

Insolvency and Restructuring Update

In re American Home Mortgage Holdings, Inc.

Third Circuit affirms bankruptcy court's expansive view of "commercially reasonable determinants of value" for measurement of damages in connection with repurchase agreements

On February 16, 2011 the Third Circuit Court of Appeals affirmed a Delaware bankruptcy court's 2009 ruling that "commercially reasonable determinants of value" for purposes of measuring damages resulting from the rejection of a repurchase agreement were not limited to the actual sale or market value of an asset; a discounted cash flow valuation can also be utilized. This significant decision, one of first impression, provides helpful guidance in the determination of damages resulting from the termination of a safe harbor contract, such as a repo, in distressed market conditions, but also leaves a number of important questions unanswered.

Background

For detailed background and summary of the bankruptcy court decision, [click here](#) to see our client update dated September 14, 2009.

Section 562 of the U.S. Bankruptcy Code, 11 U.S.C. § 562, provides for the timing of damage measurements in relation with swap agreements, securities contracts, forward contracts, commodity contracts, repurchase agreements and master netting agreements that are rejected or terminated and accelerated in connection with a bankruptcy case. Section 562 provides, in relevant part, that "damages shall be measured as of the earlier of (1) the date of . . . rejection [of such contract]; or (2) the date or dates of such liquidation, termination, or acceleration . . . [but that if] there are not any commercially reasonable determinants of value as of any [such] date . . . damages [are to] be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value."

The transaction at issue was a repurchase agreement between Calyon New York Branch ("Calyon") and certain of the American Home Mortgage Holdings debtors (the "Debtors") relating to mortgage loans or interests in mortgage loans. Shortly before the Debtors' chapter 11 filings, Calyon served the Debtors with a notice of default, pursuant to which Calyon accelerated the Debtors' obligations under the repurchase agreement and terminated the repurchase agreement (the date of the notice, the "Acceleration Date"). Calyon then sought to have its damages liquidated by the bankruptcy court and contended that the only appropriate valuation methodology to be used as a "determinant" of value was the asset's market price (i.e., the actual market or sale value) and that Calyon could not have obtained a commercially reasonable price for the loan portfolio on the Acceleration Date because the market was distressed and the marketability of the loan portfolio was therefore affected.

The Debtors countered that, as of the Acceleration Date, a discounted cash flow analysis ("DCF analysis") could be adopted to identify commercially reasonable values for the loan portfolio. Because the Debtors' DCF analysis valued the loan portfolio on the Acceleration Date at or above the Repurchase Price (i.e., the price at which the Debtors were obligated to repurchase the loans as a result of the acceleration of the repurchase agreement), the Debtors asserted that Calyon had no deficiency claim and, therefore, no damages claim under section 562.

The Delaware bankruptcy court (Sontchi, J.) agreed with the Debtors, concluding that the notion of "commercially reasonable determinants of value" is not limited to the actual sale or market value of an

asset, and that, when no market exists for an asset, another method of valuation must be used—in this case, a DCF analysis. Consequently, the court held that Calyon had no deficiency claim.

Analysis

The Third Circuit held that the bankruptcy court's findings and conclusions were persuasive and supported by the evidence. The court agreed with the bankruptcy court's analysis that the asset's market price should be used to determine its value "when the market is functioning properly", but that other determinants of value must be used "when the market is dysfunctional and the market price does not reflect an asset's worth."¹ In this case, all parties agreed that the market was dysfunctional. The court found persuasive the lower court's finding that problems with the loans (relating to ownership, direction of proceeds and servicing) were variables that may have affected the market or sale price of the loan portfolio (had it been placed on the market for sale) but were irrelevant to the identification of "commercially reasonable determinants of value," since Calyon had decided to hold the loans rather than sell them. Thus, Calyon's choice not to sell the loan portfolio, and instead to retain the income generated thereby, was a "logical flaw" in its position that market price should be the only determinant of value. Calyon's challenge to the use of the DCF analysis, while making no effort to sell the loan portfolio and continuing to receive the income it generated, the court reasoned, "involves a moral hazard that is counter to the policy of preserving liquidity."² The court was persuaded by the Debtors' expert witness testimony that a DCF analysis was "a particularly apt" methodology for valuing debt instruments such as mortgage loans where assets are held for cash flow and the owner continues to receive cash flows.³

Future Implications

The Third Circuit's decision, one of first impression, is limited by the facts of the case. Calyon's evidence supporting its intent and proposed valuation was partly discredited by the court, and the outcome might have been different had it not been. The decision nevertheless provides helpful guidance regarding the determination of damages resulting from the termination of a protected contract, such as a repurchase agreement, in distressed market conditions.

The decision raises a number of important questions—among them, when is the market "functioning properly," such that market forces should be used to determine an asset's value? While in this case the parties agreed that the market was dysfunctional during the dramatic collapse of the mortgage securitization market in 2007, whether a market is "functioning properly" may be subject to varying interpretations in different market scenarios.

- ▶ [See: *In re American Home Mortgage Holdings, Inc.*, Case No. 09-4295 \(3d Cir. Feb. 16, 2011\)](#)

¹ Op. at 21.

² Op. at 21-22.

³ Op. at 20.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Laureen F. Bedell	212 450 4167	laureen.bedell@davispolk.com
Donald S. Bernstein	212 450 4092	donald.bernstein@davispolk.com
Giorgio Bovenzi	212 450 4260	giorgio.bovenzi@davispolk.com
Timothy Graulich	212 450 4639	timothy.graulich@davispolk.com
Marshall S. Huebner	212 450 4099	marshall.huebner@davispolk.com
Daniel G. Kelly, Jr.	650 752 2001	dan.kelly@davispolk.com
Damian S. Schaible	212 450 4580	damian.schaible@davispolk.com
Erika Diane White	212 450 4183	erika.white@davispolk.com
Brian M. Resnick	212 450 4213	brian.resnick@davispolk.com

© 2011 Davis Polk & Wardwell LLP

Notice: This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have any questions about the matters covered in this publication, the names and office locations of all of our partners appear on our website, davispolk.com.