WILL SECTION 1141(d)(6) OF THE BANKRUPTCY CODE DESTROY CORPORATE CHAPTER 11 REORGANIZATIONS BY RENDERING SEC CLAIMS NON-DISCHARGEABLE?

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INTRODUCTION

In 2005, Congress enacted a statute that threatens to significantly alter the landscape of chapter 11 reorganizations for corporate debtors, 11 U.S.C. § 1141(d)(6).[1] Historically, corporate debtors received a total discharge of their debts for fraud.[2] Now, according to the Securities and Exchange Commission, the enactment of section 1141(d)(6)(A) created a vast exception to the total discharge of a corporate debtor in a chapter 11 case by excepting from discharge debts owed to *any* governmental unit when predicated on fraud.

The SEC's asserted position on section 1141(d)(6) went unchallenged and was later approved by the bankruptcy court in the reorganization plan of Bally Total Fitness of Greater New York. In *In re Bally Total Fitness of Greater New York*,[3] *Bally* sought the most efficient route to reorganization when it filed for bankruptcy in July of 2007, a prepackaged plan of reorganization, which requires pre-approval by the creditors before filing for bankruptcy and cooperation amongst the parties to expedite the bankruptcy process.[4] *Bally* completed its reorganization in October of

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[1] 11 U.S.C. § 1141(d)(6) (2006).

> Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt—
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> (A) of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to domestic governmental unit, or owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31 or any similar State statute; or
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> (B) for a tax or customs duty with respect to which the debtor—
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> (i) made a fraudulent return; or
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> (ii) willfully attempted in any manner to evade or to defeat such tax or customs duty.

Id.

[2] *See* 11 U.S.C. § 523 (2006) (preventing discharge of fraud debts for individuals, but not corporations); *see also In re* E & J Underground, Inc., 98 B.R. 580, 581 (Bankr. M.D. Fla. 1989) (indicating section 523's exemptions from discharge do not apply to corporate debtors); Nancy C. Dreher & Matthew E. Roy, *Bankruptcy Fraud and Nondischargeability Under Section 523 of the Bankruptcy Code*, 69 N.D. L. REV. 57, 59 (1993) (suggesting corporate debtors should receive discharge for all pre-petition debts, including those for fraud).

[3] No. 07-12395 (BRL), 2007 WL 2779438 (Bankr. S.D.N.Y. Sept. 17, 2007) [hereinafter *In re Bally*].

[4] *See In re Bally*, 2007 WL 2779438, at *1 (indicating Bally's filed prepackaged plan of reorganization); *see also In re* TS Indus., Inc., 117 B.R. 682, 688–89 (Bankr. D. Utah 1990) (explaining prepackaged bankruptcy plans are efficient because they are "well thought-out" and "reduce the time and expense of litigation"); Matthew P. Goren, Note, *Chip Away at the Stone: The Validity of Pre-Bankruptcy Clauses*

2007, in line with a normal timetable for a "pre-pack," with one exception, the SEC reserved its claims against the debtor, asserting that its claims were non-dischargeable under section 1141(d)(6) and section 523(a)(2) of the Bankruptcy Code.[5,6] In essence, the SEC allowed *Bally* to reorganize on paper but reserved its statutory right to investigate and adjudicate against the debtor, however, the SEC would hold the reorganized *Bally* responsible for those debts.[7] In confirming the debtors' prepackaged plan of reorganization, no party objected and the court confirmed the language contained in the *SEC Issues* section with the following language:

> the SEC expressly reserves its right to continue to investigate, and in its sole discretion, prosecute and enforce any and all Claims against any or all of the debtors or the Reorganized Debtors arising from any prepetition violations by any debtor of any of the U.S. securities laws . . . including, without limitation, any claims for disgorgement of any benefits received by any debtor as a result of any such violations and any claims for penalties imposed by the SEC in respect of any such violations . . . . Nothing in this Confirmation Order or the Plan shall result in the discharge of any Reserved SEC Claims, and the SEC expressly reserves its rights to assert that any and all Reserved SEC Claims are non-dischargeable as against the Reorganized Debtors pursuant to Sections 1141(d)(6)(a)[sic] and 523(a)(2)(A) of the Bankruptcy Code.[8]

Contracting Around Section 363 of the Bankruptcy Code, 51 N.Y.L. SCH. L. REV. 1077, 1094 n.77 (2007) (describing prepacks as "efficient, economical, and sensible"). The average non-prepackaged bankruptcy takes 674 days, while the average prepackaged bankruptcy takes sixty-one days. Lynn M. LoPucki, WEB BRD, http://lopucki.law.ucla.edu/bankruptcy_research.asp (selecting prepackaged plans only in section F, then submitting the query) (showing mean length of prepackaged plans in chapter 11 filed between 1989 and 2009 is sixty-one days); Lynn M. LoPucki, WEB BRD, http://lopucki.law.ucla.edu/bankruptcy_research.asp (selecting non-prepackaged, non-prenegotiated in section F, then submitting the query) (showing mean length of non-prepackaged non-prenegotiated plans in chapter 11 filed between 1989 and 2009 is 681 days); *see also* Eric D. Green et al., *Prepackaged Asbestos Bankruptcies: Down But Not Out*, 63 N.Y.U. ANN. SURV. AM. L. 727, 730–31 (2008) (showing first asbestos prepack bankruptcy lasted just over two months, whereas non-prepackaged asbestos bankruptcies average five or six years).

[5] *See generally* Complaint, SEC v. Bally Total Fitness Holding Corp., 1:08-cv-00348 (D.D.C. Feb. 28, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20470.pdf.

[6] *See In re Bally*, 2007 WL 2779438, at *12 ("[T]he SEC expressly reserves its rights to assert that any and all [r]eserved SEC [c]laims are non-dischargeable as against the [r]eorganized [d]ebtors pursuant to Sections 1141(d)(6)(a) and 523(a)(2)(A) of the Bankruptcy Code."); *see also* 11 U.S.C. § 1141(d)(6)(A) (2006) (indicating confirmation of plan does not discharge debtor from any debt described in section 523(a)(2)(A) or section 523(a)(2)(B) of Bankruptcy Code); Barry L. Zaretsky, *Loan Extensions and the Fraud Exception to Discharge*, N.Y.L.J., Sept. 16, 1993, at 3 (noting 11 U.S.C. § 523(a)(2) denies discharge of particular debts under certain circumstances even if debtor is entitled to receive discharge generally).

[7] *In re Bally*, 2007 WL 2779438, at *13 (stating SEC reserves right to investigate, prosecute, and enforce "any and all" claims against debtors).

[8] *Id.*

On February 28, 2008, the SEC filed financial fraud charges against *Bally*, claiming, from 1997 to 2003, *Bally* filed financial statements that contained accounting misrepresentations, which resulted in the overstatement of its 2001 stockholder's equity by $1.8 billion, its reported 2002 net loss by $92.4 million, and it's 2003 net loss by $90.8 million.[9] *Bally* consented to an injunction, preventing them from future violations of "[s]ection 17(a) of the Securities Act of 1933, Sections 10(b), 13(a), 13(b)(2)(A) and 13(b)(2)(B) of the Securities Exchange Act of 1934, and Rules 10b-5, 12b-20, 13a-1, 13a-11, and 13a-13."[10] The most important line of the entire SEC release is the last line, which states, "[t]he Commission's investigation is continuing."[11]

If the SEC continues its investigation and proceeds with disgorgement proceedings and/or civil penalties, then the reorganized *Bally* would be responsible for forfeiting those funds, which could be billions, to the SEC. The SEC can, in turn, redistribute the disgorgement and civil penalty funds to the injured investors through the "Fair Funds" provision enacted in the Sarbanes-Oxley Act of 2002. The loss of those funds would destroy *Bally*, as the last 10-Q filed by *Bally* indicates that their totals assets were only $109 million.[12]

Because of the nature of the SEC's claims—disgorgement and civil penalties—excepting these claims from discharge substantially increases the likelihood that: (1) the debtor's plan of reorganization will fail the "best interest of the creditors test," Bankruptcy Code section 1129(a)(7); (2) The SEC's civil penalty claim will not be subordinated, as required by section 726(a)(4) of the Bankruptcy Code, when the civil penalty claims become non-dischargeable; and (3) the SEC will redistribute its collected funds to shareholders, in violation of Bankruptcy Code section 510(b), which subordinates the shareholders fraud claims below those of the unsecured creditors.

After a close examination of the statutory language and the pertinent case law, it is apparent that Congress could not have intended to except from discharge the government's claims arising from enforcement of the securities laws; and its intention must have been to except governmental fraud claims only if they seek to recover for a direct financial loss suffered by the Government. This conclusion rests on three primary arguments.

First, section 1141(d)(6)(A) expressly incorporates 11 U.S.C. § 523(a)(2)(A)-(B), which has threshold requirements for non-dischargeability that the defrauded creditor has itself relied on the debtor and suffered a loss because of that reliance.[13]

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[9] Bally Total Fitness Settles Financial Fraud Charges With SEC, Litigation Release No. 20470 (Feb. 28, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20470.htm (alleging Bally's financial statements were tainted by over two dozen accounting improprieties).

[10] *See id.* (stating complaint charged Bally with violating Securities Acts of 1933 and 1934).

[11] *Id.*

[12] *See* Bally Total Fitness Holding Corp., Quarterly Report (Form 10-Q) at 4 (Sept. 28, 2007), *available at* http://www.sec.gov/Archives/edgar/data/770944/000095013707014840/c18921e10vq.htm (indicating Bally's 2007 unaudited current assets totaled $109,010,000.00).

[13] Field v. Mans, 516 U.S. 59, 68–70 (1995).

These threshold requirements, as confirmed by the Supreme Court in *Field v. Mans*, are not satisfied by the SEC's enforcement claims for the recovery of money. [14] Because *shareholder* reliance and damage, rather than that of the Government, is the predicate for SEC monetary enforcement claims,[15] section 1141(d)(6) should be construed not to cover such SEC claims.

Second, the SEC's literal reading of one portion of section 1141(d)(6)(A) produces a result that is inconsistent with the other portions of the statute and other provisions of the Bankruptcy Code. Therefore, the canons of statutory construction should be used to clarify the statute so that its application is both internally consistent and compatible with the rest of the Bankruptcy Code.

Third, throughout the history of the SEC, Congress has always made clear its intentions as to the SEC's role in bankruptcy. The SEC, however, has read section 1141(d)(6) as effecting a drastic and fundamental change in its role, which would enable it to assert enormous monetary claims after a debtor's reorganization and require bankruptcy relief for the reorganized debtor. Such a change, which provides a dominant position for the SEC in bankruptcy, should not be imputed to Congress in absence of a clear statement of its intention to do so.

Congress must have intended that governmental claims based on fraud would only survive a corporate debtor's chapter 11 confirmation if the Government has itself suffered a fiscal loss. An interpretation of section 1141(d)(6) that excepts from discharge such claims of the SEC will subvert other sections of the Bankruptcy Code, contradict long-standing bankruptcy policy, and destroy the possibility that corporations could successfully reorganize under chapter 11.

I. HISTORY AND BACKGROUND

Traditionally, the SEC had equitable powers to seek disgorgement of ill-gotten gains in the district court. Since the enactment of the Securities Act of 1933[16] and the Securities Exchange Act of 1934,[17] Congress has strengthened those powers. In discussing the remedies of the SEC, the Second Circuit provided the following analysis of the enforcement role of the SEC, among the traditional powers of the SEC is the equitable power of disgorgement, which is meant to deter violations of the securities laws by depriving violators of their ill-gotten gains:

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[14] 516 U.S. at 76 (1995) (endorsing justifiable reliance, not reasonable reliance).

[15] *See* 15 U.S.C. § 78(j)(b) (2006) (stating "[i]t shall be unlawful for any person … [t]o use… any manipulative or deceptive" strategies in opposition to SEC regulations prescribed for investor protection); Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 178 (2d Cir. 2001) (requiring proof of shareholders' reliance on false statements as prerequisite for recovery for fraudulent misrepresentation); San Leandro Emergency Med. Group Profit Sharing Plan v. Philip Morris Cos., 75 F.3d 801, 808 (2d Cir. 1996) (noting cause of action under 15 U.S.C. § 78(j) requires plaintiff prove reliance on defendant's action caused plaintiff's injury).

[16] Ch. 38, 48 Stat. 74 (1933) (codified as amend at 15 U.S.C. § 77a (2006)) [hereinafter '*33 Act*].

[17] Ch. 404, 48 Stat. 881 (1934) (codified as amend at 15 U.S.C. § 78a (2006)) [hereinafter '*34 Act*]; '*33 Act*, '*34 Act* [hereinafter *Acts*].

> Finding that disgorgement insufficiently deters securities laws violations because it merely restores the *status quo ante*, Congress enacted the Securities Enforcement Remedies Act and Penny Stock Reform Act of 1990 to further 'the dual goals of punishment of the individual violator and deterrence of future violations.' . . . The Remedies Act permits the SEC, in addition to seeking disgorgement of ill-gotten profits, to seek civil penalties of generally up to the amount of the gross pecuniary gain from the securities.[18]

Over the last 10 years, a host of large-scale fraud cases darkened the national bankruptcy landscape. Corporate greed led to bankruptcy filings for corporations like Enron, Worldcom, Adelphia, Global Crossing, Tyco and many others. Billions of invested dollars were lost and deemed unrecoverable by the small-time investor and the sophisticated, institutional investor alike. The misdeeds of the executives of Enron provided daily fodder for the news cycle, chronicling the criminal trials of the "granddaddy of all corporate fraud cases."[19] Never before had the public at large been so aware of corporate fraud, and never before had so much damage come from it. Alongside the millions of outside investors dollars lost, over 4,000 employees lost their jobs, and, concomitantly, many lost their life savings, having invested everything back into Enron.[20]

It was not Enron alone that inspired Congress to pass legislation in 2002, several other high profile companies were also found to have committed fraud and other securities laws violations: Worldcom founder Bernard Ebbers received excessive, multi-million dollar off-the-book loans from his company, and the company reported operating expenses as capital expenses;[21] Global Crossing

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[18] Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 81–82 (2d Cir. 2006); *see* SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997); SEC v. Kane, No. 97 Civ. 2931 (CBM), 2003 U.S. Dist. Lexis 5043, at *7 (S.D.N.Y. Mar. 31, 2003) (acknowledging Congress enacted civil penalties to security law violators for punishment and deterrence purposes).

[19] Shaheen Pasha & Jessica Seid, *Lay and Skilling's Day of Reckoning*, CNN MONEY, May 25, 2006, http://money.cnn.com/2006/05/25/news/newsmakers/enron_verdict/index.htm.

[20] *See* Lisa H. Nicholson, *The Culture of Under-Enforcement: Buried Treasure, Sarbanes-Oxley and the Corporate Pirate*, 5 DEPAUL BUS. & COM. L.J. 321, 331 (2007) (affirming Enron's fraud caused devaluation in investors' assets); *see also* Vaughn K. Reynolds, *The Citigroup and J.P. Morgan Chase Enron Settlements: The Impact on the Financial Services Industry*, 8 N.C. BANKING INST. 247, 247 (2004) (positing Enron scandal cost over 5,600 jobs and 28,000 pensions); Pasha & Seid, *supra* note 19 (showing ramifications of Enron scandal include severe losses in jobs and life saving, and billions of investment dollars).

[21] *See* Sheldon A. Jones & James M. Storey, *Is Mutual Fund Governance a Model For Corporate America?*, 22 ANN. REV. BANKING & FIN. L. 265, 275–76 (2003) (remarking WorldCom utilized fraudulent accounting practices to inflate stock price and CEO Bernard Ebbers used company funds for personal expenses); *see also* Ethan G. Zelizer, Student Article, *The Sarbanes-Oxley Act: Accounting for Corporate Corruption?*, 15 LOY. CONSUMER L. REV. 27, 38–39 (2003) (stating CEO Bernard Ebbers used WorldCom funds to pay off personal debts in attempt to make company appear profitable); Penelope Patsuris, *The Corporate Scandal Sheet*, FORBES.COM, Aug. 26, 2002,

shredded documents to cover up the misdeeds of its executives, after engaging in artificial sales inflation;[22] and, the Government secured a conviction of Tyco's chief executive for tax evasion, leading to investigations into the accounting practices of the company itself. And, in the most daring example of corporate debauchery, John Rigas, the founder of Adelphia, hid $2.3 billion in debts, deceiving investors and stealing company funds.

After the discovery of such overwhelming and brazen corporate fraud perpetrated by the corporate community, Congress quickly passed legislation aimed at strengthening the remedies against corporate wrongdoing. In July of 2002, President Bush signed into law the most comprehensive overhaul of securities regulation since the enactment of the Acts: the Sarbanes-Oxley Act of 2002[23] ("SOX"). Among the provisions that altered many facets of corporate life and levied stiff civil and criminal penalties, SOX included a "Fair Funds" provision ("Fair Funds"),[24] which empowered the SEC to redistribute to "victims" of securities frauds—the shareholders of the offending corporation[25]—money recovered as civil penalties for fraud, when collected in conjunction with disgorgement of ill-gotten gains from the corporate wrongdoer.

However, the expansion of the SEC's role came in section 523(a)(19) of the Bankruptcy Code, where Congress, addressing *individual* debtors, made non-dischargeable "the violation of any of the securities laws . . . , any of the state securities laws, or any regulation or order issued under such Federal or State Securities laws; or common law fraud, deceit, or manipulation in connection with the purchase or sale of any security . . . ."[26] As Congress has traditionally done

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http://www.forbes.com/2002/07/25/accountingtracker.html (stating WorldCom misreported its balance sheets with off-the-book loans to CEO).

[22] *See* Jones & Storey, *supra* note 21, at 270 (indicating Global Crossing artificially inflated revenue to deceive investors); *see also* Oleg Rezzy, Comment, *Sarbanes-Oxley: Progressive Punishment For Regressive Victimization*, 44 HOUS. L. REV. 95, 100 (2008) (positing Global Crossing was forced into bankruptcy by fraudulent accounting techniques); Patsuris, *supra* note 21 (stating Global Crossing inflated revenue to skew accounting numbers).

[23] *See generally* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.) (providing securities regulation to prevent corporate fraud).

[24] *See generally* 15 U.S.C. § 7246 (2006) (stating various civil penalties for corporate fraud).

[25] *Id.* § 7246(a):

> (a) Civil penalties added to disgorgement funds for the relief of victims
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> > If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

[26] 11 U.S.C. § 523(a)(19)(A)(i)–(ii) (2006).

when addressing the role of the SEC in bankruptcy, it issued a statement, which appears in the legislative history, as to why it enacted this statute.[27] Senator Leahy (D - Vt.) noted:

> This provision would amend the federal bankruptcy code to make judgments and settlements arising from state and federal securities law violations brought by state or federal regulators and private individuals non-dischargeable. Current bankruptcy law may permit wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and securities law violations. The section, by its terms, applies to both regulatory and more traditional fraud matters, so long as they arise under the securities laws, whether federal, state, or local. This provision is meant to prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible.[28]

Three years passed before Congress again amended the Bankruptcy Code when it enacted the Bankruptcy Abuse Prevention Consumer Protection Act of 2005 ("BAPCPA").[29] Most of the enactments in BAPCPA made things more difficult for consumers seeking to obtain relief from the bankruptcy system by beefing up hurdles for filing chapter 7 for individual filers; BAPCPA instituted the "means test," a presumption of abuse against individuals when filing chapter 7, and mandated credit counseling as a prerequisite to filing for bankruptcy, among other things.[30] But, a corporate reorganization statute did emerge from BAPCPA, section 1141(d)(6) of the Bankruptcy Code. Entitled, "No Discharge of Fraudulent Taxes in chapter 11," as part of title VII (Bankruptcy Tax Provisions), section 708 of BAPCPA added section 1141(d)(6)(A)-(B) to the Bankruptcy Code. The added subsection made certain governmentally held fraud debts of corporate chapter 11 debtors non-dischargeable. Specifically, subsection (A) made non-dischargeable fraud debts "of a kind specified" in section 523(a)(2)(A)-(B) when the corporate

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[27] *See, e.g.*, H.R. REP. No. 108-724, pt. 3, at 37, 49, 84 (2004) (reporting purposes of 9/11 Recommendations Implementation Act, which amends Bankruptcy Code and grants authority to SEC); H.R. REP. No. 91-1613, at 1, 12 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5255, 5265–66 (stating purpose of Securities Investor Protection Act of 1970, which grants SEC rulemaking authority); 148 CONG. REC. H1544, 1545 (daily ed. Apr. 24, 2002) (statement of Rep. Oxley) (discussing purpose of Corporate and Auditing Accountability, Responsibility, and Transparency Act, which grants SEC authority).

[28] 148 CONG. REC. S7418-01 (daily ed. July 26, 2002) (statement of Sen. Leahy).

[29] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8.

[30] *See* Schultz v. United States, 529 F.3d 343, 347 (6th Cir. 2008) (citing 11 U.S.C. §§ 707(b)(1), (b)(2)(A)(ii), (b)(7) (2006)) (stating BAPCPA requires "means test" for individuals filing for chapter 7 bankruptcy in order to avoid presumption of abuse of bankruptcy proceedings); *In re* Meza, No. 2:06cv1307 MCE, 2007 WL 1821416, at *1 (E.D. Cal. June 25, 2007) (noting credit counseling is prerequisite for individuals filing for bankruptcy under BAPCPA); Adams v. Finlay, Nos. 06 Civ 6039(CLB), 06-6040, 06-6041, 06-6042, 06-6075, 06-6077, 2006 WL 3240522, at *1 (S.D.N.Y. Nov. 3, 2006) (discussing BAPCPA-required credit counseling).

debtor owed the debt to a domestic governmental unit. In stark contrast to the legislative history of section 523(a)(19) of the Bankruptcy Code, though, Congress said nothing in the legislative history of section 1141(d)(6) or if it intended to include the SEC or its claims under that section. With such a long history of defining its intentions for the SEC in bankruptcy it is unlikely that Congress, by its silence, intended to make governmental securities claims non-dischargeable, particularly where the government itself was not injured by fraud.

A. The History of the SEC's Role in Bankruptcy

Congress has always expressly stated its intentions as to the SEC's role in the bankruptcy process. Now, with the enactment of section 1141(d)(6), the SEC asserts that Congress has changed course and granted the SEC broad powers within bankruptcy, which undermine existing provisions of the Bankruptcy Code. Congress would not enact such a sea change in the Bankruptcy Code, whether it concerned the SEC or not, without an explanation as to its policy shift. As the below examples illustrate, shifts in the SEC's role in bankruptcy are thoroughly discussed and drafted with intent.

Early in the twentieth century, Congress enacted the *'33 Act* and the *'34 Act*, two pieces of powerful legislation designed to regulate the securities markets, provide enforcement mechanisms for violations of the Acts, and create a federal agency—the SEC—to coordinate, oversee, and enforce these statutes.

Congress left bankruptcy out of the *'33 Act* and the *'34 Act* but for one provision, which required the SEC to conduct a study of bankruptcies.[31] This study led Congress to enact the Chandler Act in 1938, which reformed the corporate reorganization chapter, chapter X, of the Bankruptcy Act. The Chandler Act granted the SEC oversight authority within the bankruptcy process,[32] which ushered in a new era in bankruptcy, one designed to change the power structure of those participating in corporate reorganizations by shifting power from corporate managers, investment bankers, and other "friendly faces" to the Government.[33]

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[31] *See '34 Act*, Pub. L. No. 73-291, § 211, 48 Stat. 881, 909 (codified as amended at 15 U.S.C. § 78jj) (repealed 1987) (providing for "study and report by the [SEC] of reorganization proceedings"); *see also* James M. Shea, Jr., Note, *Who is at the Table? Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy Procedure 2019*, 76 FORDHAM L. REV. 2561, 2571 (2008) (discussing SEC's study of reorganization authorized by *'34 Act*); David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* 7 (Univ. of Pa. Law Sch., Inst. for Law and Econ., Working Paper No. 267, 1999), *available at* http://ssrn.com/abstract=172030 [hereinafter Skeel, *Rise and Fall*] (stating *'34 Act*, by requiring SEC to conduct study, "added only one piece to the bankruptcy puzzle").

[32] *See* Chandler Act of 1938, ch. 575, § 265, 52 Stat. 840, 903 (repealed 1978) (requiring SEC be given notice of chapter X proceedings); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 110 (1998) (commenting on SEC's supervisory power over chapter X proceedings); Skeel, *Rise and Fall*, *supra* note 31, at 47 n.136 (noting Chandler Act granted SEC oversight authority).

[33] *See* F.H. Buckley, *The American Stay*, 3 S. CAL. INTERDISC. L.J. 733, 767 (1994) (observing Chandler Act gave SEC power to replace managers); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1323, 1371 n.174 (1998) [hereinafter Skeel, *Evolutionary*

In continuing its mission for bankruptcy oversight, Congress vested control over chapter X debtors to the bankruptcy trustee, who replaced managers and investment bankers who had previously controlled the bankruptcy process and insulated debtors.[34] After the passage of the Chandler Act, the trustee provided investors with a neutral party at the helm of the bankruptcy estate, as opposed to the insiders who had previously dominated the process.[35]

The Chandler Act also gave the SEC great control over the reorganization process.[36] Among the powers given to the SEC was the ability to intervene as an interested party at any time in the reorganization process. More importantly, when the value of the estate exceeded $3 million dollars, the Chandler Act charged the debtor with submitting its plan of reorganization to the SEC for comments before the debtor could emerge from bankruptcy.[37] With the trustee at the helm and with oversight by the SEC, the small investor—who previously had lost out to collusion

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Theory] (asserting Chandler Act eliminated bankers' authority); Skeel, *Rise and Fall*, *supra* note 31, at 1, 10–11 ("If the reformers' objectives could be distilled to a single aim, their goal was to inject ongoing governmental oversight into the reorganization process.").

[34] *See* BRUCE G. CARRUTHERS & TERENCE C. HALLIDAY, RESCUING BUSINESS: THE MAKING OF CORPORATE BANKRUPTCY LAW IN ENGLAND AND THE UNITED STATES 264 (1998) ("[T]he Chandler Act had created Chapter X to take reorganizations of large publicly traded companies out of the hands of management and put them under the direction of an independent trustee.") (internal citation omitted); Skeel, *Evolutionary Theory*, *supra* note 33, at 1370 ("Thus in every sizable case, Chapter X required that the debtor's current managers be replaced by a trustee."); *see also* Richard E. Mendales, *Intensive Care for the Public Corporation: Securities Law, Corporate Governance, and the Reorganization Process*, 91 MARQ. L. REV. 979, 988 (2008) (stating chapter X "includ[ed] appointment of Chapter X trustees for reorganizing corporations").

[35] *See* Skeel, *Evolutionary Theory*, *supra* note 33, at 1356–57 ("Rather than preparing to liquidate assets, as a creditor's bill contemplated, the receivers, who generally included members of the railroad's management, worked out the terms of a reorganization. At the same time, the railroad's investment bankers formed bondholder "protective committees" and attempted to persuade the bondholders to deposit their securities with the committee, which would commit the bondholders to the terms of the eventual reorganization. Once everything was in place, the bonds and other security interests were foreclosed and the railroad's assets were 'sold' in a foreclosure sale. In reality, the "sale" simply effected a reorganization of the railroad's capital structure."); *see also* CARRUTHERS & HALLIDAY, *supra* note 34, at 264 (describing chapter X as mechanism to transfer control over reorganizing corporations from managers to "independent" trustees); Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264, 270 (1993) (stating appointment of trustee under chapter X intended "to address . . . prior problems surrounding shareholder participation in reorganization cases").

[36] *See* Mendales, *supra* note 34, at 988 (explaining chapter X provides SEC "extensive participation … in the reorganization process"); A.C. Pritchard & Robert B. Thompson, *Securities Law and the New Deal Justices*, 95 VA. L. REV. 841, 843 (2009) (stating Chandler Act gave "SEC a critical role in the reorganization of insolvent public companies"); Skeel, *Evolutionary Theory*, *supra* note 33, at 1370 (discussing how Chandler Act adopted "almost verbatim" proposals from SEC).

[37] *See* Chandler Act of 1938, ch. 575, §§ 172–73, 52 Stat. 840, 890–91 (repealed 1978) (stating judges must submit reorganizations plans to SEC for examination when debts exceed $3 million and shall not rule until receiving report from SEC regarding submitted plans); *see also* Kelch, *supra* note 35, at 270 (stating SEC "gave advice and provided detailed review and comment" on reorganization plans for corporations with debt greater than $3 million); Skeel, *Evolutionary Theory*, *supra* note 33, at 1371 ("Chapter X . . . also required that any reorganization plan in a case over $3 million be submitted to the SEC for comments prior to confirmation.").

between the large investors and the debtor—had an effective voice in the bankruptcy and reorganization of a corporation.

The role of the trustee would continue but the SEC's position was fleeting as Congress vested the SEC's regulatory power over corporate debtors solely in chapter X cases. In the 1940s, the courts forced corporate debtors to use chapter X to reorganize, siding with the Government and the SEC.[38] Citing public policy concerns and the important role of the SEC in bankruptcy, the Supreme Court, in *Securities and Exchange Commission v. U.S. Realty & Improvement Co.*, held in favor of the SEC and restricted corporate debtors to using chapter X.[39]

However, in the 1950s, the Supreme Court rang the death knell of the SEC's role in bankruptcy by refusing to deem chapter X as the only course available to a reorganizing debtor.[40] Instead, the Supreme Court acknowledged that debtors should have options and could utilize either chapter X or chapter XI. The Supreme Court, in *General Stores Corp. v. Shlensky*, held that no single characteristic of the debtor could determine the appropriate chapter, whether chapter X or chapter XI, under which to pursue reorganization; instead, the Court held that the "needs to be served" should determine the appropriate chapter.[41] Justice Douglas stated,

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[38] *See* SEC v. U.S. Realty & Improvement Co., 310 U.S. 434, 461 (1940) (holding SEC had right to intervene in bankruptcy proceeding to prevent debtor from filing under chapter XI); *see also* Pritchard & Thompson, *supra* note 36, at 884–86 (describing Supreme Court's support for SEC's power to force chapter X in *SEC v. U.S. Realty & Improvement Co.*, as well as its general support for SEC in early 1940s); Skeel, *Evolutionary Theory*, *supra* note 33, at 1374 (noting SEC's success in forcing large corporations to file under chapter X rather than chapter XI during early years of Chandler Act).

> The [SEC] is, as we have seen, charged with the performance of important public duties in every case brought under Chapter X, which will be thwarted, to the public injury, if a debtor may secure adjustment of his debts in a Chapter XI proceeding when, upon the applicable principles which we have discussed, he should be required to proceed, if at all, under Chapter X.

U.S. Realty & Improvement Co., 310 U.S. at 458–59.

[39] *U.S. Realty & Improvement Co.*, 310 U.S. at 455–56 (holding corporate debtor is restricted to chapter X proceedings, which allows adequate remedies, unlike chapter XI proceedings); *see, e.g.*, Tyler v. Marine Midland Trust Co. of N.Y., 128 F.2d 927, 928 (2d Cir. 1942) (holding corporate debtor was not entitled to proceed under chapter XI in *SEC v. U.S. Realty & Improvement Co.*); *In re* Herold Radio & Electronic Corp., 191 F. Supp. 780, 784 (S.D.N.Y. 1961) (highlighting *SEC v. U.S. Realty & Improvement Co.*, among other cases, showed Court's preference for chapter X over chapter XI proceedings).

[40] *See* Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 465–66 (1956) (rejecting interpretation of *SEC v. U.S. Realty Improvement Co.* as *per se* restriction of corporate debtors to chapter X proceedings but instead deciding, by factual inquiry, whether remedies under chapter X or XI would better serve public and private interests); Recent Developments, *Discretion Properly Exercised in Relying on Business Prospects to Allow Chapter XI Arrangement of Large Public Corporate Debtor*, 64 COLUM. L. REV. 155, 158 (1964) (referring to new "flexible standard" created by Supreme Court in *General Stores Corp. v. Shlensky*); Skeel, *Evolutionary Theory*, *supra* note 33, at 1374 (1998) (explaining Justice Douglas "made it clear" in *General Stores Corp. v. Shlensky* "that even a publicly held corporation could invoke Chapter XI in an appropriate case").

[41] *Gen. Stores Corp.*, 350 U.S. at 465–66 (advocating for "needs to be served" test, which includes "public and private interests"); *see, e.g.*, *In re* Barchris Const. Corp., 223 F. Supp. 229, 230 (S.D.N.Y. 1963) (applying "needs to be served" test from *General Stores Corp. v. Shlensky*); Richard W. Jennings, *Mr. Justice Douglas: His Influence On Corporate and Securities Regulation*, 73 YALE L.J. 920, 960 (1964)

> [t]he character of the debtor is not the controlling consideration in a choice between c. X and c. XI. Nor is the nature of the capital structure. It may well be that in most cases where the debtor's securities are publicly held c. X will afford the more appropriate remedy. But that is not necessarily so. A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but between the needs to be served.[42]

By adopting the "needs to be served" doctrine, the Court acknowledged the importance of the efficiency and reduced cost that reorganization provided to the debtor and suggested that SEC oversight would only hamper a debtor's ability to reorganize.

The *General Stores* holding led to a host of decisions over the next 20 years that diminished the SEC's role in bankruptcy and its protection of the investor.[43] Congress, in 1978, again chose to revise the SEC's role in bankruptcy; this time, though, the SEC's bankruptcy role was not only downgraded but almost eliminated. Congress combined chapters X and XI into the present chapter 11 and removed the SEC's oversight position, essentially erasing the SEC's previously significant role in bankruptcy.

Twenty-four years elapsed before Congress began resurrecting the SEC's role in bankruptcy through the passage of SOX in 2002.[44]

(emphasizing Justice Douglas's influence on corporate and securities regulation cases and discussing his "needs to be served" test is determinant when choosing between chapters X and XI).

[42] *See Gen. Stores Corp.*, 350 U.S. at 466 (de-emphasizing distinction between large and small companies and stressing importance of serving public and private interests); Grayson-Robinson Stores, Inc. v. SEC, 320 F.2d 940, 950 (2d Cir. 1963) ("'The essential difference is not between the small company and the large company but between the needs to be served . . . .'" (quoting *Gen. Stores Corp.*, 350 U.S. at 466)); Skeel, *Rise and Fall*, *supra* note 31, at 12 (noting "needs to be served" test allowed lawyers to argue for chapter XI so that by 1960s "many large firms had made their way into Chapter XI").

[43] *See* SEC v. Transvision, Inc., 348 U.S. 952, 952 (1955) (denying SEC's writ for certiorari to Second Circuit); Barnes v. Alrac Corp. (*In re* Alrac Corp.), 550 F.2d 1314, 1319 (2d Cir. 1977) (affirming bankruptcy court's denial of conversion to chapter X and confirming chapter XI arrangement); *Grayson-Robinson Stores, Inc.*, 320 F.2d at 950 ("The court can hardly ignore a substantially uncontradicted factual showing that Chapter XI affords some hope of paying off creditors whereas Chapter X offers none."); *In re* Lea Fabrics, Inc., 272 F.2d 769, 772 (3d Cir. 1959) (stating "district court exercised sound business [and] legal judgment" in denying SEC's motion to dismiss chapter XI proceeding); SEC v. Wilcox-Gay Corp., 231 F.2d 859, 862 (6th Cir. 1956) (holding district court's decision to dismiss SEC's petition for chapter X should be affirmed when it is clear judge "exercised sound discretion within allowable bounds"); *In re* Transvision, Inc., 217 F.2d 243, 247 (approving district court denying SEC's motion for leave to intervene and stopping chapter XI proceeding).

[44] *See* SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES-OXLEY ACT OF 2002, at 1 (2003), *available at* http://www.sec.gov/news/studies/sox308creport.pdf (giving SEC new powers through passage of Sarbanes-Oxley Act in 2002).

II. DETAILED ANALYSIS OF BANKRUPTCY CODE SECTION 523(A)(2)(A)-(B)

The first clause of section 1141(d)(6)(A) incorporates into that section, section 523(a)(2)(A)-(B), making non-dischargeable those debts "of a kind specified in"[45] section 523(a)(2)(A)-(B) when owed to a governmental unit by a corporate debtor in chapter 11. When it enacted section 1141(d)(6), Congress, by incorporating section 523(a)(2)(A)-(B) into section 1141(d)(6) did not just incorporate the words of section 523(a)(2)(A)-(B) but incorporated the judicial interpretations of section 523(a)(2) as well.[46]

Prior to the enactment of section 1141(d)(6), the Supreme Court interpreted section 523(a)(2)(A)-(B) and held that non-dischargeability under that section is limited to those cases where the creditor has relied on, and suffered a financial loss because of the debtor.[47] In short, if a debt is not "of a kind" that is dischargeable under section 523(a)(2), it is not to be discharged under section 1141(d)(6). The SEC's claims for disgorgement and civil penalties are not "of a kind specified in" section 523(a)(2)(A)-(B) because the SEC has neither relied on the debtor nor suffered a financial loss and therefore should be discharged.

Bankruptcy Code section 523 determines the claims against an *individual* debtor that will survive the bankruptcy process and remain as obligations of the debtor after its discharge.[48] Specifically, section 523(a)(2)(A)-(B) makes non-dischargeable:

> . . . an individual debtor from any debt for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by —
>
> (a) False pretense, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;

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[45] 11 U.S.C. § 1141(d)(6)(A) (2006); *see* Hafer v. U.S. Dep't of Labor Admin. Review Bd., 277 F. App'x 739, 741 (9th Cir. 2008) (describing plaintiff's claim against corporation discharged in bankruptcy because claim did not fall under any exceptions in sections 523(a) or 1141(d)(6)); *In re* Breezy Ridge Farms, Inc., No. 08-12038-JDW, 2009 WL 1514671, at *2 (Bankr. M.D. Ga. May 29, 2009) (applying section 523 to corporate debtors pursuant to section 1141(d)(6) despite language in section 523(a) excluding corporate debtors).

[46] Dewsnup v. Timm, 502 U.S. 410, 419 (1992) ("When Congress amends the bankruptcy laws, it does not write 'on a clean slate.'"); *see* Pacific Gas & Elec. Co. v. California, 350 F.3d 932, 943, 945 (9th Cir. 2003) (arguing *Dewsnup v. Timm*, among other cases, demonstrates Supreme Court consistently presuming purpose of Bankruptcy Code is not to alter preexisting bankruptcy laws); *see also* Cohen v. De la Cruz, 523 U.S. 213, 221 (1998) (refusing to construe Bankruptcy Code as departure from past bankruptcy practice unless Congress clearly indicated otherwise).

[47] Field v. Mans, 516 U.S. 59, 68–70 (1995).

[48] *See* Tuttle v. United States (*In re* Tuttle), 291 F.3d 1238, 1244 (10th Cir. 2002) (holding individual liable for tax interest under section 523 despite successful completion of chapter 11 plan); *In re* Wong, 291 B.R. 266, 273 (Bankr. S.D.N.Y. 2003) (enumerating debts nondischargeable under section 523); *In re* Ballard, Nos. 00-71225-S, 00-07041-S, 2001 WL 1946239, at *28 (Bankr. E.D. Va. July 18, 2001) (construing section 523 to determine dischargeability of debt owed under marriage separation agreement).

> (b) Use of a statement in writing —
> (1) That is materially false;
> (2) Respecting the debtor's or an insider's financial condition;
> (3) On which the creditor to whom the debtor is liable for such money, property services, or credit reasonably relied; and
> (4) That the debtor caused to be made or published with intent to deceive.[49]

These debts are generally based on fraud. Although normally a discharge provides the debtor with a "fresh start," occasionally that new beginning is not completely "fresh." The debts that are exceptions to discharge are still the responsibility of the debtor after the Bankruptcy Code's discharge under section 524 frees the debtor from its other debts. Bankruptcy Code section 524 governs the "Effect[s] of Discharge," which states:

> (a) a discharge . . .
> (1) voids any judgment . . .
> (2) operates as an injunction against the commencement or continuation of an action, employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, . . .
> (3) operates as an injunction against the commencement or continuation of an action, employment of process, or an act, to collect, recover or offset against, property of the debtor . . . .[50]

Understanding that excepting these fraud debts from discharge is an extreme remedy comes from an understanding of the effects of a discharge. The expected outcome from filing bankruptcy is the discharge of the debtor's debts and only in specific narrowly drafted circumstances is the debtor not given that full discharge. Section 524 bars creditors from collecting or initiating proceedings against the debtor once the debtor is discharged, unless, like in section 523, Congress has made a claim of the creditor non-dischargeable. Often, though, the burden rests on the creditor to establish that its claims are non-dischargeable.[51]

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[49] 11 U.S.C. §§ 523(a)(2)(A)–(B) (2006).
[50] 11 U.S.C. § 524(a) (2006).
[51] *See* FED. R. BANKR. P. 4007(c); LAWRENCE R. AHERN, III & NANCY FRAAS MACLEAN, BANKRUPTCY PROCEDURE MANUAL: FEDERAL RULES OF BANKRUPTCY PROCEDURE ANNOTATED § 4007:2 (2009 ed. 2009) (discussing either creditor or debtor can bring action to determine whether particular debt is nondischargeable, but creditor has burden of proving nondischargeability); *see also* Hartford Cas. Ins. Co. v. Fields (*In re* Fields), 926 F.2d 501, 503 (5th Cir. 1991) ("[T]he party seeking an exception to discharge bears the burden of proof as to nondischargeability."). This requirement does not extend to all claims under section

Creditor must satisfy certain conditions before it can gain non-dischargeability status for its section 523(a)(2)(A)-(B) claims. Under section 523(c), a creditor must bring suit to determine the dischargeability of its fraud claims under section 523(a)(2). If no such suit is brought, the debtor will receive a discharge as to that claim.[52] Additionally, Bankruptcy Rule 4007 requires the creditor to bring this non-dischargeability suit within 60 days of the first date set for the meeting of creditors.[53, 54]

523(a); to be sure, many subsections of section 523(a) do not require the creditor to take any particular actions to prove the dischargeability of its claim. All of the debts listed in section 523(a) are automatically excepted from discharge except those described in subsections (2), (4), (6), or (15). *See In re* Ellsworth, 158 B.R. 856, 858 (Bankr. M.D. Fla. 1993) (finding although certain debts are discharged under section 523(a), other debts require creditor to file complaint seeking determination of nondischargeability in bankruptcy court); *In re* Surface, 133 B.R. 411, 415 (Bankr. S.D. Ohio 1991) (requiring creditor to initiate proceedings in bankruptcy court under section 523(c) to except from dischargeability of debts described in subsections (2), (4), and (6) of section 523(a)); AHERN & MACLEAN, *supra*, at § 4007:3 (observing only those debts described in subsections (2), (4), (6), or (15) of section 523(a) of Bankruptcy Code require creditors to file timely adversary proceedings to prevent discharge).

[52] Under 11 U.S.C. § 523(c), the creditor to whom such debt is owed must file a complaint with the court or else the debtor will receive a discharge on those claims. 11 U.S.C. § 523(c)(1) (2006) (providing if creditor does not bring claims under subsections (2), (4), and (6) of section 523(a), debtor will be discharged from such debts); *see In re Ellsworth*, 158 B.R. at 858 (observing creditor's failure to file complaint seeking determination of nondischargeability automatically discharges debtor's debts under subsections (2), (4), and (6) of section 523(a)); *In re Surface*, 133 B.R. at 415 (concluding creditor's failure to initiate proceedings in bankruptcy court concerning debts falling under subsections (2), (4), and (6) of section 523(a) may result in discharge). "Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section." 11 U.S.C. § 523(c)(1) (2006); *see In re Ellsworth*, 158 B.R. at 858 (examining 11 U.S.C. § 523(c)(1)); *In re Surface*, 133 B.R. at 415 (highlighting 11 U.S.C. § 523(c)(1)'s requirement on creditor to take action).

[53] FED. R. BANKR. P. 4007(c) ("[A] complaint to determine the dischargeability of a debt under § 523(c) shall be filed no later than 60 days after the first date set for the meeting of creditors under § 341(a)"); *see* Kelly v. Gordon (*In re* Gordon), 988 F.2d 1000, 1001 (9th Cir. 1993), *as amended on denial of reh'g*, (June 21, 1993) (finding Rule 4007(c)'s 60 day requirement is triggered from first day for meeting pursuant to section 341(a)); *In re* Miller, 228 B.R. 399, 401 (B.A.P. 6th Cir. 1991) (showing Rule 4007(c) is unambiguous and therefore discharging debts because creditor failed to file complaint within time limit). That time limit is sixty days from the first date set for the meeting of creditors, under Bankruptcy Code section 341. It is unimportant if the meeting of creditors actually takes place on that assigned day. The clock begins to run on any creditor wishing to seek non-dischargeability status for its claim as soon as the original date set elapses. *See In re Gordon*, 988 F.2d at 1001 (explaining Rule 4007(c) makes deadline sixty days after "first date set" for meeting, not date when meeting is actually held); *In re Miller*, 228 B.R at 401 (recognizing majority of cases interpret 60-day period as running from "first date set for the meeting of creditors" even if meeting is continued and actually occurs on different date); AHERN & MACLEAN, *supra* note 51, at § 4007:4 (noting key date is date of first scheduled meeting, not date of first actual meeting or first rescheduled meeting).

[54] This requirement does not extend to all claims under section 523(a); to be sure, many subsections of section 523(a) do not require the creditor to take any particular actions to prove the dischargeability of its claim. All of the debts listed in section 523(a) are automatically excepted from discharge except those described in subsections (2), (4), (6), or (15). *See In re Ellsworth*, 158 B.R. at 858 (finding although certain debts are discharged under section 523(a), other debts require creditor to file complaint seeking determination of nondischargeability in bankruptcy court); *In re Surface*, 133 B.R. at 415 (concluding creditor is required under section 523(c) to initiate proceedings in bankruptcy court to except from discharge

Once the creditor has timely filed a suit as required by Bankruptcy Code section 523(c), the burden rests on the creditor to establish non-dischargeability under section 523(a)(2)(A)-(B) of the Bankruptcy Code.[55] The creditor must prove that: (1) The creditor is the "creditor to whom the debt is owed;" (2) The creditor justifiably relied on the debtor; and (3) The creditor was damaged by that reliance.[56] The Supreme Court established these requirements for section 523(a)(2)(A) non-dischargeability status in *Field v. Mans.*[57]

A. Field v. Mans Established the Elements of a Claim for Non-Dischargeability Under section 523(a)(2)(A)-(B).

In *Field v. Mans*, the Supreme Court examined the debts for fraud covered by Bankruptcy Code section 523(a)(2)(A)-(B) to determine the necessary elements required for a creditor to gain non-dischargeable status for its fraud claims. The Court's determination of these elements was necessitated by the absence of an explicit requirement of reliance in subsection (A), which it did set forth in subsection (B). Although Congress had expressly specified a "reasonable reliance" standard in section 523(a)(2)(B), Congress failed to indicate the standard governing section 523(a)(2)(A); therefore, the Court needed to determine both, whether creditor reliance was a required element in subsection (A), and if so, the level of reliance required in subsection (A).

The Court began its discussion by reviewing section 523(a)(2) and determined that it contained language which indicated that both subsection (A) and subsection (B) require some level of reliance by the creditor.[58] In stating that "[n]o one . . . doubts that some degree of reliance is required to satisfy the element of causation inherent in the phrase 'obtained, by' . . . ,"[59] the Court confirmed that, at a minimum, the creditor must have relied on the debtor in order for a fraud debt to be non-dischargeable.

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those debts described under subsections (2), (4), and (6) of section 523(a)); AHERN & MACLEAN, *supra* note 51, at § 4007:3 (emphasizing only certain debts described in subsections (2), (4), (6), or (15) of section 523(a) of Bankruptcy Code require creditors to file timely adversary proceedings to prevent their discharge).

[55] FED. R. BANKR. P. 4007(a) (stating "any creditor" may file complaint to obtain determination of dischargeability of "any debt"); *see In re Fields*, 926 F.2d at 503 (stating party seeking exception to discharge bears burden of proof as to nondischargeability of debt); AHERN & MACLEAN, *supra* note 51, at § 4007:2 (discussing how although either creditor or debtor can bring action to determine whether particular debt is nondischargeable, only creditor bears burden of proving nondischargeability).

[56] *See* Field v. Mans, 516 U.S. 59, 69 (1995) (stating common law fraudulent misrepresentation should apply to section 523(a)(2)(A)); Foley v. Biondo (*In re* Biondo), 180 F.3d 126, 134 (4th Cir. 1999) (applying common law doctrine of fraudulent misrepresentation to section 523(a)(2)(A)); *see also* RESTATEMENT (SECOND) OF TORTS § 537 (2009) ("The recipient of a fraudulent misrepresentation can recover . . . but only if, (a) he relies on the misrepresentation in acting or refraining from action, and (b) his reliance is justifiable.").

[57] *See Field*, 516 U.S. at 70 n.9 ("We construe the terms of § 523(a)(2)(A) to incorporate the general common law of torts . . . .").

[58] *See id.* at 66 (noting section 523(a)(2) uses words "obtained by" to require reliance in proving causation element).

[59] *Id.*

The Court then began an examination of the text of the statute to determine if the level of reliance required in the two subsections differed. The creditors, and the Government as *Amici Curiae*, suggested that Congress intended subsection (A) to require only the minimum level of reliance, reliance-in-fact, because subsection (A) lacked the requirement of reasonableness expressed in subsection (B). Petitioners argued that this meant that, "the apparent negative pregnant, under the rule of construction that an express statutory requirement here, contrasted with statutory silence there, shows an intent to confine the requirement to the specified instance [of its use in the statute]."[60]

The Court found little value in the "negative pregnant" argument and determined that the common law tort of actual fraud is the standard for section 523(a)(2)(A) non-dischargeability,[61] which includes the following requisites: (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.[62] The basis of the Court's decision was the common-law components of the terms-of-art used in subsection (A)—false pretenses, false representation, and actual fraud—when the statute was written in 1978. As noted by the Court: "It is well established that where Congress uses terms that have accumulated settled meaning under the common law, a court must infer, unless the statute dictates otherwise, that Congress means to incorporate the established meaning of these terms."[63] Because section 523(a)(2) did not indicate or provide a definition of the terms used, the Court construed the terms in section 523(a)(2)(A) to have the meaning assigned to them by the common law of torts.[64] The common law of torts, as stated in the Restatement of Torts,[65] requires four parts, two of which are a *pecuniary loss* and *justifiable reliance*.[66] Hence, at a minimum, when seeking non-dischargeability for a fraud claim under section 523(a)(2)(A), every creditor must prove that it *justifiably relied* on the debtor and suffered a pecuniary loss because of such reliance.

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[60] *Id.* at 67.

[61] *See id.* at 59–60 (rejecting "negative pregnant" argument while embracing "common-law of torts" argument). "A 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." SEC v. Bilzerian (*In re* Bilzerian), 153 F.3d 1278, 1281 (11th Cir. 1998) (citing *Field*, 516 U.S. at 73–75).

[62] *In re Bilzerian*, 153 F.3d at 1281 (enumerating elements of common law tort for fraud); *see, e.g.*, Fowler Bros. v. Young (*In re* Young), 91 F.3d 1367, 1373 (10th Cir. 1996) (requiring showing of intentional creditor deception by debtor, reasonable creditor reliance, and debtor misrepresentation causing creditor loss for section 523(a)(2)(A) claims); Harmon v. Kobrin (*In re* Kobrin), 250 F.3d 1240, 1246 (9th Cir. 2000) (enumerating specific elements of non-dischargeability claims: (1) fraudulent or deceptive debtor conduct; (2) debtor knowledge of falsity or deception; (3) intentional debtor deception; (4) justifiable creditor reliance; and (5) proximate reliance damages incurred by creditor).

[63] *Field*, 516 U.S. at 69 (quoting Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 739 (1989)).

[64] *Id.* at 69–70 (finding "no reason to doubt Congress's intent to adopt a common law understanding" of undefined terms used).

[65] *See* RESTATEMENT (SECOND) OF TORTS § 537 (1977).

[66] *See id*. (allowing creditor recovery for pecuniary loss only, providing reliance was justifiable).

B. The SEC's Monetary Claims do not Meet the Field v. Mans Standards

When the SEC seeks non-dishchargeability status for claims in bankruptcy resulting from an exercise of its police powers, it cannot establish that it meets the requirements of subsection (A) as required by *Field v. Mans* or expressly stated in subsection (B).[67] The SEC neither relied on any misrepresentation by the debtor nor suffered a pecuniary loss from the debtor's fraud that is a predicate of a disgorgement claim.

The SEC's claims for disgorgement and civil penalties are fundamentally different from the private action claims for damages or restitution that non-governmental persons have for their own damages. In SOX, Congress required the SEC to conduct a study about disgorgement and civil penalties.[68] In that study, the SEC dedicates several pages of its discussion to outlining the difference between the remedies sought by the SEC for disgorgement and civil penalties and the private shareholder's remedies of damages and restitution. Its pages include a section entitled, "Disgorgement isn't Restitution."[69] In this discussion, the SEC demonstrates that its disgorgement claims are not to compensate the government for any loss on its part by stating:

> The aim of restitution is to make investors whole and the aim of disgorgement is to deprive defendants of their ill-gotten gains in order to deter future violations . . . . While the Commission may seek to return disgorged funds to injured investors, the main objective of disgorgement is to take the profits away from the wrongdoers and thereby make violations unprofitable.[70]

Additionally, the SEC cannot be viewed as seeking to recover on behalf of the injured investors (e.g. as the investors' agent) or as acting in any capacity other than to enforce compliance with the securities laws. Although the SEC recognizes that it *can* return disgorged funds to injured shareholders, it states that it only does so

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[67] *See, e.g.*, *Field*, 516 U.S. at 66 (discussing creditors must meet section 523(a)(2)(A)–(B) requirements); Kasey T. Ingram, *The Interface Between the Bankruptcy Code and a Disgorgement Judgment Held by the Securities and Exchange Commission*, 5 TEN. J. BUS. L. 31, 45–46 (2003) (explaining SEC's standing under section 523 "relates to its position as a creditor"); Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603, 614–15 (2005) (stating fraudulently incurred debt owed to domestic governmental units provides standing under section 523(a)(2)(A)–(B)).

[68] *See* 15 U.S.C. § 7246(c)(1) (2006) (requiring commission to analyze recent cases "that have included proceedings to obtain civil penalties or disgorgements" in order to find ways to "efficiently, effectively and fairly provide restitution for injured investors")*; see also It's Only Fair: Returning money to Defrauded Investors: Hearing Before the House Comm. on Fin. Servs.*, 108th Cong. 5 (2003) (statement of Stephen M. Cutler, Director, Div. of Enforcement, U.S. SEC) (acknowledging commission's study on how to "provide recompense to injured investors"); SEC, *supra* note 44, at 2 (reporting findings as required by Congress in section 308(c) of Sarbanes-Oxley Act).

[69] SEC, *supra* note 44, at 19–20.

[70] *Id.*

"when appropriate."[71] Because the SEC can retain the recovery for the government, it does not act as an agent for defrauded investors. Indeed, the normal course of action is for the SEC to deposit the disgorged funds with the U.S. Treasury.[72]

The Fair Funds provision of SOX, in granting the SEC the ability to return civil penalty funds to injured shareholders, recognizes that the return of these funds is subject to the SEC's inclination to do so; the provision expressly states that,

> [when] . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.[73]

This language places no mandates on the SEC to return disgorged funds or civil penalties to injured shareholders; it merely gives the SEC the option to do so, as the SEC declared in its report, "when appropriate."[74]

The Fair Funds statute illuminates the disparate goals of the SEC and the shareholder: the SEC's purpose is the enforcement of the securities laws, while the shareholders goal is to recoup the loss of its investment. The statute contains several prerequisites before the SEC has the option to return civil penalty funds to

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[71] *See It's Only Fair*, *supra* note 68, at 5 (noting Commission was always authorized to distribute disgorged moneys to investors in "appropriate circumstances"); *see also* SEC, *supra* note 44, at 4 ("When the Commission receives payment of disgorgement, it may distribute such money to injured investors if appropriate."); Marvin E. Sprouse III, *A Collision of Fairness: Sarbanes-Oxley and § 510(b) of the Bankruptcy Code*, 24 AM. BANKR. INST. J. 8, 8 (October 2005) ("The primary goal of disgorgement is deterrence, and although disgorged funds may go to the victims of securities laws violations, 'such compensation is a distinctly secondary goal.'") (citing *SEC v. Fischbach Corp.*, 133 F.3d 170, 175 (2d. Cir 1997)).

[72] *See* SEC v. Lange, No. 97-6018, 2002 WL 475130, at * 1 (E.D. Pa. Mar. 28, 2002) (noting in cases where numerous victims suffered relatively small losses, many or all victims cannot be identified, or none are entitled to damages, disgorged funds are appropriately paid to Department of Treasury); SEC v. Drexel Burnham Lambert, Inc., 956 F. Supp. 503, 507 (S.D.N.Y. 1997) ("Where distribution to identifiable injured parties is not feasible or appropriate, the money disgorged by the defendant is paid to the Treasury."); SEC, *supra* note 46, at 4 (indicating Commission returns sums to investors "when appropriate", but otherwise transfers disgorgements to U.S. Treasury).

[73] 15 U.S.C. § 7246(a) (2000); *see* Official Comm. of Unsecured Creditors of WorldCom v. SEC, 467 F.3d 73, 83 (2d Cir. 2006) ("[A]s the SEC correctly observes, even after the enactment of the Fair Fund provision, the decision remains in the hands of the SEC whether to distribute civil penalties to victims *at all*."); *Fischbach Corp.*, 133 F.3d at 176 (explaining proceeds of disgorgement funds need not always be distributed to investors).

[74] SEC, *supra* note 44, at 4 (providing SEC will disburse funds to investors only "when appropriate"). *See generally* SEC v. Tome, 833 F.2d 1086, 1096 (2d Cir. 1987) (stating main objective of disgorgement is forcing defendant to pay unjustly received funds, not reimbursing injured investors); *Drexel Burnham Lambert, Inc.*, 956 F. Supp. at 507 (noting returning disgorged funds to private party victims is not required under statute, but may be appropriate in certain instances).

injured shareholders. First, the SEC must obtain a disgorgement order;[75] then, the SEC must impose a civil penalty against the offender;[76] next, it must deem it appropriate to create a disgorgement fund for the benefit of injured shareholders;[77] and, finally, after the aforementioned requirements have been satisfied, the SEC must, on its "own motion or direction," add the civil penalty funds to the disgorgement funds.[78] With no *actual* requirement to return the funds to shareholders, Fair Funds strengthens the argument against an agency relationship between the SEC and the private citizen attempting to recover its loss.

The SEC's report distinguished the remedy sought by the SEC and the remedy in favor of shareholders further, noting that,

> [p]rivate litigation . . . offers the dual benefit of complementing Commission enforcement action and providing a mechanism to compensate investors through the award of restitution or damages. In contrast to Commission enforcement actions which have several aims, the aim of private litigation is solely to compensate injured investors . . . . Thus, while the Fair Fund provision may facilitate investor compensation in some cases, in other cases private litigation remains the best mechanism for investor recovery of losses.[79]

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[75] 15 U.S.C. § 7246(a) (providing process by which disgorged profits are returned to investors). *See generally* SEC v. First City Fin. Corp. LTD., 890 F.2d 1215, 1231 (D.C. Cir. 1989) ("[D]isgorgement need only be reasonable approximation of profits casually connected to the violation."); SEC v. Blavin, 760 F.2d 706, 713 (6th Cir. 1985) (acknowledging once SEC establishes securities law violation, disgorgement is equitable remedy granted by district court).

[76] 15 U.S.C. § 7246(a) (providing process by which disgorged profits are returned to investors). *See generally* SEC v. Opulentica LLC, 479 F. Supp. 2d 319, 331 (S.D.N.Y. 2007) (listing factors to consider when imposing civil penalties, including "(1) the egregiousness of the defendant's conduct[,] (2) the degree of the defendant's scienter[,] (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to other persons[,] (4) whether the penalty should be reduced to the defendant's demonstrated current[,] and (5) future financial condition"); SEC v. Marker, 427 F. Supp. 2d 583, 592 (M.D.N.C. 2006) (noting civil penalties are valuable in both deterring security law violations and punishing violators).

[77] 15 U.S.C. § 7246(a) (providing process by which disgorged profits are returned to investors). *See generally* SEC v. Wang, 944 F.2d 80, 81 (2d Cir. 1991) (acknowledging SEC favors distribution of disgorgement funds to injured investors as long as distribution is "fair and reasonable"); *Official Comm. of Unsecured Creditors of WorldCom, Inc.*, 467 F.3d at 81 (noting courts authorize payment of disgorged funds to United States Treasury if allocation to injured parties is deemed impractical).

[78] 15 U.S.C. § 7246(a) (providing process by which disgorged profits are returned to investors); *see Official Comm. of Unsecured Creditors of WorldCom, Inc.*, 467 F.3d at 82 (observing SEC's authority to request disgorged funds in addition to civil penalties amounting to aggregate monetary gain from securities fraud); SEC v. DiBella, 409 F. Supp. 2d 122, 134 (D. Conn. 2006) (noting SEC has option to recompense injured investors by either disgorgement or civil penalties).

[79] SEC, *supra* note 44, at 20; *see also Drexel Burnham Lambert, Inc.*, 956 F. Supp. at 507 (distinguishing disgorgement from restitution by highlighting purpose of disgorgement as eradicating unjust enrichment rather than compensating injured investors); SEC v. Penn Cent. Co., 450 F. Supp. 908, 916 (E.D. Pa. 1978) ("The SEC does not stand in the shoes of the purchasers and sellers who it asserts were defrauded.").

The above statement, the Fair Funds statute, and the SEC's SOX report clarify two points: (1) That the SEC is not the agent of the injured shareholder, as it is not bound to return the funds to them but can deposit the funds in the U.S. Treasury; and (2) The basis for the disgorgement and civil penalties is not a fiscal loss of the Government. As to the first point, if the SEC were an agent it would be duty bound to return the funds to the injured shareholder, whereas under the securities laws the SEC has the option to retain the funds for the benefit of the Government, and the injured shareholder has its own private cause of action by which it can seek to enforce against the debtor. Further, without an investment by the SEC in the debtor, the SEC cannot be deemed to have relied on any misrepresentation by the debtor or to have suffered a pecuniary loss, as required by *Field v. Mans*.[80] If the SEC cannot meet the implied requirement of justifiable reliance under subsection (A), it certainly cannot meet the expressed requirement of reasonable reliance under subsection (B).

As to the second point—concerning the basis of the disgorgement and civil penalties—the SEC report and the Fair Funds statute show that the SEC is enforcing the securities laws based on injury to, and losses of the shareholders; the losses suffered are not the losses of the Government, but rather the lost financial investments of the shareholders. Consequently, the SEC disgorgement and civil penalty claims are thus, *not* "of a kind specified in" section 523(a)(2)(A)-(B) and, therefore, are not excepted from a corporation's discharge under section 1141(d)(6)(A).

C. The Misreading of Nathanson v. NLRB has Led Courts to Ignore the Requirements Placed on section 523(a)(2)(A)-(B) by Field v. Mans

Based on one point of analysis in a Supreme Court case from 1952, *Nathanson v. NLRB*,[81] lower courts have ignored the requirements prescribed by the Court in *Field v. Mans* for debts under section 523(a)(2)(A)-(B), and have allowed the SEC to use section 523(a)(2)(A)-(B) to gain non-dischargeability status for disgorgement and civil penalties.[82] *Nathanson* concerned whether a claim for back pay brought by

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[80] 516 U.S. 59, 69–70 (1995) (requiring proof of common law tort elements nondischargeability status); *see In re* Woodford, 403 B.R. 177, 188 (Bankr. D. Mass. 2009) (examining common law tort requirements stated in *Field v. Mans* for nondischargeability case); *see also In re* Storer 380 B.R. 223, 232 (Bankr. D. Mont. 2007) (applying reliance element stated in *Field v. Mans*).

[81] 344 U.S. 25, 27 (1952) ("The Board is the public agent chosen by Congress to enforce the National Labor Relations Act."); *see In re* Egea, 236 B.R. 734, 740 (Bankr. D. Kan. 1999) (defining "creditor" as public agents designated by Congress to enforce federal public interest laws); *see also In re* Mountain View Coach Line, Inc., 99 B.R. 555, 562 (Bankr. S.D.N.Y. 1989) (affirming *Nathanson v. NLRB* as good law).

[82] *See In re* Cross, 218 B.R. 76, 79 (B.A.P. 9th Cir. 1998) (applying definition of "creditor" to SEC); *see also* Fezler v. Davis (*In re* Davis), 194 F.3d 570, 575 (5th Cir. 1999) (determining SEC has standing to bring nondischargeable action as public agent designated by Congress); *In re* Hodge, 216 B.R. 932, 936 (Bankr. S.D. Ohio 1998) (concurring with other decisions which held that denying SEC standing to pursue actions would interfere with its congressional mandate); *In re* Kane, 212 B.R. 697, 700 (Bankr. D. Mass. 1997) (applying *Nathanson v. NLRB*'s "creditor" standard rather than *Field v. Mans*'s common law tort elements to determine standing); *In re* Maio, 176 B.R. 170, 171 (Bankr. S.D. Ind. 1994) (remarking creditors have

the National Labor Relations Board ("NLRB") on behalf of injured employees was: first, provable in bankruptcy under the former Bankruptcy Act, so that the NLRB would have a right to liquidate its claim in the Bankruptcy Court even though it was not the ultimate recipient of the money;[83] and, second, whether the NLRB's claim was entitled to priority treatment as a claim of the Government.[84] The lower courts in that case held that the NLRB's claim was provable in the bankruptcy case and that its claim was entitled to priority status. However, the Supreme Court did not agree fully with the lower courts, holding that the NLRB deserved creditor status to prove its claim, but that the claim was not entitled to priority status; and, in the Court's opinion, Justice Douglas made a statement that lower courts have used as the basis for granting the SEC non-dischargeability for its claims under section 523(a)(2)(A)-(B): "[t]he [National Labor Relations] Board is the public agent chosen by Congress to enforce the National Labor Relations Act."[85]

The lower courts have seized upon this language, treating it as a declaration from the Supreme Court that the SEC acts as the public's chosen agent—akin to the NLRB—and that its claims should be granted non-dischargeability status, even when those claims do not meet the prescribed standards set by the Supreme Court.[86] However, further analysis of the opinion in *Nathanson* demonstrates that the Supreme Court also intended to draw a line between claims brought by a government agency to recover losses for private citizens and claims brought by a government agency for harms committed directly against the Government, as the latter were due priority status, while the former were not.[87]

Several key distinctions exist between the NLRB's action in *Nathanson* and the actions brought by the SEC. In *Nathanson*, the Court noted that the back pay order, which constituted the basis of the NLRB's claim, was designed to make the employees whole for losses suffered on account of unfair labor practices. By

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authority to bring nondischargeability actions and distinguishing their claims from private individuals' claims).

[83] *See Nathanson*, 344 U.S. at 27 (discussing whether claim is provable); *see also* 11 U.S.C. §§ 103(a)(4)–104(a)(5) (2006) (determining which claims are provable in bankruptcy).

[84] *See Nathanson*, 344 U.S. at 27–28 (examining whether claim qualifies as priority); *see also* 31 U.S.C. § 3713–261 (2000) (giving government claims priority).

[85] *Nathanson*, 344 U.S. at 27 (stating NLRB, as "creditor", can enforce National Labor Relations Act); *see* Amalgamated Util. Workers v. Consol. Edison Co. of N.Y., 309 U.S. 261, 269 (1940) (acknowledging Congress gave NLRB "exclusive power" to enforce issues concerning National Labor Relations Act); s*ee also In re* Taibbi, 213 B.R. 261, 269 (Bankr. E.D.N.Y. 1997) (upholding *Nathanson v. NLRB*'s rationale that "creditor" can enforce Act); *In re* Smith, 39 B.R. 690, 692 (Bankr. N.D. Ill. 1984) (discussing applicability of *Nathanson v. NLRB* standard in employment contexts).

[86] *See e.g.*, *In re Cross*, 218 B.R. at 79 (comparing SEC's standing in case at bar with NLRB's standing in *Nathanson*); *In re Egea*, 236 B.R. at 740 (stating *Nathanson* advocates courts being "flexible" and "liberal" when granting agencies creditor standing); *In re Hodge*, 216 B.R. at 935–36 (relying on *Nathanson v. NLRB* to grant SEC creditor standing).

[87] *Nathanson*, 344 U.S. at 27–28 ("It does not follow that because the Board is an agency of the United States, any debt owed it is a debt owing the United States . . . ."); *see* United States v. Oklahoma, 261 U.S. 253, 257 (1923) ("Whenever any person indebted to the United States is insolvent, . . . the debts due to the United States shall be first satisfied . . . .") (internal quotations omitted); *see also* United States v. State Bank of N.C., 31 U.S. 29, 35 (1832) (noting extensive history of sovereign's priority rights to debts).

contrast, as the SEC stated repeatedly in its report on SOX,[88] it does not act on behalf of the investors, and it believes that private parties' lawsuits are the best vehicles for making shareholders whole. Further, Justice Douglas pointed out in *Nathanson* that Congress made the NLRB the only entity capable of enforcing these back pay orders.[89] Contrariwise, with regard to the SEC, a private right of action exists for the aggrieved private citizen that is based on his loss and reliance on the debtor; the SEC, by contrast, seeks to enforce compliance with the securities laws.[90]

Another significant distinction is that at the time of *Nathanson*, the Bankruptcy Act's definition of "[c]reditor" included "duly authorized agent[s], attorney[s] or prox[ies]."[91] The current version of the Bankruptcy Code[92] does not include these designated parties—duly authorized agents, attorneys or proxies—in its definition, meaning that these entities do not have express permission to act on the claims of those they represent. Even if these terms carried over from the prior act to the current definition of "[c]reditor," the SEC does not act as the agent of the private citizen; in fact, the object of the SEC's claim is not to obtain any recovery for injured investors, which precludes treating the SEC as their agent. There is, thus, no basis to hold that such claims of the SEC are based on a financial loss to the Government. Therefore, they are not "of a kind specified" in section 523(a)(2)(A)-(B).

With such vast differences between the circumstances in which the SEC brings its claims and the claim brought by the NLRB in *Nathanson*,[93] the case is easily distinguishable and should not be relied on as a basis for granting non-dischargeability status to the claims of the SEC.

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[88] *See generally* SEC, *supra* note 44 (elaborating interplay between civil and administrative penalties).

[89] *See Nathanson*, 344 U.S. at 27 (recognizing Congress designated NLRB as public agent to enforce National Labor Relations Act); *see also* 29 U.S.C. § 153 (2000); Amalgamated Util. Workers v. Consol. Edison Co. of N.Y., 309 U.S. 261, 269 (1940) (affirming NLRB's power).

[90] *See* Basic Inc. v. Levinson, 485 U.S. 224, 230–31 (1988) (highlighting private lawsuits' crucial role in securities law enforcement); *see also In re* M.D.C. Holdings Secs. Litig., No. CV89-0090 E (M), 1990 WL 454747, at *5 (S.D. Cal. Aug. 30, 1990) ("The federal securities laws are remedial in nature. In order to effectuate their statutory purpose of protecting investors, private lawsuits are to be encouraged."); SEC, *supra* note 46, at 20 (listing private actions' "dual benefit of complementing [SEC] enforcement action and providing mechanism to compensate investors").

[91] *Nathanson*, 344 U.S. at 27 n.1 (citing 11 U.S.C. § 1(11) (1938)) (noting definition of "creditor" in Bankruptcy Code); *see, e.g.*, Abraham v. Shinberg, 190 F.2d 595, 597 n.6 (D.C. Cir. 1951) (applying Bankruptcy Code's definition of "creditor").

[92] 11 U.S.C. § 101(10)(a) (2006).

[93] *See supra* note 89 and accompanying text (noting NLRB was sole entity capable of enforcing back pay orders when *Nathanson* was decided); *supra* note 90 and accompanying text (noting SEC can bring private actions and also enforce securities laws). *Compare* 11 U.S.C. § 101(10)(a) (2006) (excluding "authorized agent[s], attorney[s] or prox[ies]") in definition of "creditor") *with* 11 U.S.C. 1(11) (1938) (including "authorized agent[s], attorney[s] or prox[ies]" in definition of "creditor").

1. The Case Law that Misapplies Nathanson.

Based on a misapplication of *NLRB v. Nathanson* in an Indiana bankruptcy court case[94] decided prior to *Field v. Mans*, several subsequent courts have allowed the claims of the SEC to become non-dischargeable in disregard of the elemental requirements announced in *Field v. Mans*. The cases holding SEC claims non-dischargeable were wrongly decided for three basic reasons: (1) the courts relied on *Nathanson* even when, as stated above, the facts giving rise to *Nathanson* were distinguishable from the factual premises at hand; (2) the courts ended their investigation at section 523(c), determining that (i) a district court judgment for a violation of the securities law was akin to fraud and, therefore, *res judicata*, and (ii) as long as the SEC met the requirement of a "creditor to whom the debt is owed" under section 523(c), then the district court judgment was non-dischargeable; or (3) the courts did not apply the *Fields v. Mans* standard to the SEC, demonstrating a failure to comprehend the distinction between establishing fraud and establishing dischargeability.

The bankruptcy court case that initially held the claims of the SEC as non-dischargeable was *In re Michael A. Maio*.[95] In *Maio*, the debtor owed the SEC for disgorgement and civil penalties assessed against him by a district court for violations of the anti-fraud provisions of the securities laws.[96] The SEC commenced a proceeding in the bankruptcy court in order to determine the dischargeability of its claims under section 523(a)(2)(A). The debtor argued that section 523(c) of the Bankruptcy Code prevented the SEC from bringing these claims because section 523(c) required that the party bringing the action be the "creditor to whom the debt

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[94] *See In re* Maio, 176 B.R. 170, 171 (Bankr. S.D. Ind. 1994) (endorsing plaintiff's argument in *Nathanson v. NLRB* "inherently recognized the ability of governmental agencies to enforce a debt in bankruptcy even though it will not be the ultimate recipient of the monies owed") (citation omitted); *see also Nathanson*, 344 U.S. at 29 (concluding NLRB's claim for amount of back pay order for unfair labor practices was provable in bankruptcy even though Board was not entitled to priority for debt owed to United States).

[95] *In re Maio*, 176 B.R. at 171 ("[A] private right of action does not strip the [SEC] of standing to enforce the federal securities laws through nondischargeability actions.").

[96] *Id.* Under 15 U.S.C. § 78u, the only court that has jurisdiction to hear the claims of the SEC is the Federal District Court. *See* 15 U.S.C. § 78aa (2006) ("The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder . . . ."); *see also* SEC v. Talbot, 530 F.3d 1085, 1090 (9th Cir. 2008) ("[D]istrict court had jurisdiction pursuant to 15 U.S.C. §§ 78u(d)–(e) and 78aa, which confer jurisdiction in the district courts over violations of federal securities laws."); SEC v. Mohn, 465 F.3d 647, 650–51 (6th Cir. 2006) (explaining 15 U.S.C. § 78u grants SEC injunctive relief, civil monetary penalties, or mandamus only in federal district court to enforce Exchange Act). The bankruptcy court cannot adjudicate the claims of the SEC in the first instance. This often means that the SEC comes to the bankruptcy court with a judgment in hand, seeking to have a determination of non-dischargeability only, not to litigate the issues in the bankruptcy court. *See, e.g.*, *In re* Telsey, 144 B.R. 563, 564 (Bankr. S.D. Fla. 1992) (highlighting non-dischargeability determination of debt arising from district court order); *In re* Der, 113 B.R. 218, 222 (Bankr. D. Md. 1989) (enumerating non-dischargeability of debt rendered by jury verdict in district court); *In re* Peterson, 96 B.R. 314, 315 (Bankr. D. Colo. 1988) (presenting non-dischargeability case in federal district court).

is owed."[97] The SEC argued, and the court agreed, that the SEC was not precluded from bringing the claim simply because the shareholders had a private right of action. Under the court's analysis, the private claim was fundamentally different from the claim of the SEC, subject to different standards and elements of proof.[98] While *Field v. Mans* was yet to be decided, the distinction drawn in *Maio* between the private citizens' claims and the SEC's claims makes this case bad precedent *after Field v. Mans* as the SEC's claims could not withstand a section 523(a)(2)(A) analysis. The court concluded that, "to deny the Commission the right of a creditor to bring a non-dischargeability complaint would unduly hinder enforcement of the Securities Act and would be contrary to legislative intent."[99] It found that the SEC had standing as a "creditor," within the meaning of section 523(c), to bring a disgorgement claim; but, the court never considered whether the claims of the SEC met the requirements of section 523(a)(2)(A)-(B).

The holding in *Maio*[100] goes directly against Justice Douglas's analysis of the situation in *Nathanson*,[101] which held that "[t]he theme of the Bankruptcy Act is 'equality of distribution', and if one claimant is to be preferred over others, the purpose should be clear from the statute."[102] This statement by Justice Douglas illustrates the extraordinary remedy that comes when one claim is preferred over another, whether that is through priority or non-dischargeability. The NLRB argued that, "the interest of the United States in eradicating unfair labor practices is so great that the back pay order should be given the additional sanction of priority in payment."[103] Like the reasoning used by the court in *Maio* to make the claims of the SEC non-dischargeable, the NLRB thought that its claims should get priority so that the purposes of the Labor Act could fully be recognized. However, in response, Justice Douglas stated: "Whether that should be done is a legislative decision. The policy [of the National Labor Relations Act] . . . is fully served by recognizing the claim . . . as one to be paid by the estate,"[104] signifying that it was up to Congress to grant priority to the claims of the NLRB. This same analysis should apply to the SEC in that if Congress wants to provide a special right to a governmental agency's

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[97] 11 U.S.C. § 523(c)(1) (2006) ("[T]he debtor shall be discharged from a debt . . . unless, on request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge . . . .").

[98] *In re Maio*, 176 B.R. at 171–72 (indicating individual's right to private cause of action in bankruptcy does not preclude SEC from bringing nondischargeability claim to enforce federal law); *see In re* Austin, 138 B.R. 898, 903 (Bankr. N.D. Ill. 1992) (considering Federal Trade Commission as debtor to allow its recovery of debt owed to private consumers); *In re* Smith, 39 B.R. 690, 693 (Bankr. N.D. Ill. 1984) (authorizing Attorney General to prosecute complaint pertaining to dischargeability of debt under Consumer Fraud Act even though consumer had private claim).

[99] *In re Maio*, 176 B.R. at 172.

[100] *In re Maio*, 176 B.R. at 171–72 (holding SEC can enforce bankruptcy debt and bring nondischargeability action on behalf of private parties).

[101] *Nathanson*, 344 U.S. 25, 28–29 (1952) (noting legislature does not give NLRB priority when collecting back pay for private individuals).

[102] *Id.* at 29.

[103] *Id.* at 28.

[104] *Id.*

claims it must do so clearly and expressly.[105] Congress has not done that in section 523(a)(2)(A)-(B) and it should not be read into section 1141(d)(6)(A).

After allowing the SEC creditor status under Bankruptcy Code section 523(c), the court in *Maio* failed to examine the claims of the SEC under section 523(a)(2)(A)-(B). The court in *Maio* clearly held that the claim was fundamentally different from that of the private individual,[106] who had actually been injured by the debtor; yet, the court never engaged in an analysis of section 523(a)(2)(A)-(B). The court's failure to do so set a precedent that subsequent courts, even after the *Field v. Mans* decision, have used as a basis for their conclusory holdings, never reaching the actual section 523(a)(2) issues.[107]

Although *Field v. Mans* would not be decided for another year—clarifying the necessary elements for a debt to be non-dischargeable under section 523(a)(2)(A)-(B)—the court never scrutinized the claims of the SEC; instead, the court decided that, based on *Nathanson*, the SEC—as the governmental entity chosen to enforce the securities laws—has the right to enforce a debt in bankruptcy even though it will not be the ultimate recipient of the monies owed.[108] After *Field v. Mans*, though, that of course is not a relevant consideration, as the debt owed to the SEC must represent some loss by the government as a defrauded party, not as an enforcement claim.

Several cases decided after *Field v. Mans* have either cited to *Maio* or followed its reasoning.[109] Generally, the courts were correct in concluding: (1) that the SEC

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[105] *See* Howard Delivery Serv. Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 655 (2006) (disallowing priority treatment for workers' compensation insurance claims and explaining all creditors are equal unless Congress mandates priority); *see also Nathanson*, 344 U.S. at 29 (requiring legislature to clearly indicate whether NLRB had priority when collecting back pay debt owed to private individuals); Sampsell v. Imperial Paper Corp., 313 U.S. 215, 219 (1941) (emphasizing purpose of Bankruptcy Act is equal distribution to creditors).

[106] *See In re* Maio, 176 B.R. 170, 171 (Bankr. S.D. Ind. 1994); *see also* SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993) (explaining focus for calculating damages in private action involves quantifying injury contrary to SEC's action which serves to fulfill statutory obligation); SEC v. Lorin, 869 F. Supp. 1117, 1129 (S.D.N.Y. 1994) (alluding government, unlike private individuals, suffers relatively small injury from securities fraud).

[107] *See In re* Cross, 218 B.R. 76, 79 (B.A.P. 9th Cir. 1998) (classifying SEC as "creditor" and immediately declaring it has standing to enforce debt without first conducting fraud analysis under 11 U.S.C. 523(a)(2)(A)–(B)); *In re* Hodge, 216 B.R. 932, 936 (Bankr. S.D. Ohio 1998) (determining SEC meets burden of proving fraud under 11 U.S.C. 523(a)(2)(A)–(B)); *In re* Kane, 212 B.R. 697, 702 (Bankr. D. Mass. 1997) (asserting debt owed to SEC is non-dischargeable under section 523(a)(2)(A) because "[t]he judgment in the civil action and the guilty plea in the criminal action each make out a fraud case under section 523(a)(2)(A)"); *see also* Field v. Mans, 516 U.S. 59, 59–60 (1995).

[108] *In re Maio*, 176 B.R. at 171 (Bankr. S.D. Ind. 1994) (disagreeing with argument SEC is not "creditor" because private right of action exists); *see* Sherman v. SEC (*In re* Sherman), 441 F.3d 794, 807 (9th Cir. 2005) (stating SEC's creditor status is unaffected by obtaining money judgment); SEC v. Bilzerian (*In re* Bilzerian), Nos. 93-486-Civ-T-24A, 94-635-Civ-T-24E, 1995 WL 934184, at *1 (M.D. Fla. May 15, 1995) (citing *Nathanson*, 344 U.S. at 27) (noting SEC has standing as "creditor", even if it will not ultimately keep money); *see also Field*, 516 U.S. at 59–60.

[109] *In re Cross*, 218 B.R. at 79 (implying SEC need not first prove requirements of fraud under 11 U.S.C. 523(a)(2)(A)–(B) because "the only issue before the [court] concerns the Commission's standing to pursue its dischargeability action"); *In re Hodge*, 216 B.R. at 936 (acknowledging its factual similarity to *In re Maio*); *In re Kane*, 212 B.R. at 700 (paraphrasing *In re Maio* to surmise SEC's inability to bring non-dischargeability actions would hinder Securities Act enforcement).

met the definition of creditor under section 523(c), whether the debtor disgorged the claims to the SEC or a third party;[110] and (2) that the district court judgment was *res judicata*.[111] But these courts failed after their initial inquiries because they never conducted the necessary analysis of a claim covered by section 523(a)(2)(A) or section 523(a)(2)(B), allowing the misapplication of *Nathanson* to rule the day.

"Creditor" is a broad term in bankruptcy. The definition of a "claim" in the Bankruptcy Code is construed broadly, and the creditor status determination for the SEC is reasonable given the accepted interpretation of "claims."[112] When the SEC comes into the bankruptcy court with a decision from a district court, that judgment is *res judicata* and entitled to that recognition in the bankruptcy court; but, following *Field v. Mans*, courts should engage in an additional inquiry, beyond the SEC's status as a creditor and its prior judgment in the district court: for purposes of non-dischargeability, did the "creditor to whom the debt is owed"[113] suffer damages and justifiably rely on the debtor to its detriment as a result of the securities fraud for which it sought non-dischargeability status. Faced with this inquiry, the SEC would be unable to establish that *it* relied on the false pretenses, false representations, or actual fraud of the debtor to its detriment, as required by section

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[110] *See In re Cross*, 218 B.R. at 80 (allowing SEC to bring adversary proceeding against chapter 7 debtor because it meets definition of "creditor"); *In re Hodge*, 216 B.R. at 936 (granting SEC standing to bring dischargeability action for purpose of complying with Congressional mandate to enforce securities law); *In re Kane*, 212 B.R. at 700 (acknowledging SEC has claim against chapter 7 debtor as holder of disgorgement order).

[111] *See In re Bilzerian*, 153 F.3d at 1280 (affirming district court's order applying collateral estoppel to SEC's action to except discharge under section 523(a)(2)(A)); *In re Hodge*, 216 B.R. at 937 (holding collateral estoppel applies when issue of fraud was raised and litigated in district court action, and declaring judgment on fraud necessitates collateral estoppel); *In re Kane*, 212 B.R. at 702 (finding debtor was collaterally estopped from disputing dischargeabiltiy of disgorgement debt in his subsequent bankruptcy proceeding when judgment was previously entered in civil action and guilty plea entered in criminal action for fraud under section 523(a)(2)(A)).

[112] *See* Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 558 (1990) (stating restitution obligations are dischargeable debts in chapter 13 proceedings); *see also* H.R.REP. NO. 95-595, at 309 (1977), *reprinted in* 1978 U.S.C.C.A.N. 6266 (describing definition of "claim" as "broadest possible" and noting Code "contemplates that all legal obligations of the debtor . . . will be able to be dealt with in the bankruptcy case"); *accord*, S.REP. NO. 95-989, at 22 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5808 (affirming definition of "claim" as set forth in House of Representatives Report).

> A "claim" is a "*right to payment*, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(4)(A) (emphasis added). As is apparent, Congress chose expansive language in both definitions relevant to this case. For example, to the extent the phrase "right to payment" is modified in the statute, the modifying language ("whether or not such right is …") reflects Congress' broad rather than restrictive view of the class of obligations that qualify as a "claim" giving rise to a "debt."

Pa. Dep't of Pub. Welfare, 495 U.S. at 558.

[113] *See* 11 U.S.C. § 523(c)(1) (2006) (stating creditor to whom such debt is owed must request dischargeability determination, including debts from fraud).

523(a)(2)(A).[114] Likewise, the SEC would be unable to prove that *the SEC* reasonably relied on a writing that is materially false, as mandated by section 523(a)(2)(B).[115]

2. According to Continuity of Law Canons of Statutory Construction, the Substantive Requirements of section 523(a)(2)(A)-(B) of the Bankruptcy Code Must Apply to Bankruptcy Code section 1141(d)(6)(A).

The SEC's invocation of section 1141(d)(6)(A) in *Bally* fails to account for an important canon of statutory construction, which states that when "judicial interpretations have settled the meaning of an existing statutory provision, repetition of the same language in a new statute indicates, as a general matter, the intent to incorporate its . . . judicial interpretations as well."[116] This demonstrates that when Congress enacted section 1141(d)(6)(A) of the Bankruptcy Code—fully aware of the decision in *Field v. Mans*[117]—it must have intended for the substantive requirements of section 523(a)(2)(A) to apply to section 1141(d)(6)(A). Yet, in *In re Bally Total Fitness*, the SEC applies section 1141(d)(6)(A) as though those strictures did not apply.[118] The SEC cites to Bankruptcy Code section 1141(d)(6)(A)

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[114] *See* Field v. Mans, 516 U.S. 59, 61, 64 (1995) (holding fraud exception to discharge requires creditor to have justifiably relied on fraudulent misrepresentation, not reasonably relied); Lentz v. Spadoni (*In re* Spadoni), 316 F.3d 56, 59–60 (1st Cir. 2003) (excepting debt from discharge because creditor justifiably relied on creditor's promises to pay overdue rent); *see also* Foley v. Biondo (*In re* Biondo), 180 F.3d 126, 135–36 (4th Cir. 1999) (discussing Settlement Agreement obtained by debtor falls under section 523(a)(2)(A) because actual fraud occurred).

[115] *See* 11 U.S.C. § 523(a)(2)(B) (enumerating debtor's written statement be: (1) materially false; (2) about debtor's financial condition; (3) what creditor reasonably relied and; (4) made by debtor with intent to deceive); *see also* Coston v. Bank of Malvern (*In re* Coston), 991 F.3d 257, 259 (5th Cir. 1993) (applying section 523(a)(2)(B) to case where debtor submitted materially false written statement to bank and affirming bankruptcy court's denial of debtor's discharge); Martin v. Bank of Germantown (*In re* Martin), 761 F.2d 1163, 1165 (6th Cir. 1985) (affirming bankruptcy court finding all four elements of section 523 (a)(2)(B) were satisfied for materially false statements made on financial statement to bank).

[116] Merill Lynch, Pierce, Fenner, & Smith, Inc. v. Dabit, 547 U.S. 71, 85 (2006) (quoting Bragdon v. Abbott, 524 U.S. 624, 645 (1998)); *see also* United States v. Hayes, 129 St. Ct. 1079, 1085-86 (2009) (highlighting sections 921(a)(33)(A) and 2803(3)(C) of U.S. Code are consistent with each other because "Congress presumably knew how § 921(a)(33)(A) had been construed, and presumably intended § 2803(3)(C) to bear the same meaning"); Rowe v. N.H. Motor Transp. Ass'n, 552 U.S. 364, 364-65 (2008) (construing 1978 Airline Deregulation Act's pre-emptive effect on state law due to same language used).

[117] *Field*, 516 U.S. at 71, 73–75 (holding creditor must establish justifiable reliance on debtor's fraudulent representation in order to exempt debt from discharge under section 523(a)(2)(A) and defining "justification" as "a matter of the qualities and characteristics of the particular plaintiff, and the circumstances of the particular case, rather than of the application of a community standard of conduct to all cases"); Sanford Inst. for Savs. v. Gallo, 156 F.3d 71, 74 (1st Cir. 1998) (discussing and following justifiable reliance standard when applying 11 U.S.C. § 523(a)(2)(A)); Goldberg v. Ojeda, No. 08 C 2808, 2009 WL 721097, at *8 (N.D. Ill. Mar. 17, 2009) (recognizing justifiable reliance standard is less demanding than reasonable reliance standard).

[118] *See In re* Bally Total Fitness of Greater N.Y., Inc., No. 07-12395 (BRL), 2007 WL 2779438, at *12 (Bankr. S.D.N.Y. Sept. 17, 2007) [hereinafter *In re Bally*] ("[T]he [SEC] expressly reserves its right to continue to investigate, and, in its sole discretion, prosecute and enforce any and all Claims against any or all of the debtors or the Reorganized Debtors arising from any prepetition violations by any debtor of any of the U.S. securities laws . . . including, without limitation, any claims for disgorgement of any benefits received

and section 523(a)(2)(A) as its reasoning to why its claims are non-dischargeable without applying the standards of *Field v. Mans*, that the creditor must suffer a pecuniary loss from justifiably relying on the debtor.[119] The SEC's use of section 1141(d)(6)(A) and section 523(a)(2)(A) is misplaced because its disgorgement and civil penalty claims cannot satisfy that it suffered a loss based on the factors required in *Field v. Mans.*[120]

III. DETAILED ANALYSIS OF BANKRUPTCY CODE SECTION 1141(D)(6)

Section 1141 of the Bankruptcy Code governs the discharge of the chapter 11 debtor.[121] Section 708 of BAPCPA, entitled "No Discharge for Fraudulent Taxes in chapter 11," amended 11 U.S.C. § 1141(d) by adding subsections (d)(6)(A) and (B). Subsection (A) states that,

> [n]otwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt —
> (A) of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to domestic governmental unit, or owed to a person as the result of an action filed under Subchapter III of Chapter 37 of title 31 or any similar State statute.[122]

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by any Debtor as a result of any such violations and any Claims for penalties imposed by the SEC in respect of any such violations . . . . Nothing in this Confirmation Order or the Plan shall result in the discharge of any Reserved SEC Claims, and the SEC expressly reserves its rights to assert that any and all Reserved SEC Claims are non-dischargeable as against the Reorganized Debtors pursuant to Sections 1141(d)(6)(a) and 523(a)(2)(A) of the Bankruptcy Code."); *In re* Cross, 218 B.R. 76, 79 (B.A.P. 9th Cir. 1998) (holding SEC has claim under section 523(a)(2)(A); *In re* Hodge, 216 B.R. 932, 936 (Bankr. S.D. Ohio 1998) (authorizing SEC's standing for both disgorgement and civil penalty claims). *But see* GORDON D. HENDERSON & STUART J. GOLDRING, TAX PLANNING FOR TROUBLED CORPORATIONS 738 n.7 (2009) ("[S]ection 1114(d)(6) . . . excepts from discharge any debt described in Bankruptcy Code section 523(a)(2)(A) or (B) . . . .").

[119] *Field*, 516 U.S. at 69, 73–75 (stating Congress's use of common law terms in statute does not alter their common law definition); Wood v. Wood (*In re* Wood), 245 F. App'x 916, 917–18 (11th Cir. 2007) (recognizing 11 U.S.C. § 523(a)(2)(A) has been interpreted to require elements of common law fraud and listing those elements); Lightner v. Lohn, 274 B.R. 545, 549 (Bankr. M.D. Fla. 2002) (stating 11 U.S.C. § 523 claim requires satisfying elements of fraud).

[120] *Field*, 516 U.S. at 69, 73–75 (1995) (indicating common law definition of fraud applies to section 523(a)(2)(A)); *In re* Gonzales, 241 B.R. 67, 71–72 (Bankr. S.D.N.Y. 1999) (stressing common law fraud elements must be met to sustain claim under 11 U.S.C. § 523); *In re* Panem, 352 B.R. 269, 282 (Bankr. D. Colo. 2006) (citing *Field*, 516 U.S. at 70).

[121] *See* 11 U.S.C. § 1141 (2006) (providing confirmation of plan discharges debt); *In re* Boston Harbor Marina Co., 157 B.R. 726, 730 (Bankr. D. Mass. 1993) ("[C]onfirmation of a plan'discharges the debtor."'); Seaport Auto. Warehouse, Inc. v. Rohnert Park Auto Parts, Inc. (*In re* Rohnert Park Auto Parts, Inc.), 113 B.R. 610, 616 (B.A.P. 9th Cir. 1990) (positing section 1114 of Bankruptcy Code discharges debtor from debt).

[122] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 708, 119 Stat. 23 (to be codified at 11 U.S.C. § 1141(d)(6)(A) and 11 U.S.C. § 523) (including reference within statute to Bankruptcy Code section 523,"Exceptions to Discharge", which contains exceptions to discharge for individual debtor. By its terms, discharge prevents creditors from attacking any real or personal property

Under the SEC's view of section 1141(d)(6)(A) in *In re Bally Total Fitness of Greater New York*, the first clause of section 1141(d)(6)—meaning the "debt[s] of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a)" clause—Congress intended to except from discharge those debts accruing as a result of the SEC's enforcement of the securities laws.[123] To read this clause as if its plain meaning includes the enforcement claims of the SEC produces a result that is demonstrably at odds with the other portions of the statute and conflicts with other sections of the Bankruptcy Code.

Such a prohibited reading was referred to by the Supreme Court in such statutory interpretation cases as *Hartford Underwriters*[124] and *Ron Pair*,[125] where the Court stated that "the plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of the drafters.'"[126] Overcoming the "plain meaning" standard is not done with ease, as the Court found that examples of awkwardness or poor grammar in the Bankruptcy Code fail to rise to the level of ambiguity necessary to deem a statute inapplicable.[127] But, because of the disparate results produced by the various sub-parts of Bankruptcy Code section 1141(d)(6)(A) and the usurpation of other Bankruptcy Code sections, interpretation of the provision is required in order to determine the intent of Congress.[128]

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of debtor once bankruptcy court grants discharge, whether they previously obtained judgment against debtor or not. Discharge is basis for debtor's "fresh start" granted by Bankruptcy Code).

[123] *See In re Bally*, 2007 WL 2779438, at *12 ("Reserved SEC Claims are non-dischargeable as against the Reorganized Debtors pursuant to Sections 1141(d)(6)(a) and 523(a)(2)(A) of the Bankruptcy Code."). *But see Field*, 516 U.S. at 61 (remarking "justifiable reliance" is standard for exception to discharge); George H. Singer, *Section 523 of the Bankruptcy Code: The Fundamentals of Nondischargeability in Consumer Bankruptcy*, 71 AM. BANKR. L.J. 325, 331 (1997) ("In determining whether a particular obligation falls within one of the enumerated exceptions to dischargeability, it is universally agreed that the statute should, as a matter of public policy, generally be construed liberally in favor of the debtor and strictly against the creditor.").

[124] Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000) (remarking statutory interpretation should be limited to plain language of statute if such language is not ambivalent).

[125] United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1989) (acknowledging statutory interpretation should begin and end with plain language of statute).

[126] *Ron Pair Enters., Inc.*, 489 U.S. at 242 (citing Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)) (noting literal administration of statute in "rare cases" may result with interpretation contrary to drafters' intent); *see* Comm'r of Internal Revenue v. Brown, 380 U.S. 563, 571–72 (1965) (affirming narrow definition of word when literal definition would frustrate purpose of statute); Helvering v. Hammel, 311 U.S. 504, 510 (1941) ("[C]ourts in the interpretation of a statue have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results . . . .") (citation omitted).

[127] *See* Dewsnup v. Timm, 502 U.S. 410, 434–35 (1992) (Scalia, J., dissenting) (stressing statutory interpretation starts with language of statute despite existence of any pre-Code practices, even if statute has been rewritten); Union Bank v. Wolas, 502 U.S. 151, 157–58 (1991) (determining plain language of rewritten statute takes precedence in statutory interpretation even where preceding statutory application may differ and Congress gave no explanation for change); Toibb v. Radloff, 501 U.S. 157, 164 (1991) (asserting legislative history being indicative of intent bears no importance where plain language of statute dictates).

[128] *See* Dodd v. United States, 545 U.S. 353, 359 (2005) (noting court must enforce terms of statute if language is plain); Lamie v. United States Trustee, 540 U.S. 526, 534 (2004) (remarking it is "well

A. The Plain Meaning of Bankruptcy Code section 1141(d)(6)

The plain text of the first clause of section 1141(d)(6)(A) excepts from discharge the fraud debts that section 523(a)(2)(A)-(B) makes non-dischargeable when those debts are owed to a governmental unit.[129] The SEC reads this section broadly and in isolation from the other sections of the statute to include all claims for fraud, no matter how accrued, so as to include its claims for enforcement of the securities law.

However, for two principled reasons, Congress could not have intended the result produced by a plain reading of the first clause of section 1141(d)(6)(A). First, when read in context with the rest of the subsection, this broad reading of the first clause of section 1141(d)(6)(A) excepts from discharge claims that are substantially different than the debts excepted from discharge by the second clause of section 1141(d)(6)(A) and subsection (B). Second, the plain text of the first clause of section 1141(d)(6)(A) subverts other provisions of the Bankruptcy Code, without an expression of Congress that it intended such a result. Below, each reason is discussed in turn.

1. The Other Portions of section 1141(d)(6) Require an Injury to the Government for Non-dischargeability Status.

In the second or "*qui tam*" clause of section 1141(d)(6)(A), Congress establishes non-dischargeability for those debts that result from a *qui tam* civil action adjudicated under 31 U.S.C. § 3730.[130] This section, entitled "Civil Actions for False Claims," permits civil actions by private persons ("the Qui Tam Relator") for violations of 31 U.S.C. § 3729.[131] The primary concern of section 3729 is claims

established" that courts should enforce statute according to its terms if language is plain); *Hartford Underwriters Ins. Co.*, 530 U.S. at 6 (enforcing plain language of statute).

[129] 11 U.S.C. § 1141(d)(6)(A) (2006) ("[T]he confirmation of a plan does not discharge a debtor that is a corporation from any debt . . . of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit . . . ."); Gregory Germain, *Discharging Income Tax Liabilities in Bankruptcy: A Challenge to the New Theory of Strict Construction for Scrivener's Errors*, 75 UMKC L. REV. 741, 743 (2007) (discussing corporate debtors' inability to discharge tax fraud debt under 11 U.S.C. § 1141(d)(6)); Jay Lawrence Westbrook, *Chapter 15 and Discharge*, 13 AM. BANKR. INST. L. REV. 503, 506 (2005) (noting certain debts are not dischargeable under 11 U.S.C § 1141).

[130] 11 U.S.C. § 1141(d)(6)(A) ("[T]he confirmation of a plan does not discharge a debtor that is a corporation from any debt . . . of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is . . . owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31 . . . ."); Ralph Brubaker, *Taking Exception to the New Corporate Discharge Exceptions*, 13 AM. BANKR. INST. L. REV. 757, 757–58 (2005) (noting debt from False Claims Act action is non-dischargeable under section 1141(d)(6)); Levin & Ranney-Marinelli, *supra* note 67, at 615 (2005) (indicating debt from action under subchapter III of chapter 37 of title 31 is excepted from discharge).

[131] 31 U.S.C. § 3730 (b)(1) (2000) ("A person may bring a civil action for a violation of section 3729."); Zelenka v. NFI Indus., Inc, 436 F. Supp. 2d 701, 703 (D.N.J. 2006) (observing 31 U.S.C. § 3730 allows private individual to bring civil action for False Claims Act violation); Levin & Ranney-Marinelli, *supra* note 67, at 615 (examining section 3730 permits filing of civil actions in government's name for *qui tam* action).

where a party has fraudulently garnered money from the Government. A person who performs any of the following acts may face liability to a Qui Tam Relator under this provision:

> (A) knowingly presents, or causes to be presented, to an officer or employee of the United States Government or a member of the Armed Forces of the United States a false or fraudulent claim for payment or approval;
> (B) knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government;
> (C) conspires to defraud the Government by getting a false or fraudulent claim allowed or paid;
> (D) has possession, custody, or control of property or money used, or to be used, by the Government and, intending to defraud the Government or willfully to conceal the property, delivers, or causes to be delivered, less property than the amount for which the person receives a certificate or receipt;
> (E) authorized to make or deliver a document certifying receipt of property used, or to be used, by the Government and, intending to defraud the Government, makes or delivers the receipt without completely knowing that the information on the receipt is true;
> (F) knowingly buys, or receives as a pledge of an obligation or debt, public property from an officer or employee of the Government, or a member of the Armed Forces, who lawfully may not sell or pledge the property; or
> (G) knowingly makes, uses, or causes to be made or used, a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government,[132]

The common theme throughout section 3729 is fraud or fraudulent conduct committed *against* the Government resulting in a financial loss to the Government. The same is true of governmental claims rendered non-dischargeable by section 1141(d)(6)(B).

In section 1141(d)(6)(B), Congress again addressed debts arising from fraudulent conduct against the Government.[133] The debts at issue in section

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[132] 31 U.S.C. § 3729 (2000); *see* United States ex rel. R.A. McElmurray v. Consol. Gov't of Augusta-Richmond County, 464 F. Supp. 2d 1327, 1339 (N.D. Ga. 2006) (stating those who knowingly present fraudulent claim to government are liable for False Claims Act violation); United States ex rel. Sutton v. Double Day Office Servs., Inc., 121 F.3d 531, 533 (9th Cir. 1997) (discussing False Claim Act's implication on "any person who knowingly induces the United States to make payment on a false claim liable to the United States").

[133] 11 U.S.C. § 1141 (d)(6)(B) ("[T]he confirmation of a plan does not discharge a debtor that is a corporation from any debt . . . for a tax or customs duty with respect to which the debtor . . . made a

1141(d)(6)(B) are claims predicated on fraudulent tax returns and tax evasion. Subsection (B) specifically excepts from discharge debts owed "for a tax or customs duty with respect to which the debtor — (i) made a fraudulent return; or (ii) willfully attempted in any manner to evade or to defeat such tax or customs duty."[134] Again, Congress focused on fraud committed by the debtor directly against the Government in an attempt to fleece the Government's coffers.

The tie that binds the subsections of section 1141(d)(6) together is debts owed for perpetrating a fraud against the Government, which results in a pecuniary harm to the Government. The second clause of subsection (A) deals with defrauding the Government itself; it covers claims by private citizens on behalf of the Government for various frauds against the Government.[135] Subsection (B) concerns fraudulently denying the Government its rightful tax dollars.[136] Therefore, a logical reading of the first clause of subsection (A) is it must have been intended to cover only those debts owed to the Government for fraud perpetrated by debtors against the Government.

2. The Plain Text of the First Clause of section 1141(d)(6)(A) Overrides other Portions of the Bankruptcy Code.

By its text, the first clause of section 1141(d)(6)(A) overrides other provisions of the Bankruptcy Code, a result for which Congress has failed to express any intent. Textual integrity canons of construction, as the Court stated in *Kelly v. Robinson*, dictate that "the text is only the starting point . . . in expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy."[137] Judge Gerber applied this canon of construction in *In re Ames Dept. Stores Inc.* when he stated that, "[s]tatutory provisions (including, and perhaps especially, those in the Bankruptcy

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fraudulent return . . . ."); *see* Brubaker, *supra* note 130, at 757–58 (examining discharge exception in case of debt owed from willful attempt to evade tax obligations under section 1141 (d)(6)(B)); Levin & Ranney-Marinelli, *supra* note 67, at 617 (noting certain debts are non-dischargeable if incurred due to fraudulent conduct under section 1141 (d)(6)(B)).

[134] 11 U.S.C. § 1141(d)(6)(B); *see, e.g.*, Brubaker, *supra* note 130, at 757–58 (explaining 1141(d)(6)(B) precludes corporate debtors from discharging tax debts where fraudulent tax returns or willful tax evasions occurred); Germain, *supra* note 129, at 741–43 (discussing how BAPCA amendments "denied corporate Chapter 11 debtors the ability to discharge tax fraud debts").

[135] *See* Levin & Ranney-Marinelli, *supra* note 67, at 615–16 (explaining 1141(d)(6)(A) generally deals with claims against government, including claims by individuals "on behalf of the government [for] any false claim . . . collected from the government").

[136] *See* John C. Anderson, *Highlights of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005—Part I—Consumer Cases*, 33 S.U. L. REV. 1, 23 (2006) (highlighting debtors' inability to discharge fraudulently incurred debts owed to government).

[137] Kelly v. Robinson, 479 U.S. 36, 43–44 (1986); *see also* Bradley C. Karkkainen, "*Plain Meaning": Justice Scalia's Jurisprudence of Strict Statutory Construction*, 17 HARV. J.L. & PUB. POL'Y 401, 470 (1994) (noting "[t]extual integrity" involves reading plain language of statute in light of policy implications). *See generally* King v. St. Vincent's Hosp., 502 U.S. 215, 221 (1991) ("[T]he cardinal rule [is] that a statute is to be read as a whole . . . since the meaning of statutory language, plain or not, depends on context.").

Code) must be construed *in pari materia*,[138] and one statutory provision in the Bankruptcy Code cannot be considered without reference to other relevant provisions of the same statute, and its object and policy."[139]

There are at least two significant Bankruptcy Code sections that the plain text reading of section 1141(d)(6)(A) would subvert: (1) section 510(b);[140] and (2) section 1129(a)(7)(A)(ii);[141] These statutes represent major doctrinal positions of pre-Code practice and were well engrained in the bankruptcy laws prior to the enactment of section 1141(d)(6).

Section 510(b)—a fundamental principle of bankruptcy, considered by scholars to be a fruit of the SEC's labor[142]—subordinates the fraud claims of shareholders to those of all other unsecured claimants. Often referred to as the "absolute priority rule," section 510(b) is a core, fundamental principle of bankruptcy,[143] which Congress enacted in order to properly allocate the risk of bankruptcy to the shareholders. It states that,

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale

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[138] "[*In pari materia*] is a canon of construction that statutes that are *in pari materia* may be construed together, so that inconsistencies in one statute may be resolved by looking at another statute on the same subject." BLACK'S LAW DICTIONARY 807 (8th ed. 2004). *See generally* Capital Communications Federal Credit Union v. Boodrow (*In re* Boodrow), 126 F.3d 43, 49 (2d Cir. 1997) ("The Supreme Court has thus explained in interpreting other sections of the Bankruptcy Code that 'we must not be guided by a single sentence or [part] of a sentence, but look to the provisions of the whole law, and to its object and policy.'" (quoting *Kelly*, 479 U.S. at 43)).

[139] *In re* Ames Dept. Stores Inc., 306 B.R. 43, 66 & n.83 (Bankr. S.D.N.Y. 2004) (citing 6A NORTON BANKRUPTCY LAW AND PRACTICE 2d, § 154:5 (ed., Xth ed. rev. 2003)) (explaining Bankruptcy Code sections cannot be interpreted without examining "*all* of the relevant statutory text—including [other] Bankruptcy Code sections . . . ."); *cf.* Amy S. Ashworth, Note, *Adequate Protection—The Equitable Yardstick of Chapter 11*, 22 U. RICH. L. REV. 455, 459 (1988) (arguing it is "necessary to consider the . . . concept of section 361 in light of other provisions in the Code" because congressional intent and legislative history are unclear).

[140] 11 U.S.C. § 510(b) (2006) (prioritizing unsecured creditors' claims over shareholders' claims).

[141] 11 U.S.C. § 1129(a)(7)(A)(ii) (2006) (explaining court shall confirm plan if, among other requirements, creditors will receive more than they would under chapter 7 liquidation).

[142] *See* Caplin v. Marine Midland Grace Trust Co. of N.Y., 406 U.S. 416, 436–37 n.2 (1972) (Douglas, J., dissenting) (explaining "absolute priority rule", as codified by section 510(b), transcends all areas of bankruptcy); *see also* John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 261 (1973) ("Not many doctrines have passed more fully into the collective consciousness of the legal and commercial communities than the absolute priority rule . . . ."). *See generally* 11 U.S.C. § 510(b) (2006).

[143] *See, e.g.*, SeaQuest Gen. Holdings, LLC v. S&J Diving, Inc. (*In re* SeaQuest Diving, LP), No. 08-20516, 2009 WL 2450680, at *8 (5th Cir. Aug. 19, 2009) (upholding principles contrary to absolute priority rule "threatens to swallow up [a] fundamental rule of bankruptcy law" (quoting *In re* Granite Partners, L.P., 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997))); Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173, 1180 (10th Cir. 2002) (calling absolute priority rule "a central feature of American bankruptcy law"); *see also* Slain & Kripke, *supra* note 142, at 263 (noting historical controversy surrounding absolute priority rule since 1930s when Supreme Court adopted and advocated fundamental, contemporary changes).

> 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.[144]

The basis for section 510(b) of the Bankruptcy Code is the 1973 New York University Law Review article by Professors John Slain and Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*.[145] The professors begin their article by defining the absolute priority rule as "in bankruptcy, stockholders seeking to recover their investments cannot be paid before provable creditor claims have been satisfied in full."[146] The result the SEC seeks through section1141(d)(6)(A) and the "Fair Funds" provision is a direct end run around this pronouncement, allowing the shareholders to collect when the other creditors have not been paid in full. This is an odd move by the SEC, as Professors Slain and Kripke noted: "The main burden of advancing the absolute priority position was borne by the staff of the Securities and Exchange Commission . . . . In an important sense, the Commission can claim the absolute priority rule as it is currently understood as one of its achievements."[147] Although the SEC was instrumental in the creation of the absolute priority rule (which has become a bedrock principle of bankruptcy), it now seeks to destroy it. The absolute priority rule allocates the most risk to the party capable of the most gain: the shareholder.[148] The average unsecured creditor cannot participate in the gains of the corporation and, therefore, should not suffer the initial loss. This is the foundation of the absolute priority rule; those with the most to gain should also be the first to shoulder the loss.[149] The subordination of the shareholder class creates a larger pool of funds

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[144] 11 U.S.C. § 510(b).

[145] *See* Slain & Kripke, *supra* note 142, at 294 (proposing solution in bankruptcy for "rescinding stockholders and general creditors").

[146] *Id.* at 263.

[147] *Id.*; *see also* Robert T. Swaine, *A Decade of Railroad Reorganization Under Section 77 of the Federal Bankruptcy Act*, 56 HARV. L. REV. 1193, 1205 (1943) (suggesting SEC's studies and reports strongly supporting absolute priority rule foreshadowed Supreme Court's ruling in favor of absolute priority rule over relative priority rule); Comment, *The Full Compensation Doctrine in Corporate Reorganizations: A Schizophrenic Standard*, 63 YALE L.J. 812, 812 n.1 (1954) (recognizing, in regards to absolute priority rule specifically, views of SEC and Interstate Commerce Commission have greatly impacted reorganization law).

[148] *See In re Geneva Steel Co.*, 281 F.3d at 1180 (recognizing, in reference to investor's fraudulent retention claim, investors should shoulder risk when illegally deprived of their ability to hold or sell because they alone can profit from holding or selling investments); *In re* Granite Partners, L.P., 208 B.R. 332, 337 (Bankr. S.D.N.Y. 1997) (stating subordination of investors is caused by their level of risk assumed and their ability to profit); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 792 (1987) (stressing equity owners should suffer loss up to their full investment with business failures because they have greatest chance to profit).

[149] *See In re* SPM Mfg. Corp., 163 B.R. 411, 416 (Bankr. D. Mass. 1994) (justifying risk of shareholders because they are sole potential beneficiaries of profit); *In re* Comtec Indus., Inc., 91 B.R. 344, 348 (Bankr.

for the unsecured creditor and prioritizes their claim. However, the SEC's attempt at an end run around section 510(b) through section 1141(d)(6) could change the priority structure of bankruptcy.

Congress could not have intended to fully usurp the existing priority regime without some discussion. The SEC's reading of section 1141(d)(6) cannot withstand the scrutiny of Congress's previous announcement in SOX and silence in BAPCPA. The two statutes, section 510(b) and section 1141(d)(6)(A), broadly read, cannot co-exist without a pronouncement from Congress that it desired to change completely the priority scheme of corporate bankruptcy.

Section 1129 of the Bankruptcy Code, entitled "Confirmation of a Plan," lists the required findings the court must make prior to confirming a plan. Included in this section is section 1129(a)(7), the "best interest of the creditor's test," which requires the court to determine that the creditors will receive more in chapter 11 than they would in a chapter 7 liquidation.[150] However, if the plain text reading of section 1141(d)(6)(A) stands, then the court faces a multi-faceted problem. First, the non-dischargeable claims would take away from the total value of the estate, lowering the payout to the secured creditors. Second, it would promote the civil penalty claims of the SEC above the claims of the other unsecured creditors, although section 726(a)(4) would subordinate those claims in chapter 7. The lower value of the estate means that there is less distribution for the creditors in chapter 11, while in chapter 7 the non-dischargeable claims would not survive the bankruptcy. In chapter 7, the civil penalty claims of the SEC would be subordinated to the unsecured shareholders and, therefore, they would not affect the

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E.D. Pa. 1988) (stating creditors should not have to bear equal losses with shareholder because they would not have profited from debtor's success as shareholders would have); Scott. F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 U. KAN. L. REV. 507, 514 (1998) (noting while shareholders can make decisions to increasing profit as residual owners, they must bear costs when business fails as potential profit is tied with possibility of loss).

[150] 11 U.S.C. § 1129(a)(7)(A)(ii) (2006) ("The court shall confirm a plan only if . . . [w]ith respect to each impaired class of claims or interests—each holder of a claim or interest of such class . . . will receive . . . under the plan . . . a value . . . not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title . . . ."); ReGen Capital I, Inc. v. Halperin (*In re* U.S. Wireless Data, Inc.), 547 F.3d. 484, 495 (2d Cir. 2008) (noting each claim holder must either accept plan or not receive less than it would under chapter 7); Official Comm. of Unsecured Creditors v. Dow Corning Corp. (*In re* Dow Corning Corp.), 456 F.3d. 668, 672 (6th Cir. 2006) (stating plan cannot be confirmed unless objecting class receives amount equal to or greater than what they would receive from debtor liquidating his assets). The author understands that in many major corporate chapter 11 cases that have disgorgement and civil penalty claims, the unsecured creditors often get nothing. However, that fact does not make it any more likely that Congress intended to draft the statute in such a way as to override the actual language of section 1129(a)(7) of the Code, merely because the practical realities dictate it as so. *See* SEC v. Wang, 944 F.2d. 80, 88 (2d Cir. 1991) (rationalizing some claims will ultimately not be paid because disgorgement is not about compensating investors, but about preventing unjust enrichment); *see also In re* Adelphia Commc'ns Corp., 327 B.R. 143, 162 (Bankr. S.D.N.Y. 2005) (admitting as between SEC's claims for billions of dollars in disgorgement and civil penalties and subsequent challenge by creditor's committee, it is unclear who would prevail); Matthew G. Doré, *Presumed Innocent? Financial Institutions, Professional Malpractice Claims, and Defenses Based on Management Misconduct*, 1995 COLUM. BUS. L. REV. 127, 144 (1995) (noting shareholders will generally not recover losses resulting in part from misconduct of management).

payout to the unsecured creditors in chapter 7. The promotion of these claims in chapter 11 to non-dischargeable status means that they will be paid in full prior to the unsecured creditors' recovery, which results in less distribution to the unsecured creditor body. Another problem arises if, as in the *Bally* case, the SEC has not adjudicated its claims then section 502(c) of the Bankruptcy Code requires an estimation of the contingent claims of the debtor, which may hinder or delay the case.[151] Certainly, the claims of the SEC are those that would hinder or delay the case in the event that they reach as much as 40% of the total assets, but the SEC's reading of the statute allows the SEC to bring those claims *after* the reorganization. In so doing, the court will need to establish an amount for both the disgorgement[152] and the civil penalties of the SEC.[153] These estimations are not binding on the SEC and it might seek additional penalties or disgorgement once it has completed its investigation, which could amount to millions of dollars in additional disgorgement and penalties.

In 2002, Congress, in SOX, added a section to section 523 to handle securities law claims against individuals, section 523(a)(19).[154] If Congress wanted to make the claims of the SEC non-dischargeable against corporate debtors, then Congress

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[151] *See In re* Adelphia Bus. Solutions, Inc., 341 B.R. 415, 423 (Bankr. S.D.N.Y. 2003) (stating it is necessary for bankruptcy courts to estimate claims in order to avoid awaiting results of claims outside of bankruptcy); *In re* Rusty Jones, Inc., 143 B.R. 499, 505–06 (Bankr. N.D. Ill. 1992) (suggesting estimation may involve retrieving additional information from thousands of claimants and setting up facilities to field information); *In re* Apex Oil Co., 107 B.R. 189, 193 (Bankr. E.D. Mo. 1989) (stating estimation of claim is mandatory if liquidation of claim would cause undue delay).

[152] *See* Official Comm. of Unsecured Creditors of Worldcom, Inc. v. SEC, 467 F.3d 73, 81–82 (2d Cir. 2006) ("District courts possess broad equitable discretion to craft remedies for violations of the Exchange Act. Within this discretion district courts may require wrongdoers to disgorge fraudulently obtained profits."); SEC v. Fishbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (acknowledging court has discretion to determine how money will be distributed); SEC v. First Jersey Secs., Inc., 101 F.3d 1450, 1474–75 (2d Cir. 1996) (stating defendant must disgorge unlawful profits plus interest).

[153] *See* 15 U.S.C. § 78u(d)(3) (2006). Civil penalties, specifically in this case, are governed by 15 U.S.C. § 78u(d)(3)(B)(iii):

> Notwithstanding clauses (i) and (ii), the amount of penalty for each such violation shall not exceed the greater of (I) $100,000 for a natural person or $500,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if--
>
> **(aa)** the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and
>
> **(bb)** such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons.

See also Official Comm. of Unsecured Creditors of Worldcom, 467 F.3d at 82 ("The Remedies Act permits the SEC, in addition to seeking disgorgement of ill-gotten profits, to seek civil penalties of generally up to the amount of the gross pecuniary gain from the securities fraud."); H.R. REP. NO. 101-616, at 17 (1990), *reprinted in* 1990 U.S.C.C.A.N. 1379–80 (discussing federal securities laws amended by legislation to authorize order of disgorgement and civil penalties).

[154] *See* 11 U.S.C. § 523(a)(19) (2006) (stating debtor violating federal securities laws will not receive discharge from debt); *see also* SEC v. Sherman, 406 B.R. 883, 887 (C.D. Cal. 2009) (stating Sarbanes-Oxley Act guarantees remedies under federal securities laws).

would have referenced section 523(a)(19) in section 1141(d)(6), in addition to section 523(a)(2)(A)-(B). If Congress intended such a drastic change to the Bankruptcy Code through the enactment of section 1141(d)(6)(A), it certainly would have made a pronouncement to do so in the legislative history of BAPCPA; yet, there is no indication of such Congressional intent. The only indication of the intentions of Congress for section 1141(d)(6)(A) was the title of the statute, "No Discharge for Fraudulent Taxes in Chapter 11," and the section in which the enacted statute appeared in BAPCPA, "Part VII Bankruptcy Tax Provisions," which do not suggest any relation to securities laws violations.[155] In fact, when Congress addressed non-dischargeability of securities law fraud in SOX, it did so directly.[156] The legislative history is wrought with information about section 523(a)(19) and the protection it was to add for investors, including a statement by Senator Leahy: "This provision [section 523(a)(19)] is meant to prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible."[157] Congress provided specific guidance as to the purpose of section 523(a)(19), yet they provided none for section 1141(d)(6).[158]

With such conflicts between the provisions of the Bankruptcy Code and no indication from Congress that it intended such a result, other methods of interpretation must be employed to determine Congress's true intent. When the Supreme Court considers a contention that the plain text of a Code provision changes the Code substantially, the Court looks to pre-Code practice and the interaction between the new statute and other Bankruptcy Code provisions to determine the scope of the statute. Critically, "[the Supreme Court] has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-

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[155] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 708, 119 Stat. 23 (amended by 11 U.S.C. § 1141(d)(6)(A)) (noting confirmation plan cannot discharge debt resulting from fraudulent taxes for corporation); *see also In re* Breezy Ridge Farms, Inc., No. 08-12038-JDW, 2009 WL 1514671, at *2 (Bankr. M.D. Ga. May 29, 2009) (indicating corporations are not discharged from any debt incurred by fraud-related activities); 9D AM. JUR. 2D *Bankruptcy* § 3563 (2009) (discussing differing treatment of corporate and individual reorganization proceedings).

[156] *See* 11 U.S.C. § 523(a)(19) (stating debtors are not discharged from debt arising from violations of Federal securities law); *see also* 148 CONG. REC. S7418-01 (daily ed. July 26, 2002) (statement of Sen. Leahy) ("This provision would amend the federal bankruptcy code to make judgments and settlements arising from state and federal securities law violations brought by state or federal regulators and private individuals non-dischargeable.").

[157] 148 CONG. REC. S7418-01 (daily ed. July 26, 2002) (statement of Sen. Leahy); *see also* H.R. 3763, 107th Cong. § 6(c)(1) (2002) (stating purpose to protect investors through corporate disclosures under securities laws). *See generally* 148 CONG. REC. H1540 (daily ed. Apr. 24, 2002) (discussing investor protection and corporate disclosure).

[158] *See* 148 CONG. REC. S7418 (daily ed. July 26, 2002) (statement of Sen. Leahy) (positing Congress's intent for section 523(a)(19) is to prevent use of bankruptcy laws as form of protection for criminals); *cf.* H.R. REP. NO. 109-43, at 1 (2005) (proving no such guidance as to intent of Congress). *See generally* 11 U.S.C. § 523(a)(19); 11 U.S.C. § 1141(d)(6) (2006).

Code practice that is not the subject of at least some discussion in the legislative history."[159]

B. Legislative History

When considering amendments to the Bankruptcy Code that would effect a major change from the previous statute, established case law or doctrine, Congress has made clear its intention to do so in the legislative history.[160] However, in the case of section 1141(d)(6), Congress provided no guidance as to the statute's meaning or purpose.

On April 14, 2005, Congress passed BAPCPA, which the supporters of the reform painted as a wholesale reform of chapter 11.[161] Representative Sensenbrenner (Wisconsin-5th), the Congressman who began and controlled the debate about BAPCPA on the day of its passage, issued the opening statement in the final floor debate on the bill: "This legislation consists of a comprehensive package of reform measure pertaining to consumer and business bankruptcy cases."[162] The Representative never spoke of business bankruptcies again that day.[163] In fact, 18 members of the House of Representatives spoke on April 14 and not one of them mentioned the corporate scandals that still faced adjudication in the bankruptcy and district courts.[164] Rather, the focus of the discussion was almost entirely on consumer bankruptcy.

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[159] Dewsnup v. Timm, 502 U.S. 410, 419 (1992); *see also* United States v. Ron Pair Enters., 489 U.S. 235, 244 (1989) (affirming use of pre-Code practice as means of statutory interpretation); United Savs. Assn. of Tex. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 380 (1988) (finding petitioner's argument that pre-Code law gave unsecured creditor relief from automatic stay lacked legislative support).

[160] *See, e.g.*, *Dewsnup*, 502 U.S. at 419 (indicating hesitancy of allowing Code interpretations lacking support from legislative history); *Ron Pair Enters.*, 489 U.S. at 244 (discussing Code interpretation through use of legislative history); *Timbers of Inwood Forest Assocs.*, 484 U.S. at 380 (suggesting intent of statute is evident from legislative history).

[161] *See, e.g.*, 151 CONG. REC. H1971, H2047 (daily ed. Apr. 14, 2005) (statement of Rep. Sensenbrenner) (stating BAPCPA is "comprehensive package of reform" for bankruptcy cases); Neill D. Fuquay, Note, *Be Careful What You Wish For, You Just Might Get It: The Effect on Chapter 11 Case Length of the New Cap on a Debtor's Exclusive Period to File a Plan*, 85 TEX. L. REV. 431, 431 (2007) (discussing BAPCPA as most thorough reformation of Bankruptcy Code since 1978). *But see* Lindsay E. Donn, *The Best And Worst of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Its Effect On Bankruptcy Courts, The Reorganizing Business, and The American People*, 38 RUTGERS L.J. 573, 599 (2007) (stating Congress incorrectly reformed chapter 11 in BAPCPA).

[162] 151 CONG. REC. H2047 (daily ed. Apr. 14, 2005) (statement of Rep. Sensenbrenner).

[163] *See* 151 CONG. REC. H2047–77 (daily ed. Apr. 14, 2005) (discussing consumer bankruptcies). He did introduce a document entitled, "Summary of Principal Provisions of S. 256, 'The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005'", which contained two headings and twelve sub-headings; of the seven sub-headings under "Business Bankruptcy and Other Reforms", the author considers one, "Small business debtors", as actually pertaining to corporate bankruptcy. *Id.* at H2048–49 (describing how S. 256, in effort to deal with "special problems" posed by small business debtors, imposes concrete deadlines and enforcement means to "weed out" debtors unlikely to reorganize in addition to requiring strict supervision of small business debtor cases).

[164] *See id.* at H1974–93, H2047–77 (2005) (discussing BAPCPA and issues related to consumer debtors, including mansion loophole, needs-based test, and need for safeguards along with exceptions for special circumstances such as child support and bankruptcies involving veterans).

The only serious discussion of corporate bankruptcy took place when Senator Durbin suggested an Amendment to the proposed version of BAPCPA on March 3, 2005.[165] Senator Durbin aimed to protect the employees who lost their pensions when large corporate debtors filed for bankruptcy, yet left corporate bankruptcy unaffected. He used examples from the early 2000's—Global Crossing, WorldCom, Adelphia, and Enron (the same companies that inspired the reforms of SOX)—to illustrate that the malfeasance of a few debtors could potentially harm thousands of people.[166] Senator Durbin did not suggest any additional changes to the Bankruptcy Code to prevent such large-scale fraud-fueled bankruptcies in the future; he only sought a higher-priority status for employees of these companies in section 507 of the Bankruptcy Code.[167]

In total, BAPCPA exceeded 500 pages in length, and, of those 500 pages, only five of them addressed corporate bankruptcies.[168] Except for section 1141(d)(6), most of the "corporate" provisions served other purposes, providing: relief for farmers;[169] additional requirements—checkpoints, filing requirements—for small business debtors to emerge from chapter 11;[170] and the protection of employees that had been sought by Senator Durbin.[171]

However, if the SEC's broad plain text interpretation of section 1141(d)(6) prevails, then Congress, without written indication[172] or discussion, changed corporate reorganizations in a way that threatens all possibility of reorganization. The Supreme Court requires some thoughtful expression of Congress when a statute

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[165] *See* 151 CONG. REC. S1986–90 (daily ed. Mar. 3, 2005) (suggesting amendment to proposed version of BAPCPA requiring court scrutiny of "fraudulent transfers made by corporate insiders" and giving employees of bankrupt companies priority unsecured claims in bankruptcy for value of company stock in their pension plans).

[166] *See id.* at S1986–87 (asserting CEOs of these "scandal-tainted companies" "were feathering their own beds when their companies went bankrupt", leaving their employees, shareholders, and retirees with "little more than their dignity" and "nowhere to turn").

[167] *Id.* at 1988 (proposing amendment to BAPCPA giving employees of bankrupt companies "a place in line as creditors that they don't currently have").

[168] 151 CONG. REC. S1986 (daily ed. Mar. 3, 2005) (statement of Sen. Durbin) ("When one takes a look at this 500-page bill, how many pages in this bill address corporate bankruptcies? Five.").

[169] *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, §§ 1001–07, 119 Stat. 23, 185–88 (codified as amended in scattered sections of 11 U.S.C.) (alleviating burden of meeting requirements to qualify as family farmer or fisherman).

[170] *See id.* §§ 431–47, at 109–18 (mandating increased reporting requirements for small business owners for purposes of facilitating disclosure of complete information to court and creditors and encouraging small business debtor to have better understanding of financial status).

[171] *See id*. §§ 323, 1101–06, 1401, 1403, at 97–98, 189–92, 214–15 (implementing measures for protecting corporate employees whose wages were withheld for health care and employee benefit plan payments).

[172] In neither the section title—Bankruptcy Tax Provisions—nor the title of the statute—Fraudulent Taxes in chapter 11—is there any indication of Congress's intentions, and these are the only places where Congress addresses this statute. *See* 151 CONG. REC. H1994 (daily ed. Apr. 14, 2005) (reflecting section titles are not indicative of congressional intent); *see also In re* Best Refrigerated Express, Inc., 168 B.R. 969, 973 (Bankr. D. Neb. 1994) (stating agency's interpretation is acceptable as long as it does not conflict with statute); *In re* Georgia Scale Co., 134 B.R. 69, 70 (Bankr. S.D. Ga. 1991) ("It should be generally assumed that Congress expresses its purposes through the ordinary meaning of the words it uses . . . ." (quoting Escondido Mut. Water Co. v. La Jolla Band of Mission Indians, 466 U.S. 765, 772 (1984))).

seems to alter significant sections of the Code or general bankruptcy practices and policies.[173] Hence, without some indication of congressional intent, section 1141(d)(6)(A) cannot be so read.

IV. THE DELETERIOUS EFFECT OF THE SEC'S READING OF BANKRUPTCY CODE SECTION 1141(D)(6)

The SEC's interpretation of section 1141(d)(6) of the Bankruptcy Code ignores the restraints placed on section 523(a)(2) by Bankruptcy Code section 523(c), Bankruptcy Rule 4007 and case law. To sustain this disregard for the mandates of Congress and the Supreme Court would allow the SEC to maintain its contingent securities law claims past the reorganization of the debtor, creating uncertainty and instability in the wherewithal of the reorganized debtor. More important than the bankruptcy court's inability to determine if the debtor will need additional financial reorganization or liquidation, as section 1129(a)(11) requires the court to find,[174] is that debtor in possession lenders, and post-bankruptcy lenders and creditors will not be able to assess the credit of the reorganized debtor with such potentially large contingent claims. *Black's Law Dictionary* defines "Credit" as "the faith in one's ability to pay debts."[175] Future creditors and lenders cannot determine "the faith" that they should place in the debtor if the creditors and lenders cannot properly assess the liabilities of the reorganized debtor. Compounding the problem is the need for the reorganized debtor to devote funds to defending itself against the disgorgement and civil penalty claims of the SEC after the reorganization.

The above scenario unfolded for Bally Total Fitness in February of 2008—nearly five months after its discharge—when the SEC finally brought charges for its

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[173] *See* Swarts v. Hammer, 194 U.S. 441, 444 (1904) ("If Congress has the power to declare otherwise and wished to do so, the intention would be clearly expressed, not left to be collected or inferred from disputable considerations of convenience in administering the estate of the bankrupt."); *In re* St. Laurent, II, 991 F.2d 672, 679 (11th Cir. 1993) ("[The Court] will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." (quoting Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 563 (1990))). *But see* CSX Transp. v. United States, 867 F.2d 1439, 1442 (D.C. Cir. 1989) ("[U]nambiguous language must be regarded as conclusive, absent a clearly expressed legislative intent to the contrary.").

[174] *See* 11 U.S.C. § 1129(a)(11) (2006):

> (a) The court shall confirm a plan only if all of the following requirements are met:
> (11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

See also In re Sis Corp., 120 B.R. 93, 95 (Bankr. N.D. Ohio 1990) (noting feasibility of plan is mandatory and should be denied if conditional); *In re* Stuart Motel, 8 B.R. 48, 50 (Bankr. S.D. Fla. 1980) (denying confirmation of plan when impossible to tell whether further financial reorganization or liquidation will subsequently be needed).

[175] BLACK'S LAW DICTIONARY 164 (8th ed. 2004) (defining credit as "[o]ne's ability to borrow money; the faith in one's ability to pay debts").

securities law violations.[176] The SEC and Bally settled, which insured that the accounting irregularities and mismanagement of the corporation would not reoccur, but it expressly left open the investigation.[177] By leaving open the investigation, the SEC retained its ability to seek disgorgement and penalties, thereby extending the uncertainty of the credit-worthiness of the debtor.

To interpret section 1141(d)(6) to except SEC claims allows shareholders to receive funds they could not attain for themselves in the reorganization. As discussed in the previous section, section 510(b) subordinates the claims of the shareholders, but the SEC collects *pari passu* with the unsecured creditors; *and*, with its non-dischargeable claims, the SEC can continue to collect from the debtor after its reorganization, when the collection powers of the other unsecured creditors are cut off. This allows the SEC to return funds to shareholders in amounts that exceed the returns received by the other unsecured creditors. Not only are the shareholders promoted to a priority level that is equal to the unsecured creditors, they are actually promoted above the unsecured creditors because the SEC can distribute the disgorgement and civil penalty funds after the reorganization, making the funds returned to the shareholders greater than their *pari passu* amount. Additionally, the SEC can look-back to the creation of the company for violations of the securities laws, as the SEC is not bound by state statutes of limitations when it seeks disgorgement, thus creating a timeline from the birth of the company until past the reorganization from which the SEC can seek disgorgement.

A. Statutes of Limitation and Disgorgement

The disgorgement remedy of the SEC is not subject to any statute of limitations. Years prior to the reforms created by SOX and BAPCPA, the Supreme Court handed down decisions holding that state statutes of limitations and the doctrine of laches did not apply to actions taken by the federal government.[178] In *United States v. Summerlin*,[179] the Supreme Court held that,

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[176] Bally Total Fitness Settles Financial Fraud Charges with SEC, Litigation Release No. 20470, 92 SEC Docket 2772 (Feb. 28, 2008) (highlighting SEC's complaint alleging Bally's committed fraud from 1997 through 2003 when many financial statements contained accounting improprieties).

[177] *Id.* (noting while Bally's cooperation with SEC's investigation led to settlement, investigation remains open).

[178] *See, e.g.*, United States v. Summerlin, 310 U.S. 414, 416 (1940) ("It is well settled that the United States is not bound by state statutes of limitation or subject to the defense of laches in enforcing its rights."); Bd. of County Comm'rs of Jackson, Kan. v. United States, 308 U.S. 343, 351 (1939) (noting inapplicability of state statute of limitations to suits brought by federal government); United States v. Peoples Household Furnishings, Inc., 75 F.3d 252, 255–56 (6th Cir. 1996) (noting United States was not bound by state statute of limitations because it acted in federal capacity); FSLIC v. Landry, 701 F. Supp. 570, 572 (E.D. La. 1988) (recognizing state statute of limitations does not apply to United States when acting in governmental capacity).

[179] *Summerlin*, 310 U.S. at 416 (discussing state statute of limitations as inapplicable to federal government).

> [Previous decisions of the Supreme Court have determined that] the United States is not bound by state statutes of limitation or subject to the defense of laches in enforcing its rights. The same rule applies whether the United States brings its suit in its own courts or in a state court.[180]

In later cases, the lower courts have determined that state and federal statutes of limitation do not limit the time for the SEC to sue on its claims for disgorgement. In one case, the SEC initiated a civil enforcement action against Maurice Rind and 13 other defendants for securities fraud and reporting and recording violations associated with the demise of ZZZZ Best Corporation in 1987.[181] The SEC sought disgorgement of wrongfully obtained profits and an injunction prohibiting the defendants from committing these acts again.[182] The district court held that no federal or state statutes of limitations bound or prohibited the SEC from bringing civil actions, even when the SEC was seeking disgorgement on behalf of others, the Ninth Circuit affirmed.[183]

On appeal to the Ninth Circuit, Rind, the only remaining defendant,[184] argued that the SEC violated the statute of limitations assigned to causes of action brought by *private investors* asserting their implied private right of action under Rule 10b-5.[185] Rind claimed that, because ZZZZ Best Corporation filed for bankruptcy in

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[180] *Id.* (upholding United States is not bound by state statutes of limitations or defense of laches regardless of how claim was acquired); *see also* United States v. Nashville, 118 U.S. 120, 125 (1886) (stressing state statute of limitations applies only where there is clear congressional intent to do so); *In re* Greater Southeast Cmty. Hosp. Corp. I, 365 B.R. 293, 302–04 (Bankr. D. D.C. 2006) (relying on *Summerlin* to hold United States cannot be barred as unsecured creditor, because state statute of limitations does not apply).

[181] SEC v. Rind, 991 F.2d 1486, 1488 (9th Cir. 1993) (rejecting argument Congress, in its silence, intended one-year statute of limitations to apply to civil suits brought by SEC). *Compare* Lampf v. Gilbertson, 501 U.S. 350, 361 (1991) (finding one-and three-year statute of limitations apply to SEC rather than local two-year limitations) *and* Abner J. Mikva & James E. Pfander, *On the Meaning of Congressional Silence: Using Federal Common Law to Fill the Gap in Congress's Residual Statute of Limitations*, 107 YALE L.J. 393, 394 n.3, 411 & n.80 (1998) (citing *Lampf v. Gilbertson*'s example of Court borrowing statute of limitations from federal source).

[182] *Rind*, 991 F.2d at 1488 (explaining relief sought in civil action).

[183] *See id*. (reciting procedural background and affirming); *see also* Dole v. Local 427, 894 F.2d 607, 610 (3d Cir. 1990) (applying general rule of inapplicability of state statutes of limitations to federal government); Glenn Elec. Co. v. Donovan, 755 F.2d 1028, 1033 (3d Cir. 1985) (positing federal government is exempt from statute of limitations unless there is specific congressional intent to contrary).

[184] For reasons unimportant here, the SEC settled with the other defendants or they were discharged from the action. *Rind*, 991 F.2d at 1488 (stating previous defendants defaulted or settled).

[185] *See generally* SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008) [hereinafter Rule 10b-5]. The rule prevents corporations from committing frauds with broad language to include almost any action that a violator might commit that ultimately results in the committing of a fraud by a person or corporation.

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of

1987, the SEC should have known then that potential violations existed at that time and that the statute of limitations clock began to run at that time, as it would have for private investors.

The Ninth Circuit declared early in its decision that this case did not concern the private citizen's implied right to sue under Rule 10b-5, which was bound by the precedent set in the Supreme Court case of *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*.[186] To the contrary, the issue in *SEC v. Rind* concerned the expressed right of the SEC to seek disgorgement under the securities laws.[187] When discussing the SEC's ability to bring a civil action, the Ninth Circuit said:

> Our analysis begins with the structure of the securities laws themselves. In the 1933 and 1934 Acts, Congress developed a comprehensive plan to regulate the securities markets. As part of that plan, Congress created a number of private claims, each bound by an express statute of limitations. At the same time, and in the same acts, Congress granted the Commission broad power to enforce the substantive provisions of the securities laws but refrained from imposing an explicit time limit on Commission enforcement actions. Congress clearly devoted its time and attention to limitations issues. The fact that it did not enact an express statute of limitations for lawsuits instituted by the Commission, therefore, must be interpreted as deliberate.[188]

This conclusion allowed the SEC to bring its claims and to seek disgorgement free from any statute of limitations.

Combined, the ability to seek disgorgement and the absence of a time limitation on that ability provides the SEC with a continuous window of time into the debtor's past—from the inception of the company until the current day—from which it can investigate and measure violations of the securities laws. The SEC's claims for disgorgement can often reach enormous sums and, in the absence of an applicable statute of limitations, the burden on the malfeasor is practically impossible to

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> the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id; see also Rind, 991 F.2d at 1488 (citing Rule 10b-5 as rule allegedly violated); SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1308 (2d Cir. 1971) (discussing violation of Rule 10b-5 and subsequent consequences).

[186] *Rind*, 991 F.2d at 1489–90. In *Lampf v. Gilbertson*, the Supreme Court faced the implied private right of action under Rule 10b-5, a court-created remedy to determine the proper application of this private right of action and, in turn, establish a statute of limitations, the court needed to look to analogously expressed law, which used the federal statute of limitations of one year. 501 U.S. at 361.

[187] *Rind*, 991 F.2d at 1488.

[188] *Id.* at 1490.

overcome.[189] If the SEC can look all the way back to the inception of the company, creditors can never fully know if the company has committed securities laws violations. This uncertainty means that creditors will charge more for their goods and services because of the possibility that the potential debtor has committed some violation and the SEC will seek disgorgement from the debtor in bankruptcy.

More deleterious is the SEC's ability to seek these remedies *after* the reorganization because the SEC acts free of the Bankruptcy Code's measures that level the field for creditors—dischargeability, *pari passu* collection, subordination of securities fraud claims. After the bankruptcy case, there is no *pari passu* collection or subordination and the SEC can fully enforce its claims and the claims of the shareholders, resulting in huge disgorgement claims, penalty claims, and fees and costs associated with defending against those claims. This ability will change the way creditors and debtor-in-possession lenders interact with corporations pre-bankruptcy, if the corporation must compete with the SEC and the shareholders to collect on its claims. The lack of protection for general unsecured creditors may result in less desire for the potential creditors to participate in the markets necessary for the debtor to operate—whatever trade creditor market exists in order for the debtor to survive, or, at a minimum, the creditor will charge higher prices or charge higher credit rates for the debtor to obtain those same goods. Creditors will adjust their prices to reflect the additional risk they face, raising prices for goods all around. Additionally, the risk that debtor-in-possession lenders will lose out to the SEC and the subordinated shareholders may prevent the debtor from entering chapter 11 if it cannot get the financing necessary to fund its bankruptcy and emergence from bankruptcy. These are the problems the "Absolute Priority Rule" and the SEC, as its progenitor, intended to quash. Stable markets require certainty and the SEC's use of 1141(d)(6) destroys that certainty.

B. Civil Penalties

Since the passage of SOX, when the SEC receives judgments for disgorgement and civil penalties, the SEC may create a fund and distribute the money received from the disgorgement and the civil penalty to the former shareholders of the corporate wrongdoer. The addition of the civil penalty funds is an important power when added to the disgorgement remedy because the assessed penalty can equal 100% of the disgorgement sought by the SEC.[190] With the addition of this power,

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[189] *See* SEC v. JT Wallenbrock & Assocs., 440 F.3d 1109, 1117 (9th Cir. 2006) (affirming district court's discretionary decision to assess $253.2 million in damages against defendants for disgorgement of ill-gotten gains); *see also* SEC v. Silverman, No. 08-16710, 2009 WL 1376248, at *3–4 (11th Cir. May 19, 2009) (upholding district court's decision to hold defendants responsible for $8,117,527 for disgorgement penalties); SEC v. Gemstar-TV Guide Intern., Int'l, Inc., 401 F.3d 1031, 1047 (9th Cir. 2005) (discussing action against defendants for multiple securities violations including fraud, disgorgement, civil penalties, and ill-gotten gains for at least $223 million).

[190] 15 U.S.C. § 78u(d)(5) (2006) ("In any action or proceeding brought . . . by the Commissioner under any provision of the securities laws, the Commissioner may seek . . . any equitable relief that may be appropriate or necessary for the benefit of investors."). The statute allows in the most severe cases a penalty, which is

the SEC can now come closer to recovering an amount that will allow the SEC to redistribute to the shareholder their full investment when the unsecured creditors would receive far less than their full claim—and often receive nothing. This is significant because the Bankruptcy Code *subordinates* the claims of the shareholders, it does not elevate them.[191]

CONCLUSION

The purpose of section 1141(d)(6) is to prevent the discharge of a corporation's fraud debts owed to the Government for a direct pecuniary loss suffered by the Government. If Congress had intended section 1141(d)(6) to apply to the claims of the SEC, through an exercise of its police powers, then Congress would have indicated so—either in the text of the statute or its legislative history—as it did with section 523(a)(19). By incorporating sections 523(a)(2)(A)-(B) into section 1141(d)(6), Congress made the conscious choice not to include those claims of the SEC, as the SEC's claims cannot meet the standards of *Field v. Mans* that the creditor "to whom the debt is owed" relied on the debtor and suffered a pecuniary loss. In obtaining its claim, the SEC has neither relied on the debtor nor suffered a pecuniary loss.

Without some express indication by Congress that it intended to overhaul corporate reorganizations so drastically as suggested by the SEC, the statute must be read to conform with the rest of the provisions of section 1141(d)(6), the rest of the Bankruptcy Code and the policies of bankruptcy in general. The only way to accomplish all three of these mandates is to limit the reading of section 1141(d)(6) to claims where the Government suffers a direct pecuniary loss.

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equal to the amount of pecuniary gain. *See, e.g.*, SEC v. Leffers, Nos. 07-0594-cv (L), 07-0596-cv (con), 2008 WL 3841141, at *3 (2d Cir. Aug. 12, 2008) (affirming District Court's discretionary decision setting civil penalty equal to disgorgement); SEC v. Opulentica, LLC, 479 F. Supp. 2d 319, 332 (S.D.N.Y. 2007) (claiming maximum civil penalty is equal to disgorgement sum, while assessing smaller civil fine for other reasons).

[191] *See* 15 U.S.C. § 78u(d)(3) (codifying right of SEC to sue for violations under securities exchanges chapter of United States Code). *Compare Lampf*, 501 U.S. at 364 (establishing statute of limitations for private section10(b) claims as one year after discovery of violation and within three years after such violation) *with Rind*, 991 F.2d at 1492–93 (finding no statute of limitations for SEC's disgorgement claims).