



November 15, 2011

## Third Circuit Provides Guidance on Determining Value

*In re Am. Home Mortg. Hldgs., Inc.*, 637 F.3d 246 (3d Cir. 2011)

*In re Am. Home Mortg. Hldgs., Inc.*, 411 B.R. 181 (Bankr. D.Del. 2011)

In *Am. Home Mortg.*, the Third Circuit addressed an issue of apparent first impression: whether the term “commercially reasonable determinants of value” under section 562(b) is limited to market or sale value. The U.S. Bankruptcy Court for the District of Delaware held that commercially reasonable value can be demonstrated through a discounted cash flow analysis (DCF) under appropriate circumstances. The Third Circuit affirmed the Bankruptcy Court’s holding and reasoning in substantial measure.

The debtor and Calyon New York Branch were parties to a mortgage loan repurchase agreement as defined in section 101(47) of the Bankruptcy Code. Pursuant to such agreement, Calyon had purchased a portfolio of approximately 5,700 mortgage loans with a principal unpaid balance of approximately \$1.2 billion. Before the debtor’s petition date, the debtor defaulted, and Calyon accelerated the debtor’s obligations under the repurchase agreement, including the debtor’s purported obligation to repurchase the loan portfolio for approximately \$1.143 billion. At issue was Calyon’s claim for damages under section 562 for amounts in excess of the debtor’s purported \$1.143 billion repurchase obligation.

Under section 562, damages under a repurchase agreement are determined on either the date of rejection, liquidation, termination, or acceleration if there are commercially reasonable determinants of value on such dates, or on such subsequent dates on which there are such commercially reasonable determinants of value. The debtor argued that Calyon had not incurred any damages because the value of the portfolio exceeded the repurchase price as of the date of acceleration as demonstrated by the DCF analysis prepared by its expert witness. Calyon argued that market or sale value was the only appropriate determinant of value under section 562 and that market or sale value of the loan portfolio at the appropriate valuation date resulted in damages to Calyon of approximately \$478.9 million.



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The Bankruptcy Court held in favor of the debtor. The Bankruptcy Court first examined the relationship between section 562 and section 559 as each such section relates to repurchase agreements. The court noted that section 559 provides that, on termination of a repurchase agreement, a debtor is entitled to the return of excess funds to the extent that the selling or market price of the subject assets is greater than the debtor's obligation. Thus, with respect to repurchase agreements, the court found that section 559 appears to limit damage calculations related to repurchase agreements to market or sale price. Section 562, however, uses the term "commercially reasonable determinants of value" as opposed to market or sale. Moreover, "determinants" is plural and thus suggests that more than one valuation methodology may be appropriate. In light of these apparent contradictions between sections 562 and 559, the Bankruptcy Court held that Congress' use of the phrase "commercially reasonable determinants of value" in section 562 was ambiguous.

Turning to legislative history, the Bankruptcy Court found that the common purpose among the repurchase-related provisions of the Bankruptcy Code was to preserve liquidity in the assets subject to a repurchase agreement. Section 562 fit within those objectives by aligning the risks and rewards related to such assets by permitting a damage calculation as of the date of termination, acceleration, etc., and thus operated to prevent a repo participant from being able to exercise a right to hold the assets but also calculate its damages at a future date when the market for such assets has further developed. The Bankruptcy Court held that section 562 discourages this moral hazard where the repo participant is permitted to shift the risk of future loss to the debtor.

The Bankruptcy Court further rejected Calyon's argument, based in part on Section 559, that market or sale price was the only reasonable determinant of value. As noted by the Bankruptcy Court, the fundamental purpose of any valuation is to determine as accurately as possible the sale price of the subject asset. But Calyon's argument would lead to the very moral hazard that the Bankruptcy Code seeks to discourage—the ability of a repo participant to hold the assets but still convert a subsequent decline in value into a deficiency claim against the debtor. Accordingly, the Bankruptcy Court rejected Calyon's argument that market or sale price were the only permissible methods of calculating damages for purposes of section 562.

The parties certified appeal from the Bankruptcy Court's order directly to the Third Circuit. The Third Circuit accepted direct appeal to address the apparent question of first



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impression of the construction of the terms “commercially reasonable determinants of value” under section 562.

At the outset, the Third Circuit disagreed with the Bankruptcy Court’s conclusion that section 562’s use of the term “commercially reasonable determinants of value” was ambiguous. Instead, the Third Circuit held that section 559 by its terms concerned the calculation of excess value due to the debtor and did not address the damages to which a repo participant might be entitled under section 562. These different purposes precluded a determination that section 562 was ambiguous.

Aside from this threshold issue, the Third Circuit otherwise generally agreed with the Bankruptcy Court’s analysis and found that the Bankruptcy Court’s findings were well supported by the evidence. The Third Circuit agreed with the Bankruptcy Court that the phrase “commercially reasonable determinants of value” on its face did not support Calyon’s argument and that only market or sale evidence was acceptable to establish damages. The Third Circuit agreed with the Bankruptcy Court’s conclusion that the lack of a properly functioning market at the time of acceleration, the valuation date, precluded the utility of market price as an indicator of value, particularly here, where Calyon chose to retain ownership of the loan portfolio. The Third Circuit supported the Bankruptcy Court’s discussion of canons of statutory construction, noting that “if Congress had intended § 562 to be limited to market or sale price, it would have said so. It did so in § 559.” The Third Circuit also agreed with the Bankruptcy Court that a DCF analysis was a commercially reasonable measure of value under the facts of this case, which included Calyon’s decision to retain ownership of the loan portfolio from and after the date of acceleration and the lack of a reliable market as of the date of acceleration.

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