

# THE INTERFACE BETWEEN THE BANKRUPTCY CODE AND A DISGORGEMENT JUDGMENT HELD BY THE SECURITIES AND EXCHANGE COMMISSION

KASEY T. INGRAM<sup>1</sup>

A client approaches you about filing for protection under the Bankruptcy Code (the “Code”).<sup>2</sup> After determining his eligibility to file, you discover that the Securities and Exchange Commission (the “SEC”) plans to seek a disgorgement judgment against your client.<sup>3</sup> What should you do?

Guiding the debtor<sup>4</sup> through bankruptcy requires knowing the various effects this disgorgement judgment could have on the bankruptcy process.<sup>5</sup> This article addresses the basic actions the SEC may take against a debtor in bankruptcy. Part I provides a quick review of the bankruptcy process. Part II discusses what disgorgement entails. Part III outlines the general actions the SEC takes to obtain and enforce a disgorgement judgment under the Code. Part IV presents a proposal for subordinating the SEC’s judgment for the protection of creditors when the debtor is an issuer of securities. Finally, Part V summarizes and concludes the material presented.

---

<sup>1</sup> B.S. United States Naval Academy 1994; J.D. University of Cincinnati College of Law 2002; Judicial Clerk, Delaware Court of Chancery 2002-2003; Associate, Jones Day 2003-Present. Special thanks to Professor Donna Nagy for her assistance on this article. The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

<sup>2</sup> The client will be referred to by masculine pronouns throughout this article for ease of use. Under the filing requirements of the Code, the client may be an individual of either gender or a business entity. 11 U.S.C. § 109 lists who may qualify as a debtor under the various chapters within the Code.

<sup>3</sup> This article could also help the creditors of a bankrupt debtor with a disgorgement judgment. As will be explained later, a creditor could use the arguments in this article to subordinate the SEC’s claim to the other creditors’ claims.

<sup>4</sup> The Code refers to the individual or entity filing for bankruptcy protection as the debtor.

<sup>5</sup> In addition to seeking disgorgement, the SEC may also seek other sanctions, such as monetary penalties. The U.S. Attorney may also investigate your client for criminal sanctions. This article is limited to the effect of the disgorgement within bankruptcy. If the SEC seeks further sanctions, an experienced securities counsel should be retained.

## I. The Bankruptcy Process

The United States Constitution provides for federal power to establish “uniform Laws on the subject of Bankruptcies throughout the United States.”<sup>6</sup> The first modern bankruptcy statute was the Bankruptcy Act of 1898.<sup>7</sup> Congress established the current Code in 1978.<sup>8</sup> The Code serves two major purposes. First, the Code gives the debtor the opportunity to organize its debts and make a fresh start.<sup>9</sup> Second, the Code ensures that similarly situated creditors are treated the same, which prevents creditors from racing to the courthouse to claim the residue of the debtor’s assets.<sup>10</sup> The Code attempts to reconcile the somewhat conflicting interests of the debtor and creditor through the bankruptcy process.

There are two types of bankruptcy, liquidation or reorganization. Liquidation is covered by 11 U.S.C. §§ 701 *et seq.* (collectively, “Chapter 7”), which permits individuals or entities to liquidate their assets and distribute the proceeds to creditors. Reorganization, on the other hand, allows individuals and entities to reorganize their debts and continue operations. Individuals meeting certain financial requirements can file under 11 U.S.C. §§ 1301 *et seq.* (collectively, “Chapter 13”). Business entities and high-income individuals must file for reorganization under 11 U.S.C. §§ 1101 *et seq.* (collectively, “Chapter 11”). Municipalities file under 11 U.S.C. §§ 901 *et seq.* (collectively, “Chapter 9”), while farms must file under 11 U.S.C. §§ 1201 *et seq.* (collectively, “Chapter 12”). This article will primarily focus on Chapters 7 and 11 because these are the predominant chapters utilized by clients with disgorgement problems.

Upon filing a bankruptcy petition, the debtor must list its creditors and send them notice of the bankruptcy petition.<sup>11</sup> Upon receiving notice, the creditors meet

---

<sup>6</sup> U.S. CONST. art. I, § 8, cl 4.

<sup>7</sup> See ELIZABETH WARREN, BUSINESS BANKRUPTCY 3 (Federal Judicial Center 1993).

<sup>8</sup> See *id.*

<sup>9</sup> See DAVID L. BUCHBINDER, FUNDAMENTALS OF BANKRUPTCY § 1.4, at 13 (Little, Brown and Co. 1991).

<sup>10</sup> See *id.*

<sup>11</sup> 11 U.S.C. § 342.

and the United States Trustee (“UST”)<sup>12</sup> may establish committees to monitor the case.<sup>13</sup> If the debtor liquidates under Chapter 7, a trustee is appointed to administer the estate.<sup>14</sup> If the debtor reorganizes under Chapters 9, 11, 12, or 13, the debtor can carry out the duties of the trustee as a debtor-in-possession (“DIP”).<sup>15</sup> However, a trustee or examiner may be appointed in a reorganization if the creditors or the UST ask for an appointment and the court agrees.<sup>16</sup>

After filing a bankruptcy petition, a tension develops between the debtor and the creditors over, among other things, what claims exist, priorities among creditors, assets available to creditors, and what debts will be dischargeable.<sup>17</sup> In Parts III and IV, this article analyzes how the Code addresses this tension as it relates to the SEC’s actions to obtain a disgorgement judgment.

The final step in the bankruptcy process discharges all of the debtor’s debt under Chapter 7,<sup>18</sup> or confirms a plan of reorganization under Chapter 11.<sup>19</sup> The

---

<sup>12</sup> The U.S. Congress established the UST system nationally in 1986. The purpose of the UST is to monitor the proceedings and ensure that the purposes behind the Code are met. *See generally* BUCHBINDER, *supra* note 8, at §§ 10.3, 10.4. 28 U.S.C. §§ 581-589a establishes and controls the UST.

<sup>13</sup> The creditors meet with the debtor and the UST as required by 11 U.S.C. § 341, commonly known as the “341 meeting.” The creditors’ committees are formed according to the provisions of each chapter. Chapter 7 committees are established pursuant to 11 U.S.C. § 705, while chapter 11 committees are governed by 11 U.S.C. § 1102.

<sup>14</sup> 11 U.S.C. §§ 701-704.

<sup>15</sup> 11 U.S.C. § 1107 outlines the rights and duties of the DIP.

<sup>16</sup> 11 U.S.C §§ 1104-1106, 1108 delineate the requirements for appointing and terminating a trustee or examiner, as well as the duties of the trustee or examiner. A trustee or examiner may be appointed, or at least requested, in a case involving the SEC because of the potential allegations of fraud or inappropriate activity that caused the SEC’s involvement in the first place.

<sup>17</sup> 11 U.S.C. §§ 301 *et seq.* (“Chapter 3”) and 11 U.S.C. §§ 501 *et seq.* (“Chapter 5”) delineate most of the provisions involving those issues. Chapters 3 and 5 apply regardless of which chapter the debtor filed under for protection. Much of the litigation in bankruptcy centers on the provisions of these chapters, as will be outlined further in this article.

<sup>18</sup> 11 U.S.C. § 727.

<sup>19</sup> 11 U.S.C. § 1129. Chapters 9, 12, and 13 outline different requirements for confirming a plan, but this article will not discuss these chapters. The general principles, however, still apply.

previous Bankruptcy Act of 1898 (as amended in 1938) required the SEC to review the plan of reorganization before confirmation.<sup>20</sup> However, the current Code removed that requirement.<sup>21</sup> The SEC may appear and be heard on any issue within the case,<sup>22</sup> but may not appeal any court orders.<sup>23</sup> In my hypothetical, however, the SEC will most likely qualify as a creditor and be allowed to vote on the reorganization plan.<sup>24</sup>

The bankruptcy process is much more complex and time intensive than the brief synopsis just given. The synopsis serves as a framework to discuss specific issues relating to disgorgement within the context of a bankruptcy. Before addressing these issues, however, Part II provides a brief overview of disgorgement itself.

## II. Disgorgement

Disgorgement is an equitable remedy that requires the wrongdoer to return the profits of his wrongdoing.<sup>25</sup> The SEC uses disgorgement as its primary equitable remedy.<sup>26</sup> The United States Code gives the SEC its authority to seek disgorgement in administrative proceedings.<sup>27</sup> District courts grant disgorgement based upon the ancillary powers of the court. The purpose of disgorgement is to discourage

---

<sup>20</sup> See Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211, 1293-94 (1994).

<sup>21</sup> See *id.* at 1293-95. Under the current system, the UST carries out many of the roles of the SEC as to investor protection. Whether this actually happens or not is up to debate.

<sup>22</sup> The SEC potentially holds an interest in all cases involving investors, but realistically cannot participate in every case. Therefore, the SEC focuses only on certain cases, such as those discussed in this article.

<sup>23</sup> 11 U.S.C. § 1109.

<sup>24</sup> 11 U.S.C. § 1126 governs acceptance of the plan. To vote, one must hold a claim allowed under 11 U.S.C. § 502. If the SEC holds a claim under § 502, then the SEC may vote under most conditions.

<sup>25</sup> 69A AM. JUR. 2D *Securities Regulation – Federal* § 1708 (1993).

<sup>26</sup> Ralph C. Ferrara & Philip S. Khinda, *SEC Enforcement Proceedings: Strategic Considerations for When the Agency Comes Calling*, 51 ADMIN. L. REV. 1143, 1177 (1999).

<sup>27</sup> 15 U.S.C. § 78u-2(e); Securities and Exchange Act of 1934, ch. 404, tit. I, 15 U.S.C. § 21B(e); Securities Act of 1933, ch. 38, tit. I, 15 U.S.C. § 8A(e).

securities law violations, not to compensate investors for losses.<sup>28</sup> Unfortunately, this principle does not always deter potential violators.<sup>29</sup> Disgorgement also prevents unjust enrichment by ensuring that violators do not profit from their undeserved gains.<sup>30</sup> Further, requiring the violator to return any gains, along with the headaches associated with a SEC investigation, will show a potential violator that the risk of disgorgement outweighs any possible reward.<sup>31</sup>

Disgorgement arises in various instances where securities law violators file for bankruptcy protection. In the past, the SEC has sought disgorgement of illegal profits obtained by a broker-dealer who defrauded his customers by convincing them to “buy certain securities at excessive prices unrelated to prevailing market prices.”<sup>32</sup> The SEC also sought disgorgement for commissions obtained in violation of an SEC order prohibiting a debtor’s association with brokers, dealers, registered investment advisers, and registered investment companies.<sup>33</sup> Disgorgement of profits was also sought when a debtor used fraud and misrepresentation to fake a hostile takeover and force a “white knight” to purchase securities at an inflated price.<sup>34</sup> Further, an illegal takeover attempt in violation of securities laws may subject a corporation to disgorgement.<sup>35</sup> Although not exhaustive, these representative cases illustrate the myriad of situations under which the SEC will seek disgorgement.

An order for disgorgement is probably the most common and understandable sanction the SEC possesses. In a bankruptcy context, however, disgorgement may prove difficult because the debtor most likely commingled legitimate and illegitimate funds. The debtor will not reserve a stack of cash labeled

---

<sup>28</sup> 69A AM. JUR. 2D, *supra* note 24, at § 1708.

<sup>29</sup> *Id.*

<sup>30</sup> H.R. REP. NO. 101-616, at 22 (1990).

<sup>31</sup> The options available to the SEC against a securities violator include monetary penalties and referral to the U.S. Attorney for criminal sanctions. These other remedies available are not discussed in this article, but should be reviewed if your client is facing possible sanctions from the SEC.

<sup>32</sup> SEC v. Brennan, 230 F.3d 65, 67-68 (2d Cir. 2000).

<sup>33</sup> SEC v. Telsey (*In re Telsey*), 144 B.R. 563, 564 (Bankr. S.D. Fla. 1992).

<sup>34</sup> SEC v. Bilzerian (*In re Bilzerian*), 153 F.3d 1278, 1280-81 (11th Cir. 1998).

<sup>35</sup> SEC v. Drexel Burnham Lambert, Inc., 956 F. Supp. 503, 504 (S.D.N.Y. 1997).

“ill-gotten gains” to satisfy the SEC’s judgment. It is also important to remember that most debtors in bankruptcy lack sufficient assets to cover their liabilities. Noting this, the SEC must determine what actions it will take within the bankruptcy process, what protections exist to the debtor, and how the goals of bankruptcy can merge with the goals of disgorgement.

### III. Issues Relating to Disgorgement in the Bankruptcy Context

Several factors come into play when a debtor files a petition for bankruptcy protection. Upon filing for bankruptcy, the debtor receives protection via the automatic stay.<sup>36</sup> Thus, the SEC must first consider how the automatic stay affects its case. After discussing the automatic stay, Part III examines the actions the SEC must take to ensure payment of the disgorgement judgment by declaring it nondischargeable.

#### *Automatic Stay*

The purpose of the automatic stay<sup>37</sup> “is to grant complete, immediate, albeit temporary relief to the debtor from creditors, and also to prevent dissipation of the debtor’s assets before orderly distribution to creditors can be effected.”<sup>38</sup> The automatic stay arises immediately upon filing a bankruptcy petition. The stay acts to stop litigation, lien enforcement, judgment actions, and most other attempts to collect or enforce a collection against a debtor.<sup>39</sup> In addition, most actions that affect any property of the estate or property in its custody, or any property of the debtor, must cease.<sup>40</sup>

Regulatory or police actions by a governmental unit are excepted from the automatic stay.<sup>41</sup> This exception allows actions taken by a governmental unit in exercising its police or regulatory powers to continue to protect the public and

---

<sup>36</sup> 11 U.S.C. § 362.

<sup>37</sup> 11 U.S.C. § 362(a)(1).

<sup>38</sup> *Penn Terra Ltd. v. Dep’t of Env’tl. Res.*, 733 F.2d 267, 271 (3d Cir. 1984).

<sup>39</sup> *See* COLLIER ON BANKRUPTCY ¶ 362.01 (15th ed. 2001).

<sup>40</sup> *See id.*

<sup>41</sup> 11 U.S.C. § 362(b)(4).

ensure that bankruptcy is “not a haven for wrongdoers.”<sup>42</sup> Section 362(b)(4) of the Code prevents a debtor from “frustrating ‘necessary governmental functions by seeking refuge in bankruptcy court.’”<sup>43</sup>

However, an exception within the exception exists. Governmental units may not violate the stay to enforce money judgments.<sup>44</sup> The exception exists only with respect to regulatory or police powers.<sup>45</sup> Collecting a money judgment is an attempt to recover property of the estate outside of the normal bankruptcy process.<sup>46</sup> Since an attempt to collect money lacks the immediacy of protection inherent in police or regulatory powers, Congress decided that a governmental unit must seek relief from the stay to enforce a money judgment.<sup>47</sup>

The debtor in my hypothetical case will receive the protection of the automatic stay upon filing its petition. The SEC generally brings its disgorgement action in the United States District Court.<sup>48</sup> The timing of the SEC’s suit vis-à-vis the filing of the bankruptcy petition will determine what actions the SEC may take. If the SEC has not obtained a judgment upon the filing of the bankruptcy petition, the SEC will not violate the automatic stay by continuing to seek “the *entry* of a money judgment against a debtor so long as the proceeding in which such a judgment is entered is one to enforce the governmental unit’s police or regulatory power.”<sup>49</sup> If the SEC obtained a judgment prior to the filing of the bankruptcy petition, an action to enforce or collect that judgment will violate the stay.<sup>50</sup>

---

<sup>42</sup> See COLLIER, *supra* note 38, ¶ 362.05[5][a]

<sup>43</sup> City of New York v. Exxon Corp., 932 F.2d 1020, 1024 (2d Cir. 1991) (quoting United States v. Seitles, 106 B.R. 36, 38 (S.D.N.Y. 1989)).

<sup>44</sup> 11 U.S.C. § 362(b)(4).

<sup>45</sup> See COLLIER, *supra* note 38, ¶ 362.05[5][a].

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> See Ferrara, *supra* note 25, at 1176-77. The 1990 Remedies Act may be changing this, however, since the SEC now possesses the ability to seek disgorgement in administrative proceedings.

<sup>49</sup> SEC v. Brennan, 230 F.3d 65, 71 (2d Cir. 2000) (emphasis in original).

<sup>50</sup> *Id.*

In *SEC v. Brennan*,<sup>51</sup> the SEC violated the automatic stay while attempting to collect a disgorgement judgment. The debtor, Brennan, was a broker-dealer of low-priced securities.<sup>52</sup> The United States District Court for the Southern District of New York found Brennan liable of federal securities law violations for perpetrating a fraud on his customers, and ordered Brennan to disgorge approximately \$75 million.<sup>53</sup> Before the judgment and the bankruptcy petition, Brennan established an offshore trust with about \$5 million in assets.<sup>54</sup> Brennan did not list the trust as property of the estate during his initial petition for bankruptcy.<sup>55</sup> When confronted by law enforcement authorities about the trust, he amended his petition, but valued his interest at \$0.<sup>56</sup>

The SEC alleged that Brennan maintained control of the trust, and with the support of the bankruptcy trustee appointed to administer Brennan's estate, attempted to force Brennan to repatriate the assets so that the SEC and other creditors could reach them.<sup>57</sup> The United States Bankruptcy Court for the District of New Jersey denied the SEC's motion, but enjoined Brennan, with his consent, from transferring any assets out of the trust.<sup>58</sup> The bankruptcy trustee then unsuccessfully attempted to recover the assets from the foreign nation where the trust was located.<sup>59</sup>

The SEC did not appeal the bankruptcy court's denial of its motion.<sup>60</sup> Instead, the SEC filed a motion in the district court where it obtained the

---

<sup>51</sup> 230 F.3d 65 (2d Cir. 2000).

<sup>52</sup> *Id.* at 67.

<sup>53</sup> *Id.* at 68.

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 68-69.

<sup>58</sup> *Id.* at 69.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*



disgorgement judgment.<sup>61</sup> The SEC then sought to have Brennan held in civil contempt for not paying the disgorgement judgment and requested that the trust be repatriated.<sup>62</sup> The SEC claimed that it was not attempting to collect on the disgorgement judgment, arguing instead that it was seeking only to account for and preserve the assets for the benefit of all creditors.<sup>63</sup> The SEC recognized that it would only receive a pro rata share of the trust assets once repatriated.<sup>64</sup> The United States District Court for the Southern District of New York ordered Brennan to repatriate the trust assets and to show cause why the court should not hold him in contempt.<sup>65</sup>

The district court granted an interim stay while Brennan appealed its order to the United States Court of Appeals for the Second Circuit.<sup>66</sup> On appeal, Brennan contended that the order to repatriate the trust assets violated the automatic stay.<sup>67</sup> The Second Circuit agreed, holding that the repatriation order violated the automatic stay as an action to collect on a money judgment.<sup>68</sup> The court stated that the entry of a money judgment cuts off the government's police and regulatory powers.<sup>69</sup> Thus, any action taken after the entry of the money judgment is seen as an attempt to collect that judgment, not a permissible regulatory or policy action, and is stayed under the money judgment exception in § 362(b)(4).<sup>70</sup>

---

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.*

<sup>65</sup> *Id.*

<sup>66</sup> *Id.* at 69-70.

<sup>67</sup> *Id.* at 70. Brennan also argued res judicata and violation of due process, but the Second Circuit did not address these arguments because it found that the order violated the automatic stay. *Id.*

<sup>68</sup> *Id.* at 75.

<sup>69</sup> *Id.* at 73.

<sup>70</sup> *Id.* at 71.

The court's analysis focused on the regulatory aspects of the disgorgement judgment:

When the government seeks to impose financial liability on a party, it is plainly acting in its police or regulatory capacity – it is attempting to curb certain behavior (such as defrauding investors, or polluting groundwater) by making the behavior that much more expensive. It is this added expense that deters a party from defrauding or polluting – not the identity of the entity which it must eventually pay. Accordingly, up to the moment when liability is definitively fixed by entry of judgment, the government is acting in its police or regulatory capacity – in the public interest, it is burdening certain conduct so as to deter it. However, once liability is fixed and a money judgment has been entered, the government necessarily acts only to vindicate its own interest in collecting its judgment. Except in an indirect and attenuated manner, it is no longer attempting to deter wrongful conduct. It is therefore no longer acting in its “police or regulatory” capacity....<sup>71</sup>

Since the regulatory nature of the judgment disappears upon entry, the court reasoned that the exception to the stay ends at that time as well.

This bright line rule protects the policy interests behind the automatic stay.<sup>72</sup> First, the rule protects the priority scheme by forcing the SEC to wait to collect its judgment just like other creditors.<sup>73</sup> Second, the debtor receives both breathing room and time to implement an orderly distribution of its assets.<sup>74</sup> Finally, the bankruptcy court centralizes all disputes and adjudicates an orderly reorganization or liquidation without dealing with uncoordinated actions in other courts.<sup>75</sup>

---

<sup>71</sup> *Id.* at 72-73.

<sup>72</sup> *Id.* at 75.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> *Id.*

According to the appellate court, the purpose behind § 362(b)(4) was not frustrated in this case because of the third goal delineated above.<sup>76</sup> The SEC tried to get repatriation within the bankruptcy court, but failed. Allowing the SEC to search for another forum to grant it the relief desired undermines the policy behind the automatic stay and does not further the policies behind § 362(b)(4)'s governmental unit exception.<sup>77</sup> Therefore, the appellate court vacated the district court's order forcing the repatriation of assets once Brennan entered the bankruptcy court as violating the automatic stay.<sup>78</sup>

The lone dissenter, Judge Guido Calabresi, disagreed with the bright line rule stated by the majority.<sup>79</sup> Judge Calabresi felt the district court's order was not an action to enforce a money judgment.<sup>80</sup> Further, the dissent noted that the SEC agreed to only take a pro rata share of the funds, thereby protecting all other creditors.<sup>81</sup> In fact, Judge Calabresi correctly pointed out that Brennan was the only party adversely affected by the district court's repatriation order,<sup>82</sup> because the SEC agreed to make the funds available for all creditors.<sup>83</sup> Further, Judge Calabresi emphasized that creditors would benefit from the availability of more assets for distribution.<sup>84</sup>

---

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 76. The holding in this case did not prevent the SEC from seeking relief from the stay. Since the bankruptcy court had already denied the SEC's first motion, the proper course for the SEC would have been to appeal that decision to the United States District Court for the District of New Jersey. The Second Circuit recognized this in its holding and admonished the SEC for failing to follow procedure and, instead, attempting to forum shop by filing its motion in a court it already knew as friendly. *Id.*

<sup>79</sup> *Id.* at 78.

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 82.

<sup>83</sup> *Id.*

<sup>84</sup> *Id.*

Despite the dissent's reasoned arguments and equitable position, the bright line rule better serves the purposes of the bankruptcy process because the same equitable results that the SEC desired are available through a relief from stay motion. The only difference between the majority and the dissent is that the majority leaves the decision in the hands of the bankruptcy court, while the dissent allows any court to carry out the same actions.

The lasting effect of this decision seems to permit SEC actions for disgorgement only up to the entry of judgment. After that point, the SEC must seek a relief from the stay to collect on its judgment. If the funds are commingled, the need to protect all creditors will likely prevent a court from granting relief. Therefore, the SEC will need to explore other avenues to collect its disgorgement.

### *Dischargeability*

After filing a bankruptcy petition, the general bankruptcy process requires a determination of the debtor's debts and assets and an equitable distribution to the creditors. After the distribution, the debtor receives a discharge from those debts.<sup>85</sup> Section 523(a), however, excepts certain debts from discharge.<sup>86</sup> Thus, the debtor is still responsible for a nondischargeable debt even after receiving the discharge from the bankruptcy court.

Section 523(a) allows the filing of a motion to declare the SEC's disgorgement judgment nondischargeable. Two provisions are available, and each is explored separately below. The first provision, § 523(a)(7), applies in all cases, while the second provision, § 523(a)(2)(A), applies only in cases involving fraud.

---

<sup>85</sup> The provisions relating to discharge vary depending upon the chapter under which the debtor filed for bankruptcy protection. Chapter 7 discharges the debtor under 11 U.S.C. § 727. Chapter 11 provides for discharge as an effect of confirmation under 11 U.S.C. § 1141.

<sup>86</sup> 11 U.S.C. § 523(a). A § 1328(a) discharge may trump portions of § 523(a). Chapter 13 petitions, however, are not common with disgorgement judgments and this provision will not be explored further in this article.

## § 523(a)(7)

Section 523(a)(7) excepts from discharge any debt “to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss.”<sup>87</sup> Under § 523(a)(7), a disgorgement judgment could be treated as a monetary penalty imposed by the SEC for securities law violations.

In *SEC v. Telsey*, the United States Bankruptcy Court for the Southern District of Florida held that § 523(a)(7) applied to a disgorgement judgment.<sup>88</sup> The debtor, Telsey, was barred “from associating with any broker, dealer, registered investment adviser or registered investment company.”<sup>89</sup> In March 1991, the United States District Court for the Southern District of New York found that Telsey consciously violated that order.<sup>90</sup> The court ordered Telsey to disgorge the profits he received as commissions in violation of the SEC order.<sup>91</sup> Six months later, Telsey filed for protection under Chapter 7.<sup>92</sup>

The SEC filed a motion to except Telsey’s disgorgement order from discharge under § 523(a)(7) and § 523(a)(2) of the Code.<sup>93</sup> The court granted the SEC’s motion, classifying the debt as nondischargeable under § 523(a)(7). The court did not address the issue of whether § 523(a)(2) also excepted the debt from discharge.<sup>94</sup> Both parties agreed that the debt was payable to a governmental unit and not compensation for a pecuniary loss.<sup>95</sup> Therefore, the only issue was whether

---

<sup>87</sup> 11 U.S.C. § 523(a)(7).

<sup>88</sup> 144 B.R. 563, 565 (Bankr. S.D. Fla. 1992).

<sup>89</sup> *Id.* at 564.

<sup>90</sup> *Id.* at 564 n.1.

<sup>91</sup> *Id.* at 564.

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.* at 565. *See infra* p. 14 for a discussion of § 523(a)(2).

<sup>95</sup> *Id.* at 564 n.2. One distinguishing factor is that the violation in this case did not create an actual pecuniary loss, while a fraud perpetrated on investors may qualify. Later in the decision, however, the

the debt was a fine, penalty, or forfeiture under § 523(a)(7).<sup>96</sup> The court's decision focused on the deterrent effect of disgorgement.<sup>97</sup> The slightest penal purpose behind an order of restitution or disgorgement will qualify the debt for nondischargeability under § 523(a)(7).<sup>98</sup> The court stated that its "holding comports with its sense of equity, the object and policy of § 523(a)(7), and case law. In this instance, Telsey is not an 'honest but unfortunate debtor' entitled to a discharge."<sup>99</sup>

On the other hand, the presence of fraud implicates § 523(a)(2)(A), which provides an additional source of nondischargeability.

§ 523(a)(2)(A)

Section 523(a)(2)(A) "does not discharge an individual debtor from any debt ... for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by false pretenses, a false representation, or actual fraud."<sup>100</sup> The issues relating to § 523(a)(2)(A) involve (1) the standing of the SEC to

---

court cites *Kelly v. Robinson*, 479 U.S. 36 (1986), which held that restitution fell under § 523(a)(7). *Telsey*, 144 B.R. at 565. The court contrasted this with an Eleventh Circuit case where restitution will not fall under § 523(a)(7) if solely designed to compensate the victim. *Id.* Therefore, since the primary purpose of disgorgement is to deter securities law violations, any disgorgement order would not compensate for an actual pecuniary loss.

<sup>96</sup> *Id.* at 564.

<sup>97</sup> *Id.* at 565.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* The penal nature of disgorgement was discussed at length in *SEC v. Lorin*, 869 F. Supp. 1117, 1124-25 (S.D.N.Y. 1994). The *Lorin* court found disgorgement was not a penalty under 28 U.S.C. § 2462 for purposes of determining the statute of limitations. Recognizing this differed from the *Telsey* court, the *Lorin* court stated that the definition of whether an action was a fine, penalty, or forfeiture varied based on the statute. Because 11 U.S.C. § 523(a)(7) interpreted disgorgement much broader than 28 U.S.C. § 2462, disgorgement might qualify as a fine, penalty, or forfeiture under that statute and not under 28 U.S.C. § 2462. *Lorin*, 869 F. Supp. at 1125.

<sup>100</sup> 11 U.S.C. § 523(a)(2)(A). Materially false written statements with respect to a debtor's (or insider's) financial condition are not covered by § 523(a)(2)(A). Section 523(a)(2)(B) covers false writings, but, because that provision has not been raised with respect to the disgorgement actions covered in this article, it will not be discussed. Most of the fraud covered by a SEC disgorgement action falls under SEC Rule 10b-5. Therefore, the fraud provision of § 523(a)(2)(A) is sufficient.

seek nondischargeability, and (2) whether the fraud meets the requirements of fraud under the securities laws.

*Standing under § 523*

The standing of the SEC relates to its position as a creditor. Section 523(c) requires “the creditor to whom such debt is owed” request that the court declare a debt nondischargeable under § 523(a)(2). Unless classified as a creditor, the SEC would lack the standing to raise the dischargeability issue under § 523(c). Debtors usually argue that the SEC is not a creditor because the actual persons defrauded are the investors.<sup>101</sup>

A debtor successfully made this argument to the United States Bankruptcy Court for the Middle District of Florida.<sup>102</sup> In *SEC v. Bilzerian*, the bankruptcy court held that the SEC lacked standing to raise the issue of nondischargeability because private investors maintained the right to bring a private cause of action under the securities laws.<sup>103</sup> Therefore, since an individual investor could object to the discharge, the SEC lacked the authority to stand in that investor’s place under § 523(c).<sup>104</sup>

The United States Bankruptcy Court for the Southern District of Indiana disagreed with this reasoning.<sup>105</sup> In *SEC v. Maio*, the court opposed the *Bilzerian* court’s distinction that a private cause of action removed the SEC’s standing as a creditor. According to the *Maio* court, individual investors have different claims, with different elements of proof.<sup>106</sup> Therefore, denying the SEC standing based on

---

<sup>101</sup> See *SEC v. Bilzerian (In re Bilzerian)*, 151 B.R. 954 (Bankr. M.D. Fla. 1993), *reversed and remanded by* 1995 WL 934184 (M.D. Fla. May 15, 1995); *see also SEC v. Maio (In re Maio)*, 176 B.R. 170 (Bankr. S.D. Ind. 1994).

<sup>102</sup> *Bilzerian*, 151 B.R. at 954.

<sup>103</sup> *Id.* at 958-59.

<sup>104</sup> *Id.*

<sup>105</sup> *Maio*, 176 B.R. at 170.

<sup>106</sup> *Id.* at 171-72.

the rights of other creditors would hinder the SEC's ability to enforce the securities laws.<sup>107</sup>

Subsequent to the decision in *Maio*, the *Bilzerian* decision was reversed and remanded.<sup>108</sup> On remand the court agreed with the *Maio* court that the bankruptcy court's distinction made no difference.<sup>109</sup> The court stated that a private cause of action did not remove the SEC's ability to seek disgorgement.<sup>110</sup> Therefore, since private investors can seek to deny the debtor a discharge based on § 523(a)(2), so can the SEC.<sup>111</sup>

These cases grant the SEC standing to dispute the dischargeability of the disgorgement judgment. The next question is whether the disgorgement judgment based on fraud is binding in the bankruptcy court.

#### *Elements of Fraud under § 523*

Because the SEC's request to deny discharge is based on a collateral judgment, collateral estoppel requires identical fraud judgments based on proof of identical elements.<sup>112</sup> The SEC's disgorgement judgment cannot except that debt from discharge, unless the fraud upon which the disgorgement judgment was based satisfies the elements of fraud under § 523(a)(2)(A). However, fraud under § 523(a)(2)(A), or common law fraud, is not the same as securities law fraud.

---

<sup>107</sup> *Id.* at 172.

<sup>108</sup> SEC v. Bilzerian (*In re Bilzerian*), 1995 WL 934184 (M.D. Fla. May 15, 1995). The *Bilzerian* case spawned numerous cases relating to disgorgement judgments by the SEC in bankruptcy.

<sup>109</sup> *Id.* at \*3.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> SEC v. Bilzerian (*In re Bilzerian*), 153 F.3d 1278, 1281 (11th Cir. 1998). If the disgorgement resulted from a consent decree with the SEC, the violator typically neither admits nor denies the infraction. Therefore, collateral estoppel would not apply. See *In re Cenco Inc. Sec. Litig.*, 529 F. Supp. 411, 415-16 (N.D. Ill. 1982); see also *Lipsky v. Commonwealth United Corp.*, 551 F.2d 887 (2d Cir. 1976).



Although not identical, most courts consider the elements of traditional common law fraud as the basis for fraud under § 523(a)(2)(A).<sup>113</sup> To meet the elements of common law fraud required to except the debtor from discharge under § 523(a)(2)(A), the “creditor must prove that: (1) the debtor made a false representation to deceive the creditor, (2) the creditor relied on the misrepresentation, (3) the reliance was justified, and (4) the creditor sustained a loss as a result of the misrepresentation.”<sup>114</sup>

In *Bilzerian*, the Eleventh Circuit Court of Appeals found that elements one and three above were easily met by Bilzerian’s criminal conviction for securities fraud.<sup>115</sup> Consequently, only elements two and four above required further consideration in Bilzerian’s civil liability for securities fraud.<sup>116</sup>

Common law fraud requires proof of loss and reliance.<sup>117</sup> Securities fraud cases that involve omission allow for the presumption of reliance on proof of materiality.<sup>118</sup> A private cause of action under Rule 10b-5, however, requires proof of loss and causation.<sup>119</sup>

The Eleventh Circuit found that fraud under § 523(a)(2)(A) was essentially the same as securities fraud under Rule 10b-5:

While some courts have not required proof of actual reliance in SEC enforcement actions, we nevertheless believe that the causation requirement of “materiality” in Rule 10b(5) satisfies the requirement for actual reliance necessary to apply collateral estoppel in a § 523(a)(2)(A) case. Any other decision would conflict with the general principles behind § 523(a)(2)(A). This court has taken an

---

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* at 1281-82.

<sup>116</sup> *Id.* at 1282.

<sup>117</sup> *Id.*

<sup>118</sup> *See* *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972).

<sup>119</sup> *Bilzerian*, 153 F.3d at 1282.

expansive view of “debts obtained by fraud” because “the malefic debtor may not hoist the Bankruptcy Code as protection from the full consequences of fraudulent conduct.”<sup>120</sup>

Thus, a bankruptcy court may not discharge the SEC’s disgorgement judgment under § 523(a)(2)(A) if the violator committed fraud.<sup>121</sup> The SEC, in fraud cases, can move for exception from discharge under both the fraud provision of § 523(a)(2)(A) and the penalty provision of § 523(a)(7) to classify the debt as nondischargeable. Therefore, a disgorgement judgment will likely be nondischargeable under either § 523(a)(7) or § 523(a)(2)(A). Even though a temporary stay may suspend the SEC’s ability to collect, the debt will remain with the debtor after other debts are discharged.

The next step focuses on protecting the other creditors in the distribution process by looking at how the debt fits in the priority scheme.

#### IV. Equitable Subordination of Disgorgement Judgments under § 510(b)

At this point in our hypothetical debtor’s case, the automatic stay prevented the SEC from collecting his judgment. The SEC, however, obtained a ruling that its claim was nondischargeable, and thus will survive regardless of the bankruptcy. If the debtor has other debts, he must develop a plan to pay those creditors based on the priority scheme established within the Code.<sup>122</sup>

There are four major types of claim holders: (1) secured creditors, (2) administrative claim holders, (3) unsecured creditors, and (4) equity holders.<sup>123</sup> Secured creditors are those creditors with a valid security interest in the debtor’s

---

<sup>120</sup> *Id.* (quoting *St. Laurent, II v. Ambrose*, 991 F.2d 672, 680 (11<sup>th</sup> Cir. 1993)).

<sup>121</sup> Bilzerian also raised the argument that the disgorgement judgment constituted double jeopardy in violation of the United States Constitution. *Bilzerian*, 153 F.3d at 1283. The court dismissed this objection because a civil remedy only constitutes punishment following a criminal conviction when it is disproportionate or unrelated to its remedial goals. The Eleventh Circuit held that “exception from discharge in bankruptcy is not an excessive fine because it is not disproportionate to the wrongful conduct it was designed to remedy.” *Id.*

<sup>122</sup> *See* 11 U.S.C. §§ 506, 507.

<sup>123</sup> There are actually several more types of claims, typically involving the status of the creditor (such as employee, etc.) that will not be discussed in this article.

assets. These claims are paid first to the extent of the value of the asset used as security.<sup>124</sup> Administrative claims are paid second, and consist of debts owed after the filing of the petition for services rendered to preserve the estate, as well as other claims listed within the Code, including attorney's fees.<sup>125</sup> Unsecured claims, such as credit card debts, are paid third and include any claims for payment not secured by an asset. Finally, equity security holders get paid last. Equity security holders include any person or entity with an equity security interest in the debtor, such as corporate shareholders.<sup>126</sup> Equity security holders incur the most risk in not getting paid, but enjoy an unlimited upside gain potential during corporate growth periods.<sup>127</sup>

The distribution and priority scheme established by the Code exists to ensure similar treatment of like creditors.<sup>128</sup> A disgorgement judgment qualifies as an unsecured claim because there is no special collection right associated to any specific property related to disgorgement.<sup>129</sup> However, when the debtor is an issuer, the SEC is not like an unsecured creditor. An unsecured creditor negotiates with the debtor for the loan and the repayment of a set value. On the other hand, the SEC claims assets from the debtor based on violations of the securities laws. The typical unsecured creditor is unaware of the legal violations a debtor may or may not commit. Also, when calculating the risk of default, the typical unsecured creditor will not factor in the possibility of SEC intervention. Additionally, if the SEC's claim is nondischargeable, it will survive the debtor's discharge, while the typical unsecured claim does not.<sup>130</sup> Therefore, it is inaccurate to say that the SEC and the typical unsecured creditor are like creditors deserving equal treatment.

The SEC stands in the shoes of investors who were potentially harmed by the debtor's securities law violations when issuing its securities. If those investors were to bring the actions individually, their claims would be based on the purchase

---

<sup>124</sup> 11 U.S.C. § 506.

<sup>125</sup> 11 U.S.C. § 503.

<sup>126</sup> 11 U.S.C. § 101(17).

<sup>127</sup> 11 U.S.C. § 507.

<sup>128</sup> *See supra* note 9.

<sup>129</sup> *Id.*

<sup>130</sup> *See supra* the discussion on dischargeability.

or sale of a security. The Code maintains the distribution policy that equity security holders have equal repayment priority to claims based on securities litigation.<sup>131</sup>

Section 510(b) states:

[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.<sup>132</sup>

Section 510(b) provides for automatic subordination; it is not discretionary.<sup>133</sup> The purpose behind § 510(b) is the protection of general creditors.<sup>134</sup> All creditors take the risk of insolvency, but “only the security holders share the risks of an unlawful issuance of securities.”<sup>135</sup> Therefore, the Code prevents a security holder from elevating its claim to that of an unsecured creditor merely through litigation when the debtor issued the securities.<sup>136</sup>

A disgorgement judgment by the SEC should represent a claim arising from the purchase or sale of a security under § 510(b) when the debtor issued the securities.<sup>137</sup> Several factors support this position. First, the SEC can still collect its

---

<sup>131</sup> 11 U.S.C. § 510(b).

<sup>132</sup> *Id.*

<sup>133</sup> COLLIER, *supra* note 38, ¶ 510.04[1].

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* ¶ 510.04[2].

<sup>136</sup> *In re Cincinnati Microwave, Inc.*, 210 B.R. 130, 133 (Bankr. S.D. Ohio 1997).

<sup>137</sup> If the debtor is not an issuer of securities under § 510(b), the SEC’s disgorgement claim cannot be subordinated. Additionally, subordination is not possible under the equitable subordination provision

judgment after the close of the bankruptcy case. Even though there is a decreased probability that the SEC will recover its judgment, the probability is still higher than that of the unsecured creditor whose debt was completely discharged. Second, the public fisc will not be depleted because the judgment reflects undeserved profits and not unpaid taxes. Thus, the public fisc does not rely on receipt of the judgment, and a failure to receive the judgment will not cause the burden of the bankruptcy to fall on the public. Third, individual investors may still maintain a private cause of action against the debtor. Therefore, the individual investors can attempt to recover with no impediment to their suit. Finally, in light of the third point, an individual investor who brings suit becomes subordinated. Therefore, it seems equitable to allow the SEC to hold the same position as the investors it is protecting.

Precedent exists for extending automatic subordination under § 510(b) beyond the securities litigation claimants. The United States Bankruptcy Court for the District of Delaware extended § 510(b) to indemnification claims by both underwriters, directors and officers in *In re Mid-American Waste Systems, Inc.*<sup>138</sup>

In *Mid-American*, the plaintiffs' brought suit against Mid-American's directors and officers ("D&Os") and the securities underwriters alleging false representations and omissions by Mid-American in the statements it filed regarding the sale of the securities.<sup>139</sup> Just prior to the filing of the suits, Mid-American filed for Chapter 11 bankruptcy protection.<sup>140</sup>

The D&Os and the underwriters each had indemnification agreements with Mid-American.<sup>141</sup> The D&Os filed an administrative claim against Mid-American for

---

of § 510(c). See *United States v. Noland*, 517 U.S. 535 (1996); see also *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213 (1996).

<sup>138</sup> 228 B.R. 816 (Bankr. D. Del. 1999); accord *In re Walnut Equip. Leasing Co.*, 1999 Bankr. LEXIS 1626 (Bankr. E.D. Pa. Dec. 28, 1999); *In re Jacom Computer Servs., Inc.*, 280 B.R. 570 (Bankr. S.D.N.Y. 2002).

<sup>139</sup> *In re Mid-American Waste Sys., Inc.*, 228 B.R. at 819. The securities at issue were senior subordinated notes issued by Mid-American. *Id.* at 818.

<sup>140</sup> *Id.* at 820.

<sup>141</sup> *Id.* at 818-20. The D&Os were also entitled to indemnification by statute under Delaware corporate law.

indemnification with respect to the securities litigation.<sup>142</sup> Likewise, the underwriters filed a general unsecured claim against Mid-American for indemnification based on the same suits.<sup>143</sup> Mid-American objected to the claims on two grounds.<sup>144</sup> First, Mid-American felt § 510(b) subordinated the claims.<sup>145</sup> Alternatively, Mid-American wanted the claims disallowed pursuant to § 502(e)(1)(B).<sup>146</sup> The court held that the claims should be subordinated pursuant to § 510(b) and, thus, did not decide whether § 502(e)(1)(B) applied.<sup>147</sup>

The court determined that § 510(b) applied by comparing the original statute with the amended version.<sup>148</sup> Congress amended § 510(b) to make claims for reimbursement and contribution subject to subordination.<sup>149</sup> The court found that Congress merely added new classes subject to subordination based on their involvement with the securities transaction. The court stated:

[t]he 1984 amendment to § 510(b) is a logical extension of one of the rationales for the original section – because Congress intended the holders of securities law claims to be subordinated, why not also subordinate claims of other parties (e.g., officers and directors and underwriters) who play a role in the purchase and sale transactions which give rise to the securities law claims? As I view it, in 1984 Congress made a legislative judgment that claims emanating from

---

<sup>142</sup> *Id.* at 820.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

<sup>147</sup> *Id.* at 818.

<sup>148</sup> *Id.* at 824. The court actually began its analysis by determining that the D&O claims did not qualify as administrative expenses because the contract for indemnification occurred prepetition. *Id.* at 821-23. As this analysis is not necessary to the § 510(b) discussion, it will not be addressed.

<sup>149</sup> *Id.* at 826.

tainted securities law transactions should not have the same priority as the claims of general creditors of the estate.<sup>150</sup>

This rationale also applies to the SEC. The SEC's claim stands in the role of a securities law claim; therefore, it could be subordinated through an expansive view of § 510(b). The decision in *Mid-American* presents an expansive view of § 510(b) that would allow the SEC to be subordinated when the debtor is the issuer of securities.

Additionally, *Mid-American* holds that § 510(b) subordination should apply to participants in the securities transactions at issue. The SEC oversees most securities transactions and participates fully in those transactions. Without the SEC's approval or consent, many transactions would not occur.

A disgorgement judgment by the SEC, when § 510(b) applies to the debtor, varies little from an indemnification claim against the securities law violator. The SEC participates in security transactions and acts as a watchdog over the securities markets to prevent securities law violations. When a violation occurs, the SEC seeks, among other things, disgorgement of the illegal profits.

A request for disgorgement deters future securities law violations. Therefore, disgorgement acts as an indemnification for securities law violations in that it forces a violator to reimburse the SEC for losses sustained by investors for failure to comply with the securities laws. Thus, subordinating an SEC disgorgement judgment under § 510(b) mirrors subordinating the indemnification claims of an underwriter, director, or officer.

## V. Conclusion

Debtors with SEC disgorgement judgments against them face many obstacles in the administration of the bankruptcy estate. An attorney involved in the administration of the estate can expect the SEC to take certain actions against the debtor.<sup>151</sup>

---

<sup>150</sup> *Id.*

<sup>151</sup> Other actions not listed in this article may be taken depending on the circumstances of each case. All that has been presented is an overview of those actions that should occur in most cases.

First, the SEC will attempt to collect its disgorgement judgment outside bankruptcy. The automatic stay will allow the SEC to obtain an entry of judgment, but will prevent the SEC from collecting on that judgment until either a relief from stay is granted or the distribution plan is put into effect under the Code.

The SEC will then move to have the disgorgement judgment declared nondischargeable under § 523(a)(7) (governmental unit exception) or, if fraud is present under § 523(a)(2)(A) (fraud exception). Typically, the SEC can successfully have the judgment declared nondischargeable. Since the SEC is protected through its order of nondischargeability, the estate's attorney needs to determine how to best protect the other creditors.

When the debtor is an issuer of securities under § 510(b), the best way to protect the remaining creditors is by subordinating the SEC's judgment. By recognizing the SEC's claim as similar to a securities claim under § 510(b), the claim can be subordinated below the general unsecured creditors. Therefore, more assets are available for the general unsecured creditors, the SEC maintains its claim outside bankruptcy, and the goals of both bankruptcy and disgorgement are adequately met.