

DIRT Periodic Development for Tuesday, August 13, 2013
Residential Funding Co., LLC v. Terrace Mortgage Co.

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Residential Funding Co., LLC v. Terrace Mortgage Co., --- F.3d ---, 2013 WL 4007552
U.S. Court of Appeals for the Eighth Circuit (August 7, 2013)

SYNOPSIS: Loan originator's repurchase obligation can be triggered by the loans' purchaser in its sole discretion.

This case is a dispute between a buyer of residential mortgages and the originator with whom the buyer had a repurchase agreement. The agreement incorporated by reference the terms of the buyer's "Client Guide" which provided that 1) the originator would repurchase a loan within 30 days if the buyer concluded that the originator was in default and demanded repurchase, 2) the originator could "appeal" by providing "additional information or documentation," and 3) the buyer would "in its sole discretion" determine the validity of any appeal.

The two parties did business under this arrangement for many years without incident, but after the collapse of the mortgage market in 2008, the buyer demanded that the originator repurchase 13 loans. The basis for the demand was the claimed presence of misstatements in the loan applications and other documentation for the loans. When the originator refused, the buyer sued and was granted summary judgment by the district court, which apparently ruled that the originator had agreed in the contract to "contract away" its right to judicial review by granting the buyer the "exclusive right" to determine if an event of default had occurred --- and that the originator could not then later ask a court to review the buyer's determination. The 8th Circuit agreed and affirmed, basically concluding that the contract was unambiguous.

It may well be that on the underlying merits, there really were problems with the loans in question --- that would hardly be surprising.

Nevertheless, the court's conclusion that the buyer's decision was final and unreviewable is troubling. It seems to us that it makes these sales too much like "illusory" contracts, in which one party has not really agreed to do anything. In an ordinary contract, a provision giving one party the sole discretion, unreviewable, to

withdraw or refuse to perform would be viewed as illusory. Should the fact that this is a repurchase agreement somehow change that? We don't see any basis for saying so.

In such a situation, a court usually has two options: (1) to declare the consideration for the contract illusory, and therefore to treat the contract as unenforceable, or (2) to read into the buyer's rights an obligation to exercise them only "reasonably" or "in good faith" or something of the sort. The latter interpretation gets rid of the "illusory contract" issue, and the contract becomes enforceable.

In the Eighth Circuit's opinion, the court seems to say that Residential had a duty of good faith, but that good faith merely means that they have to go through the procedure of reviewing their decision, not that the decision has to be supportable on the merits. At a minimum, we would suggest that "good faith" means that the buyer would have to have an actual belief, founded in facts, that an event of default had occurred. But the court doesn't seem to require that such a belief must exist. Instead, it seems to require only that the procedure be followed. We have serious doubts that this is enough.

The court also seems off-base when it explains that the buyer gave consideration because it paid a premium for the loans. Whether it bought the loans at a premium, at par, or at a discount seems completely irrelevant to us. The point of the "sole discretion" clause, as the court interprets it, is that the buyer could get its money back simply by demanding that the loan be repurchased -- even if, on the merits, there was no actual event of default and no basis for demanding a repurchase. The court doesn't address this issue adequately.

We are troubled by the suggestion in the court's language that the originator had effectively "contract[ed] away judicial review by granting [the buyer] the exclusive right to determine an 'Event of Default' has occurred." There seems to be no logical bound on that --- if that's right, then one contracting party can effectively make itself both a party and an arbitrator of all disputes under the agreement.