Testimony of Hon. Christopher S. Sontchi

United States Bankruptcy Judge for the District of Delaware

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

United States House of Representatives

Washington, D.C.

March 26, 2014

Chairman Bachus, Ranking Member Johnson and Members of the Committee:

Thank you for inviting me to testify today. My name is Christopher Sontchi and I am a sitting United States Bankruptcy Judge for the District of Delaware. I have presided over a number of cases involving the safe harbors for financial contracts, derivatives and repurchase agreements. Most notably, I presided over the *American Home Mortgage* case. At the time of its filing in 2007, American Home Mortgage was the 10^{th} largest home mortgage originator in the country and was in the business of originating, securitizing, selling and servicing "Alt-A" home mortgage loans, a step above the now infamous subprime market. As part of its origination and securitization business the company was a party to numerous repurchase agreements involving billions of dollars. In addition, commencing in late 2007, I presided over the case of *Delta Financial Corporation*, which was a somewhat smaller version of American Home Mortgage, albeit in the riskier subprime market. I have presided over numerous other cases and issued numerous opinions involving repurchase agreements, tri-party setoffs and swaps. Finally, I have had the honor of serving as a member of the *Committee on Financial Contracts, Derivatives and Safe Harbors* of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Today, I would like to discuss two important issues related to the "safe harbors" for derivatives, repurchase agreements and other similar contracts. The first is narrow in scope and, I think, for the most part uncontroversial. I believe Congress should consider amending section 546(e) of the Bankruptcy Code to significantly narrow its scope. As set forth more fully below, Section 546(e) exempts from avoidance as preferences or fraudulent conveyances "settlement payments" and transfers made to a class of financial institutions. I believe Congress's intent was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

The second issue is broader and significantly more controversial. I believe Congress should consider scaling back the scope of the safe harbors for repurchase agreements. The original 1984 safe harbor for "repurchase agreements" or "repos" encompassed repos on U.S. government and Agency securities and other highly liquid assets. In 2005 and 2006, the definition of "repurchase agreement" and "securities contract," under which certain repos had been afforded safe harbor treatment, were expanded to include a broader range of potentially less liquid assets, including mortgage loans and interests in mortgage loans. The current safe harbors for repurchase agreements allow for "runs" on financial institutions by counterparties who are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually impossible to reorganize companies with significant repo exposure such as American Home Mortgage.

Section 546(e) of the Bankruptcy Code

As written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts and other transactions, even if the securities were privately issued. Absent the safe harbors, these payments – often made to the directors, officers and other company insiders that led the company into bankruptcy - would be potentially voidable as fraudulent or preferential transfers. The safe harbor of section 546(e) should protect the *securities transfer system*, if and when the financial institutions are acting as conduits for payment, regardless of whether the securities involved are public or private. This safe harbor for the securities industry is important because the initial transferee is not accorded a good faith defense under section 550, potentially exposing the securities industry to large and inappropriate liability for acting as mere intermediaries in securities transactions.

However, section 546(e) should not protect settlement payments or other transfers with respect to the beneficial owners of *privately* placed debt securities or of equity securities of a closely held entity. With regard to *publicly* traded securities, section 546(e) should only protect transfers to the beneficial owners of public securities holders that have acted in good faith.

Section 546(e) of the Bankruptcy Code provides as follows:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

"Settlement payment" is defined in section 741(8) in a circular fashion as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." Because of this broad and circular language, courts have interpreted it to include many kinds of transactions regardless of whether it advances the legislative intent/policy behind enactment of the safe harbor, i.e., protection of the securities transfer system. These have included transfers to insiders owning private and public securities and LBO's that would otherwise have been fraudulent transfers.

Courts have applied section 546(e) literally and shielded from avoidance transfers involving little or no impact on the functioning of the public securities market. For example, in the case of *In re Quebecor World (USA), Inc.*, 719 F.3d. 94 (2d Cir. 2013), *aff'g*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), the Second Circuit affirmed the holding of the bankruptcy court that payments made to repurchase *privately-placed notes* were both "settlement payments" and transfers made in connection with a securities contract that were protected under the safe harbor.[1] I propose narrowing the scope of section 546(e) to make it clear that the safe harbor only protects the securities transfer system and settlement payments made in connection with publicly traded securities.

Section 546(e) has also been successfully invoked to protect leveraged buyouts or LBO's. In cases involving LBO transactions, the issue is whether a payment made to the shareholders of the target company in exchange for their securities is a settlement payment entitled to protection. There is a split in authority in cases interpreting the safe harbor in the LBO context. A minority of courts have held that the safe harbor only applies to LBO's involving publicly traded securities or involving the public system of intermediaries and guarantees typical of the securities industry[2] but a majority of courts have increasingly found that the safe harbor protects the beneficial recipient even if the transaction involved private securities and regardless of the involvement of a financial intermediary.[3] My proposal supports the minority position and calls for revising the statute to specifically exclude private transactions from the safe harbor.

Section 546(e) can also impact LBO's of public companies. If the LBO leaves the firm with an unreasonably small capital or if it renders the firm insolvent, then the payments to shareholders are potentially recoverable in a subsequent bankruptcy, for the benefit of the target firm's pre-transaction creditors, if the other elements of a

---

[1] *See also Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. 2011); and *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[2] *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996); *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (S.D.N.Y. 2012); and *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68 (E.D.N.Y. 2007).

[3] *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re Kaiser Steel Corporation*, 952 F.2d 1230 (10th Cir. 1991); and *AP Services LLP v. Silva*, 483 B.R. 63 (S.D.N.Y. 2012).

fraudulent transfer are in place. Section 546(e) as written, however, can immunize transfers made in connection with LBO's involving public companies, including those that render the target firm insolvent, even if the target's insiders acted in bad faith.[4] I propose that shareholders of public companies would not be automatically immunized, *per se*, by section 546(e). Rather they would only be protected if they have acted in good faith.

Again, I believe Congress's intent in implementing the safe harbor in section 546(e) was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

---

[4] *Compare Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D.Ill. 1988) (With respect to fraudulent conveyance claim against insider shareholders of a public company, the court "collapsed" the LBO transaction so that insiders were considered to have received property of the debtor in the transaction but did not collapse the transaction with respect to non-insider shareholders and, therefore, dismissed the actions against the non-insiders); and *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71 (D. Del. 2002). (In a fraudulent conveyance action against insider shareholders resulting from an LBO of a public company, the court concluded that the distinction between insider and non-insider status was "not one that [held] legal significance under section 546(e)" and the insider shareholders were protected by the safe harbor).

I respectfully recommend that Section 546(e) of the Bankruptcy Code be amended (1) to affirm the current statutory protections in section 546(e) to security industries participants who act as conduits in both public and private securities transactions, (2) to remove the section 546(e) protection from avoidance actions for beneficial owners of privately-issued securities, and (3) to continue to safe harbor public securities holders from avoidance actions, if the public securities holder acted in good faith.

More specifically, without providing precise statutory language, section 546(e) should be amended as follows:

> (1) If the settlement payment or transfer is made to (or a securities contract is made with) a stockbroker, bank, clearing agency such as the DTC or a similar financial institution obligated to forward what has been paid or transferred, then, to the extent that the institution received such settlement payment or transfer for the benefit of a client or customer of the transferee and is obligated to forward that payment or transfer, then the institution shall receive the benefit of the existing section 546(e).
>
> (2) The first beneficial recipient of the transfer chain in question will be deemed to have received the relevant settlement payment or transfer directly from the debtor.
>
> (3) Parties receiving payments or transfers as beneficial owners of non-public securities shall not be protected by section 546(e).
>
> (4) Parties receiving payments or transfers as beneficial owners of public securities shall be protected by section 546(e) from constructive fraudulent transfer actions, as well as preferences under section 547, provided they acted in good faith without knowledge of the avoidability of the underlying transaction.

I have and continue to be faced with a flurry of motions to dismiss and for summary judgment filed by insiders of bankrupt companies seeking shelter from liability through the section 546(e) safe harbor. The "secret" is out and defense attorneys are seeking to take advantage of the safe harbor to the fullest extent possible. I believe these changes would align the statutory language and the courts' interpretation of the statute with Congress' original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith.

I respectfully urge Congress to act quickly to close this unintended loophole in the otherwise necessary safe harbor for the securities transfer system.

The Scope of the Safe Harbors for Repurchase Agreements

The second subject I would like to discuss is more controversial: what is the proper scope of the safe harbors governing mortgage repurchase agreements?

For the reasons discussed below, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A). The effect would be to remove "mortgages" and "interests in mortgages" from the safe harbors of sections 555 and 559 (and 561 under Chapter 15).

The genesis of my request is my experience in the *American Home Mortgage* bankruptcy case filed in 2007. It became quickly apparent to me during that case that mortgages simply do not fit into one of the primary purposes behind protecting repurchase agreements, i.e., preservation of liquidity of investments. In fact, mortgages and interests in mortgages are not liquid assets. This is due in large part to the fact that mortgages are sold by the originators to investors or securitization trusts in bundles containing as many as thousands of mortgages as well as the unique nature of mortgages. Every mortgage is secured by a unique piece of real property and involves a buyer that has a unique credit profile and payment history. In order to address the uncertainty arising from the individual nature of mortgages, sales often include lengthy look back periods where the buyer can return some mortgages in a portfolio to the seller if there is an early default or representations regarding the loans turn out to be inaccurate. In fact, it can take several months to complete the sale of a portfolio of mortgages.[5] These are not United States government securities. The reality is that the counterparties to repurchase agreements, i.e., the lenders, are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The current safe harbors for repurchase agreements allow for "runs" on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually

[5] While the same argument may be applied to "mortgage related securities" and "interests in mortgage related securities" there can be no question that these agreements are much more liquid than the underlying mortgages themselves and, thus, I do not recommend their removal from the protections of the safe harbors.

impossible to reorganize companies with significant repo exposure such as American Home Mortgage.[6]

The business of originating mortgages requires access to a huge amount of capital. For example, when a new homeowner buys a house for $100,000 with 20% or $20,000 down and borrows the remainder of the purchase price through a mortgage, the mortgage company must deliver $80,000 in cash at the closing of the sale. As of the end of 2013, there were approximately $9.9 trillion in home mortgage loans outstanding, every penny of which came from a mortgage lender. [7] In most cases, the mortgage lender providing the cash at closing obtained that money from a counterparty to a repurchase agreement or through a secured loan.

Traditionally, a mortgage lender would borrow the money necessary to originate mortgage loans through a warehouse secured line of credit or loan. That warehouse loan would be for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come from the warehouse lender (either directly or through the mortgage lender). The amount of the balance under the warehouse loan would increase by the amount of the mortgage loan and the mortgage itself would automatically become the warehouse lender's collateral. However, the mortgage would remain property of the

[6] There is a persuasive argument to be made that the current scope of the repo safe harbors increases systematic risk for the financial system as a whole and exacerbated the financial crisis of 2007-09. Although I support that position, I am not addressing it in today's testimony. Rather, I am limiting my comments to the adverse effect that allowing the termination of repurchase agreements, notwithstanding the automatic stay, has on a company's ability to reorganize.

[7] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MORTGAGE DEBT OUTSTANDING (March 6, 2014), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

mortgage lender. When the mortgage lender later sold the mortgage loan to another financial institution or a securitization trust, the cash received from the sale would be used to pay down the warehouse secured loan (plus interest) and the mortgage loan would automatically be removed from the warehouse lender's collateral pool. In the event of a bankruptcy by the mortgage lender, the mortgage loans that had been originated but not yet sold would become property of the bankruptcy estate, the automatic stay would prevent the warehouse lender from taking control of the mortgage loans, and the warehouse lender would both have a secured claim against the estate collateralized by the mortgage loans and be entitled to adequate protection.

Starting in the late 1990's, master repurchase agreements began to replace warehouse secured loans. The prevalence of mortgage repos increased slowly until, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include mortgages.[8] Since 2005, the bulk of lending to mortgage originators has been through repurchase agreements. Mortgage repurchase agreements are virtually identical to warehouse secured loans except for the fact that, under a repo, the mortgage belongs to the repo counterparty/lender rather than to the mortgage lender. As discussed below, this difference is of huge import.

[8] Prior to 2005, mortgage repurchase agreements proceeded under the theory that they were protected by the safe harbors governing securities contracts. The number of repos under that theory were limited by the litigation risk that courts might not agree the safe harbors were applicable and the transaction was, in fact, a loan.

The procedure for originating mortgage loans under a master repurchase agreement and a warehouse secured loan are virtually identical. The mortgage lender and the repo counterparty/lender would enter into a master repurchase agreement for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come either directly from the repo counterparty or the mortgage lender. Simultaneously with the mortgage loan closing (or very shortly thereafter), the mortgage lender would sell the mortgage loan to the counterparty with an agreement that the mortgage lender would repurchase the mortgage loan within a specified period of time (usually between thirty and ninety days) for the original purchase price plus a fee. The mortgage lender would use the time of the repurchase agreement to arrange to sell the mortgage to a "permanent" investor or a securitization trust. At the time of the closing of the ultimate sale or securitization of the mortgage loan (or immediately prior), the mortgage lender would repurchase the mortgage from the repo counterparty and flip it to the buyer. As mortgage loans were sold to the repo counter party the balance of loans subject to the master repurchase agreement would increase and as they were repurchased it would decrease. I hope it is readily apparent that warehouse secured loans and repurchase agreements are virtually identical except for the ownership of the mortgage loans themselves.

Under a repurchase agreement, the mortgage loan is property of the repo counterparty. In the event of a default or bankruptcy by the mortgage lender, the repo counterparty has the right to declare a default and require the mortgage lender to immediately repurchase the mortgages (in secured creditor parlance this would be the equivalent of calling the loan). In the event the mortgage lender could not immediately repurchase the loan, the repo counterparty would obtain permanent ownership over the mortgage loans and would be able to immediately sell them directly to permanent investors, securitization trusts or any other third party willing to buy the loans. Alternatively, the repo counterparty could maintain ownership over the mortgages. In any event, the mortgage loans would not be property of the estate and the automatic stay would not be applicable. The structure discussed above and the safe harbor from the rules governing warehouse secured loans such as the automatic stay have been codified by the repo safe harbors.[9]

The ability of a repo counterparty/lender to be able to immediately sell the mortgage loans to a third party and, thus, limit its exposure to the risks inherent in the mortgage itself, i.e., liquidity, is asserted as one of the primary bases for the repo safe harbors. The argument is that without the liquidity supplied by the safe harbors the cost of lending would increase and, in the event of a default, there could be a cascading series of defaults that might spread to the repo counter party/lender and parties to other agreements with the repo counterparty.

So far, so good. But, in my experience, the repo counterparty may not be interested in having the ability to preserve liquidity by selling the mortgages but, rather, is likely to hold the loans for later disposition, especially in a crisis such as in 2007-2009 where the value of the mortgage was artificially low. Indeed, as described

[9] See Exhibit A attached hereto for a brief recitation of the relevant safe harbor provisions.

above, mortgage loans are illiquid assets and, thus, the counterparty may have no choice but to hold the loans. The safe harbors allow the repo counterparty rather than the debtor to hold the mortgage and obtain the upside of any increase in value. In the event the transaction was treated as a loan, the debtor would be able to retain ownership and control over the mortgage loans, subject to providing adequate protection, and preserve the upside for the estate as a whole. As applied to mortgages, the safe harbors allow for the repo counter party/lender to grab what otherwise would be its collateral and prevent the mortgage lender/debtor from maximizing the value of those loans for the benefit of the bankruptcy estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Bankruptcy Code on its head. The economic reality is that a mortgage lender such as American Home Mortgage can be stripped of its assets in days or even hours, leaving no ongoing business and denying its creditors in general of the value of its assets, i.e., its mortgage loans.[10] While these safe harbors make sense in the context of assets that are actually liquid such as U.S. Treasuries, they do not in the context of an illiquid asset such as mortgages.

Let me close my discussion of mortgage repurchase agreements with a real world example. In the *American Home Mortgage* case, the debtor was a party to a master repurchase agreement with Calyon Bank. At the time of the bankruptcy filing in 2007,

[10] Generally speaking, a debtor would not be able to force a lender under a warehouse secured loan or a repurchase agreement to continue funding future mortgages. 11 U.S.C. §365(c)(2). But, at the very least, the debtor would still own its portfolio. In addition, forcing a debtor and a secured lender to deal with each other often results in continued lending.

the outstanding principal amount of the mortgage loans subject to the master repurchase agreement was approximately $1 billion. Immediately prior to the bankruptcy filing, Calyon declared a default under the master repurchase agreement and took ownership of the mortgage loans. If a repo counterparty such as Calyon takes ownership of the mortgages subject to the repurchase agreement and the value of those mortgages is less than the outstanding principal balance of the loans, the counterparty, *i.e.*, Calyon, can assert an unsecured claim for the deficit. They are, in effect, an undersecured creditor asserting a claim for unsecured portion of their loan.

I conducted a trial over two related issues: (1) at what time does the court value the mortgage loans for considering whether there is a deficit and, thus, a claim; and (2) how does the court calculate the value of the loans. I ultimately issued an opinion on those issues that was affirmed by the Third Circuit.[11] I raise the issue here, however, for a different reason. It became clear in trial that Calyon never had any intention of selling the mortgage loans in the foreseeable future. Rather, its strategy was to hold the mortgages until value rebounded and in the interim its credit exposure was minimized because the mortgage borrowers, i.e., the homeowners, were continuing to make principal and interest payments.

There is nothing morally wrong with Calyon's strategy to hold on to the loans. Indeed, it makes perfectly valid economic sense. The problem is that it should have been in the debtor's purview – not Calyon's - to make the decision whether to hold the

[11] *In re American Home Mortgage Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

loans for the benefit of the bankruptcy estate and the debtor's creditors rather than just for Calyon. With virtually every other type of asset that serves as collateral for a secured loan control rests in the debtor. But secured creditors are not without protection. For example, they may be entitled to adequate protection. The law governing the rights of secured creditors and the balance of those rights with other considerations are well developed. The repo safe harbors remove what would otherwise be considered a secured loan from the bankruptcy estate, depriving the debtor with any control over what would otherwise be its property and the lender's collateral. The asserted reason for exempting mortgages from the rules governing virtually every other type of collateral is that those protections are necessary to preserve liquidity in the system and, more particularly, for the repo counterparty's exposure. But, that asserted basis for extraordinary treatment is fallacious because mortgage loans are not liquid, especially in times when there is likely to be a default under the loans such as in 2007–2009. There is no reason to exempt mortgage loans and interests in mortgage loans from the ordinary, well established rules governing secured lending.

I am cognizant that the application of the safe harbors to mortgages and interests in mortgages is a complicated and controversial subject and any amendment to the safe harbors should be carefully weighed. It is not my intention to address the entirety of the issues. Rather, I have attempted to pass on my conclusions as to one issue based on my experience as a bankruptcy judge overseeing several cases involving repurchase agreements governing mortgages, especially the *American Home Mortgage* case.

Based on my experience, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A).

In closing, thank you very much for inviting me to testify on these important issues. I do not envy this committee's task in addressing these complicated issues. Nonetheless, I believe there are important, discrete changes that can be quickly addressed such as amending section 546(e) to align the statutory language and the courts' interpretation of the statute with Congress's original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith. In addition, I think the committee should take a step back and reconsider the scope of the repo safe harbors, especially as they apply to mortgages. While there are a number of issues and arguments that should be considered in such an examination, I think one thing is clear – the assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages. They should be returned to whence they came and be subject to the normal, long-standing, well-developed law governing secured lending.

Thank you again.

Exhibit A

Since 1982, Congress has enacted a number of amendments to the Bankruptcy Code that work in concert to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions such as the automatic stay:

- Sections 555, 559 and 561, which protect the exercise of certain contractual rights to liquidate, terminate and accelerate repurchase agreements from stays, avoidance and other limitations;
- Sections 362(b)(7) and 362(o), which exempt from the automatic stay and all other Bankruptcy Code stays setoffs under repurchase agreements and the realization against collateral for repurchase agreements;
- Sections 546(f) and 548(d), which provide exemptions from preference and fraudulent transfer avoidance for settlement and margin payments; and
- Portions of sections 101 and 741, which define the key terms repurchase agreement, margin payment, settlement payment, repo participant and financial participant.

Section 559 and its exclusion of repurchase agreements from the automatic stay are of primary significance. Collier explains that "[m]ost repurchase agreements afford a non-defaulting party the right to 'close-out' or 'liquidate' the agreement upon the other party's default.[1] Furthermore, virtually all repurchase agreements contain *ipso facto* clauses which authorize repo participants to terminate "for cause" (or otherwise forfeit or modify rights) if the other party becomes bankrupt, insolvent, or fails to maintain contractually specified conditions.[2] "In almost all instances, commencement of a Bankruptcy Code case by a party ... will constitute a default triggering the availability of such rights."[3] Such clauses permit termination of the repurchase

---

[1] 5 COLLIER ON BANKRUPTCY ¶¶ 559.04 (Alan N. Resnick and Henry J. Sommer eds. 15th ed. rev. 2007).

[2] *Id.* at ¶¶ 559.04 and 559.LH.

[3] *Id.*

agreement simply because of the other party's distressed financial condition. Section 559 protects rights triggered by a condition of the kind specified in section 365(e)(1), i.e., *ipso facto* clauses or bankruptcy defaults.[4] Thus, "section 559 allows protected parties to act upon *ipso facto* clauses."[5]

In addition, section 555 of the Bankruptcy Code provides the tool for the non-defaulting repo participant to exercise its contractual right to close-out, terminate or accelerate a "securities contract."[6] "Such a close-out or liquidation typically entails termination or cancellation of the contract, fixing of the damages suffered by the non-defaulting party based on market conditions at the time of the liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages."[7]

Finally, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include the transfer of "mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans."[8]

Section 101(47) of the Bankruptcy Code contains the definition of a repurchase agreement. A repurchase agreement is an agreement, including related terms, which (i)

---

[4] *Id.*

[5] *Id.*

[6] As defined in 11 U.S.C. § 741.

[7] 5 COLLIER ON BANKRUPTCY ¶ 555.04.

[8] 11 U.S.C. § 101(47).

provides for the transfer of one or more mortgage loans or interests in mortgage loans; (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage loans; (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests mortgage loans; (iv) at a date certain not later than 1 year after such transfer or on demand; and (v) against the transfer of funds.[9] No other criteria are set forth in the statute for a contract to be considered a repurchase agreement under the Bankruptcy Code.

The definition of repurchase agreement is incorporated into section 559 of the Bankruptcy Code. As noted earlier, since 1982, Congress has enacted a number of amendments to the Bankruptcy Code to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions of the Bankruptcy Code. Section 559 and its companion statute, section 555, preserve market liquidity by providing a "safe harbor" for non-defaulting repo participants "to terminate, liquidate or accelerate . . . repurchase agreements with the bankrupt or insolvent party."[10] Indeed, the legislative history of the 2005 amendments specifically provides that:

> The reference to "repurchase and reverse repurchase transactions" is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. Repurchase and reverse repurchase transactions meeting certain criteria are already covered under the definition of "repurchase agreement" in the Bankruptcy Code.[11]

---

[9] *Id.*

[10] H.R. Rep. 109-31, pt. 1, at 133 (2005).

[11] *Id.* at 130.