A Coming Wave of Repo Litigation?

Four Key Takeaways

Since the last financial crisis, the commercial real estate industry has accumulated vast amounts of debt. By one account, there is currently more than $3.6 trillion in mortgage debt secured by commercial and multi-family residential properties. Much of this debt is held by real estate investment trusts ("REITs"), in the form of commercial mortgage-backed securities ("CMBS"). REITs, in turn, often finance their investments through repurchase ("repo") agreements, under which they obtain short term loans by selling CMBS to financial institutions and agreeing to repurchase the securities at a higher price on a specified date. The CMBS sold under the repo agreements effectively serves as collateral for the loans. Repo agreements give the lender (the "Buyer") the right to make margin calls if the value of that collateral drops below a specified level; if the borrower (the "Seller") fails to meet a margin call, the lender may declare an event of default and sell the collateral.

As CMBS markets experience high levels of stress from the COVID-19 crisis, financial institutions will face difficult decisions about whether to make margin calls under repo agreements and whether and how to sell collateral. Efforts by banks to reduce their exposure to CMBS carry significant litigation risk. Below, we discuss four key takeaways from *AG MIT CMO LLC et al. v. Royal Bank of Canada*, No. 20-cv-2547 (S.D.N.Y. Mar. 25, 2020), the first of what may be a new wave of litigation under repo agreements.

1

Banks should expect borrowers to challenge their mark-to-market determinations.

In *AG*, two affiliated REITs filed suit against the Royal Bank of Canada ("RBC") after RBC issued margin calls under repo agreements and scheduled an auction of the underlying CMBS. The complaint asserts that RBC breached the repo agreements, and artificially precipitated the margin calls, by unilaterally marking down the value of the CMBS collateral rather than obtaining a price from a "generally recognized source agreed to by the parties," as required by the repo agreements (which were based on a standard SIFMA form). The plaintiffs' claim illustrates that lenders may face significant litigation risk when they mark CMBS collateral to market during the COVID-19 crisis.

Lenders should carefully review their repo agreements to determine how to mark securities to market and be mindful of the potential for challenge by borrowers. Where, as in *AG*, a repo agreement does not specify a particular source for determining the market value of CMBS collateral, litigation risks will be heightened. Similar claims were asserted in litigation arising from the last financial crisis, and courts found that they raised factual issues that required resolution by a jury. *See Sher v. Barclays Capital, Inc.*, 35 F. Supp. 2d 725 (D. Md. 2014).

2

Banks should expect challenges to procedures for liquidating collateral.

The complaint in *AG* also asserts that RBC's contemplated auction would breach the contractual requirement that RBC sell collateral "in a recognized market (or otherwise in a commercially reasonable manner)"—another standard provision that appears in many repurchase agreements. The plaintiffs allege that, as a result of the COVID-19 crisis, there currently is no recognized market for CMBS, and that RBC's proposed auction procedure was otherwise commercially unreasonable.

Similar claims were asserted in the last financial crisis, and the *AG* complaint indicates that disputes over collateral auction procedures may once again be a fertile ground for litigation. Financial institutions should thus be careful to sell collateral employing procedures that will withstand scrutiny in litigation.

3

Plaintiffs likely will invoke recent regulatory action to support their claims.

On March 21, 2020, the Governor of New York issued Executive Order 202.9, which deemed it an "unsafe and unsound business practice" for any bank regulated by the New York Department of Financial Services ("DFS") to fail to grant a 90-day forbearance to "any person *or business* who has a financial hardship as a result of the COVID-19 pandemic . . . . " While the implementing regulations suggest that the order was intended primarily to encourage banks to grant forbearances to individuals facing financial hardships such as residential mortgage customers, the complaint in *AG* alleges that the regulation requires New York chartered banks to grant forbearances to counterparties under repo agreements.

Financial institutions should expect similar claims that efforts to enforce their rights under repo agreements violate the letter or spirit of recent mandates by state and federal regulators.

4

Banks should be prepared to defend repo claims on short notice.

Because margin calls typically must be satisfied within a few days, with collateral liquidation following immediately thereafter, banks should expect their counterparties to seek relief from the courts on an emergency basis. The plaintiffs in *AG* filed suit the same day as a scheduled auction and sought a temporary restraining order enjoining the sale. While the TRO application was denied as moot because the auction had already commenced, not all defendants will be so lucky. Banks should have outside counsel retained and ready to respond immediately when served with applications for emergency relief.

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