade, with retail and lodging loans comprising a significant proportion of the affected transaction balances.<sup>7</sup>

There have been calls for regulators to provide additional flexibility and liquidity to real estate participants to prevent further widespread disruption to the markets. For example, regulators have been implored to take a col-

\* Joseph Cioffi is a partner at Davis & Gilbert LLP and the chair of the firm’s Insolvency, Creditors’ Rights & Financial Products Practice Group. Joel Melendez is an associate within the group. The authors may be reached at [JCioffi@dglaw.com](mailto:JCioffi@dglaw.com) and [JMelendez@dglaw.com](mailto:JMelendez@dglaw.com), respectively.

laborative approach to sustain the CMBS market and halt the “significant margin call[]” activity which had “result[ed] in a severe liquidity crisis across the entire real estate finance market.”<sup>8</sup> Similar pleas have been made by other market participants seeking to alleviate downward price pressure on MBS and other real estate-backed assets.<sup>9</sup> To be sure, state and federal agencies have taken remarkable steps to stabilize markets and, more specifically, to enact policies to provide much-needed relief to REITs.<sup>10</sup> However, further measures may be required.

### **AG vs. RBC**

The litigation between AG MIT CMO (“AG”) and Royal Bank of Canada (“RBC”) arose in late March after RBC issued margin calls to AG. RBC then sought to auction off \$11 million of the REIT’s CMBS, which prompted AG to commence litigation against the bank, seeking a temporary restraining order and preliminary injunction to prevent what it described as an “opportunistic” fire sale of its assets.<sup>11</sup>

Plaintiffs complained that the bank’s use of margin calls were threatening the REIT market to the “brink of collapse,” and argued that RBC’s actions were at odds with government measures aimed at restoring liquidity to the markets.<sup>12</sup> Further, AG disputed RBC’s “entirely subjective and self-serving” calculation of market value, which it contended was “unilaterally determined” based on a temporarily illiquid market.<sup>13</sup> The complaint was not filed in time to prevent the auction, which had already begun,<sup>14</sup> and a settlement was reached among the parties in late May 2020.<sup>15</sup>

### **Echoes of the Past**

The case highlights how COVID-19 has

thrown into question what constitutes a “recognized market” for the purpose of selling securities, similar to disputes that followed the 2008 financial crisis related to enforcement of repurchase agreements that documented subprime mortgage warehouse financing to originators. Parallels can be drawn between AG’s arguments and the 2011 case of *Sher v. Barclays Capital Inc.*,<sup>16</sup> in which the trustee for Thornburg Mortgage challenged the bank’s “improper margin calls” based on “inappropriately low valuations” that were made in late 2007 when the subprime mortgage market was in disarray.<sup>17</sup> Plaintiff contended that Barclays did not use commercially reasonable methods to liquidate the securities and failed to sell the assets in a recognized market.<sup>18</sup>

Similarly, much of the dispute in the case centered on the bank’s calculation of market value as it pertained to the securities.<sup>19</sup> The repurchase agreement in question did not specify the source to be used, but rather, provided that this should be obtained from a “generally recognized source agreed to by the parties.”<sup>20</sup> Agreement on such a source reflecting “true” value becomes an issue in a seriously depleted market, providing grounds to challenge an auction sale as not “commercially reasonable.”

### **Lessons to Be Learned**

All of this underscores the need for greater clarity in repurchase agreements and for repurchase parties to review contract provisions carefully to assess provisions governing margin calls, “market value,” asset liquidation and events of default. In addition, keeping abreast of policy changes in such a fluid time is critical. In *AG v. RBC*, the plaintiffs argued that the bank’s conduct contravened Governor

Cuomo's Executive Order No. 202.9, which essentially instructs banks to grant forbearance to any person or business experiencing financial hardship as a result of COVID-19.<sup>21</sup> Temporary and emergency executive orders that have been coming thick and fast in response to the daily challenges posed by the pandemic should be examined, as these may afford REITs additional protection when faced with margin calls and the prospect of asset liquidation. REITs should also be prepared to challenge efforts to liquidate asset collateral during this crisis, and lenders should expect such challenges. For now, *RBC* remains the outlier in respect of its aggressive actions, but valuation disputes and related margin calls can be expected to continue for as long as the CMBS market remains depressed.

### Looking Forward

The valuation issues that arose in mortgage warehouse lending in the last financial crisis caught many by surprise. (As a warehouse lender once said to me back then, "What do you mean I can't just assign a value to the collateral and give the borrower credit? That's what the agreement says.") There is no reason for parties to be taken by surprise this time around. But in the same way that viruses mutate, the next strain of repo litigation - this time arising from an economic crisis of a different nature - will be subtly different from what went before. Enforcement provisions in repurchase agreements will need to be reevaluated in a different light in the midst of the pandemic. Participants should assess their risks and rights under current provisions to prepare for a long-term impact on collateral markets.

### NOTES:

<sup>1</sup>No. 1:20-cv-2547 (S.D.N.Y. 2020).

<sup>2</sup>FitchRatings, Fitch Wire, *Coronavirus Pushes \$35.5B of US CMBS to Special Servicing in 2Q*, FitchRatings, Aug. 17, 2020 ("2Q 2020 Fitch Update"), available at <https://www.fitchratings.com/research/structured-finance/coronavirus-pushes-35-5b-of-us-cmbs-to-special-servicing-in-2q-17-08-2020>; see also FitchRatings, Fitch Wire, *Coronavirus Pushes \$20 Billion of CMBS Into Special Servicing*, June 17, 2020, available at <https://www.fitchratings.com/research/structured-finance/coronavirus-pushes-20-billion-of-cmbs-into-special-servicing-17-06-2020>.

<sup>3</sup>2Q 2020 Fitch Update, *supra* note 2.

<sup>4</sup>See 2Q 2020 Fitch Update, *supra* note 2.

<sup>5</sup>FitchRatings, Non-Rating Action Commentary, *Spike in U.S. CMBS Delinquencies and Special Servicing in May Due to Coronavirus*, May 20, 2020, available at <https://www.fitchratings.com/research/structured-finance/spike-in-us-cmbs-delinquencies-special-servicing-in-may-due-to-coronavirus-20-05-2020>.

<sup>6</sup>See FitchRatings, Non-Rating Action Commentary, *supra* note 5.

<sup>7</sup>Kroll Bond Rating Agency, *CMBS Loan Performance Trends: August Update*, Aug. 26, 2020, available at <https://www.krollbondratings.com/documents/report/38075/cmbs-cmbs-loan-performance-trends-august-update> (password required).

<sup>8</sup>Thomas J. Barrack, *Preventing Covid-19 From Infecting the Commercial Mortgage Market*, Mar. 22, 2020, <https://medium.com/@tombarrackjr/preventing-covid-19-from-infecting-the-commercial-mortgage-market-e7444701745e>; see also Barrack Gives Up on Rescue, Says "We're Fighting Politics," Bloomberg Law, Apr. 6, 2020, available at <https://news.bloomberglaw.com/coronavirus/barrack-gives-up-on-rescue-says-were-fighting-politics>.

<sup>9</sup>See, e.g., Letter dated Mar. 29, 2020 from Robert D. Broeksmit, President and Chief Executive Officer of the Mortgage Bankers Association, to the Financial Industry Regulatory Authority and U.S. Securities and Exchange Commission, at 1-2 (requesting "urgent" guidance to address broker-dealer practices potentially hampering recovery efforts in the RMBS markets), available at [https://www.mba.org/Documents/MBA\\_Mortgage\\_Market\\_Stabilization\\_3.29.2020.pdf](https://www.mba.org/Documents/MBA_Mortgage_Market_Stabilization_3.29.2020.pdf).

<sup>10</sup>See Barrack, *Preventing Covid-19 From Infecting the Commercial Mortgage Market*, *supra* note 8; see, e.g., Internal Revenue Serv. Rev. Proc. 2020-19 (providing temporary relief via an expanded safe harbor for elective cash-stock distributions for publicly-offered REITs "in recognition of the need for enhanced liquidity during the current period of economic disruption"), available at <https://www.irs.gov/pub/irs-drop/rp-20-19.pdf>. The Internal Revenue Service provided similar temporary relief following the 2008-12 financial crisis. See Internal Revenue Serv. Rev. Proc. 2008-68 & Rev. Proc. 2009-15.

<sup>11</sup>Complaint, *AG MIT CMO, LLC v. Royal Bank of Canada*, No. 1:20-cv-2547 (S.D.N.Y. 2020), ECF No. 1

(“AG Complaint”), at 1–4.

<sup>12</sup>AG Complaint, *supra* note 11, at 1–4, 7–10.

<sup>13</sup>AG Complaint, *supra* note 11, at 2, 11–15.

<sup>14</sup>See Order dated March 25, 2020, *AG MIT CMO, LLC v. Royal Bank of Canada, No. 1:20-cv-2547 (S.D.N.Y. 2020)*, ECF No. 9 (denying request for temporary restraining order as moot).

<sup>15</sup>See Notice of Dismissal With Prejudice dated May 29, 2020, *AG MIT CMO, LLC v. Royal Bank of Canada, No. 1:20-cv-2547 (S.D.N.Y. 2020)*, ECF No. 25.

<sup>16</sup>No. 11-cv-1982 (D. Md.).

<sup>17</sup>Complaint, *Sher v. Barclays Capital Inc., No. 11-cv-1982 (D. Md. 2011)*, ECF No. 7 (“Sher Complaint”), at 1–2.

<sup>18</sup>Sher Complaint, *supra* note 17, at 11–13.

<sup>19</sup>Sher Complaint, *supra* note 17, at 1–2, 6–16.

<sup>20</sup>Sher Complaint, *supra* note 17, at 8 & Ex. 1 (Master Repurchase Agreement) at 2.

<sup>21</sup>AG Complaint, *supra* note 11, at 10.