NOTE

A CRITIQUE OF 11 U.S.C. § 510(b)'s CLAIM SUBORDINATION: PERSPECTIVES FROM PRIVATE ENFORCEMENT

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INTRODUCTION

With Congress's adoption of title 11 of the United States Code (the "Bankruptcy Code") in 1978 came section 510(b), which requires that particular securities claims against a debtor be subordinated "to all claims or interests that are senior to or equal the claim or interest represented by such security . . . ."[1] Prior to section 510(b)'s enactment, shareholders asserting securities claims were provided equal treatment with general unsecured creditors.[2] This sparked criticism and led to the eventual adoption of section 510(b), as it was argued that "creditors should not bear any portion of the risk of illegal securities issuance because the stock was not offered to them."[3] The implication of section 510(b) is "that shareholders should seek their recovery from others directly responsible for the fraud, such as the issuer's officers, directors and accountants."[4]

Section 510(b) has also generated peculiar consequences for SEC civil enforcement actions. Particularly, "§ 510(b) has motivated the SEC to avoid bankruptcy altogether, and instead utilize equitable receiverships as a primary civil enforcement tool to compensate securities fraud victims of insolvent and near-insolvent entities."[5] The SEC's influence over this process has resulted in receiver distributions that disadvantage creditors, insolvency proceedings that lack the certainty and structure of bankruptcy proceedings, and conflicts within the federal system.[6] This paper will build on the scholarship critiquing the discordance in securities fraud enforcement in bankruptcy that section 510(b) has engendered, with a particular focus on private enforcement. Part II of this paper will discuss the existing difficulties in private litigants' recovery from individual defendants and how claim subordination further exacerbates these difficulties. Part III of this paper will explain and problematize how such difficulties have shifted the burden of illegal securities issuance from the debtor to individual defendants, as corporate governance reforms cannot be obtained from individual settling defendants. Part IV will then demonstrate the need for oft-ignored corporate governance reform in bankruptcy reorganization, which can aid in the successful reemergence of the debtor and prevent securities fraud recidivism.

This paper proposes that courts interpret section 510(b) narrowly by only subordinating claims arising from the issuance of a security. This narrow interpretation would limit the number of claims subject to mandatory subordination, encourage recovery, and demand reform from the debtor corporation. Encouraging

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[1] 11 U.S.C. § 510(b) (2018); *see* Nicholas Georgakopoulos, *Strange Subordinations: Correcting Bankruptcy's § 510(b)*, 16 BANKR. DEV. J. 91, 94–95 (1999).

[2] *See infra* Part II.A.

[3] Kenneth B. Davis, *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 43 (1983).

[4] *Id.*

[5] Sean Kelly, Note, *SEC v. Creditors: Why SEC Civil Enforcement Practice Demonstrates the Need for a Reprioritization of Securities Fraud Claims in Bankruptcy*, 92 ST. JOHN'S L. REV. 915, 916 (2018).

[6] *See id.*

the proliferation of private securities claims against bankrupt debtors will alleviate the pressure on the SEC to utilize out-of-bankruptcy mechanisms to compensate securities fraud victims whose claims would otherwise be subordinated under section 510(b). Additionally, a greater opportunity to recover in the bankruptcy process would further incentivize private litigants to exact corporate governance reforms obtained in out-of-bankruptcy private securities litigation settlements. This, in tandem with the business and financial restructuring that occurs in bankruptcy, can assure courts that the debtor is truly rehabilitated in accordance with the policy rationale behind the Bankruptcy Code. Providing shareholders a greater incentive to participate in the bankruptcy process would promote a more symbiotic ecosystem between the public and private enforcement of the securities laws and the Bankruptcy Code.

I. CURRENT LAW

A. The Historical Prioritization of Creditors' and Shareholders' Claims in Bankruptcy

The subordination doctrine encompassed in section 510(b) came with the adoption of the Bankruptcy Code in 1978.[7] However, the tension between an insolvent issuer's creditors and shareholders was an issue that had been litigated for over one hundred years,[8] with varying trends in the priority of these claims.[9] In the nineteenth and early twentieth centuries, defrauded shareholders sought relief under the common law or a state's "blue sky" state securities laws.[10] In those cases, "some shareholder claims were protected by a common-law constructive trust that gave them priority over creditors, some were granted creditor seniority, and others were subordinated."[11] Throughout that time period, "case law proceeded on a case-by-case basis, with a resistance toward subordinating the claims of innocent passive investors."[12] Around the first half of the twentieth century, most United States jurisdictions accepted the rule that "not only provided the defrauded shareholder an opportunity to litigate the merits of his fraud claim in the bankruptcy proceeding, it also allowed him to raise procedural obstacles that may have significantly improved his settlement position."[13] It was around this time that Congress created our primary source of modern shareholders' remedies through its creation of federal securities laws and the SEC.[14] In so doing, Congress ignored the question of subordination, and

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[7] *See* Georgakopoulos, *supra* note 1, at 93–94.
[8] *See* Davis, *supra* note 3, at 4.
[9] *See id.* at 4–12.
[10] Georgakopoulos, *supra* note 1, at 94.
[11] *Id.*
[12] *Id.*
[13] Davis, *supra* note 3, at 7.
[14] *See id.* at 8.

the question was not actively litigated until the late 1970s.[15] Exercising its authority under chapter X of the former Bankruptcy Act, "the SEC took the position that shareholder claims based on violations of the securities laws had to be given parity with other unsecured claims . . . . On this basis, shareholder fraud victims were permitted to share in the bankrupt corporation's assets despite its insolvency."[16]

However, in 1973, Professors John Slain and Homer Kripke published a law review article advocating for the "subordination of shareholders' fraud and rescission claims based in part upon a reliance-like argument that shareholders' and creditors' expectations require subordination."[17] This argument posits that shareholders can expect to benefit when the firm performs well, and if it does not, "shareholders [can] exercise their fraud claims and receive a portion of the value of the failed firm, sharing with the creditors."[18] In contrast, creditors "rely on the capital contributed by shareholders for the satisfaction of their claims. Allowing rescission claims to share the same priority as debt eliminates this safety cushion."[19] Slain and Kripke submitted a draft of their article to the Commission on Bankruptcy Laws of the United States.[20] The pattern of shareholder participation in bankruptcy was reversed when, in July of 1973, "the Commission proposed that investor claims based on federal and state securities legislation, and similar laws, be subordinated in payment to all general creditor claims."[21] Ultimately, Congress codified Slain and Kripke's position into section 510(b) of the 1978 Bankruptcy Code.[22]

B. The Historical Relationship Between Public and Private Enforcement of the Securities Laws

Today's securities regulation and enforcement landscape was born out of a series of statutes passed by Congress following the stock market crash of 1929 and the Great Depression.[23] In formulating these statutes, "Congress recognized the importance of private citizens[] having an ability to seek redress for the harm they suffer from securities law violations."[24] In particular, to promote "a philosophy of full disclosure" in the national securities markets, Congress enacted the Securities Exchange Act of

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[15] *See id.* at 8–9.
[16] *Id.* at 9–10.
[17] Georgakopoulos, *supra* note 1, at 94. *See generally* 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 (1973).
[18] Georgakopoulos, *supra* note 1, at 95.
[19] *Id.*
[20] *See* Davis, *supra* note 3, at 10 n.44.
[21] *Id.* at 10.
[22] *See* Georgakopoulos, *supra* note 1, at 94.
[23] *See* Amanda M. Rose, *Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1307 (2008).
[24] Elisse B. Walter, *The Interrelationship between Public and Private Securities Enforcement*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REGUL. (Dec. 11, 2011), https://corpgov.law.harvard.edu/2011/12/11/the-interrelationship-between-public-and-private-securities-enforcement/.

1934, which created the Securities and Exchange Commission and charged it with the civil enforcement of these new statutes.[25] In section 10(b) of the 1934 Act, Congress "granted the Commission broad authority to enact regulations banning manipulation or deception in connection with the purchase or sale of securities."[26] Pursuant to that authority, in 1942, the SEC enacted Rule 10b-5.[27] Rule 10b-5 was enacted with the purpose of closing "a loophole in the Commission's enforcement authority by prohibiting individuals or companies from buying securities if they engaged in fraud in their purchase; previously enacted rules prohibited only the fraudulent sale of securities (or applied only to brokers and dealers)."[28] Five years after the promulgation of Rule 10b-5, the court in *Kardon v. National Gypsum Co.* found an implied private right of action to sue for damages under the rule.[29] The *Kardon* court reasoned that the Exchange Act "'does no more than forbid certain types of conduct . . . [and] does not even provide in express terms for a remedy, although the existence of remedy is implicit under general principles of law.'"[30] Thus, at the outset, the implied private right of action under Rule 10b-5 was regarded as serving a different purpose than SEC enforcement—that is, to compensate defrauded investors for their losses.[31] In contrast, the envisioned purpose behind SEC enforcement was to deter securities fraud.[32]

However, the distinction between the purposes motivating public and private enforcement began to blur in the 1960s.[33] This was reflected in the 1964 decision in *J.I. Case Co. v. Borak*, where the Court explicitly noted that "[p]rivate enforcement of the proxy rules provides a necessary supplement to [Securities and Exchange] Commission action[,]" and that "the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements."[34] The supplement to SEC enforcement is critical, because public enforcers:

> may be 'captured' by some part of the industry they are supposed to be policing and therefore go too 'easy' on these targets; they may be pressured by Congressional overseers to pursue certain classes of cases and not others for political reasons; they may suffer from 'bureaucratic slack' a result of employees' desire to maximize leisure time; or they may be overzealous enforcers or skew toward high-profile and aggressive cases because individual employees get career

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[25] Rose, *supra* note 23, at 1307.
[26] *Id.* at 1308.
[27] *See id.*
[28] *Id.*
[29] *See id.*
[30] Walter, *supra* note 24 (quoting Kardon v. Nat'l Gypsum Co., 73 F. Supp. 798, 802 (E.D. Pa) (1947)).
[31] *See* Rose, *supra* note 23, at 1310.
[32] *See id.*
[33] *Id.* at 1311.
[34] J. I. Case Co. v. Borak, 377 U.S. 426, 428 (1964).

> benefits (revolving door) from being involved in tough, high-profile cases.[35]

Indeed, "[t]he Commission has long recognized the relationship between public and private enforcement . . . ."[36]

C. The Modern Constriction of Private Rights of Action

Section 10(b) of the Securities Exchange Act is the central antifraud provision of the federal securities laws, which "prohibits a defendant from engaging in a 'manipulative or deceptive device or contrivance' in violation of SEC rules."[37] After finding an implied private cause of action in *Borak*, the Supreme Court continued interpreting the provisions of section 10(b) in a manner favorable to investors.[38] That trend was reversed in 1975 when the Court expressed a novel policy concern about "the proliferation of vexatious litigation in Section 10(b) cases" in its decision in *Blue Chip Stamps*.[39] In that decision, the Court curtailed the reach of the antifraud provisions of the securities laws to only purchasers and sellers of securities, not to those who relied on fraudulent statements in deciding to forego purchasing.[40] A few years later, the Supreme Court continued pursuit of that policy concern in *Ernst & Ernst v. Hochfelder*, holding that "claims under [s]ection 10(b) and Rule 10b-5 require scienter."[41] This decision had the effect of "narrow[ing] the class of permissible defendants to those active in the fraud."[42] The Court continued to limit private causes of action in the 1994 *Central Bank* decision where it eliminated liability for aiding and abetting a section 10(b) violation, further constraining private plaintiffs to only those defendants who are primary violators under Rule 10b-5.[43] Although private plaintiffs are constrained by *Central Bank*, the SEC is able to prosecute civil actions against defendants who aid and abet due to Congressional intervention.[44] In 1995, Congress too sought to bring about "a reduction in the filing of frivolous securities lawsuits" in passing the Private Securities Litigation Reform Act (PSLRA).[45]

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[35] Alexander I. Platt, *"Gatekeeping" in the Dark: SEC Control Over Private Securities Litigation Revisited*, 72 ADMIN. L. REV. 27, 74 (2020) (footnotes omitted).

[36] Walter, *supra* note 24.

[37] JONATHAN N. EISENBERG ET AL., LITIGATING SECURITIES CLASS ACTIONS § 2.03, LEXIS (database updated 2024) (quoting 15 U.S.C. § 78j(b)).

[38] *See* Gary J. Aguirre, *The Enron Decision: Closing the Fraud-Free Zone on Errant Gatekeepers?*, 28 DEL. J. CORP. L. 447, 474 (2003).

[39] *Id.* at 466 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975)).

[40] *See id.* at 465–66.

[41] *See id.* at 479 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976)).

[42] Davis, *supra* note 3, at 45.

[43] *See* Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 172 (1994).

[44] *See* Aguirre, *supra* note 38, at 485.

[45] Shaun Mulreed, *Private Securities Litigation Reform Failure: How Scienter Has Prevented the Private Securities Litigation Reform Act of 1995 from Achieving Its Goals*, 42 SAN DIEGO L. REV. 779, 780 (2005).

Amongst other things, the PSLRA heightened the pleading requirements of securities fraud complaints.[46] Specifically, the PSLRA requires that for a plaintiff's complaint in a securities fraud action to survive a motion to dismiss it must "state with particularity facts giving rise to a strong inference" that the defendant acted with scienter.[47] The inference "must be cogent and at least as compelling as any opposing inference of nonfraudulent intent."[48] Scholars have concluded that "in most cases pleading a 'strong inference' of scienter remains a difficult task."[49] The onerous pleading requirements of Rule 10b-5 have resulted in dismissal in thirty-five percent of all securities class actions that have reached finality.[50] Thus, despite the initial recognition of a private cause of action, both the Supreme Court and Congress have significantly pared down the reach of the antifraud provisions of the laws and created formidable obstacles in successfully pleading a cause of action under them.

D. Private Enforcement of the Securities Laws in Bankruptcy

1. The problem of the bankrupt issuer and section 510(b)

As shown, there are pervasive complications presented by the Supreme Court's and Congress's efforts to curtail the reach of the federal securities laws in bringing a private securities claim against a non-bankrupt issuer. Further complications arise in bringing a private securities class action against a bankrupt issuer. Against a non-bankrupt issuer, "[i]n the typical Rule 10b-5 action, the plaintiff names as defendants the corporate issuer and its senior management."[51] Against a bankrupt issuer, however, "such litigation is generally subject to the Bankruptcy Code's automatic stay, which typically halts litigation against a company upon its filing for bankruptcy."[52] As a result, "most bankrupt issuers are not named as defendants or are later dismissed from the securities class action . . . ."[53] For instance, in *Dudley v. Haub*, the court explicitly noted that the issuer-corporation was not named as a defendant because it filed for protection under chapter 11 of the Bankruptcy Code.[54] Even if named in the action, section 510(b) provides that "any recovery by shareholders from the bankruptcy estate would be subordinate to recovery by the company's more senior creditors."[55] Due to the priority given to securities claims in

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[46] *See* 15 U.S.C. § 78u-4(b) (2018).
[47] Eisenberg, *supra* note 37 (citing Tellabs, Inc. v. Makor Issues & Rts., Ltd., 551 U.S. 308, 314 (2007)).
[48] *Id.*
[49] *Id.*
[50] Nishal R. Ramphal, *The Role of Public and Private Litigation in the Enforcement of Securities Laws in the United States* (2007) (Ph.D. dissertation, Pardee RAND Graduate School) (on file with Pardee RAND Graduate School) at 4.
[51] Warren R. Stern & Geoffrey A. Starks, *Defining Corporate Scienter*, 3 NO. 8 SEC. LITIG. REP. 21 (2006) at 1.
[52] James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 556 (2013).
[53] *Id.* at 557.
[54] *See* Dudley v. Haub, No. 2:11-CV-05196, 2013 WL 1845519, at *1 n.1 (D.N.J. Apr. 30, 2013).
[55] Park, *supra* note 52, at 556.

bankruptcy, a plaintiff investor who files a class action against the firm and its management, despite a win in court, "may face great difficulty in recovering any money from the firm itself."[56]

Hence, by virtue of the bankruptcy process, the issuer-corporation is often unnamed in the securities enforcement action or unable to contribute to its settlement.[57] Remaining as potential defendants and contributors to the settlement are "only individual defendants . . . and perhaps third-party defendants such as underwriters and auditors."[58] To the private plaintiff, however, causes of action against such third-party defendants were generally eliminated in *Central Bank*.[59] Thus, shareholders seeking recovery from securities fraud claims asserted against an issuer in bankruptcy must pursue individual defendants who are directly responsible for the fraud, such as the issuer's officers, directors, and accountants.[60]

Adequately alleging securities fraud against an individual defendant, as opposed to a corporation, can prove itself to be arduous for the private plaintiff. To allege securities fraud against a corporation, "the plaintiff must allege facts that support a strong inference of scienter with respect to at least one authorized agent of the corporation; to allege fraud against an individual defendant, the plaintiff must allege facts supporting a strong inference of scienter as to that person."[61] While successfully doing so is challenging regardless of whether the defendant is a corporation or an individual, alleging securities fraud against a corporation has the advantage of the possibility to "draw a strong inference of corporate scienter without being able to name the individuals who concocted and disseminated the fraud."[62] In those circumstances, where corporate statements are dramatically false, "collective corporate scienter may be inferred."[63] The particular challenge in proving an individual defendant's scienter lies in the age-old complication of proving any mental state, that "direct evidence of the complex inner workings of the mind is virtually nonexistent."[64] For the private plaintiff without the SEC's subpoena power:[65]

> direct evidence of a person's state of mind is rare because this evidence is usually limited to an actual admission by the defendant under oath or the testimony of a witness based upon personal knowledge, both of which are unlikely to be available without

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[56] Davis, *supra* note 3, at 2.
[57] *See* Park, *supra* note 52, at 551.
[58] *Id.*
[59] *See* Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 191 (1994).
[60] *See* Davis, *supra* note 3, at 43.
[61] 9 AM. JUR. PROOF OF FACTS 2D *Participation by Corporate Officer in Illegal Issuances of Securities* § 2.5, Westlaw (database updated Oct. 2024); *see also* 15 U.S.C. § 78j(b); 15 U.S.C. § 78u–4(b)(2).
[62] Makor Issues & Rts., Ltd. v. Tellabs Inc., 513 F.3d 702, 710 (7th Cir. 2008).
[63] Jackson v. Abernathy, 960 F.3d 94, 99 (2d Cir. 2020).
[64] Michael J. Kaufman & John M. Wunderlich, *Messy Mental Markers: Inferring Scienter from Core Operations in Securities Fraud Litigation*, 73 OHIO ST. L.J. 507, 508 (2012).
[65] *See infra* note 131.

> discovery, which is stayed in securities litigation pending any motion to dismiss.[66]

Thus, the individual defendants available to a private plaintiff when the issuer is bankrupt present complications in sufficiently pleading scienter.

Even if a private plaintiff can ascertain an applicable non-issuer individual defendant and prevail beyond the pleading stage, the nature of an insolvent issuer nonetheless poses further obstacles to recovery. Often, applicable "nonissuer defendants are members of the issuer's management."[67] Accordingly, "[t]heir personal wealth . . . depends on the fortunes of the issuer. The issuer's insolvency and the expenses of the fraud and bankruptcy litigation make these defendants poor targets for successful execution of large judgments."[68] Indeed, courts have advised plaintiffs to seek dismissal of actions against the senior officers of insolvent corporations because none of the defendants appeared able to satisfy a judgment for a significant amount.[69] This depresses the number of suits filed as "[e]conomic theorists have usually assumed that revenue-seeking, risk-neutral private litigators file an action . . . on some rational calculation of the expected economic value of the suit including the costs of litigation i.e. the probability of success in a case multiplied by the expected damages award less legal costs."[70] Indeed, for the private securities fraud litigant, it is not cost effective to bring suit "because the likely recovery is small and the likelihood of certifying a class and surviving a motion to dismiss pursuant to the standards set by the Private Securities Litigation Reform Act of 1995 (PSLRA) and the Supreme Court is low."[71] Ultimately, such grim prospects for recovery "impact a number of cases where victims of a debtor's fraud have no economic incentive to participate in the bankruptcy process."[72]

2. The SEC's response to section 510(b)'s implications

With section 510(b) in place, it is "unlikely that securities fraud plaintiffs will receive any distribution in bankruptcy, with the practical effect of deterring securities fraud plaintiffs from pursuing claims against insolvent companies."[73] To provide a means of recourse for would-be private plaintiffs deterred by the economic realities of filing suit and to compensate defrauded security holders whose claims for compensation would otherwise be subordinated under section 510(b), the SEC has

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[66] Kaufman, *supra* note 64, at 516.
[67] *See* Davis, *supra* note 3, at 45.
[68] *Id.* at 45.
[69] *See id.*
[70] Ramphal, *supra* note 50, at 97.
[71] Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STAN. L. REV. 331, 369 (2015).
[72] Kelly, *supra* note 5, at 938.
[73] *Id.* at 920.

devised particular strategies.[74] One is the utilization of the Fair Fund Provision of Sarbanes-Oxley, section 308(a), to bring civil enforcement actions as an unsecured creditor to recover funds for defrauded security holders that would normally go to creditors.[75] The Fair Fund Provision permits the SEC "to take civil penalties collected in enforcement actions—previously required to be paid to the United States Treasury—and add them to disgorgement funds to benefit victims of securities law violations."[76] Indeed, the SEC has been found to utilize the Fair Funds provision to compensate "harmed investors for losses where a private lawsuit is either unavailable or impractical."[77] However, the process of distributing the penalties deposited into Fair Funds in large and complex cases "has proven to be slow and cumbersome."[78] In these cases, "it has taken months or even years to develop and implement distribution plans for amounts deposited into Fair Funds."[79] In the interests of expedition, the utilization of receiverships emerged as a means to more effectively compensate securities fraud claims.[80] Accordingly, receiverships have emerged as the SEC's preferred enforcement mechanism.[81] Section 305(b) of the Sarbanes-Oxley Act permits the SEC to "seek receivers in situations of insolvency or near insolvency to wind down distressed, fraudulent entities and to compensate defrauded security holders."[82] The SEC requests receivers pursuant to the court's equitable authority; they are definitionally "equitable receiverships, meaning that the receiver's powers and duties are set by a district court's appointment order."[83] Initially, courts typically "appoint a receiver with limited powers and narrowly defined objectives, such as conducting an inventory or accounting."[84] Thus, SEC receivers are bound by the court's equitable orders to identify assets, but are "without the traditional powers associated with receivers such as the right to investigate and pursue litigation to preserve claims."[85] Accordingly, courts have increasingly permitted incremental increases in a receiver's power.[86] Such develops into what has been defined as a "creeping receivership" wherein "the duties and powers of the receiver start off as what has been referred to as 'relatively benign' and eventually develop into those of a full-fledged trustee responsible for all aspects of the enterprise."[87] In situations where

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[74] *See id.* at 924.
[75] *See id.* at 925.
[76] *Id.* at 923.
[77] Velikonja, *supra* note 71, at 336.
[78] NICOLE A. BAKER ET AL., SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 208 (Michael J. Missal & Richard M. Phillips eds., 2d ed. 2007).
[79] *Id.*
[80] *See* Kelly, *supra* note 5, at 926–27.
[81] *See id.* at 928–29.
[82] *Id.* at 927.
[83] *Id.*
[84] Marcus F. Salitore, *Affairs of State, SEC Receivers vs. Bankruptcy Trustees: Liquidation by Instinct or Rule*, 22 AM. BANKR. INST. J., Oct. 2003 at 8, 46.
[85] Ralph S. Janvey, *An Overview of SEC Receiverships*, 38 SEC. REGUL. L.J. 1, 19 (2010).
[86] *See* Salitore, *supra* note 84, at 46.
[87] Janvey, *supra* note 85, at 19.

SEC receivers are appointed to insolvent entities, "by the time the decision to liquidate is made, economy of administration appears to support a process of letting the receiver complete the liquidation rather than commencing a bankruptcy case."[88]

Instead of the Bankruptcy Code, SEC receivers are driven by broad equitable principles.[89] In a receivership, there is no absolute priority rule like that in bankruptcy.[90] Therefore, the SEC receiver becomes a liquidator employing principles of equity as opposed to the structure of the Bankruptcy Code.[91] This has resulted in "unpredictable, disorganized and haphazard receivership liquidations with procedures constructed and developed only as needed at the potential expense of creditors or other parties."[92] Absent the confines of the absolute priority rule in bankruptcy, an SEC liquidating receiver "may focus on protection and recovery of assets for the purpose of compensating defrauded securities investors and afford such investors a priority in distribution."[93]

Since the SEC, through receiverships, can disrupt the Bankruptcy Code's priorities and instead prioritize compensating defrauded securities investors, receiverships have become the "preferred vehicle for the SEC to compensate securities fraud victims of insolvent entities outside of the Code's strictures . . . ."[94] Indeed, in 2020, the SEC announced the newly-formed Office of Bankruptcy, Collections, Distributions, and Receiverships to oversee the SEC processes of collecting "outstanding monetary judgments, both in district court and bankruptcy proceedings, and return[ing] money to harmed investors through distributions and the work of court-appointed receivers."[95] Often within SEC receiver requests are anti-bankruptcy injunctions, which effectively foreclose the use of the involuntary bankruptcy provision of the Bankruptcy Code.[96] The SEC's ability to do so was entrenched in *SEC v. Byers*, where the Second Circuit found that "district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers in the context of an SEC receivership."[97] The Chief Bankruptcy Counsel to the SEC Division of Enforcement has interpreted the Byers decision to mean "that equity receiverships are permissible as an alternative to bankruptcy."[98] Although not grounded within the holding, it illuminates the implication that the

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[88] Salitore, *supra* note 84, at 46.
[89] *See id.*
[90] *See* Kelly, *supra* note 5, at 929.
[91] *See* Salitore, *supra* note 84, at 46.
[92] *Id.*
[93] *Id.* at 8.
[94] Kelly, *supra* note 5, at 928–29.
[95] *SEC Names Nichola L. Timmons Chief of New Office of Bankruptcy, Collections, Distributions, and Receiverships*, SEC (Oct. 7, 2020), https://www.sec.gov/news/press-release/2020-250/.
[96] *See* Kelly, *supra* note 5, at 931.
[97] SEC v. Byers, 609 F.3d 87, 91 (2d Cir. 2010).
[98] Kevin Moore, *The SEC's Role in American Corporate Reorganization: A Historical Analysis, in* NORTON'S ANN. SURV. OF BANKR. L. 143, 163 (William L. Norton, Jr. ed., 2011).

"SEC feels that it has not only solidified its newest toehold in the insolvency practice but can assume the seat at the head of the table when it believes it necessary."[99]

Problematically, this ability of the SEC runs directly counter to a notable goal found in the Bankruptcy Code, which differs from its predecessor, the Bankruptcy Act. Under those provisions, the SEC assumed a vital function in the administration of chapter X cases, an analogue to today's chapter 11.[100] In chapter X, the SEC had the right to evaluate the plan and the power to be heard on any issue.[101] The basic assumption of the SEC's function in chapter X cases was that "the investing public dissociated from control or active participation in the management, needs impartial and expert administrative assistance in the ascertainment of facts, in the detection of fraud, and in the understanding of complex financial problems."[102] However, the Bankruptcy Code curtailed the SEC's role in bankruptcy, acknowledging that "equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or [governmental agencies such as] the SEC."[103] Interestingly, the Commission unanimously approved reducing its involvement in the number of chapter 11 cases it involves itself in on the premise that "so long as public security holders are adequately represented . . . there is less need for day-to-day Commission participation in reorganization cases . . . ."[104] In place of the SEC's function prior to the Bankruptcy Code, the United States Trustee was created.[105]

Thus, the SEC's devised remedies to address the practical effects of section 510(b) on private enforcement usurps a fundamental revision to the Bankruptcy Code and negates the interdependent relationship between public and private enforcement of the securities laws.

II. PROBLEMATIZING THE SHIFT OF THE SECURITIES FRAUD BURDEN FROM CORPORATE ISSUERS TO INDIVIDUALS

A. Private Securities Litigation Increasingly Has Sought Corporate Governance Reform in Settlement

Securities litigation has sought to impose liability on fraudulent officers, to provide compensation to harmed investors, and to deter future violations of the securities laws.[106] These ends are achievable through several means such as

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[99] *Id.*

[100] *See* 7 COLLIER ON BANKRUPTCY, ¶ 1109.03[3] at 1109-14–15 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2024).

[101] Moore, *supra* note 98, at 154.

[102] SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 608 (1965).

[103] Kelly, *supra* note 5, at 921.

[104] 7 COLLIER ON BANKRUPTCY, *supra* note 100, ¶ 1109.03[3] at 1109-15.

[105] *See* Kelly, *supra* note 5, at 922.

[106] *See* Ramphal, *supra* note 50, at 90.

regulatory enforcement, private investor suits, and criminal liability.[107] Congress acknowledged in the PSLRA that "[t]he private securities litigation system is . . . important to the integrity of American capital markets . . . [and] is an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."[108] In the private securities litigation system, "most securities class action cases settle when defendants come to appreciate that they face a serious threat of liability . . . ."[109] Investors have increasingly sought "to exact important accountability through therapeutic corporate governance changes as part of the adjudication of securities class actions . . . . seeking these changes as part of the settlement of suits for violation of the federal securities laws . . . ."[110] Demanding corporate governance reform is particularly effective in the settlement context, because when defendants decide to settle these cases, "they are more motivated to do so . . . [and] agreement to corporate governance enhancements that seemed abhorrent in the context of voluntary requests for such action seem much more palatable."[111] In addition to a heightened willingness to acquiesce to corporate governance, the context of a class action settlement enhances the enforceability of the proposed reforms. Private securities litigation class action settlements "must be approved by the court and are therefore judicially enforceable. The enforceability of these negotiated changes makes them all the more valuable to shareholders and an attractive way to secure the value of a long-term investment."[112] Even outside of the settlement context, a recent development within the securities class action arena displays the value of utilizing such litigation to shareholders, as plaintiffs "rather than waiting to raise the issue of corporate governance reforms during settlement negotiations[ ]have affirmatively sought in their complaints equitable relief in the form of specific corporate governance reforms."[113]

One empirical analysis found that "[w]here governance reforms are pursued by public and private enforcement mechanisms, private investors have been successful in obtaining a wider range of reforms from settling defendants than the SEC."[114] Additionally, private investors are twenty percent more likely to adopt more than one major class of reforms than is the SEC.[115] The categories of corporate reform adopted in settlement agreements of private action include changes to board structure and functioning, "[a]dopt[ing] . . . internal control and auditing procedures that are more stringent than those required by Sarbanes Oxley or the SEC," requiring a "[r]otation

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[107] *See id.*

[108] William S. Lerach, *Achieving Corporate Governance Enhancements Through Litigation*, 24 T. JEFFERSON L. REV. 1, 3 (2001) (quoting H.R. Rep. No. 104-369, at 31 (1995)).

[109] *Id.* at 8.

[110] *Id.* at 9.

[111] *Id.* at 8.

[112] *A Primer on Shareholder Litigation*, KESSLER TOPAZ MELTZER CHECK LLP, at 9, https://www.ktmc.com/files/522_Primer.pdf/ (last accessed Jan. 22, 2024).

[113] Anthony Marchetta, *Corporate Reform Through Securities Class Action Settlement*, CORP. COUNS. (Sept. 21, 2007), https://www.bloomberglaw.com/document/X8TC4J2K000000?jcsearch=900005491591#jcite.

[114] Ramphal, *supra* note 50, at 6–7.

[115] *See id.* at 133.

of [an] External Auditor on a regular basis," limitations on executive compensation, expanded disclosure and improved channels of communication with shareholders, and requiring that directors attend accredited fiduciary colleges.[116] Specifically, reforms aimed at the board structure and functioning included governance changes such as "[r]equiring a supermajority of independent directors, enhanced provisions for determining director independence and the appointment of a lead independent director . . . [and] limitations on the tenure of independent directors."[117]

Where studied in the securities law context, the private class actions that resulted in corporate governance reform overwhelmingly targeted corporations as defendants.[118] Within such, there have been a limited number of instances where private enforcers have utilized securities class actions to coerce defendant firms into reforming their corporate governance structures, because negotiating the additional reforms is costly.[119] In the bankruptcy context, where the issuer-corporation is often unavailable as a defendant, private plaintiffs are confined to individual defendants to seek recovery.[120] As previously discussed, surviving the motion to dismiss stage and receiving and enforcing a judgment from such an individual is also cost inefficient.[121] Since section 510(b) has the effect of deterring private claimants from filing suit, of those who do, negotiating corporate governance reforms with the settling defendants represents yet another cost.[122] While the SEC may recover funds for would-be private plaintiffs discouraged from filing suit through its use of Fair Funds and receiverships, such will never be a substitute for the distinct positioning of the private plaintiff in the settlement context.

B. Private Enforcers Are Uniquely Positioned to Exact Reform Through Settlement

Unlike the SEC, private enforcers are uniquely positioned to withstand the costs and time associated with negotiating corporate governance reform as part of a class action settlement. For one, the SEC is generally reluctant to interfere with corporate governance—particularly, the functioning of a corporation's board—out of "respect for the notion that the board is a democratically elected institution that functions at the behest of shareholders."[123] But additionally, the SEC is a large bureaucracy.[124] Bureaucracies are often "governed by rigid hierarchies that are risk averse, relying on

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[116] *Id.* at 109–14.

[117] *Id.* at 109.

[118] *See id.* at 3, 40, 122.

[119] *See id.* at 124 ("Private enforcers . . . are usually reluctant to negotiate costly governance reforms, for which they ostensibly receive no additional compensation. However, there have been a limited number of instances where private plaintiffs have used the class action mechanism to coerce defendant firms into reforming their corporate governance structures.").

[120] *See* discussion *supra* Part II.D.1.

[121] *See id.*; *see also* Velikonja, *supra* note 71.

[122] *See* discussion *supra* Part III.A; *see also* Ramphal, *supra* note 50, at 109.

[123] Ramphal, *supra* note 50 at 109.

[124] *See* James J. Park, *Rules, Principles, and the Competition to Enforce the Securities Laws*, 100 CAL. L. REV. 115, 146 (2012).

extensive formal procedures to govern decision making."[125] Typical of a bureaucratic structure, SEC enforcement of the securities laws has been governed by an extensive review process.[126] As a consequence, a report by the U.S. Government Accountability Office described that "SEC 'enforcement staff said a burdensome system for internal case review has slowed cases and created a risk-averse culture.'"[127] The tendency to be risk averse is further magnified by the fact that the SEC is judged by and is "expected to produce a certain amount of enforcement output."[128]

Hence, it is rational for the SEC to focus on "rule-enforcement cases that are straightforward and likely to settle quickly."[129] In contrast, private enforcers do not have to navigate an extensive bureaucracy to bring an enforcement action.[130] Private enforcers, unlike their public counterparts, are only paid if successful, and do not have the subpoena power to enable them to locate "smoking guns before filing a case . . . ."[131] Such renders private enforcers "risk-preferring enforcers"[132] who are "often able to act quickly and aggressively."[133] Since private enforcers have the opportunity to receive a portion of a settlement or judgment, they possess:

> an incentive to litigate a case with merit until the other side capitulates. In contrast, a government enforcer may be satisfied with a quick settlement that results in a smaller pay-off because he does not capture monetary benefits from a higher settlement and may be judged by the number of cases he has resolved.[134]

Since private enforcers are uniquely positioned to pursue the aggressive settlement of a case but are nonetheless revenue-seeking, claims whose recovery would be subordinated under section 510(b) may be cost-inefficient to exact negotiating corporate governance reforms at the settlement stage—if that stage is reached at all. Thus, in addition to deterring securities claims altogether, section 510(b) may dissuade the costly negotiation of corporate governance reforms in their eventual settlement.

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125 *Id.*
126 *See id.*
127 *Id.* at 147.
128 *Id.*
129 *Id.* at 148.
130 *See id.* at 159.
131 *Id.*
132 *Id.*
133 *Id.*
134 *Id.* at 160.

III. PROPOSAL FOR REFORM AND CONCLUSION

A. The Need for Increased Attention to Corporate Governance Reform in Bankruptcy

Financial restructuring is the central theme in chapter 11 reorganization, which "involves an apportionment of economic interests in the estate between creditors and shareholders, and the plan must be confirmed by a bankruptcy court."[135] In addition to the financial restructuring, the debtor's business plan aims at restoring the company's financial health "not through debt restructuring, but through managerial decisions aimed at producing a more efficient business entity."[136] Often, the debtor's former management remains in office post-filing, but management's influence over the creation of the new business plan is purported to be checked by creditors and institutional investors.[137] Problematically absent, however, from "the traditional Chapter 11 reorganization is any serious attention to the principles of sound corporate governance."[138]

True, since most important decisions in bankruptcy require judicial approval, "[b]ankruptcy judges serve as the ultimate defense against managerial self-aggrandizement."[139] Nonetheless, "bankruptcy judges suffer an informational disadvantage vis-a-vis managers which impairs the ability of the bankruptcy governance structure to provide adequate checks on managers."[140] This informational disadvantage is caused by two factors. First, as bankruptcy filings have soared, so has the caseload of bankruptcy judges.[141] As a consequence, "[t]he resulting time limitations, coupled with the limits of the adjudicative role, allows managers to restrict the information available to the parties and to the judge."[142] Second, the provisions of the Bankruptcy Code that require that managers provide some information to the other participants in the case and are subject to broad oversight, "may be inadequate to highlight more subtle information that managers hold about the prospects for reorganization."[143] Particularly in the realm of corporate governance reform pursued in tandem with reorganization:

> the acquisition of knowledge about alternatives to reorganization requires that one take the initiative to explore those alternatives.

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[135] Charles M. Elson et al., *Corporate Governance Reform and Reemergence from Bankruptcy: Putting the Structure Back in Restructuring*, 55 VAND. L. REV. 1917, 1924 (2002).
[136] *Id.* at 1925.
[137] *Id.*
[138] *Id.*
[139] Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 125 (1998).
[140] *Id.* at 134.
[141] *See id.*
[142] *Id.*
[143] *Id.*

> While an active creditors' committee in a large case may take that initiative, in smaller cases there may be no one to do so but the judge who, of course, must look to managers for suggestions.[144]

Unfortunately, "many managers likely resist new reforms being forced upon them—after all, if they thought significant reform was a good idea, they would have adopted the reforms independent of the litigation."[145]

The types of corporate governance reforms frequently demanded in settlement of private securities litigation class actions are particularly relevant in the bankruptcy context. For one, sound corporate governance has been empirically demonstrated to have a strong relationship with superior financial and operational results.[146] Moreover, "to effectuate the contemplated financial and managerial reforms, a corporation relies upon the efficacy and integrity of its management and its ability to carry out the monitoring function."[147] "Modern corporate governance theory [provides that] two major factors . . . make the board an effective, active monitor: independence and equity ownership."[148] Within the corporate governance literature itself, an identified reform to promote an independent and effective board governance structure is requiring a substantial majority of independent outsiders on the board,[149] the same type of reform often demanded in private securities litigation settlements.[150] Ultimately, these reforms "can ensure the viability of the monitoring function and can result in the long-term financial and operational health of the enterprise that reemerges from Chapter 11."[151]

To illustrate the efficacy of corporate governance reforms in bankruptcy, a prominent example is the Loewen Group.[152] Prior to its bankruptcy, the Loewen Group's board of directors lacked substantial independence from management.[153] Four of the fourteen members of the board were employees of Loewen, and the remaining members possessed a financial tie to the company that complicated their independence.[154] Such ties were benefitting from transactions with Loewen or its subsidiaries through the use of fees for consulting services, leases for premises, and underwriting services.[155] Loewen's pre-bankruptcy management, in addition to executing a poor business strategy, made a series of other questionable decisions such

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144 *Id.* at 134–35.
145 Jessica Erickson, *Corporate Governance in the Courtroom: An Empirical Analysis*, 51 WM. & MARY L. REV. 1749, 1825 (2010).
146 Elson, *supra* note 135, at 1926.
147 *Id.*
148 *Id.*
149 *See id.* at 1928.
150 *See* Ramphal, *supra* notes 50, at 109–14, 133.
151 Elson, *supra* note 135, at 1928.
152 *See id.* at 1929.
153 *See id.*
154 *See id.* at 1930.
155 *See id.* at 1930 n.34.

as the use of a corporate yacht and substantial executive loans.[156] The Loewen Group petitioned for bankruptcy in 1999, where in addition to substantial restructuring, it committed itself to implementing several corporate governance reforms.[157] The reforms placed a substantial majority of directors completely independent of management on the board.[158] Two years later, in 2002, the Loewen Group emerged from bankruptcy as a reorganized company named the Alderwoods Group.[159] The Alderwoods Group was able to reduce its debt by two hundred million dollars in two years, as well as increase revenue.[160]

Not only does effective corporate governance aid in a corporation's reemergence from chapter 11, but it can also aid in the prevention of securities fraud recidivism. Ineffective corporate governance, demarcated by "lack of audit oversight independence, inadequate management supervision by independent directors[,] and lack of vigorous insider trading policies and controls create a corporate culture contributing to the occurrence of abuse and fraud."[161] On the other hand, effective corporate governance "can create an environment where fraud is less likely to occur . . . ."[162]

B. Resolving section 510(b)'s Constriction on Private Rights Through an Interpretive Correction

In light of this, it may appear that section 510(b) ought to be revisited by Congress to prevent the mandatory subordination of securities claims in bankruptcy. Scholars have suggested a variety of legislative corrections to address the errors of section 510(b),[163] but "legislative attempts to fix § 510(b) have repeatedly failed and . . . recent proposals about updating the Bankruptcy Code have been divisive rather than consensus-building."[164] Accordingly, an interpretive correction appears more poignant to resolve the issue. A proper interpretation of section 510(b) creates an opportunity for a larger number of securities litigation class actions that demand corporate governance reform in settlement, which have not been explored in the bankruptcy context.

Specifically, courts should interpret section 510(b) narrowly. Under a narrow interpretation, only claims for fraud in the issuance of securities are subordinated, and "fraud or other wrongful conduct occurring *subsequent* to the purchase of the

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156 *See id.*
157 *See id.* at 1931.
158 *See id.*
159 *See id.*; *see also* Ian Giddy, *The Restructuring of The Loewen Group: Life After Death*, N.Y.U. (2004), https://pages.stern.nyu.edu/~igiddy/cases/loewen-emerge.htm/.
160 *See Alderwoods Group, Inc. – Company Profile, Information, Business Description, History, Background Information on Alderwoods Group, Inc.*, REFERENCE FOR BUSINESS (2006), https://www.referenceforbusiness.com/history2/65/Alderwoods-Group-Inc.html.
161 Lerach, *supra* note 108, at 9.
162 *Id.*
163 *See, e.g.*, Georgakopoulos, *supra* note 1, at 114–22.
164 *Id.* at 122.

security is *not* a claim 'arising from' the purchase of the security."[165] In other words, the narrow interpretation only subordinates claims that "directly concern the stock transaction itself, i.e., the actual purchase and sale of the debtor's security must *give rise* to the contested claim."[166] A narrow interpretation creates a more expansive opportunity for a greater number of private securities claims to recover in bankruptcy by confining the subordination doctrine of section 510(b) to only those claims arising from the purchase or sale of the security.[167] This would leave the door to recovery more open to other allegations commonly made in private securities enforcement, such as accounting violations, restated earnings, and other allegations about misrepresentations by management and breaches of fiduciary duties.[168]

Currently, a majority of courts have adopted a broad interpretation of section 510(b), which treats the "arising from" language differently.[169] Under this interpretation, "most claims arising from a securities transaction [are] subject to mandatory subordination, if the purchase or sale is part of the chain of events that led up to the claim."[170] This interpretation is so expansive so as to subordinate not only most securities claims arising from a purchase or sale but even "ordinary breach of contract claims so long as there is a sufficient nexus between the claim and the purchase of securities . . . ."[171] This interpretation is based on the legislative and policy rationales which produced section 510(b), as courts have consistently recognized "the legislature's intent in instituting the subordination of these securities claims in bankruptcy is to ensure that in the general bankruptcy case there will be no unexpected reallocation of risk."[172]

As previously discussed, the rationale behind preventing this unexpected reallocation of risk is protecting creditors' reliance on the legitimate expectation that their claims will be senior to the investment claims of shareholders.[173] However, the interests of creditors and shareholders have changed since the initial promulgation of

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165 *In re* Angeles Corp., 177 B.R. 920, 927 (Bankr. C.D. Cal. 1995), *aff'd*, 199 B.R. 220 (B.A.P. 9th Cir. 1996) (holding that claims arising from bad acts subsequent to the purchase of the security are not subject to subordination because they are not acts "arising from the purchase or sale" of the security).

166 *In re* Montgomery Ward Holding Corp., 272 B.R. 836, 842 (Bankr. D. Del. 2001).

167 *See* 11 U.S.C. § 510(b) (2018).

168 Ramphal, *supra* note 50, at 41.

169 Penso Trust Co. v. Tristar Esperanza Props., LLC (*In re* Tristar Esperanza Props., LLC), 782 F.3d 492, 495 (9th Cir. 2015) ("[W]e [hold] that the statute sweeps broadly . . . . Our sister circuits share our broad interpretation of § 510(b)."); *Mandatory Subordination in Bankruptcy*, Prac. Law Bankr. & Restructuring (2024), Westlaw w-002-4518.

170 *Mandatory Subordination in Bankruptcy*, Prac. Law Bankr. & Restructuring (2024), Westlaw w-002-4518.

171 *In re* Tristar Esperanza Props., LLC, 782 F.3d at 495 (citations omitted).

172 Douglas A. Henry, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259, 281 (2004); *see, e.g.*, SeaQuest Diving, LP v. S&J Diving, Inc. (*In re* SeaQuest Diving, LP), 579 F.3d 411, 422 (5th Cir. 2009) ("The policy rationales underlying § 510(b) support the result in the circuit court cases because those claimants bargained for an equity position in the debtors and never converted that equity into debt pre-petition.").

173 *See supra* Part II.A.

theories of creditor reliance.[174] Today's creditors and shareholders have more resources to evaluate a corporation's financial position and a stronger grasp of what affects solvency than when mandatory subordination was proposed.[175] Additionally, a typical class of shareholders is no longer "a small group of entrepreneurs and local investors. Shareholders are now a more broadly dispersed group. The composition of creditors . . . is largely dominated by large financial institutions."[176] As a result, the "transformation in the financial landscape of the nation calls for a review of the rule of subordination because 'the comparative abilities of the debt and equity classes to protect themselves from fraud and to represent their interests vigorously in a bankruptcy proceeding may have' changed."[177] Therefore, interpreting section 510(b) narrowly not only reflects this transformation in the financial landscape but ultimately reduces the number of securities claims subject to mandatory subordination and thereby encourages filing suit.

Those skeptical of an interpretation of section 510(b) that promotes more private securities litigation are likely concerned that it would engender the very "vexatious litigation" the court in *Blue Chip Stamps* sought to prevent.[178] However, securities class actions against insolvent corporations are more likely to implicate fruitful and meritorious claims. In an empirical study comparing private securities litigation results in bankruptcy and nonbankruptcy cases, it was found that a lower percentage of bankruptcy cases were dismissed than nonbankruptcy cases, and a higher percentage of bankruptcy cases resulted in significant settlements than nonbankruptcy cases.[179] Utilizing dismissal as proxy for what courts perceive as the merits of the case, it can be said that "[i]f the dismissal rate of a set of cases is low, it might be evidence that those cases are more likely to have merit."[180] Accordingly, the claims raised against bankrupt issuers and their management are more likely to be seeking relief from the very conduct the securities laws sought to prohibit, rather than the "vexatious" claims they may have incidentally encouraged.[181]

Reducing the number of private securities claims in bankruptcy subject to mandatory subordination reverses the general trend of constricting private rights of action under the securities laws, which restores balance to the relationship between public and private enforcement. When private rights are limited, greater pressure is placed on the SEC and other public regulators to solely enforce the securities statutes, so they "must 'take up the slack'"[182] in the enforcement. In the bankruptcy context,

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[174] *See* Henry, *supra* note 172, at 284.
[175] *See id.* at 285–86.
[176] *Id.* at 284.
[177] *Id.*
[178] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
[179] *See* Park, *supra* note 52, at 568 ("By all three measures, bankruptcy cases are more likely to end successfully than nonbankruptcy cases. A lower percentage of bankruptcy cases (18%) were dismissed than nonbankruptcy cases (33%). A higher percentage of bankruptcy cases (59%) resulted in significant settlements than nonbankruptcy cases (46%).").
[180] *Id.* at 564.
[181] *See* Aguirre, *supra* note 38, at 466.
[182] Walter, *supra* note 24.

this rings particularly true. The SEC premised its reduced participation in bankruptcy cases delineated by the Bankruptcy Code on the adequate representation of shareholders within them.[183] Evidently, the SEC's use of equity receiverships that it views as an alternative to bankruptcy indicates that it does not view shareholder interests as adequately represented in the bankruptcy process, and it accordingly must overcorrect for the limited chance private litigants stand to recover in bankruptcy.[184] Rectifying the de-prioritization of private rights through an interpretive correction of section 510(b) would theoretically lessen the need for the SEC to utilize receiverships to compensate would-be-subordinated claims by reducing the number of claims subject to subordination. This promotes a much more balanced relationship between private and public enforcement and permits private enforcers to serve as a necessary supplement to public enforcement, which is critical as private enforcers are better positioned to demand corporate governance reform in settlement.

Thus, section 510(b) has had the consequence of imposing yet another barrier to recovery for private securities litigants, whose prospects of recovering from a solvent entity are already grim as a consequence of the decisions in *Central Bank* and *Blue Chip Stamps*, as well as the passage of the PSLRA.[185] Often unable to recover from the corporation itself, plaintiffs must instead seek recovery from individuals directly responsible for the fraud, who also may be unable to satisfy a judgment.[186] Since the likelihood of recovery is slight, it is cost-ineffective for private litigants to bring a lawsuit and therefore a non-starter for revenue-seeking private litigators who file an action based on some rational calculation of the expected economic value of the suit. This is unfortunate because private securities litigation settlements frequently demand corporate governance reforms.[187] These reforms are often in the category of modification to the board structure and functioning.[188] These types of reforms are especially relevant to bankruptcy, as an independent board is best suited to effectuate the reorganization plan. Corporate governance reform has long been deprioritized in bankruptcy, to a detriment, as such reforms are empirically proven to enhance the prospects that a corporation reemerges from chapter 11.[189] A proper interpretation of section 510(b) creates the possibility of recovery for more private securities claimants and ultimately corporate governance reform by only subordinating claims arising from the purchase or sale of securities.[190] Interpreting section 510(b) in such a way will not only re-balance the relationship between public and private enforcement of

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[183] *See* Kelly, *supra* note 5, at 921–22.

[184] *See id.* at 926–27 (identifying equitable receivership as an alternative strategy allowing the SEC to compensate defrauded security holders).

[185] *See* Cent. Bank, N.A. v. First Interstate Bank, N.A., 511 U.S. 164, 176 (1994); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727, 737 (1975); *see also* Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 314 (2007).

[186] *See* Davis, *supra* note 3, at 43.

[187] *See* Lerach, *supra* note 108, at 8.

[188] *See* Ramphal, *supra* note 50, at 109.

[189] *See* Elson, *supra* note 135, at 1928–31.

[190] *See supra* Part IV.B.

the securities laws in bankruptcy but will place corporate governance reform in the conversation of business and financial restructuring in bankruptcy reorganization to promote reemergence more holistically from bankruptcy.

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