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Third Circuit Finds DCF Analysis "Commercially Reasonable Determinant of Value"

On the Edge

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Counterparties to repurchase agreements and other contracts protected under the safe-harbor provisions the Bankruptcy Code have something new to worry about: the possible undervaluation of their damage claims based on a discounted-cash-flow (DCF) analysis of termination value in a dysfunctional market. The Third Circuit recently affirmed the U.S. Bankruptcy Court for the District of Delaware's denial of Calyon New York Branch's $478.5 million claim in *In re American Home Mortgage Holdings Inc.*[1] and held that a DCF analysis may constitute a "commercially reasonable determinant of value" for measuring a damage claim under an accelerated repurchase agreement under § 562 of the Code. As a result, the decision that such counterparties face upon a default (whether to sell the underlying assets into a depressed market or retain them until market conditions normalize) has become significantly more complicated, which ultimately may result in increased financing costs and a counterproductive incentive to liquidate assets prematurely into a dysfunctional market.

Repurchase Agreements

A repurchase agreement (or repo) is a contract that simultaneously provides for the sale of certain financial assets to the repo buyer and the future repurchase of those assets by the repo seller.[2] The arrangement is similar to a secured financing transaction with the difference in purchase price and repurchase price yielding an implied return to the repo buyer. A repurchase agreement is a protected contract under the Code, so the counterparty's right to terminate, liquidate or accelerate the contract upon a default based on the bankruptcy filing is not subject to the automatic stay.[3]

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Section 562, which was enacted pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), provides for the timing of damage measurements for protected contracts that are rejected by the debtor or terminated, liquidated or accelerated by the counterparty. Section 562(a) provides, in relevant part, that "damages shall be measured as of the earlier of (1) the date of such rejection or (2) the date or dates of such liquidation, termination or acceleration."[4] However, § 562(b) goes on to provide that "[i]f there are not any commercially reasonable determinants of value on [such] date...damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value."[5]

American Home Mortgage

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The transaction at issue in *American Home Mortgage* was a repurchase agreement between Calyon, as repo buyer, and American Home Mortgage Holdings Inc. and certain of its affiliate debtors, as repo sellers, covering approximately 5,700 mortgage loans with an unpaid principal balance of approximately $1.2 billion. On Aug. 1, 2007, shortly before the debtors' chapter 11 filings, Calyon served a notice of default, which accelerated the debtors' obligations to repurchase the mortgage loans at the repurchase price.[6] Given the tumultuous market for real estate assets at that time, Calyon elected not to sell the mortgages on the acceleration date but rather to hold them and collect the principal and interest payments.[7]

The parties agreed that the mortgage market was dysfunctional on the acceleration date.[8] Calyon argued that, as a result, no "commercially reasonable determinants of value" were available on that date. Calyon asserted a deficiency claim for $478.5 million based on the difference between the repurchase price and the value of the assets at the earliest date Calyon alleged it could reasonably sell the mortgage loans in a functioning

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1 *In re Am. Home Mortg. Holdings Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009) (*AHM I*), *aff'd*, No. 09-4295, 2011 WL 522945 (3d Cir. Feb. 16, 2011) (*AHM II*).
2 *See* 11 U.S.C. § 101(47).
3 *See* 11 U.S.C. § 559.
4 11 U.S.C. § 562(a).
5 11 U.S.C. § 562(b).
6 *See AHM II* at *1.
7 *See id.* at *4.
8 *See id.* at *3.

market, nearly a year after the acceleration date.[9]

The debtors objected, countering that on the date of acceleration, a commercially reasonable determinant of the value of the mortgages, namely a DCF analysis, was available and should be used under § 562. The debtors' DCF analysis valued the mortgage portfolio, as of the acceleration date, at a price that exceeded the debtors' repurchase price, leaving Calyon with no claim.[10]

The bankruptcy court sided with the debtors, holding that "commercially reasonable determinants of value" are not limited to the actual sale price or market value of an asset, and that when no functioning market exists, another method of valuation must be used. Consequently, the court denied Calyon's claim.[11]

The Third Circuit (on direct appeal from the bankruptcy court) affirmed, and held that while the assets' market price generally should be used to determine value, other determinants should be used "when the market is dysfunctional and the market price does not reflect an asset's worth."[12] The court noted that "determinants" is plural (so it must not only refer to market or sale price), and reasoned that if Congress wanted § 562 to be restricted to market or sale price, it could have said so.[13] Because the parties agreed that the market was dysfunctional, the door was left open for a DCF analysis. This result surprised many market participants and observers,[14] and raised some significant questions.

When Would a Commercially Reasonable Determinant Not Exist on Acceleration Date?

The *American Home Mortgage* decision could have the practical effect of rendering § 562(b) surplusage. A DCF analysis can be used to value practically any financial asset at any time. If a DCF analysis constitutes a commercially reasonable determinant of value, then a commercially reasonable determinant of value is always available, and § 562(b) is superfluous.

The Third Circuit did not address this point, but the bankruptcy court, in a footnote, stated that a DCF analysis may not be appropriate to value equity interests or in the event that "risk cannot be accurately gauged."[15] However, courts have recognized DCF analysis as one of the legitimate bases for determining an entity's valuation, at least where financial projections are available.[16] Moreover, if the turmoil of a "dysfunctional" market is not persuasive evidence that "risk cannot be accurately gauged," it is hard to imagine what evidence would have persuaded the bankruptcy court.

Will the *American Home Mortgage* Decision Be Limited to Its Unique Facts?

Although Calyon attacked the propriety of using a DCF analysis as a commercially reasonable determinant of value, the courts found that Calyon did not dispute the DCF methodology used by the debtors' expert. Calyon argued that the expert erred by using only the mortgagee performance expectations of the mortgage originators at the time they originated the mortgages, instead of taking into account the deterioration in the credit quality of the mortgage portfolio by the date of acceleration.[17] However, this argument was aimed at showing that the DCF analysis was not an appropriate substitute for market or sale price, rather than attacking the methodology used in the analysis.

Calyon also cited issues with the loan portfolio, such as ownership and servicing disputes and incomplete loan files, which affected the salability of the loans.[18] The courts found that these were issues that might have had an impact on sale price but were irrelevant to the DCF analysis, which was based on expected cash flows, not sale price.

Both courts failed to explain why the above-mentioned issues do not severely impact the DCF analysis—either through lowering expected cash flows (as a result of higher expected default rates or anticipated obstacles to foreclosure) or requiring the use of a higher discount rate. However, the courts' sweeping statements must be considered in the context of Calyon's communications outside the litigation regarding the accounting and regulatory treatment of the mortgage portfolio, which were found to be inconsistent with its positions in court.

Calyon acknowledged in internal correspondence that "a DCF analysis was the appropriate method for valuing the Loan Portfolio" under applicable accounting standards.[19] Also, Calyon stated in a letter sent to a syndicated loan organization that "the existence of deficiencies [in the loan portfolio] does not impact sale values" as long as Calyon makes the standard representations and warranties in the sale agreement.[20] These facts caused the bankruptcy court to question the credibility of the testimony of Calyon's witnesses. Had the evidence linking loan quality to expected future cash flows not been impeached by these inconsistent statements, the courts might have taken a different view of the appropriateness of the assumptions underlying the debtors' DCF analysis.

Does Measuring Damages at the Time of Acceleration Prevent a Moral Hazard?

The Third Circuit was also persuaded by the policy argument that measuring damages at the time of acceleration prevents a moral hazard. The bankruptcy court explained this problem as follows:

> If the price of the asset were to rise, the repo participant would capture that increase up to the full amount owed under the agreement. If the price were to fall, however, the repo participant's losses would be covered because its deficiency claim would rise accordingly. Even if such a claim were not to be paid at 100%, there would certainly be instances where the discounted claim is sufficiently large to motivate the repo participant to shift the risk to the debtor. In effect, this would make the debtor an insurer of the repo participant's investment even though the debtor has no control over the management of the asset—thus, the moral hazard.[21]

This fear of moral hazard appears to be misplaced. Once the repo is accelerated, under a plain reading of § 562, the counterparty has no control over the timing of the measurement of the damage claim. Damages are to be measured on the date of acceleration unless no commercially reasonable determinants of value are available, in which case damages would be measured on the earliest date on which such determinants are available. Even if, as the bankruptcy court postulates, Calyon was motivated "to shift the risk to the debtor," there was nothing Calyon could do to shift that risk, and therefore, there should

9 *See id.* at *2.
10 *See id.*
11 *See AHM I* at 199.
12 *AHM II* at *9.
13 *Id.*; *see* 11 U.S.C. § 559 (referring specifically to "market prices" and "prices available...from a generally recognized source or the most recent closing bid quotation from such source").
14 At the time of writing this article, the leading bankruptcy treatise was not swayed by the bankruptcy court's decision, stating that the "fact that a theoretical value for such property might be determined by an appraiser or other expert should not be construed as preventing deferral of the damages measurement date pursuant to section 562(b)." *Collier on Bankruptcy* ¶ 562.03 (2010) (citing *AHM I* as contrary authority).

15 *AHM I* at 195, n.49.
16 *See, e.g., Lippe v. Bairnco Corp.*, 288 B.R. 678, 689 (S.D.N.Y. 2003), *aff'd*, 99 Fed. Appx. 274 (2d Cir. 2004).
17 *See AHM II* at * 9.
18 *See id.*; *see also AHM I* at 191.

19 *AHM I* at 196, n.50.
20 *AHM II* at *4.
21 *AHM I* at 191.

be no moral hazard. The counterparty cannot unilaterally control the date on which a commercially reasonable determinant of value is deemed to be available for the purposes of calculating the damage claim.

Moreover, if the value of the assets is less than the repurchase price on the acceleration date, both the counterparty and the debtor benefit from any subsequent increase because the additional value captured by the counterparty reduces the counterparty's deficiency claim. If the value subsequently falls, both parties likewise suffer harm; while the deficiency claim is increased, the counterparty's losses are only "covered" to the same extent its gains would have been "captured." There should be no moral hazard given this alignment of interests.

Does It Matter if the Counterparty Actually Sells the Assets?

Had Calyon actually sold the assets upon acceleration, it is unclear whether that would have affected the court's analysis. Though the Third Circuit at one point stated that "[t]he premise underlying the acceptance of the DCF methodology for the case is that the Loan Portfolio held by Calyon was held, and not sold, at that time,"[22] the statute on its face and the Third Circuit's other findings appear contrary to the use of market or sale price in a dysfunctional market. Furthermore, using such a sale price would be inconsistent with the apparent purpose of § 562, which is to eliminate the incentive of counterparties to sell assets at artificially low prices when the market is dysfunctional (thus creating large deficiency claims against debtors).

As a practical matter, the Third Circuit limited the applicability of the DCF analysis to times when the market is dysfunctional, so market or sale prices are still the primary valuation methodology.[23] In this case, the market dysfunction was uncontroverted, but the issue may become a contested factual matter in a future case. Even if a counterparty sold the assets on the acceleration date, the counterparty could still be at risk of having its deficiency claim reduced or disallowed. The court might find the market dysfunctional and decline to use the sale price under the theory that the sale price in a dysfunctional market does not reflect the asset's worth and hence is not a commercially reasonable determinant of value.

The fact that the *American Home Mortgage* courts appear to have ignored deterioration of the credit quality of the mortgage portfolio in applying the debtors' DCF analysis presents a complicated dilemma for a counterparty. Where financial assets are concerned, defaults are more likely to occur during a "market break," when it may well be alleged that the market was dysfunctional. If the counterparty holds the assets, the absence of a sale might increase the chance that a court will apply a DCF analysis without regard to currently expected defaults and over-value the assets (reducing or eliminating any deficiency claim). On the other hand, if the counterparty sells the assets, it locks in a low price and may fail to convince the court that the sale price constitutes a commercially reasonable determinant of value. If this case cannot be limited to its unique facts, namely situations where the repo purchaser does not offer credible evidence supporting its position regarding the DCF analysis, market participants will be compelled to make risky decisions on a case-by-case basis based on their perception of how dysfunctional the market is, how low the sale price would be, and the anticipated recovery on deficiency claims.

Conclusion

By sanctioning DCF analysis as of the acceleration date without acknowledging the significance of the deterioration in asset quality, the *American Home Mortgage* decisions threaten to deprive repo participants of the benefits of their bargain. The decisions also appear to undermine the purpose of § 562 by encouraging parties to sell assets prematurely in order to establish their reduced value and discourage after-the-fact judicial valuation. Hopefully, future courts will recognize that these decisions can only be rationalized if they are not viewed to preclude taking into account credible evidence of actual asset values in determining how to apply a DCF analysis. If so, much—but not all—of the uncertainty they appear to have created would be eliminated. ■

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22 *AHM II* at *4.

23 *See AHM II* at *9 ("It is only when the market is dysfunctional and the market price does not reflect an asset's worth should one turn to other determinants of value.").