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Spring 2021

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CLEARINGHOUSE INSOLVENCY: CAUTION IN DISREGARDING CONTRACTUAL ALLOCATION OF LOSSES BETWEEN NON-DEFAULTING MEMBERS OR SHAREHOLDERS

*Thomas E. Plank**

Reading Professor Baker's article, *Clearinghouse Shareholders and "No Creditor Worse Off Than in Liquidation" Claims*[1] was a great pleasure. Over the years, I have participated in colloquia with Professor Baker and discussed issues of mutual interest, and I was delighted to have the opportunity to comment on her article and presentation at the 2020 CLE/Symposium on Business Law: Connecting the Threads IV, University of Tennessee College of Law Clayton Center, on October 16, 2020.[2]

Clearinghouses play an important, if less well known, part of our economic system.[3] Professor Baker's article highlights a particularized and

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[1] Colleen Baker, *Clearinghouse Shareholders and "No Creditor Worse Off Than in Liquidation" Claims*, 23 TRANSACTIONS: TENN. J. BUS. L. 335 (2021).

[2] *See* Colleen Baker, Assistant Professor of Legal Studies, Univ. of Okla. Price Coll. of Bus., Clearinghouse Shareholders and "No Creditor Worse Off Than in Liquidation" Claims at Transactions: Tennessee Journal of Business Law CLE/Symposium: Business Law: Connecting the Threads IV (Oct. 16, 2020). I have analyzed and provided advice on protecting clearinghouses, their members, and their members' clients from the insolvency risk of members or their clients, but I have not had occasion to analyze details of a clearinghouse insolvency. I learned a great deal from Professor Baker's presentation and article.

[3] *See generally* Baker, *supra* note 1, at 337 (showcasing clearinghouses' role in facilitating trades).

important example of an age-old social problem: every commercial or financial system includes the insolvency risk of a market participant who does not have sufficient liquid assets to repay its creditors.[4] Accordingly, every commercial or financial system must develop insolvency and loss allocation rules to address this problem.[5]

In the vast majority of transactions, the insolvency of an individual participant, by itself, has a small effect on the overall functioning of the economy. For many of these transactions, the United States has developed reasonably satisfactory regimes addressing the problem of a particular obligor having insufficient assets to repay its creditors; specifically, the United States Bankruptcy Code, which governs liquidation or reorganization of non-financial obligors,[6] and the Federal Deposit Insurance Act, which primarily governs liquidation of United States financial institutions.[7] One can quibble about particulars, but these systems work reasonably well for most types of transactions. It is not at all apparent, however, that the more recent Orderly Liquidation Authority[8] authorizing the liquidation of "failing financial companies [other than insured depository institutions] that pose a significant risk to the financial stability of the United States,"[9] enacted in 2010 as part II of the Dodd-

[4] *See generally id.* (alluding to the risk of insolvency for clearinghouses).

[5] *See generally id.* (mentioning that the Financial Stability Board has developed a set of rules to address resolution of this problem for clearinghouses).

[6] *See* Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, 92 Stat. 2549 (replacing the Bankruptcy Act of 1898 as amended).

[7] *See* 12 U.S.C. § 1811(2018). The Federal Deposit Insurance Act (the FDI Act) authorizes the appointment of the Federal Deposit Insurance Corporation (the FDIC) as the sole conservator or receiver of a FDIC-insured depository institution under certain circumstances set forth in the FDI Act. 12 U.S.C. § 1821(c)(1), (2), (3), (4), (6), (8), (9), (10) (2018). An "insured depository institution" means "any bank or savings association the deposits of which are insured by the [FDIC]," which includes all national banks, federal savings banks, and federal savings associations, and almost all state-chartered banking institutions. *Id.* § 1813(a)–(c). The FDIC also may be appointed as a conservator of a failed insured depository institution, but such authority is rarely used. See FDIC Resolutions Handbook 26 (Jan. 15, 2019), available at https://www.fdic.gov/bank/historical/reshandbook/resolutions-handbook.pdf.

[8] *See id.* §§ 5381–5394.

[9] *Id.* § 5384. The Orderly Liquidation Authority provides for the appointment of the FDIC as liquidator of a financial company if, among other criteria, "the financial company is in default or in danger of default," and "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States." *Id.* § 5383(a)–(b).

Frank Wall Street Reform and Consumer Protection Act,[10] will be a successful legislative regime for resolving the insolvency of systemically important financial companies.

In any event, as Professor Baker's article shows, clearinghouses are different:[11] they play an important part of the financial system; they assume significant risks that they hedge by contract and by security interests in liquid assets; and they are designed and organized to minimize these risks.[12] Further, unlike ordinary commercial actors that become insolvent and are liquidated or reorganized under the Bankruptcy Code or the Federal Deposit Insurance Act, clearinghouses are much less likely to become insolvent.[13] Nevertheless, while the risks of insolvency are lower, the consequences of insolvency are greater.[14] Hence, the clearinghouse creates the layers of protection against the risk of the insolvency of one or more members, as described by Professor Baker.[15]

The particular set of protections analyzed in more detail by Professor Baker—the allocation of losses between shareholders and non-defaulting members of the clearinghouse, in which non-defaulting members bear losses before shareholders bear any loss in excess of certain equity contributions from these shareholders—presents a complicated and apparently unique question.[16] As noted by Professor Baker, in ordinary commercial transactions, shareholders take the greater risks in exchange for an expected greater return.[17] Although the Bankruptcy Code expressly

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[10] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C.).

[11] *See generally* Baker, *supra* note 1, at 339–40.

[12] *See id.*

[13] *See generally id.* at 351 (discussing how clearinghouses, unlike banks, manage risk and have different rules which can mitigate the risk of insolvency).

[14] *See generally id.* at 346–347.(alluding to clearinghouses' vital role in maintaining market stability, stating "[m]ost clearing members are themselves systemically significant institutions. . . . [t]heir financial condition would also be critical to financial market stability . . . .").

[15] *See generally id.* at 343 (discussing Resolution Authority intervention for struggling clearinghouses).

[16] *See id.* at 349– 51(arguing that, because of the basic distinction in finance between shareholders and creditors, shareholders should not be allowed to pass the risk of loss onto other customers or entities).

[17] *See* Baker, *supra* note 1, at 341 (noting that "[i]n the case of publicly-traded clearinghouses, risk does not follow reward[,]" which " . . . violates basic principles of corporate finance.").

sanctions subordination agreements,[18] I am not aware of ordinary commercial transactions in which, *ex ante*, the creditors or others who deal with an entity that becomes insolvent bear losses before the owners of the entity. Indeed, the Bankruptcy Code discourages attempts by shareholders or other equity holders to elevate their status from their equity position to that of creditors who would share with other unsecured creditors through express statutory provisions, such as subordinating certain claims from the purchase of securities of the debtor[19] and codifying the absolute priority rule for reorganization plans,[20] and judicial rules, such as equitable subordination of claims[21] and the recharacterization of debt as equity.[22]

Accordingly, Professor Baker's argument that shareholders should bear the losses before non-defaulting members seems compelling. Why, then, have clearinghouse members agreed to a regime that allocates losses

[18] *See* 11 U.S.C. § 510(a) (2018) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.").

[19] *See id.* § 510(b) ("For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.").

[20] *Id.* § 1129(b)(2)(B)(ii); *see also* Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 201–02 (1988) (stating that "the absolute priority rule 'provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan,'" (citation omitted) and holding that, because the debtors did not qualify for the new value exception to the rule, "a reorganization plan in which the debtors retain an equity interest in their farm is contrary to the absolute priority rule."); Linda J. Rusch, *The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should The Rule Be?*, 19 PEPP. L. REV. 1311, 1313 (1992) (explaining that "[t]he new value exception [to the absolute priority rule] allows the debtor's owner, the equity holder, to receive or to retain an equity interest in the reorganized business through a contribution of new value, even if all senior claimants are not paid in full.").

[21] *See* 11 U.S.C. § 510(c)(1) (providing that the court may "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest[.]"); *see also* David Gray Carlson, *The Logical Structure of Fraudulent Transfers and Equitable Subordination*, 45 WM & MARY L. REV. 157, 198 (2003) (discussing the standard of equitable subordination found in 11 U.S.C. § 510(c)).

[22] *See* Paul Wallace, *Simplifying the Muddled Doctrine of Debt Recharacterization*, 86 MISS. L. J. 183, 185 (2017) (distinguishing debt recharacterization and equitable subordination).

to non-defaulting members before shareholders? Professor Baker mentions some of the arguments for allocating losses in this manner.[23] Regardless of how one views those particular arguments, the history of mandatory regulatory action in financial or commercial transaction suggests great caution, and perhaps even skepticism, about the effectiveness of overriding the choices of the members in the clearinghouse marketplace, whether by positive law or on an ad hoc basis by resolution authorities trying to rehabilitate an insolvent clearinghouse.

For example, in my view, the Bankruptcy Code, first enacted in 1978,[24] has generally worked pretty well in the liquidation or reorganization of operating companies that use equipment, goods, and other hard assets to carry on their businesses. The Bankruptcy Code was a great improvement over the Bankruptcy Act of 1898,[25] as substantially amended by the Chandler Act of 1938.[26] However, it took a long time and a great deal of experience to achieve the Bankruptcy Code's substantially improved insolvency regime.

One feature of the Bankruptcy Code is the limitation on the rights of secured creditors of debtors in bankruptcy. For operating companies that own and use hard assets like equipment in their business, most of these limitations make sense. For example, if a person becomes a debtor in bankruptcy, an automatic stay of all creditor collection actions, including the enforcement of security interests in property owned by the debtor, instantly arises.[27] For a debtor trying to reorganize, the automatic stay makes sense if the collateral is equipment or other assets that the debtor needs to possess and operate in order to continue the debtor's business; the debtor could not reorganize if the secured creditor could foreclose on

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[23] *See generally* Baker, *supra* note 1, at 346 (discussing some arguments for shareholders asserting NCWOL claims in resolution).

[24] Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

[25] Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (1898) (repealed 1978).

[26] Act of June 22, 1938, ch. 575, 52 Stat. 840 (repealed 1978) (adding robust reorganization provisions to the Bankruptcy Act of 1898).

[27] 11 U.S.C. § 362(a)(6) (2018) (providing that the filing of a bankruptcy petition "operates as a stay, applicable to all entities, of . . . any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title[.]").

and sell the equipment or other hard assets[28] that the debtor needs to continue operating the business.

In the area of receivables finance, however, the costs that the Bankruptcy Code imposes on secured creditors who would finance originators of mortgage loans and other receivables do not make sense.[29] As a result, beginning with the origination and financing of mortgage loans in the 1980s in response to the savings and loan crisis and then expanding to other types of consumer and commercial receivables, an entirely new financial technique—securitization and structured finance[30]—was developed to avoid the inefficiencies that the Bankruptcy Code created for originators of receivables and their secured creditors.

Perhaps the most significant limitation in the Bankruptcy Code is the automatic stay of creditor collection acts. The stay of a secured creditor collection act makes little or no sense when the debtor is a finance company that is in the business of making loans, or acquiring loan

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[28] *See* U.C.C. §§ 9-609(a) & 9-610(a) & (b) (AM. L. INST. & UNIF. L. COMM'N 2013) (authorizing the secured party after default to take possession of collateral and sell it in a public or private sale).

[29] *See generally* Thomas E. Plank, *The Key to Securitization: Isolating the Assets to Be Securitized from the Risk of An Insolvency Proceeding*, in Offerings of Asset Backed Securities 2-1, 2-11 to 2-24 (Reed D. Auerbach & Charles A. Sweet eds., Wolters Kluwer 4th ed. (2019)) [hereinafter *Key to Securitization*] (discussing the costs that the Bankruptcy Code imposes on secured creditors of originators of receivables); Thomas E. Plank, *The Securitization of Aberrant Contract Receivables*, 89 CHI.-KENT L. REV. 171, 171–80 (2013) [hereinafter *Securitization of Aberrant Contract Receivables*] (discussing the costs that the Bankruptcy Code imposes on secured creditors of originators of receivables); Thomas E. Plank, *The Security of Securitization and the Future of Security*, 25 CARDOZO L. REV. 1655, 1660–71 (2004) [hereinafter *Security of Securitization*] (discussing the costs that the Bankruptcy Code imposes on secured creditors of originators of receivables).

[30] In a securitization, the originator or other owner of receivables that is an operating company sells the receivables to either a trustee of a common law trust or a bankruptcy remote special purpose entity, such as an LLC or Delaware statutory trust, whose only function is to hold the receivables and to issue securities evidencing beneficial interests in the receivables or debt obligations secured by the receivables. A structured finance transaction is essentially a securitization without the issuance of securities but the borrowing of money pursuant to a secured loan agreement. *See generally Key to Securitization*, *supra* note 29, at 2-7 to 2-8, 2-24 to 2-80 (discussing the structuring of securitization and how securitization and structured finance avoids the costs that the Bankruptcy Code imposes on the secured creditors of originators of receivables); *Securitization of Aberrant Contract Receivables*, *supra* note 29, at 180–85 (same as applied to unusual receivables such as pay day loans and title loans); *Security of Securitization*, *supra* note 29, at 1671–83 (discussing securitization).

obligations in return for the sale of goods, and that finances the origination of these loans using secured credit. If the finance company becomes a debtor in bankruptcy, it need not continue to own the loans to liquidate or to reorganize. The automatic stay, however, prevents secured creditors from realizing on their collateral, as described above. The automatic stay raises the costs to the secured lenders, who must then recoup those costs by charging higher interests rates, if possible.

In addition, the commencement of a bankruptcy case causes the immediate acceleration of all debt,[31] including secured debt. For some types of long-term receivables, such as mortgage loans, the combination of the automatic stay and the risk of acceleration makes the longer term secured financing of originators of mortgage loans not feasible.[32] To finance receivables, the originators typically must sell a substantial amount of their receivables—and in the case of mortgage loans, all of their mortgage loans—in securitization or structured financing transactions.[33]

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[31] 11 U.S.C. § 502(b) (2018) (providing that, if there is an objection to a claim, the bankruptcy court shall "determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount," with some enumerated exceptions).

[32] *See* Thomas E. Plank, *Crisis in the Mortgage Finance Market: The Nature of the Mortgage Loan and Regulatory Reform*, 12 TRANSACTIONS: THE TENN. J. BUS. L. 135, 142–45 (2011) (discussing the effect of the acceleration of long-term debt secured by mortgage loans if the finance company becomes a debtor in bankruptcy and noting that, since the enactment of the Bankruptcy Code through 2009, the percentage of holders of single-family mortgage loans held by persons that were not eligible for bankruptcy or that were bankruptcy remote special purpose entities was never more than the 11.3% of all mortgage loans (by principal balance)).

[33] *See* discussion and sources cited *supra* note 30. I am currently writing a law review article tentatively entitled "*Bankruptcy Code Reform for Efficient Receivables Finance*," arguing that the Bankruptcy Code should be reformed to eliminate these costs and therefore eliminate the costs of structuring securitizations. The 2005 amendments to the Bankruptcy Code took a step in this direction when it added mortgage loans to the definitions of "securities contract" and "repurchase agreement," 11 U.S.C §§ 741(7)(A)(i), 101(47) (2018), and therefore included mortgage loans in the safe harbors that allowed for the termination, liquidation, and acceleration of "securities contracts" and "repurchase agreements" by one party immediately upon the bankruptcy of the other party, *id.* §§ 555, 559, and the exercise of any contractual right under any security agreement or arrangement forming a part of or related to any securities contract or repurchase agreement, *id.* § 362(b)(6), (7); *see generally* Thomas E. Plank, *Toward a More Efficient Bankruptcy Law: Mortgage Financing Under the 2005 Bankruptcy Amendments*, 31 S. ILL. U. L. J. 641, 641–68 (2007) (discussing mortgage financing under the 2005 amendments).

Another shortcoming of the Bankruptcy Code is the treatment of secured creditors that are under-secured. Once a person becomes a debtor in bankruptcy, interest ceases to accrue on the unsecured debt of the debtor.[34] This rule makes sense because unsecured creditors will not receive more than a pro rata share of the debtor's unencumbered assets after the payment of the administrative expenses of the bankruptcy case. Calculating and adding interest to each unsecured claim would increase administrative costs but would not increase the value of the property of the debtor's bankruptcy estate and therefore would not materially increase any creditor's pro rata share.

To the extent, however, that a creditor has a security interest in collateral owned by the debtor, and the value of the collateral exceeds the amount of the debt—for example, a $100 claim secured by assets worth $125—the creditor is over-secured and is entitled to the accrual of interest on the debt.[35] Even though this accrual may diminish the property of the debtor's bankruptcy estate available for payment of the claims of unsecured creditors, this rule makes sense. The secured creditor has a property interest to the extent of its security interest; if the debtor wants to continue to use the property interest of the secured creditor, it should pay for that use.

Unfortunately, in the case of under-secured creditors—for example, a creditor holding a $100 claim secured by assets worth $80—the creditor is not entitled to the accrual of interest on the debt.[36] Therefore, the debtor

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[34] 11 U.S.C. § 502(b)(2) (2018) (providing that the bankruptcy court shall determine and allow the amount of a creditors claim as of the date of the filing of a bankruptcy "except to the extent that . . . such claim is for unmatured interest.").

[35] *Id.* § 506(b) ("To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.").

[36] *See* United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 382 (1988) (holding that an under-secured creditor is not entitled to interest payments under the guise of "adequate protection" to compensate the creditor for the delays in foreclosing caused by the automatic stay). I believe the court was correct in its interpretation of the Bankruptcy Code provisions because the allowance of interest to over-secured creditors was an exception to the more general rule of section 502(b)(2) disallowing all unmatured interest. *But see* David Gray Carlson, *Postpetiton Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 601–21 (1989) (criticizing the Court's decision and analysis in *Sav. Ass'n of Texas* and arguing that under-secured parties may still be able

is allowed to use the property interest of the secured creditor without paying for it. Such misappropriation of assets results in an inefficient allocation of resources. The secured creditor should be allowed to accrue interest on the secured claim, the $80. Although such a rule may make it harder for debtors to reorganize, so what? If the debtor cannot reorganize because it must pay for the use of another person's property interest, then it should be liquidated. The unsecured creditors, who would benefit from a successful reorganization, should bear the costs of the debtor's operations.

The inability of under-secured creditors to receive the time value of money for their secured claims imposes costs on all secured creditors that must be passed on to future borrowers. Creditors and borrowers financing receivables can avoid those costs through securitization and structured finance; the secured creditors of other operating companies cannot. Furthermore, the imposition of these costs on secured lenders that finance the owners and operators of real estate projects makes less sense.[37] Many of these secured creditors are financial institutions like banks and savings associations that are themselves only financial intermediaries; they borrow money primarily from depositors and lend that money to borrowers. The combination of the automatic stay and the inability to receive interest on under-secured debt puts an additional strain on these financial intermediaries.

Indeed, I have often speculated that the automatic stay was a significant contributor to the final costs of resolving the savings and loan crisis of the 1980s.[38] Many savings associations tried to survive during the crisis by engaging in commercial real estate finance that permitted savings association to earning higher rates of interest but at the cost of greater risk of default. When those real estate developers filed for bankruptcy in

to show themselves entitled to post-petition interest through courts' exercising their discretion and applying principles of equity).

[37] The Bankruptcy Code includes a minor concession to this point in creating separate grounds for relief from the automatic stay for "single asset real estate." 11 U.S.C. § 362(d)(3) (2018) (allowing relief from the automatic stay unless within shorter time period than the standard period the debtor files a reorganization that has a reasonable possibility of being confirmed within a reasonable time or the debtor pays interest on the secured claim).

[38] *See* Paul T. Clark, Bryan M. Murtagh, & Carole Corcoran, *Regulation of Savings Associations Under The Financial Institutions Reform, Recovery, and Enforcement Act Of 1989*, 45 BUS. L. 1013, 1019–23 (1989) (describing the savings and loan crisis and the increased insolvency of many savings associations).

an attempt, allegedly, to "reorganize" their single real estate projects, the savings associations were often unable to foreclose on their real estate collateral quickly. A detailed study of this hypothesis would be instructive.

These problems with the Bankruptcy Code do not reflect incompetence on the part of the individuals responsible for drafting and enacting the Bankruptcy Code. Instead, they reflect three factors that, in enacting any type of reform of complicated financial systems or transactions, will be limitations of the individuals drafting and enacting legislation and regulation: the individuals will have limited knowledge in comparison to the cumulative knowledge of all of the actors in the market place; the individuals will have their own interests and points of view that will differ from those of the market participants; and, the individuals will generally not suffer the consequences of operation of the regulatory regime that is enacted. These limitations suggest caution and humility in attempting to "reform" any complex financial or commercial market.

Of course, these limitations apply to almost any type of legislation and regulation, and these limitations should not preclude good faith attempts to address problems in the functioning of any market. Good laws and regulations help participants function more efficiently in the marketplace, often by allowing such participants in the marketplace to allocate risks to those actors who are better able to ameliorate such risks. Nevertheless, despite the excellent points made by Professor Baker, I would be reluctant to overrule the allocation of losses of an insolvent clearinghouse to which, *ex ante*, sophisticated participants in the operation of clearinghouses, the members and the shareholders, agreed. At the very least, there should be a strong showing that, in fact, these agreements should not be respected because of constraints on the operation of the particular market, such as a degree of monopoly power on the part of shareholders.