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SECURING DERIVATIVES OBLIGATIONS WITH CALIFORNIA REAL ESTATE—SELECTED ENFORCEMENT ISSUES

William L. Harvey*

I. INTRODUCTION

Most American lawyers are familiar with the problems inherent in applying decades-old laws to modern financial instruments, but none, perhaps, more so than derivatives lawyers. Derivatives are relatively modern financial instruments that began to gain widespread use less than twenty years ago. Since that time, however, derivatives have evolved rapidly, forcing lawyers to analyze their legal implications in the context of statutes and regulatory laws established long before derivatives even came into existence. For example, consider the law applicable to derivative contracts secured by California real estate. California's real estate security laws were codified or materially modified to assume their present form in the late nineteenth and twentieth centuries. Those laws were enacted long before the advent of financial instruments of the 1990s and 2000s, such as derivatives.3

* William L. Harvey is a partner at Winston & Strawn LLP, San Francisco. Much of the research supporting this article was done while the author was a partner at White & Case LLP, San Francisco. The author gratefully acknowledges the research assistance of Vince Novak, formerly associated with White & Case, LLP, and Lindsey Moran, associate at Winston & Strawn LLP, as well as the helpful editorial and substantive contributions of Mark Guinn, Assistant General Counsel of Bank of America, and Randy Rogers, partner at Winston & Strawn LLP. The author can be reached at wharvey@winston.com, and is solely responsible for the views expressed and any errors and omissions. All rights reserved.


2. Examples include various statutes regulating gambling, insurance, and "bucket-shops," and the Commodity Exchange Act (in the form existing prior to recent amendments and policy statements), which are perceived (or were perceived) as potentially rendering certain forms of derivatives illegal or unenforceable. See generally TONY CIRO, DERIVATIVES REGULATION AND LEGAL RISK 16 (2004); ANTHONY GOCCHI & LINDA KLEIN, DOCUMENTATION FOR DERIVATIVES 63-128 (4th ed. 2002).

3. See generally BERNHARDT, supra note 1, §§ 4.1, 4.2. California's one-action rule was adopted in
Derivatives are financial contracts typically used by business entities either to hedge certain liability- or asset-linked risks, or to speculate on the direction of future changes in price or value. Although at one time derivatives were used mainly by the largest and most creditworthy entities, such as members of the Fortune 100, today middle-market and even small start-up concerns and other end-users are choosing to mitigate or reallocate financial risks arising in the course of their businesses and affairs by using swaps, options, forwards and other similar derivative arrangements.4

To mitigate the credit risks created under derivative contracts, less creditworthy entities are sometimes required by their derivatives counterparties to provide credit support in the form of real or personal property collateral.5 Perhaps the most common instance in which real property is used as collateral for derivatives trades is in the context of derivatives used to hedge interest rate risk associated with real estate loans. Here, the borrower may wish to convert floating to fixed interest rate exposure, or vice versa, using interest rate swaps, caps, collars, or similar option products. In such instances, the real estate loan is also secured by a deed of trust on the same real property that supports the derivatives exposure, and such loan is typically extended by the dealer (or one of its affiliates) that is providing the swap or other hedge product. A second, increasingly common scenario occurs when a commercial or industrial borrower having debt outstanding to one or more lenders, secured by all or substantially all of its assets, wishes to enter into derivatives trades, frequently with one or more members of its lender group. These trades may be secured, perhaps on a subordinated basis to the loans, by all or substantially all of the assets of the borrower, including real estate.6

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4. End-users include business, governmental, and fund entities of various kinds. During the period from 1998 through 2001, some 60 percent of all over-the-counter (OTC) derivatives were entered into by end-users. CIRO, supra note 2, at 16.

5. The most common method of collateralizing obligations under the ISDA Master Agreement is using the ISDA Credit Support Annex (“CSA”). INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., ISDA CREDIT SUPPORT ANNEX (1994), available at http://www.isda.org (follow “Bookstore/Publications” hyperlink, then follow “ISDA Credit Support Documentation” hyperlink). The CSA typically accommodates the provision of cash, treasury notes and similar instruments on a periodic, “mark-to-market” basis, but can also be modified to accept other forms of eligible collateral, including real estate.

6. A variety of documentation and other issues are encountered when combining loans and derivatives in a single credit or collateral structure. See, e.g., Thrifty Oil Co. v. Bank of America Nat’l Trust & Sav. Ass’n, 322 F.3d 1039, 1042-44 (9th Cir. 2003) (addressing characterization of swap settlement payment in combined swap/loan arrangement). See generally Christian Johnson, At the Intersection of Bank Finance and Derivatives: Who Has the Right of Way?, 66 TENN. L. REV. 1 (1998); Mark Guinn & William Harvey, Taking OTC Derivative Contracts as Collateral, 57 BUS. LAW. 1127
The decision by any creditor to accept California real estate collateral always introduces a host of potential issues and concerns, including (i) the effect of California's one-action rule, which restricts the creditor to a single (judicial) action, (ii) the effect of California's anti-deficiency rules, which (among other things) bar actions to collect deficiencies following non-judicial foreclosures and foreclosures on certain purchase money liens, (iii) the choice between non-judicial and judicial foreclosure processes (the former being generally quicker, but involving a deficiency bar; the latter not having a deficiency bar, but entailing a post-foreclosure right of redemption), (iv) the possible effect of the debtor's right of reinstatement following acceleration and prior to foreclosure, and other matters.

In addition to raising all the issues described above, securing derivatives obligations with California real estate raises several other unique derivatives-related concerns that result from the characteristics of derivatives and their documentation. This article addresses several of these issues, all of which a financial institution counterparty (referred to herein as the "derivatives creditor") should consider before accepting California real estate as collateral for derivatives obligations. It first addresses the issues of whether close-out netting under a master agreement such as the ISDA Master Agreement contravenes the "security-first" rule of section 726 of the California Code of Civil Procedure, and whether the debtor's statutory right of reinstatement, which applies in respect of judicial and non-judicial foreclosures, would permit a defaulting derivatives debtor to reinstate closed-out derivatives trades. The article then discusses the priority of intervening liens and their effect on the ability of a real estate-secured derivatives creditor to effectuate close-out netting under certain scenarios. The article also considers how to avoid inadvertently triggering the anti-deficiency bar due to excessive derivatives exposure secured by California real estate.

In addition to describing the issues and how a court of first impression may approach them, this article also offers suggested techniques for mitigating the legal risks raised. It begins, however, with a brief overview of derivative contracts.

(2002).

8. Id. at §§ 580d (barring deficiency judgment after non-judicial foreclosure), 580b (barring deficiency judgment under purchase money liens). See also id. at § 580a (demonstrating fair value limitation upon judicial foreclosure).
9. See generally Bernhardt, supra note 1, § 2.8.
11. For purposes of this article, unless otherwise specified, the derivatives dealer will be assumed to be the "derivatives creditor" and the corporate end-user the "derivatives debtor." In actuality, of course, either side could end up in the creditor or debtor position with regard to a given set of trades, depending on the applicable Close-out Amounts.
12. For a more extensive introduction to derivatives contracts and their issues, see generally Guinn
II. DERIVATIVE CONTRACTS GENERALLY

Financial derivatives are commonly defined as financial instruments that derive their value from changes in value of some underlying asset, rate, or index. Derivatives may be simple or complex and may be constructed of any of several components, including swaps, forwards, and options. They usually involve a form of net settlement. While certain derivatives may be traded over established exchanges, this article addresses derivatives that are entered into on an over-the-counter (OTC) basis between two counterparties—typically an end-user wishing to mitigate or reallocate some asset, liability, or other risk, and a dealer, the latter most commonly being a commercial or investment bank or similar entity.

Derivative contracts are executory contracts as to which either party or both parties may owe further performance at any given point in time, which performance may be in the form of payment or delivery obligations. In addition, because their values vary continuously, dependent upon changes in the value or amount of the underlying asset, rate, or index, derivative contracts may be “in” or “out” of the money as to any given counterparty at any particular point in time. Thus, a derivative may either be an asset or a liability of a given counterparty at any time of determination. The credit risk associated with derivatives, therefore, has two main components—(i) whether the derivative contract is “in” or “out” of the money as to the subject counterparty at the time of default or other enforcement (i.e., the market risk), and (ii) if such counterparty is “out of the money,” whether

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13. Such underlying asset, rate, or index is referred to as "the underlying." Derivatives are fashioned based on "notional amounts," which are the theoretical, indicated number or quantity to which the underlying is applied. See generally OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK, RISK MANAGEMENT OF FINANCIAL DERIVATIVES, 1 (1994). A counterparty that is "in the money" is owed payment or delivery; one that is "out of the money" owes it to the other counterparty.

14. See generally Guinn & Harvey, supra note 6, at 1128-32.

15. Exchange-traded derivatives, such as futures, tend to be less customized than OTC derivatives. However, the standardized aspect of such contracts facilitates their prompt and efficient sale. For a discussion of the relative advantages and disadvantages of exchange-traded versus OTC derivatives, see GOOCH & KLEIN, supra note 2, at 4. See generally Rhett Campbell, Energy Future and Forward Contracts, Safe Harbors and the Bankruptcy Code, 78 AM. BANKR. L.J. 1 (2004).

16. Most derivatives trades provide for payments in cash and are subject to cash settlement. Certain commodity derivatives may provide for the actual physical delivery of the underlying. Certain credit derivatives provide for the delivery of specified loan or bond documentation upon settlement, also deemed physical settlement.

17. The determination of the value of a derivative, or a group of derivatives, at any point in time prior to settlement is called “marking to market.” See, e.g., OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANKING ISSUANCE BC-277, at 13 (October 27, 1993) [hereinafter BC-277], available at http://www.occ.treas.gov/ftp/bc/bc-277.doc. A counterparty that is "in the money" is owed payment or delivery; one that is "out of the money" owes it to the other counterparty.
such counterparty has the credit capacity to perform (counterparty risk). Credit support in the form of collateral or third party guaranties may be demanded by either or both counterparties at the outset of the relationship, or thereafter, if there exists uncertainty as to the ability of the other counterparty to perform in accordance with the terms of the derivatives contracts.

Typically, the dealer in a derivatives trade will hedge the market risk associated with its derivatives contracts, either on a trade-specific, “back-to-back” basis (matched trading), or on a general portfolio basis, using any of a variety of instruments and strategies. Although the dealer’s counterparty may not be aware of whether or how the dealer is hedging its position, it does potentially benefit from such hedging through more favorable trade pricing, and any Close-out Amount payable by such party may include a component for the costs of terminating such hedging transactions or arrangements.

OTC derivatives are most commonly entered into under standard documentation promulgated by the International Swaps and Derivatives Association (“ISDA”). The ISDA document architecture includes several elements, but most importantly, together these elements constitute a single master agreement (the “ISDA Master Agreement”). Any number of separate derivative transactions may be undertaken between the given counterparties under their master agreement, each transaction being evidenced by a separate confirmation entered into on or shortly after the completion of the trade. Although a standard document, the ISDA Master Agreement may be customized through a schedule (“ISDA Schedule”) that is executed and delivered by the parties, usually prior to or contemporaneously with the undertaking of the initial trade. Further

18. Other risks affecting performance under derivatives contracts includes documentation risk, legal or regulatory risk and operational risk. See id. Certain options-based derivatives are pre-paid by the purchaser, leaving only the seller with a contingent obligation to perform in the future. Such trades entail credit risk being incurred only by the purchaser (usually the end-user) in respect of the seller (usually the dealer).
19. See supra note 5.
21. There are currently two versions of the ISDA Master Agreement in widespread usage—the 1992 Master Agreement (Multicurrency-Cross-Border) and the 2002 Master Agreement, see sources cited supra note 20. Unless otherwise specified, references in this article to the ISDA Master Agreement will be to the 2002 Master Agreement, and capitalized terms not otherwise defined have the definitions specified in the 2002 Master Agreement.
22. The ISDA schedule comes as an attachment to the 2002 MASTER AGREEMENT, supra note 20.
customization occurs at the level of each confirmation. All derivatives trades and their respective confirmations under an ISDA Master Agreement are together deemed to compose a single agreement. This unification principle has been recognized and upheld by Congress and certain state legislatures and has been cited as being critical in order to avoid piecemeal rejection of selected derivatives trades in a counterparty insolvency, i.e., “cherry-picking,” and interference with the close-out process. Avoiding such cherry-picking, and ensuring a timely ability to close-out derivatives trades notwithstanding counterparty insolvency, are in turn perceived as vital elements of a policy of reducing systemic risk within the banking system and financial markets.

Derivatives trades may have tenors ranging from a few months to twenty years or more, during which time either or both counterparties may be obligated to make one or more payments or deliveries of designated assets. The derivatives trades collectively are subject to early termination if any of certain events occurs. Such events include (i) events of default, which in the ISDA Master Agreement generally resemble loan agreement events of default, and (ii) “Termination Events,” which are generally

23. See 2002 MASTER AGREEMENT, supra note 20, § 1(c) (citing single agreement provision).
26. Interest rate swaps entered into in conjunction with real estate loans often have the same tenor as such loans, which may be seven to thirty years. Such lengthy tenors will tend to exacerbate the mark-to-market value impact of changes in the underlying interest rate, resulting in greater price volatility and potentially larger claims upon an Early Termination Date.
27. Such events of default include (i) failure to pay or deliver, (ii) breach of covenant, and repudiation of agreement, (iii) default under credit support documentation (such as the CSA, deeds of trust and security agreements), (iv) misrepresentation, (v) default under Specified Transactions (i.e., other derivatives not falling under such ISDA Master Agreement), (vi) cross-default, (vii) bankruptcy and insolvency, and (viii) merger by counterparty without assumption. 2002 MASTER AGREEMENT, supra note 20, § 5(a).
28. The ISDA Termination Events include (i) illegality of any transaction, (ii) force majeure events, (iii) certain tax events (including action by taxing authorities and change in tax law), (iv) additional tax amounts required to be paid upon merger of a counterparty, (v) Credit Event Upon Merger (the merger of a counterparty resulting in lessened creditworthiness), and (vi) any Additional Termination Event
"no-fault" events or circumstances, such as illegality, tax changes, force majeure, and certain mergers involving a counterparty, that the parties have agreed are sufficiently material to permit the early termination of some or all outstanding trades. Following an event of default, the Non-defaulting Party may elect to declare an Early Termination Date, thereby terminating all outstanding derivatives trades under the ISDA Master Agreement. Upon a Termination Event, any designated party may elect to declare an Early Termination Date and terminate certain or all (depending on the nature of the Termination Event) outstanding trades under the ISDA Master Agreement. In either event, upon the Early Termination Date, no further scheduled payments or deliveries are required and the termination value of each affected trade is determined, based upon a methodology agreed to by the parties in the ISDA Schedule (the “Close-out Amount”). Assuming multiple trades exist, the result is reduced to a single positive (in the money) or negative (out of the money) number through a process known as “close-out netting” and certain other amounts are added to create the “Early Termination Amount.” This number then becomes the basis for a claim by the derivatives creditor against the derivatives debtor, which in turn potentially allows the former to proceed against the latter’s collateral. The balance of this article addresses certain issues that may arise when the derivatives creditor has taken and wishes to proceed against California real estate collateral.

III. CLOSE-OUT NETTING AND THE “SECURITY-FIRST” PROBLEM

Close-out netting may be susceptible to differing legal characterizations. Insofar as the ISDA Master Agreement specifies that all trades arising under it are deemed to constitute a single agreement and specifies the method of calculating the Early Termination Amount for such trades, close-out netting is best viewed as simply the mathematical means by which a lump-sum amount (the Early Termination Amount) associated with that ISDA Master Agreement (including all of its constituent confirmations) is determined. However, since close-out netting involves

specified in the ISDA Schedule or any confirmation. 2002 MASTER AGREEMENT, supra note 20, § 5(b).
29. 2002 MASTER AGREEMENT, supra note 20, § 6(a).
30. Id. at § 6(b)(iv).
31. Id. at §§ 6(c)(ii), (e).
32. Id. at § 6(c). For close-out netting to be useful when most needed (i.e., during the bankruptcy or insolvency of the defaulting counterparty), the applicable bankruptcy laws must (i) permit the Non-defaulting Party to close-out and net the derivatives and (ii) not permit the bankruptcy trustee (or similar official) to block close-out netting and “cherry pick” “in the money” positions while repudiating “out of the money” positions. Fortunately, the United States Bankruptcy Code does provide these protections to derivatives counterparties. See, e.g., 11 U.S.C. §§ 362, 560, 561 (2000 & Supp. 2005).
33. See 2002 MASTER AGREEMENT, supra note 20, at §§ 6(c)(ii), (e). The federal banking laws (e.g., FDICIA) use the term “netting contracts,” which is defined as a contract between two or more financial institutions that “provides for netting present or future payment obligations or payment entitlements
the addition and subtraction of amounts owing by each side to the other on trades that may in some sense be deemed separate, it may also be argued that it is a form of set-off.\textsuperscript{34} Due to a line of cases decided under California law,\textsuperscript{35} this latter possibility has raised a concern with some practitioners that such close-out netting may violate the “security-first” aspect of Section 726 of the California Code of Civil Procedure.\textsuperscript{36} If this were to be the case, as discussed below, the derivatives creditor might be unable to use close-out netting without risking the loss of its California real estate collateral.

The security-first doctrine is a case law-derived outgrowth of California’s statutory one-action rule.\textsuperscript{37} The latter, which proceeds from statutory language in section 726, directs that “[t]here can be but one form of action for the recovery of any debt or the enforcement of any right secured by a mortgage upon real property . . . ”\textsuperscript{38} The term “action” is defined statutorily as a judicial action.\textsuperscript{39} Thus, the one-action rule does not proscribe non-judicial enforcement steps, such as non-judicial foreclosure of real or personal property collateral. However, as early as the nineteenth century,\textsuperscript{40} California judges discerned in the one-action rule an implicit prohibition against seizing, even without the use of judicial means, unencumbered assets of the debtor and applying those assets to the real estate-secured indebtedness.\textsuperscript{41} This implicit prohibition, which has come to be known as the “security-first” rule, requires that the secured creditor proceed first against the real estate collateral.\textsuperscript{42}

\textsuperscript{34} Federal legislation adopted to preserve close-out netting in various insolvency contexts generally uses alternative language, such as “offset or net out any termination value.” 12 U.S.C. § 4402(14) (2000 & Supp. 2005).


\textsuperscript{36} See Wozab, 51 Cal. 3d at 999-1000.

\textsuperscript{37} Id. at § 22.

\textsuperscript{38} See McKean, 118 Cal. at 339-40.

\textsuperscript{39} See discussion in Wozab, 51 Cal. 3d at 999.

\textsuperscript{40} See BERNHARDT, supra note 3, at §§ 4.1 et seq. Procedurally, the security-first rule may be
Applying the one-action or security-first rule, California courts have held that a real estate-secured creditor cannot set-off against general deposit accounts of the debtor maintained with such secured party and apply such funds to the secured indebtedness. Under the ruling of *Bank of America v. Daily*, such set-off was deemed an "action" for purposes of section 726. The later *Wozab* decision overruled that determination, but concluded that deposit account set-off contravened the security-first principle. Under *Wozab*, the remedy for such violation was stated to be forfeiture of the real estate collateral.

The set-off cases decided under section 726 have generally involved deposit account set-offs. The notable exception is *Aplanalp v. Forte*, in which a California Court of Appeal applied the *Daily* holding to conclude in a non-deposit account context that the exercise of an equitable set-off (arising from a judgment rendered against it in an independent matter) by a real estate-secured noteholder prior to conducting a non-judicial foreclosure sale violated the one-action rule. The court noted, in dictum, that where a real estate-secured creditor is sued by its borrower (even in an unrelated matter), its ability to assert a cross-complaint based on its secured note is subject to section 726. However, the *Aplanalp* case may be invoked by the debtor as an affirmative defense or as an affirmative sanction. See, e.g., R. Bernhardt, supra note 3, at § 4.11.

43. See, e.g., *Wozab*, 51 Cal. 3d at 991.
45. See *Wozab*, 51 Cal.3d at 999 n.7. The *Wozab* court premised its holding on the following policy basis:

By exercising such a setoff, a bank not only deprives the debtor of the immediate possession of funds to which the debtor is then entitled, but the bank may obtain funds of the debtor to which the bank would never be entitled or to which other creditors have an equal or greater claim. If, for example, the market value of the security equals or exceeds the debt or if any of the statutory provisions prohibiting a deficiency judgment are applicable, the bank would have no right to reach any assets of the debtor other than the security (§§ 726, subd. (b), 580b, 580d), but the bank could evade these limitations with impunity if it could collect the secured debt by setoff from a debtor's nonsecured bank account. *Id.* at 1010.

46. *Id.* Under certain aggravated circumstances the creditor may also be deemed to forfeit its claim for repayment of the debt. *Id.* at 1006. See generally Darren Conley, *Comment: The Sanction for Violation of California's One-Action Rule*, 79 CAL. L. REV. 1601 (1991).
47. See, e.g., cases cited supra note 35. There is, in addition, a case involving equitable set-off of (non-deposit) claims, decided under section 580b of the California Code of Civil Procedure, in which the court held that the set-off by a creditor of amounts it owed to the debtor in relation to a prior dispute, against a deficiency remaining after completion of the non-judicial foreclosure of a purchase money deed of trust, violated the spirit of section 580b and was therefore impermissible. See *Birman v. Loeb*, 64 Cal. App. 4th 502, 522 (1998). The court noted that the case did not arise under section 726's security-first rule, because the set-off was undertaken after completion of foreclosure on the real estate. *Id.* at 508 n.2. It reasoned that allowing such set-off would in effect provide the creditor with a second source of repayment, apart from the foreclosure proceeds, and that this was contrary to section 580b's purpose, i.e., placing the risk of inadequate security on the purchase money mortgagee. *Id.* at 513.
49. See *id.* at 616 n.46.
distinguished in that the set-off was preceded by a court order authorizing
the set-off, which court order was cited as an additional basis for the
existence of an “action” for section 726 purposes. It also relies upon an
aspect of Daily that was later overruled by the Wozab decision. Consequently, apart from the fact that Aplanalp was decided by a lower
appeals court, its current force and applicability is open to debate.

As a counter-point to the set-off line of authority under section 726,
there are cases involving additional grants or pledges of security by the
debtor to the real estate-secured creditor. In such situations, the California
courts have repeatedly held that section 726 does not prohibit the secured
party from enforcing such pledges non-judicially, even to the point of
foreclosure. This principle has also been extended to situations where the
secured party holds a letter of credit issued for the debtor’s account by a
third party institution.

It is suggested that in the foregoing lines of cases, a differentiating
principle between the additional collateral-type instances on the one hand,
and the deposit account set-off line of authority (as well as Aplanalp’s non-
consensual equitable set-off) on the other, is that in the former the debtor
has voluntarily conveyed certain property and rights to the secured party,
which rights are simply exercised by the secured party in accordance with
the agreed contractual provisions. Unilateral set-off against deposit
accounts and similar property, however, is generally viewed as a
non-consensual remedy.

There exists no case law precedent interpreting derivatives close-out
netting in the context of section 726. As noted above, the most appropriate
categorization of close-out netting is that it is simply a mathematical
means of calculating the Early Termination Amount within the context of a
single agreement and does not involve set-off at all. However, to the extent
a court should determine that close-out netting is a type of set-off, it should
nevertheless hold that such netting does not contravene the security-first
rule. Close-out netting is explicitly provided for in the ISDA Master
Agreement and is therefore voluntarily agreed-to by both parties, and it
may benefit either party depending on the nature of the trades and the
relative market values of the underlyings. It is therefore more analogous to
a voluntary pledge, rather than an involuntary set-off, for purposes of the

50. See id. at 615 n.18; Wozab, 51 Cal.3d at 999 n.7.
51. See, e.g., RTC v. Bayside Developers, 43 F.3d 1230, 1243 (9th Cir. 1994) (multiple real estate
collateral); In re Kearns, 314 B.R. 819, 826 (B.A.P. 9th Cir. 2004) (mixed collateral); In re Sunnymead
Shopping Center Co., 178 B.R. 809, 817 (B.A.P. 9th Cir. 1995) (payments from cash collateral); RTC
v. Bayside Developers, 817 F. Supp. 822, 828-29 (N.D. Cal. 1993) (mixed collateral); In re 500
53. See sources cited supra notes 50 and 51.
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security-first rule. In addition, as simply the means by which the derivatives creditor’s claim is calculated, close-out netting is not a remedy, unlike deposit account set-off. Moreover, it is not the seizure of unencumbered assets of the derivatives debtor by the derivatives creditor, nor does it facilitate the circumvention of the debtor protections in the one-action or anti-deficiency rules or deprive the debtor of the ability to litigate and protect its interests. Indeed, close-out netting, by reducing several potential claims to a single one, actually supports the underlying principle of the one-action rule—that of avoiding a multiplicity of actions.

Beyond the foregoing considerations that there is no need to extend Wozab and its related cases to interfere with close-out netting, doing so would create an inequitable result and undermine important policies and practices that are central to the derivatives markets. As noted above, it is only by application of close-out netting that a derivatives creditor is able, under the terms of the ISDA Master Agreement, to arrive at the Early Termination Amount, i.e., to fix its claim against the derivatives debtor. Therefore, a holding that close-out netting contravenes the security-first rule would place the derivatives creditor in the undesirable position of either surrendering its real estate collateral or foregoing the liquidation of its claim. In the case of the latter, the derivatives creditor would also be unable to pursue other remedies, such as non-judicial foreclosure on personal property collateral, even though such remedies would themselves be permitted by the one-action rule—clearly an inequitable result. Perhaps most importantly, blocking or disenabling close-out netting runs contrary to certain fundamental financial policies, such as the mitigation of systemic risk, that have been cited repeatedly by Congress in adopting special bankruptcy and bank insolvency legislation relating to derivatives.

Notwithstanding the foregoing arguments supporting the proposition that close-out netting should not be held to contravene the security-first rule of section 726, given the absence of dispositive California case law authority on the subject, real estate-secured derivatives creditors may wish to consider obtaining a security interest under the Uniform Commercial Code in all of the derivatives debtor’s rights under derivative contracts under the ISDA Master Agreement (including those with such derivatives creditor) and then foreclose on such rights in accordance with the UCC. As noted above, non-judicial foreclosure in respect of other collateral

54. Cf. Wozab, 51 Cal.3d at 1002 n.3.
55. See supra text accompanying note 31.
56. See, e.g., Machado v. Borges, 170 Cal. 501, 503 (1915) (demonstrating court of equity will compel set-off where such set-off is necessary to enable party to collect on claim).
58. See generally, Guinn & Harvey, supra note 6.
provided by the debtor does not contravene either the security-first or one-action rule.\textsuperscript{59}

There exists a second set-off-related issue under the security-first rule, which raises perhaps a more problematic scenario for derivatives counterparties. Section 6(f) of the ISDA Master Agreement permits a derivatives counterparty that is the Non-defaulting Party to offset any Early Termination Amount that it owes the Defaulting Party against any other amount owed to it by such Defaulting Party.\textsuperscript{60} A common instance of this relevant to the present context would be the case where the Non-defaulting Party has extended a real estate loan to the Defaulting Party and also entered into an interest rate swap, and the Non-defaulting Party is out-of-the-money on the swap at the time of acceleration of the loan and the declaration of the Early Termination Date. The issue again is whether such set-off by the Non-defaulting Party against the loan balance contravenes the security-first rule. Here, the loan/derivative set-off is not part of close-out netting, is clearly a type of equitable set-off, and does not implicate the significant policy concerns referenced above protecting close-out netting. It would appear likely that \textit{Aplanalp}, to the extent it is still good and persuasive authority, would be cited as a basis to block such set-off.\textsuperscript{61} For this reason, lenders who are real estate-secured derivatives creditors may again wish to mitigate their risk by obtaining a perfected UCC security interest in the debtor’s “in the money” derivatives claims against the former as additional security for the real estate loan.\textsuperscript{62}

IV. THE DEBTOR’S RIGHT OF REINSTATEMENT AS APPLIED TO DERIVATIVE CONTRACTS

A second area of potential concern when applying California’s real property security laws to derivatives obligations arises under the statutory right of reinstate ment afforded by section 2924c of California Civil Code.\textsuperscript{63} This section, which applies in the context of both judicial and non-judicial foreclosures, provides debtors a right to de-accelerate and reinstate an obligation secured by California real estate that has become due and payable as a result of a payment default, assuming all amounts in default (without taking into account the accelerated amount), plus so-called “recurring obligations,” are paid.\textsuperscript{64} This right may be exercised by the

\textsuperscript{59} See RTC v. Bayside Developers, 43 F.3d 1230, 1243 (9th Cir. 1994); In re Kearns, 314 B.R. 819, 826 (B.A.P. 9th Cir. 2004); In re Sunnymead Shopping Center Co., 178 B.R. 809, 817 (B.A.P. 9th Cir. 1995); RTC v. Bayside Developers, 817 F. Supp. 822, 828-29 (N.D. Cal. 1993); In re 500 Ygnacio Associates, Ltd., 141 B.R. 191, 192 (Bankr. N.D. Cal. 1992).
\textsuperscript{60} 2002 MASTER AGREEMENT, supra note 20, § 6(f), at 14.
\textsuperscript{61} See text accompanying notes 48-50, supra.
\textsuperscript{62} See generally M. Guinn & W. Harvey, supra note 6.
\textsuperscript{63} CAL. CIV. CODE § 2924c (West 2007).
\textsuperscript{64} Id. at § 2924c(a)(1). Section 2924c specifies that the debtor wishing to cure and reinstate its
debtor at any time prior to five business days before the date of foreclosure sale specified in the notice of foreclosure, in the case of foreclosure by power of sale, or any time prior to the entry of the decree of foreclosure, in the case of judicial foreclosure. The specific issue is whether section 2924c permits a derivatives debtor that has defaulted on an interim payment obligation to reinstate derivatives trades that were subsequently closed out by its counterparty pursuant to the close-out netting process.

It is not entirely clear from the face of the statute whether section 2924c was intended to extend to any obligation secured by a deed of trust, or only to loans and certain loan-equivalent obligations. The terminology applied to derivatives does not fit comfortably within section 2924c’s statutory language. For example, derivatives are not “declared due” (i.e., accelerated) following a default or Termination Event. Instead, they are terminated or closed-out, with a single Early Termination Amount being determined as of the Early Determination Date through close-out netting.

obligations shall pay the entire amount due, at the time payment is tendered, with respect to:

(A) all amounts of principal, interest, taxes, assessments, insurance premiums, or advances actually known by the beneficiary to be, and that are, in default and shown in the notice of default, . . . (B) all amounts in default in recurring obligations not shown in the notice of default, and (C) all reasonable costs and expenses . . . .

Id. “Recurring obligations” is defined as:

all amounts of principal and interest on the loan, or rents, subject to the deed of trust or mortgage in default due after the notice of default is recorded; all amounts of principal and interest or rents advanced on senior liens or leaseholds which are advanced after the recordation of the notice of default; and payments of taxes, assessments, and hazard insurance advanced after recordation of the notice of default.

Id.

65. Id. at § 2924c(e).

66. The lack of clarity as to whether section 2924c is intended to apply only in respect of loan (and similar) obligations, or more broadly, appears in the following excerpts from section 2924c:

Whenever all or a portion of the principal sum of any obligation secured by deed of trust or mortgage on real property . . . has, prior to the maturity date fixed in that obligation, become due or then declared due by reason of default in payment of interest or of any installment of principal, or by reason of failure of trustor . . . to pay, in accordance with the terms of that obligation or the deed of trust or mortgage, taxes, assessments, premiums for insurance, or advances made by beneficiary . . . in accordance with the terms of that obligation . . .

Id. at § 2924c(a)(1) (emphasis added). “T[he] term ‘recurring obligation’ means all amounts of principal and interest on the loan, or rents, subject to the deed of trust or mortgage . . . .” Id. Moreover, section 2924c provides that the notice of any default described in that section and recorded shall be mailed to the obligor and include the following language (inter alia):

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing.

Id. § 2924c(b)(1).

67. See 2002 MASTER AGREEMENT, supra note 20, § 6, at 11. Similarly, derivatives payments are not typically characterized as being in the nature of “principal,” or “interest” (other than interest in respect of past-due payments), nor do they have a “maturity date,” nor do they involve a “note.”
The application of section 2924c in the context of real estate-secured loans is relatively straightforward and generally understood. However, its application in the context of derivatives obligations raises issues that have not been addressed by case law. First, the application of section 2924c could impose unusual and seemingly inequitable burdens on the real estate-secured derivatives creditor. If the derivatives creditor has hedged its market risk associated with the derivatives transactions through "back-to-back" transactions, it will typically have closed out those hedging transactions, effective on the Early Termination Date under the ISDA Master Agreement. If section 2924c should be deemed applicable to derivatives obligations, it would permit the debtor, after the declaration of an event of default (due to a missed payment) under the ISDA Master Agreement and the termination of all trades and the calculation of the requisite Early Termination Amount, to remit whatever payment amount may have precipitated the initial default and thereby reinstate all terminated trades. Such action would, among other things, potentially leave the dealer in an unhedged position, significantly altering the economics and risks of the transaction to that dealer.68 Furthermore, absent special language added to the Schedule of the ISDA Master Agreement to address this eventuality, the derivatives debtor would probably not be responsible for defraying the cost of the reinstatement of the dealer's hedge under these circumstances.69

Second, if applied in this context, section 2924c would appear to extend inequitable and unbargained-for benefits to the derivatives debtor. The effect of applying section 2924c to derivatives trades would be to provide the debtor with an option, of potentially considerable value, to reinstate its trades as of a date more than three months following their termination.70 In other words, the debtor could elect to forego exercising this option if, during the interim, the net value of the derivative contracts dropped, while deciding to exercise the right if the net value of the derivatives significantly increased. Given the pricing volatility of many derivatives, the value swings could be considerable.71 Such optionality goes

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68. During this period of time, the value of the various Close-out Amounts could shift dramatically, perhaps in a manner opposite to the dealer, transforming what was initially an "in the money" position as to the dealer to one that is "out of the money." If the dealer has meanwhile terminated its hedge, and the derivatives debtor successfully reinstates its trades, the dealer will be exposed to a potentially significant loss. However, if the dealer retains its original hedges in place following the Early Termination Date of the underlying trade and the underlying trade is not reinstated, the dealer is again in an exposed or unhedged position, this time vis-à-vis its back-to-back transactions.

69. See 2002 MASTER AGREEMENT, supra note 20, § 14, at 21 (defining "Close-out Amount").

70. Pursuant to section 2924c, at least three months must elapse, to allow possible exercise of the debtor's right of reinstatement, before the (twenty day) notice of sale may be issued. § 2924c. Frequently, more time than this is given. See BERNHARDT, supra note 3, at § 2.44. With judicial foreclosures, a considerably longer time may elapse until actual completion of the foreclosure. See id. at § 2.8.

71. As noted above supra note 26, long-dated derivatives, such as are often used to hedge real
considerably beyond any notion of merely restoring the status quo ante; there is nothing in the case law addressing section 2924c that would support granting such a windfall benefit to a defaulted derivatives debtor.\textsuperscript{72}

The foregoing considerations, together with the repeated references in section 2924c to "principal," "interest," "note," and other loan-related terms,\textsuperscript{73} suggest that, notwithstanding certain other broadly phrased language contained in the statute, section 2924c's right of reinstatement should not be extended beyond the loan context to provide a right to reinstate closed-out derivatives trades. However, until the California courts decide this issue, real estate-secured derivatives creditors may wish to consider including certain provisions in the ISDA Schedule to ameliorate the potential effects of applying section 2924c to closed-out derivatives trades,\textsuperscript{74} perhaps as an amendment to Section 9 of the ISDA Master Agreement, such as the following:

(j) Reinstatement. To the maximum extent permitted under applicable law, the parties each hereby waive any right to reinstate, pursuant to California Civil Code § 2924c or otherwise, any Transactions as to which an Early Termination Date has occurred hereunder. If and to the extent that, notwithstanding the foregoing waiver, it may be determined that § 2924c permits such reinstatement in connection with any foreclosure upon California real estate securing the obligations of either party hereunder, and the Defaulting Party (or Affected Party) properly elects to reinstate pursuant to § 2924c Transactions as to which an Early Termination Date has occurred, the Non-defaulting Party (or Non-affected Party, as the case may be) shall be entitled to replace or reinstate, with any counterparty of its choosing, any hedging arrangement or transactions in effect as of such Early Termination Date, and the costs incurred by the Non-defaulting Party (or Non-affected Party, as the case may be) in connection with any such replacement or reinstated hedges shall be deemed advanced by the Non-defaulting Party (or Non-affected Party, as the case may be) for the account of the Defaulting Party (or Affected Party, as the case may be), which advance shall be repaid, together with interest thereon at the Default Rate, on demand.

It is suggested that the hedge expense be structured as an advance in order to enhance the likelihood that it fits within section 2924c's "recurring

\textsuperscript{72} Cf. Sec. Pac. Nat'l Bank v. Wozab, 51 Cal. 3d 991, 1005 (1990) (declining to order loss of debt as remedy for violation of the security-first rule as such an order would be "a gross injustice to the bank and a corresponding windfall to the Wozabs").

\textsuperscript{73} See sources quoted supra note 66.

\textsuperscript{74} Another approach to this issue would be to avoid relying upon payment defaults as the basis for declaring Early Termination Dates. As indicated above, section 2924c's right of reinstatement is triggered only by certain, mainly payment, defaults. To the extent that other defaults have arisen, particularly if they are not susceptible to meaningful cure, section 2924c probably should not apply. Accord, BERNHARDT, supra note 3, at § 2.34.
obligations” and should therefore be required to be paid by the Defaulting Party as part of the reinstatement payment.

V. THE PRIORITY PROBLEM—FUTURE TRADES AND THE INTERVENING LIENOR

A further issue applicable to real estate-secured derivatives arises in the context of lien priorities under California’s real estate security laws. The general priority rule with respect to deeds of trust in California is that the first in time to record prevails over subsequent lienors. However, if a subsequent creditor arises and records its lien and gives notice of such fact to a prior real estate-secured creditor, any voluntary, non-committed advances given by the prior creditor to the debtor after that date will potentially be subject and subordinate to the lien priority of the advances made by the subsequent lienor. Again, this rule operates reasonably well in the traditional lending context, but one encounters conceptual problems in applying it to derivatives subject to a master netting arrangement.

Derivatives trades generally are not undertaken on a pre-committed basis, so obligations associated with derivatives trades that are entered into after the date of recordation and notice of a subsequent lien would potentially be subject to the loan or other obligations of the subsequent lienor. However, although the termination values of any and all trades, including subsequent trades, would ordinarily be netted upon close-out netting following an Event of Default to establish the Early Termination Amount, such interruption of priority might be viewed as dictating a two-stage close-out netting process. In other words, as a result of the application of the foregoing future advance priority rule, the derivatives creditor may find itself obligated first to net out all trades entered into prior to the date the intervening lienor arises, and second to net out separately all trades

75. See § 2924c(a)(1).
77. See, e.g., Rheem Mfg. Co. v. United States, 57 Cal. 2d 621, 625 (1962); Atkinson v. Foote, 44 Cal. App. 149, 159 (1919); Garcia v. Atmajian, 113 Cal. App. 3d 516, 519-20 (1980). Where interest rate swaps are entered into with real estate loans, the lender/derivatives creditor may wish to obtain title insurance, through an interest rate exchange agreement endorsement, confirming that the lien priority of the swap obligations is the same as that of the loan principal. In such instances the title insurer may require that the swap obligation be characterized as “additional interest,” in effect melding the swap payment with the loan obligation. Counsel should consider whether such characterization of swap payments could, together with other facts involved in the transaction, result in close-out payments being characterized as post-petition interest in the event of a borrower bankruptcy (and therefore potentially subject to disallowance pursuant to 11 U.S.C. § 502(b)(2)), notwithstanding the holding in Thrifty Oil Co. v. Bank of Am. Nat’l Trust & Sec. Ass’n, 322 F.3d 1039, 1059 (9th Cir. 2003). The title insurer may also require proof of a commitment by the lender-counterparty to enter into the swap, where such swap is not consummated at loan closing.

occurring after such date.

Two problems arise with the two-stage netting approach to resolving this issue. First, the ISDA Master Agreement does not generally contemplate two-stage netting. The Agreement specifies only a single amount that is owing by the derivatives debtor to the derivatives creditor, and that is the Early Termination Amount in respect of all trades under such Agreement. Second, the application of a two-stage netting approach may yield odd or illogical results that in fact may be adverse to the subsequent lienor, depending on the relative values of the trades being netted pre- and post-intervening lien. For example, if the derivatives creditor's pre-intervening lien trades are net positive (in the money) and the subsequent trades are net negative (out of the money), the application of a two-stage netting rule would result in a larger Close-out Amount, since it would not be reduced by the (negative) subsequent trades.

As a result of the foregoing considerations, it may be argued that it is impractical or inappropriate to resolve the future advance priority issue through two-stage netting. In that event, assuming the post-intervening lien trades are net positive to the derivatives creditor, the situation may be analogized to the material modification of the first lien documentation in a manner prejudicial to the junior lien. While there exists conflicting authority as to the priority effect of a material modification to senior loan terms, certain authority supports the proposition that the modification becomes junior to the second lien, and if that is not practical, the entire senior lien should become junior to the second lien.

In the absence of definitive case law guidance in this area, and particularly in view of the theoretical risk of loss of priority as to the entire first lien position, real estate-secured derivatives creditors will probably

79. See 2002 MASTER AGREEMENT, supra note 20, at § 6. One exception to this general rule arises in the context of certain bullion trades, where the counterparties may specify matched-pair novation netting between two particular offices or in respect of certain types of trades. See INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., 1997 ISDA BULLION DEFINITIONS 10 (1997).

80. 2002 MASTER AGREEMENT, supra note 20, at § 6. There is, however, at least one other statutory situation where two-stage netting arises. Under New York's bank insolvency law, the Banking Superintendent is instructed, in the event of a counter-party foreign bank branch insolvency, to calculate a global net amount and a local net amount (the latter relating only to trades entered into by the New York branch) and pay the lesser indicated amount. N.Y. BANKING LAW § 618-a(2)(c) (Consol. 2006).

81. The junior lien creditor could even argue that the future advance priority rule should be applied in a fashion that results in "cherry-picking"—i.e., that only subsequent trades having a positive (in the money) value as of the Early Termination Date should be deemed "advances" and so subordinated to the junior lien creditor's interest, while all negative (out of the money) trades should not be deemed "advances" and should be used to set-off against or reduce the first lien position. Such an argument, of course, runs headlong into policy-based counterarguments relating to systemic risk. See sources cited supra note 23.

wish to avoid entering into further derivatives trades after receiving notice of the recordation of a junior deed of trust, unless a suitable subordination or intercreditor agreement is entered into between the derivatives creditor and the junior lien creditor. 83

VI. AVOIDING THE INADVERTENT TRIGGERING OF THE ANTI-DEFICIENCY BAR

Under one prong of California's anti-deficiency rules, a real estate-secured creditor is barred from seeking recovery from the debtor for any deficiency resulting from a non-judicial foreclosure of real estate. 84 Since non-judicial foreclosure is typically the preferred remedy for California real estate-secured creditors, such creditors will often attempt to limit the aggregate amount of debt and other obligations secured by their real estate collateral to an amount that is less than the value likely to be realized from the foreclosure on all such collateral. 85 In the case of real estate-secured loans, crafting such a limitation is relatively simple and is also generally effective, since the amount of loans extended by a lender is to a considerable extent, or entirely, within the lender's control. Due to their pricing volatility in response to factors beyond the control of derivatives counterparties, however, derivatives exposures can easily and unexpectedly cause the aggregate amount of secured obligations to exceed any given collateral value. This risk is potentially exacerbated where the possibility exists of multiple derivatives trades under a single master agreement being secured by the same real estate collateral. If the aggregate Early Termination Amount, together with all loans and other obligations similarly secured, should at the time of enforcement exceed the collateral value, the creditor would be forced either to forego its deficiency claim or to undergo the delay, expense, and complexity associated with a judicial foreclosure.

Derivatives creditors can take certain steps in order to mitigate the risk of such an unanticipated deficiency. The simplest approach is from the collateral side. The creditor simply ensures that its liens extend to all real and personal property and assets of the derivatives debtor. In so doing, the derivatives creditor will be able to proceed non-judicially against, and if necessary exhaust, all sources of value held by the debtor counterparty. Any deficiency claim remaining at that point is one that would not in any event be satisfied or reduced. Where the foregoing approach is not available, the derivatives creditor may instead proceed from the opposite

83. Appropriate negative pledge covenants should also be included in the ISDA Schedule.
85. In addition of course, under various statutes and regulations, regulated banks may be required to maintain certain loan-to-value ratios in their real estate lending activities. See, e.g., 12 C.F.R. § 34.62 (2006) (citing real estate lending standards for national banks).
side—by limiting the value or number of derivatives trades to be secured by the real estate collateral. This entails, first, applying various quantitative methods to estimate the reasonably anticipated maximum future value of each trade, and, second, adopting a documentation approach that limits the derivatives trades that are intended to be secured by the real estate collateral. The most straightforward approach as to the latter factor is (i) to recite in the deed of trust that it secures only derivatives arising under a specific master agreement, and (ii) to include language in the derivatives confirmations that ensures that only the intended derivatives are subject to that master agreement. Additional derivatives trades, beyond or in excess of the group that is intended to be so secured, could be placed under a separate master agreement. The derivatives creditor may even elect, in order to enable it to net out on an aggregate, global basis for accounting and other purposes, to place both such master agreements under an umbrella, or “master master agreement.”

VII. CONCLUSION

California’s complex real estate security laws have long presented challenges to real estate-secured creditors, which have resulted in a deep and rich body of case law. Nevertheless, derivatives creditors wishing to use California real estate as collateral must face, without the benefit of definitive case law guidance, a variety of unique and novel legal issues. It is anticipated that such case law guidance, when it arrives, will give due consideration to the special documentation and policy issues surrounding derivatives and, having done so, conclude that close-out netting does not contravene section 726's security-first rule, and that section 2924c does not enable a defaulted derivatives debtor to reinstate closed-out derivatives trades. In the meantime, derivatives creditors electing to be secured by California real estate may wish to consider the mitigation techniques discussed above.

86. Under the second prong of the California anti-deficiency statutes, a residential purchase money real estate-secured creditor is barred from enforcing any deficiency resulting from either a judicial or non-judicial foreclosure. CAL. CIV. PROC. CODE § 580b (2007). To date, the use of swaps and other derivatives in this context is relatively rare.
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