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The Value of Uncertainty

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Online Essay

THE VALUE OF UNCERTAINTY[†]

Cathy Hwang and Benjamin P. Edwards

ABSTRACT—In recent years, federal courts have heard, without clear subject matter jurisdiction, contract disputes involving billions of dollars worth of securitized financial instruments (SFIs). These SFI disputes are litigated in federal court under the federal interpleader statute, which specifies that a federal court has subject matter jurisdiction over these cases only when parties deposit the disputed amount with the court. SFI litigants have ignored this requirement, so courts have, at best, uncertain jurisdiction over these cases. Why have no parties raised the jurisdictional defect, even though some would stand to gain from raising it? This Essay advances game theoretical explanations for litigants' puzzling silence in these major post-financial crisis cases, and argues that parties may strategically value litigating in federal court under jurisdictional uncertainty over other alternatives.

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INTRODUCTION

In the aftermath of the financial crisis, the federal courts have heard arguments in contract disputes involving billions of dollars worth of securitized financial products—yet it is not clear that the federal courts have subject matter jurisdiction over these cases.

In these “default disputes,” sophisticated financial parties owning securities in different tranches of the same securitized financial instrument (SFI) litigate over whether an event of default has occurred and whether the alleged event requires liquidation of the SFI. Events of default and liquidations give some security holders better outcomes than others: a holder in the highest priority tranche may secure the accelerated return of its principal; lower priority tranche holders may collect nothing. Absent an event of default, lower priority tranches may continue to collect high interest payments from the SFI (and, ideally, later recover their principal investment).

Many of these default disputes squeak into federal court under the federal interpleader statute. Often, cases involve parties domiciled in New York or Delaware, so complete diversity rarely exists. The federal interpleader statute expands federal diversity jurisdiction to require only minimal diversity so long as certain special requirements are met.¹ One such requirement is that the interpleader plaintiff deposits the amount in dispute with the court.² But in large default disputes, the amount typically has not been deposited with the court,³ so it seems unclear whether federal courts have jurisdiction. Yet, despite the fact that some security holders

¹ *State Farm Fire & Cas. Co. v. Tashire*, 386 U.S. 523, 530–31 (1967) (holding that the federal interpleader statute required only minimum diversity).

² 28 U.S.C. § 1335(a)(2) (2012).

³ See, e.g., *infra* notes 25–26 and accompanying text.

may benefit from raising this jurisdictional issue and possibly having the case dismissed, courts and parties have generally not raised it.⁴

This silence is puzzling. In this Essay, we advance possible explanations for why parties to default disputes do not raise these jurisdictional defects. While others have discussed the value of uncertainty to parties in contracting,⁵ this Essay analyzes the value of uncertainty to parties in litigation. We argue that, even though unaddressed jurisdictional defects inject significant uncertainty into the litigation, parties may actually welcome and value this uncertainty as a litigation strategy: continued uncertainty could keep parties in a preferred forum, drive parties to settle, or permit parties to collect insurance payouts. Sometimes parties may prefer that particular issues remain unresolved. SFI default disputes serve as one example that may lead to fruitful avenues for future study.

I. A SQUARE PEG IN A ROUND HOLE

Why do default disputes continue in federal court despite uncertain subject matter jurisdiction? Why do none of the parties speak up, even when doing so would seemingly advance their interests? In this Part, we unpack the pieces underlying the puzzle. We provide necessary background about the products sparking default disputes, and the specifics of the federal interpleader statute. Litigating default disputes in federal court under the federal interpleader statute is like fitting a square peg in a round hole: it's not a good fit. In this case, it's not a good fit, but nobody is willing to say so.

A. *The Square Peg: Securitized Financial Instruments*

Securitization may be used to create a variety of financial products. The term “securitization” refers to “a process by which an entity pools together its interest in identifiable future cash flows, transfers the claims on those future cash flows to another entity . . . and then utilizes those future cash flows to pay off investors over time.”⁶

⁴ See, e.g., *U.S. Bank Nat'l Ass'n v. Black Diamond CLO 2005-1 Advisers, L.L.C.*, 839 F. Supp. 2d 639 (S.D.N.Y. 2011) (declining to address whether bond was required when the complaint stated that funds were held in escrow and asking that the court order that the interpleader plaintiff need not post the bond); *Interpleader Complaint at 17, Deutsche Bank Tr. Co. Ams. v. Elliott Int'l, L.P.*, No. 09-Civ.-5242 (S.D.N.Y. June 4, 2009) (stating that the escrow was being held apart from other funds and asking the court to order that it need not post a bond).

⁵ E.g., Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 *YALE L.J.* 848 (2010) (arguing that parties to corporate acquisition agreements may use vague terms in contracts rather than precise terms for certain strategic reasons).

⁶ Frank J. Fabozzi & Vinod Kothari, *Securitization: The Tool of Financial Transformation*, *J. FIN. TRANSFORMATION*, Sept. 2007, at 33, 34.

Mortgage-backed securities, for example, are a type of SFI.⁷ To create mortgage-backed securities, banks buy mortgages and transfer those mortgages to a new company, the Issuer. The Issuer then issues a new security—a mortgage-backed security—to investors. To pay investors, the Issuer uses the cash that mortgage borrowers pay toward their mortgages.⁸ Banks usually divide these cash flows from the mortgages into tranches. The “senior” (or highest priority) tranches have their principal paid first, and lower priority tranches receive principal payments only after more senior tranches have been paid in full. Because the senior tranches take payment priority over the lower tranches, senior tranche investments are the least risky, but receive less interest along the way. Lower tranches are riskier, but receive more interest.⁹

Purchasers often lack the expertise to assess independently the merits and risks of each SFI tranche, so opinions from ratings agencies like Moody’s, S&P, or Fitch allow investors to quickly assess the true likelihood that a particular tranche will deliver its payments.¹⁰ The ratings range from triple-A (lowest risk) to C or D (highest risk) and have been characterized as “the world’s shortest editorials.”¹¹

Under this ratings system, lower rated tranches proved harder to sell. To solve this problem, lower rated tranches were sometimes bundled into a new type of SFI—collateralized debt obligations (CDOs). Before the financial crisis, issuers bundled the lowest, least saleable tranches of mortgage-backed securities together into CDOs, which were then securitized and sold to investors.

To win triple-A ratings for the senior tranches, CDOs and SFIs often include special provisions to protect more senior tranches. For example, the issuer may be required to liquidate the securitized assets if an “event of default” occurs—one in a specific list of events that might put the senior

⁷ Randolph C. Thompson, *Mortgage Backed Securities, Wall Street, and the Making of a Global Financial Crisis*, BUS. L. BRIEF, Fall 2008, at 51, 52 (providing a general overview of the history and basic mechanics of mortgage-backed securities); Douglas J. Lucas et al., *Collateralized Debt Obligations and Credit Risk Transfer 1* (Yale Int’l Ctr. for Fin., Working Paper No. 07-06, 2007), <http://ssrn.com/abstract=997276> [<http://perma.cc/XJW9-SYCX>].

⁸ See *Investment Basics: Mortgage-Backed Securities*, PIMCO (Feb. 2009), <http://europe.pimco.com/EN/Education/Pages/MortgageBackedSecurities.aspx> [<https://perma.cc/R36P-D2MN>] (explaining the basic features of mortgage-backed securities).

⁹ See Thompson, *supra* note 7, at 52.

¹⁰ See Jason W. Parsont, *NRSRO Nullification: Why Ratings Reform May Be in Peril*, 77 BROOK. L. REV. 1015, 1021–23 (2012) (providing a general discussion of the ratings process).

¹¹ Gregory Husisian, Note, *What Standard of Care Should Govern the World’s Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 CORNELL L. REV. 411, 446 (1990) (coining the term “the world’s shortest editorials” in discussions of ratings agencies’ opinions).

tranche security holder's investment at risk.¹² These provisions provide material protections to holders of senior-level tranches. Instead of waiting and watching their cash dry up over time, holders of senior tranches may point to an event of default and demand that the CDO sell off all of its assets to repay their principal before mounting defaults dissipate the CDO assets. An event of default also carries enormous implications for lower tranche security holders. If an event of default accelerates the CDO's maturity, the CDO will return the security holders' principal in tranche-seniority order: the senior tranches get paid first. In many situations, this means that the lower tranches receive nothing.¹³

In the years before the financial crisis, banks created an incredible amount of new triple-A-rated securities.¹⁴ Although the triple-A ratings indicated an exceptionally low risk of default, subsequent events have revealed that the vaunted triple-A rating provides little assurance that the product will not default.¹⁵ Indeed, the ratings agencies have agreed to settle cases alleging that their ratings did not accurately reflect the probability of default.¹⁶

Given this development, many holders of triple-A-rated securities now warily eye their holdings and maneuver to protect themselves from default risks. In many instances, for example, if a pension fund holding a senior, triple-A-rated tranche believes that there has been an event of default, it will seek to accelerate payments or agitate for a sale to protect its pensioners against the risk that the capital flow may dry up as underlying mortgage defaults continue. In that case, the pension fund will be paid first, followed by junior creditors in their order of seniority. This, of course, sets up a conflict between the interests of senior and junior holders. The senior

¹² Events of default may occur when certain technical tests specified in the relevant indenture are not met. For instance, an event of default may occur when an "overcollateralization test" is not met—that is, when a required minimum ratio of the value of the collateral to the value of the senior tranche is not met. See Laurie S. Goodman et al., *Event of Default Provisions and the Valuation of ABS CDO Tranches*, J. FIXED INCOME, Winter 2007, at 85, 85.

¹³ See generally Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 985 n.84 (2009) (explaining that "the most junior tranches [generally] bear the first losses from any defaults").

¹⁴ See generally Claire A. Hill, *Why Did Rating Agencies Do Such a Bad Job Rating Subprime Securities?*, 71 U. PITT. L. REV. 585 (2010) (discussing why the rating agencies incorrectly granted triple-A ratings so often in the run-up to the financial crisis).

¹⁵ *Id.*

¹⁶ Aruna Viswanatha & Karen Freifeld, *S&P Reaches \$1.5 Billion Deal with U.S., States over Crisis-Era Ratings*, REUTERS (Feb. 3, 2015, 1:46 PM), <http://www.reuters.com/article/2015/02/03/us-s-p-settlement-idUSKBN0L71C120150203> [<http://perma.cc/AYS5-QKEQ>] (reporting on a recent settlement in which ratings agency Standard & Poor's agreed to pay \$1.5 billion to resolve a series of lawsuits involving alleged ratings fraud, and providing background on similar suits against ratings agency Moody's).

holders want to recoup their capital quickly and avoid looming default risks, while the junior holders want to allow the situation to develop—all the while collecting higher interest payments from the SFI.

B. The Round Hole: The Federal Interpleader Statute

An interpleader action allows the custodian of money or property to compel several parties to resolve competing claims to the money or property. Rather than making a decision about the money or property itself, an interpleader plaintiff may deposit the money in dispute with a court and allow the court to sort the matter out.

Interpleader actions work well in the insurance context. For example, after insured person Ned dies, several individuals may seek the insurance payout—Ned’s widow Catelyn, his business partner Stannis, and his illegitimate child Jon. Ned’s insurance company may file an interpleader action as an interpleader plaintiff to compel Catelyn, Stannis, and Jon (each an interpleader defendant) to resolve their competing claims in court.

For these situations, Congress created statutory interpleader jurisdiction to enable nationwide service of process and ensure that all parties to a dispute would be subject to jurisdiction before the same court.¹⁷ For example, absent statutory interpleader jurisdiction, Catelyn and Jon (who are both from the fictional state of Winterfell) might contest the matter before a court that lacks jurisdiction over Stannis’s claim because Stannis is from the fictional state of Dragonstone and is not subject to Winterfell’s jurisdiction.

In exchange for the ability to haul all interested parties before the same court, certain statutory requirements must be met to give the federal court subject matter jurisdiction.¹⁸ A statutory interpleader action requires that: (i) the amount in controversy is at least \$500; (ii) minimal, rather than complete, diversity exists; and (iii) the stakeholder deposits either the funds at issue or a bond in such amount with the court.¹⁹

The first two requirements substantially relax the ordinary requirements for federal diversity jurisdiction. The first reduces the amount in controversy from at least \$75,000 to as little as \$500 in statutory

¹⁷ 13F CHARLES ALAN WRIGHT, ARTHUR R. MILLER & EDWARD H. COOPER, FEDERAL PRACTICE & PROCEDURE § 3636 (3d ed. 2009) (“The interpleader statute . . . was enacted to provide a national forum for those cases in which it is likely . . . that there is no state in which all of the claimants will be subject to process.”).

¹⁸ In federal court, there are two types of interpleader actions: statutory interpleader and rule interpleader. In this Essay, we focus only on federal statutory interpleader because rule interpleader does not create a basis for jurisdiction. See FED. R. CIV. P. 22.

¹⁹ 28 U.S.C. § 1335 (2012).

interpleader actions. Statutory interpleader also expands diversity jurisdiction to its constitutional limit by allowing jurisdiction “so long as any two adverse parties are not co-citizens.”²⁰

The “deposit” requirement for statutory interpleader is particularly interesting in the SFI default dispute context. In full, the federal interpleader statute requires that in order for a federal court to have subject matter jurisdiction, the interpleader plaintiff has:

deposited such money or property or has paid the amount of or the loan or other value of such instrument or the amount due under such obligation into the registry of the court, there to abide the judgment of the court, or has given bond payable to the clerk of the court in such amount and with such surety as the court or judge may deem proper, conditioned upon the compliance by the plaintiff with the future order or judgment of the court with respect to the subject matter of the controversy.²¹

Interpreting this deposit requirement, courts have found that failure to deposit the full amount in dispute creates a curable jurisdictional defect.²² In other words, depositing the money with the court *is* a requirement for courts to have jurisdiction.²³ In SFI default disputes, however, where parties may litigate over millions or billions of disputed dollars, this last prong of the statutory requirement is rarely met.²⁴ Instead, interpleader plaintiffs often assert their willingness to tender the bond.²⁵ After this mild statement,

²⁰ State Farm Fire & Cas. Co. v. Tashire, 386 U.S. 523, 531 (1967).

²¹ § 1335.

²² Lincoln Gen. Ins. Co. v. State Farm Mut. Auto. Ins. Co., 425 F. Supp. 2d 738, 742 (E.D. Va. 2006); Fed. Ins. Co. v. Tyco Int’l Ltd., 422 F. Supp. 2d 357, 395–96 (S.D.N.Y. 2006) (noting that “the second requirement of the interpleader statute is the deposit of funds. The deposit of such funds is a jurisdictional requirement” and also noting that generally, courts will not dismiss a complaint without affording the parties a chance to cure a deficiency due to a lack of bond-posting). *But see* Merrill Lynch, Pierce, Fenner & Smith Inc. v. Succession of Scott, No. 08-0819, 2010 WL 4068917, at *5 (W.D. La. Oct. 14, 2010) (dismissing a case litigated under federal statutory interpleader for lack of subject matter jurisdiction when no bond is deposited because “this Court can only assume Merrill Lynch intentionally chooses not to comply with the statute as Merrill Lynch was aware of the deposit requirement at the time it filed its complaint”).

²³ Requiring a deposit before authorizing nationwide service of process makes sense. The court should have the ability to effectively deliver the disputed property before inconveniencing parties by forcing them to appear before a distant court. *See* 7 CHARLES ALAN WRIGHT, ARTHUR R. MILLER & MARY KAY KANE, FEDERAL PRACTICE & PROCEDURE § 1716 (3d ed. 2001).

²⁴ *See supra* note 4 and accompanying text.

²⁵ In a recent interpleader case involving SFIs, for instance, the parties apparently established subject matter jurisdiction by noting that, along with meeting the minimum amount in controversy and diversity requirements, the interpleader plaintiff “if necessary, . . . will deposit the Escrowed Funds . . . into the registry of the Court” (emphasis added). Interpleader Complaint at 2, U.S. Bank Nat’l Ass’n v. Barclays Bank PLC (S.D.N.Y. Mar. 12, 2013) (No. 11 Civ. 9199), 2011 WL 6284039.

each of the parties and the court simply sail past the apparent jurisdictional deficiency.²⁶

C. *Litigating the Square Peg in the Round Hole*

Many parties have apparent incentives to raise this jurisdictional defect, but generally, none do.

Federal courts take these jurisdictional issues seriously. To stay within their limited jurisdictional reach, federal courts may even dismiss a case *sua sponte* if no subject matter jurisdiction exists.²⁷ In this context, courts need not wait for a motion; rather, the law imposes an “independent obligation to determine whether subject-matter jurisdiction exists, even in the absence of a challenge from any party.”²⁸ Enforcing subject matter jurisdiction limitations early also frees up valuable judicial time, allowing the courts to concentrate on cases where there is subject matter jurisdiction.²⁹

Lower tranche interpleader defendants also have a strong incentive to challenge subject matter jurisdiction and make the default dispute disappear. SFIs are structured so that, should the debt pool be liquidated, security holders are paid in full in order of seniority. The practical result is that, in a liquidation, the lower tranche security holders may not be paid at all. As a result, lower tranche security holders have an incentive to contest liquidation-triggering events. The incentive is further amplified because lower tranche security holders receive the highest interest rates—interest which may continue to be paid until an event of default.³⁰ Therefore, barring the ability to make liquidation-triggering events disappear, lower tranche security holders would seemingly benefit from stalling or slowing the proceedings by, for instance, contesting subject matter jurisdiction in federal court and having the case dismissed in favor of a state court proceeding. Slowing the proceedings ensures that lower tranche security holders continue to collect their high rates of interest during the drawn-out litigation process.

²⁶ In contrast, some courts refuse to accept merely asserted willingness to satisfy jurisdictional requirements. *See Scott*, 2010 WL 4068917, at *5 (dismissing statutory interpleader action because of plaintiff’s prolonged failure to satisfy jurisdictional requirement after alleging a willingness to do so in its complaint).

²⁷ FED. R. CIV. P. 12(h)(3).

²⁸ *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 514 (2006) (citing *Ruhrgas AG v. Marathon Oil Co.*, 526 U.S. 574, 583 (1999)).

²⁹ *See generally* Alexander Bickel, *The Overworked Court*, NEW REPUBLIC (Nov. 17, 2011), <http://www.newrepublic.com/book/review/the-overworked-court> [http://perma.cc/UMF2-KT5E] (describing the increase in number of appealable decisions in federal courts).

³⁰ So long as the rising tide of defaults has not begun to eat away at their payment stream.

Senior tranche security holders are perhaps the only players who do not have much incentive to raise jurisdictional defects. If the case resolves in their favor, they will be paid in the liquidation. However, even senior tranche security holders may have some incentive to settle the jurisdictional question. Litigation of this type is expensive.³¹ Lingering uncertainty means that senior tranche security holders could incur substantial litigation expenses in federal court only to have their case dismissed for jurisdictional defects.

II. RATIONALES FOR RETICENCE

At first glance, it is puzzling that courts and parties do not raise jurisdictional defects, even when doing so would seemingly advance their interests. In this Part, we present possible explanations for this puzzle and argue that in certain circumstances—including in default disputes—parties may either value the uncertainty created by the lack of jurisdictional certainty or dance around the danger for other reasons.

A. Possible Explanations

1. *Preference for Federal Courts.*—It is possible that parties do not raise jurisdictional defects because they have a preference for federal court over state court. The conventional wisdom is that corporate defendants prefer federal court: their counsel may have more experience with federal rules, procedures, and judges, and litigation may move more quickly in federal court.³² The parties may also believe that federal judges are better equipped to handle the issues in dispute than state judges.³³ In particular, commentators believe that federal courts are better equipped to deal with complex issues of law,³⁴ and that federal courts may also be more familiar

³¹ See generally J. Mark Ramseyer & Eric B. Rasmusen, *Comparative Litigation Rates* (Harvard Law Sch., John M. Olin Ctr. for Law, Econ. & Bus. Fellows' Discussion Paper No. 681, 2010), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ramseyer_681.pdf [<http://perma.cc/6PWS-R5G7>] (presenting evidence of the exact costs of litigations, including settlement amounts and attorneys' fees, through 2009).

³² Marcellus McRae et al., *Handling Federal Litigation: Overview*, PRAC. L. COMPANY, <http://gibsondunn.com/publications/Documents/McRae-RichardsonRoyer-FirstStepsPLC.pdf> [<http://perma.cc/EM7J-8SUJ>] (outlining common reasons large corporate defendants prefer federal court over state court). Our own practice experience also supports the view that corporate defendants and their (sophisticated) counsel prefer federal court over state court.

³³ See generally Burt Neuborne, *The Myth of Parity*, 90 HARV. L. REV. 1105 (1977) (arguing that the federal courts may be superior forums for certain issues).

³⁴ *Id.*

with securities.³⁵ Consequently, parties may believe that litigating under a cloud in federal court beats litigating under clear skies in state court.

2. *Repeated Games*.—Litigants may also not raise jurisdictional defects because they play a repeated game. Economics literature analyzes the effects of repeat-player interactions on cooperation: specifically, if players in a game are likely to meet each other again in the future, they are more inclined to cooperate.³⁶ Likewise, the legal academic literature reveals examples of how access to information about a player's reputation can transform social interactions, facilitating the enforcement of unexpected social norms.³⁷ Reputational effects are particularly strong in small, closed communities.³⁸

In the default-dispute context, litigants are often repeat players who, in various iterations of SFI litigation, may hold securities in different tranches.³⁹ A particular financial institution may, for instance, hold the lowest tranche securities in one SFI, and higher tranche securities in another. Suppose, for example, that the Bank of Winterfell holds Class D securities in an interpleader action being litigated in the Southern District of New York, and Class A securities in a similar case in the Eastern District of New York. In the Southern District action, Winterfell, the lowest tranche security holder, would prefer to have the case dismissed or stalled. However, Winterfell may choose not to raise the jurisdictional defect in its Southern District case, because the move would adversely affect its Eastern District case, where it would like the case to be resolved quickly in its favor and have the CDO liquidated. Winterfell need not even have another simultaneous federal case to be motivated to stay silent: it need only

³⁵ *But cf.* Margaret V. Sachs, *Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes*, 49 OHIO ST. L.J. 559, 561 (1988) (arguing that “[s]tate courts should share with federal courts the adjudication of rule 10b-5 actions”). Changes to the federal securities laws have made it much more difficult to bring securities actions in state court. *See* Benjamin P. Edwards, *Disaggregated Classes*, 9 VA. L. & BUS. REV. 305 (2015).

³⁶ *See generally* David M. Kreps et al., *Rational Cooperation in the Finitely Repeated Prisoners' Dilemma*, 27 J. ECON. THEORY 245 (1982) (showing that reputational effects can generate cooperation in finitely repeated games).

³⁷ *See, e.g.*, ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 277 (1991); Lior Jacob Strahilevitz, *Reputation Nation: Law in an Era of Ubiquitous Personal Information*, 102 NW. U. L. REV. 1667 (2008).

³⁸ *See* ELLICKSON, *supra* note 37.

³⁹ U.S. Bank, for example, has been party to a number of SFI-related interpleader actions. *See, e.g.*, U.S. Bank Nat'l Ass'n v. MBIA Ins. Corp., No. 08 Civ. 4791 (S.D.N.Y. Dec. 2, 2009); Interpleader Complaint, U.S. Bank Nat'l Ass'n v. AMAC CDO Funding I, No. 11 Civ. 8541 (S.D.N.Y. Nov. 23, 2011); Interpleader Complaint, U.S. Bank Nat'l Ass'n v. Wells Fargo Bank, Nat'l Ass'n, No. 11 Civ. 4220 (S.D.N.Y. June 21, 2011).

believe that it *could* be in the senior position and prefer federal litigation in the future.⁴⁰

3. *Leverage, Threats, and Gambling.*—Among the most interesting parts of this puzzle is the lower tranche security holders' silence on possible jurisdictional defects.

Lower tranche security holders may not raise jurisdictional defects because jurisdictional defects can be raised at any point in the proceedings, even after judgment is entered⁴¹ or for the first time on appeal.⁴² A savvy lower tranche security holder may rationally choose to keep the threat of raising a jurisdictional defect in its pocket to induce other parties to settle the case. If a lower tranche security holder expects that, no matter what, the fund will eventually be liquidated and it will receive nothing, a threat of jurisdictional challenge may actually be more valuable than stalling the case by raising the jurisdictional defect immediately. That is, stalling the case may result in postponing the inevitable liquidation for months or years, but a threat of dismissal may actually yield monetary benefits immediately.

However, the efficacy of this threat as negotiating leverage may vary. Trepidation-inducing threats must possess three critical attributes: (i) the threat must worry the target, (ii) the target must believe that the threat-maker has the capacity to implement the threat, and (iii) the target must believe that the threat-maker “actually *intends* to carry it out.”⁴³ Because the jurisdictional threat seems worrying and a litigant could implement the threat with a typewriter and a postage stamp, the value of this threat depends on how credible the threat appears. Attorneys make filing threats appear more credible by circulating a draft motion to their adversary. This

⁴⁰ Note, however, that there may be a systemic bias reflected in the types of institutions who hold certain tranches of securities. For instance, pension funds often buy lower risk senior tranche securities because the Employee Retirement Income Securities Act strictly governs the types of investments that pension funds can make. In practice, this means that pension funds often only purchase securities from the highest rated tranches. For a general discussion of pension funds' investment in certain tranches of securities, see Jennifer E. Bethel et al., *Legal and Economic Issues in Litigation Arising from the 2007–08 Credit Crisis*, in *PRUDENT LENDING RESTORED: SECURITIZATION AFTER THE MORTGAGE MELTDOWN* 163 (Yasuyuki Fuchita et al. eds., 2009).

⁴¹ *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 506 (2006) (“The objection that a federal court lacks subject-matter jurisdiction may be raised by a party, or by a court on its own initiative, at any stage in the litigation, even after trial and the entry of judgment.” (citation omitted)).

⁴² See, e.g., *City of Rome v. Verizon Commc'ns Inc.*, 362 F.3d 168, 174 (2d Cir. 2004) (“As we have often observed, ‘it is well settled that lack of federal jurisdiction may be raised for the first time on appeal, even by a party who originally asserted that jurisdiction existed, or by the Court *sua sponte*.’” (quoting *United States v. Leon*, 203 F.3d 162, 164 n.2 (2d Cir. 2000))).

⁴³ JAMES C. FREUND, *SMART NEGOTIATING: HOW TO MAKE GOOD DEALS IN THE REAL WORLD* 210–14 (1992) (discussing the most effective way to go about threatening).

move demonstrates readiness and shows that the threat-maker has already incurred the motion-drafting expense.

Of course, in choosing to use the threat as leverage against other litigants, the lower tranche security holder makes a significant gamble. Senior tranche litigants could call the lower tranche security holder's bluff, and refuse to settle. A lower tranche security holder may then be forced to raise the jurisdictional defect, even if doing so may hurt its position in other simultaneous or subsequent similar litigations. Even if jurisdictional defects are raised, they may be cured⁴⁴—and once the defect is cured, the lower tranche security holder loses its leverage for settlement. Finally, a lower tranche security holder who raises jurisdictional defects too late in the proceedings may risk angering the court.⁴⁵

4. *Attorney Conflicts of Interest.*—Other conflicts of interest may diminish the parties' desire to raise subject matter jurisdiction issues. For example, large law firms in some instances encounter positional conflicts of interest. A small coterie of elite law firms frequently represents parties to default disputes. Firms may find themselves simultaneously representing some clients in low priority tranches and other clients in high priority tranches.

While their clients may not face any direct conflict, the subject matter jurisdiction issue may pose a positional conflict for these firms.⁴⁶ A firm may not wish to raise the issue in one action because it would draw attention to the issue and likely cause problems for other clients.⁴⁷ Given the nature of the conflict, it would not be surprising if these firms sought

⁴⁴ *Lincoln Gen. Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 425 F. Supp. 2d 738, 742 (E.D. Va. 2006) (“[N]either deposit[ing] the policy funds in question into the registry of the court nor enter[ing] into an appropriate bond in lieu thereof, as required by § 1335(a)(2), . . . is a jurisdictional defect that a stakeholder may easily cure and is therefore insufficient to defeat an otherwise appropriate statutory interpleader action.” (citing *CNA Ins. Cos. v. Waters*, 926 F.2d 247, 249–50 n.6 (3d Cir. 1991))).

⁴⁵ See, e.g., *Painter v. Harvey*, 673 F. Supp. 777, 778 (W.D. Va. 1987) (“While such a motion should more properly have been advanced at an early stage of the proceedings, the motion is nonetheless proper even at this late stage, because the absence of subject-matter jurisdiction can be raised at any time by either party or by the court.”).

⁴⁶ See D.C. Bar, Ethics Op. 265 (1996), <http://www.dcbar.org/bar-resources/legal-ethics/opinions/opinion265.cfm> [<http://perma.cc/WT7G-5TQ9>] (discussing positional conflicts).

⁴⁷ Attorney ethics rules in many jurisdictions bar attorneys from representing a client if doing so causes conflict with another client representation. However, attorneys may represent both clients if, among other things, the clients are informed and give consent. See, e.g., MODEL RULES OF PROF'L CONDUCT r. 1.7 (AM. BAR ASS'N 2014) http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients.html [<http://perma.cc/3CRH-ZYHX>] (setting forth model rules on conflicts of interest regarding current clients).

positional conflict-of-interest waivers from clients before agreeing to represent them in these types of disputes.⁴⁸

5. *Hedging and Moral Hazard.*—Moral hazard may also motivate lower tranche security holders to avoid the subject matter jurisdiction issue.⁴⁹

Investors purchasing lower tranche securities may hedge their investments by entering into a derivatives contract known as a credit default swap (CDS). The purchaser of a CDS makes payments to the seller, and in exchange, the seller agrees to pay a certain sum if the “reference entity” of the CDS (e.g., a particular tranche of a SFI) defaults. Essentially, the CDS functions as insurance—giving rise to the same moral hazards associated with insurance contracts.

Lower tranche security holders who are parties to a CDS do not benefit from dragging the litigation out—as the dispute continues, the lower tranche security holder must continue making payments on the CDS contract, incurring additional expenses. Lower tranche security holders may actually prefer a quick loss—a determination of default—in federal court so they can collect on the CDS.

B. Simpler Explanations?

Although we argue that litigants’ appetite for uncertainty may explain why parties do not raise jurisdictional defects in these default disputes, we have also considered simpler explanations that appear less compelling. For instance, litigants might not raise jurisdictional defects because they are unaware of the defect. We find this explanation unlikely. Parties to default disputes are represented by sophisticated counsel—in one case, for instance, interpleader plaintiffs were represented by Nixon Peabody LLP and interpleader defendants were represented by Quinn Emanuel Urquhart & Sullivan LLP.⁵⁰ Both firms are well respected. It is extremely unlikely that firms of their caliber would overlook a jurisdictional defect. Moreover, a firm that overlooks a glaring jurisdictional defect is likely to suffer reputational consequences, should their client be adversely affected.

⁴⁸ *Id.*

⁴⁹ The term “moral hazard” refers to situations where an entity may change its behavior because it does not fully bear certain economic risks. For example, a homeowner with premises liability insurance might not remove ice from his walk as quickly as he would if he did not have insurance. For a discussion of other moral hazards in the SFI context, see John C. Coffee, Jr., *What Went Wrong? A Tragedy in Three Acts*, 6 U. ST. THOMAS L.J. 403, 406 (2009) (discussing moral hazards created when loan originators no longer bore default risk).

⁵⁰ U.S. Bank Nat’l Ass’n v. Black Diamond CLO 2005-1 Adviser, L.L.C., 839 F. Supp. 2d. 639, 640 (S.D.N.Y. 2011).

It is more likely, however, that overworked courts may have overlooked the defect. Courts are often overstretched.⁵¹ In practice, although courts may raise subject matter jurisdiction issues *sua sponte*, courts may more often rely on litigants to raise jurisdictional defects, and expect that sophisticated parties and their lawyers would raise them.

It is also possible that parties and courts are aware of the defect, but choose not to address it because they find the requirement onerous or unnecessary. For instance, courts may find that putting the amount into the court for the duration of the litigation is unnecessary if it can plausibly require the interpleader plaintiff post the amount prior to judgment.

On the whole, however, the argument that all of the parties are unaware of the jurisdictional issue does not convince us. After all, we spotted it from the sidelines.

CONCLUSION

The apparent subject matter jurisdiction defect allows uncertainty to cloud SFI-related interpleader proceedings. Nonetheless, each of the above explanations describes why parties to a default dispute might prefer, or even value, this uncertainty.

For parties who prefer federal litigation to state court litigation, the uncertainty may be a rational price to stay in federal court. If the parties believe that, for instance, federal court is more likely to produce a favorable outcome, the opportunity to stay in federal court may be very valuable. Furthermore, litigants may be betting on the fact that, should a jurisdictional defect be raised, they will have an opportunity to cure it.

For a repeat player, raising a jurisdictional defect in a particular case may be shortsighted. Should that financial institution be in a senior tranche position in a separate but similar litigation, it would suffer. A repeat player may actually embrace uncertainty; if it refrains from raising the jurisdictional defect in one case, it may preserve the possibility of winning other cases.

For lower tranche security holders, the uncertainty may be particularly valuable as a negotiation tool. Lower tranche security holders can use the threat of raising a jurisdictional defect as negotiating leverage to force other litigants to share the liquidation proceeds. Depending on the probability of a favorable outcome if the litigation were to run its course, the lower tranche security holder may advance its interests by using the jurisdictional uncertainty as negotiating leverage. A particularly Machiavellian lower tranche security holder may even use the uncertain federal court

⁵¹ See Bickel, *supra* note 29.

jurisdiction as both a sword and a shield by blustering about the lack of subject matter jurisdiction in negotiations with senior tranche holders to extract a premium while quietly expediting the judgment to cash out a CDS contract.

This Essay scratches the surface of how parties may behave in seemingly irrational ways because they value uncertainty or other benefits more than the dangers posed by the uncertainty. The explanations we advance in this Essay may help explain unexpected behavior in other litigation, alternative dispute resolutions, and contracting and negotiating, and uncertainty's value in those contexts is ripe for further study. A better understanding of parties' valuation of uncertainty (or offsetting risk analysis) can help us gain insight into why parties may behave in seemingly irrational ways.