LIMITING THE SEC'S ROLE IN BANKRUPTCY

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INTRODUCTION

SEC involvement in corporate bankruptcy cases reveals weaknesses in the bankruptcy system and also raises concerns about the use of SEC resources. If the bankruptcy system is functioning properly as designed, and if the SEC is devoting its resources to the most pressing problems confronting the securities markets, then SEC involvement in corporate bankruptcies should be negligible. Instead, we see the SEC participating in many aspects of major corporate bankruptcy filings and assuming an oversight role over not just the corporate debtor, but also the bankruptcy courts and the independent United States Trustee, a branch of the Department of Justice. This officious participation in a fully functioning federal system designed to resolve financial failures in a manner consistent with important public policies is an inefficient use of federal resources and may undermine bankruptcy policies and priorities.

Of course, the SEC serves important public policies, and even bankrupt companies can affect the public securities markets in important ways.[1] When the securities markets and bankruptcy intersect, we must find ways to balance the priorities of the separate systems to reach results that advance both, or at least avoid undermining either. The balance may prove a delicate one in some instances, however, and wherever possible, the bankruptcy courts and bankruptcy system should determine the SEC's role in the reorganization of a debtor company, not the other way around.

The SEC serves the important purpose of "safeguard[ing] the public interest by enjoining securities violations."[2] The securities laws have become vital to the proper

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[1] Commentators note a variety of public purposes are attributed to the SEC. *See* Amitai Aviram & Avishalom Tor, *Overcoming Impediments to Information Sharing*, 55 ALA. L. REV. 231, 274–75 (2004) (indicating SEC's role as regulator of informational disclosure to prevent shareholder harm via negative externalities of nondisclosure); Michelle N. Comeau, *The Hidden Contradiction Within Insider Trading Regulation*, 53 UCLA L. REV. 1275, 1294–95 (2006) (stating SEC has indicated promotion of market efficiency as goal of securities regulation); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 193–94 (2006) (suggesting deterring fraud and unethical behavior as best way for SEC to accomplish primary mission of assuring investor confidence in securities markets). The central issue crystallizes around the promotion of confidence in the securities markets through regulation. *See* Robert B. Thompson, *The SEC After the Financial Meltdown: Social Control Over Finance?*, 71 U. PITT. L. REV. 567, 579–82 (2010) (observing historical role of SEC, and evolution of this mandate after 2008).

[2] Alistaire Bambach & Samuel R. Maizel, *The SEC's Role in Public Company Bankruptcy Cases Where There is a Significant Enforcement Interest*, 2005 ANN. SURV. BANKR. L. 99, 106 (quoting SEC v. Rind, 991

function of our securities markets and federal securities laws play an increasingly important role in the governance of public corporations. To excuse a public corporation from the mandates of the securities laws just because it has entered bankruptcy would be to insulate it from much of the corporate law that applies to it and may serve as an incentive for failing companies who have not yet filed to violate securities laws in anticipation of filing. When a company is in financial distress, it is crucially important that it abide by the disclosure requirements of securities laws and that its public investors be aware of the truth about its financial condition. There are ways to resolve the problem without pursuing actions against bankrupt corporations, such as continuing to hold managers accountable for the violations they caused. Further, once the company files bankruptcy, the bankruptcy system closely supervises the firm and its management, and imposes rigorous disclosure requirements.

The bankruptcy system goes a long way toward making sure that interested parties have accurate, up-to-date information about the debtor company's financial condition once bankruptcy is filed. Bankruptcy overcomes the creditor collective action problem and provides a centralized way to distribute the debtor's insufficient assets to those holding claims against it.[3] While securities in bankrupt firms can still be traded in public markets, such trading is far more limited than it is for a firm that is not in bankruptcy proceedings. Further, because there is a constant accounting of who has what interests in bankrupt firms, and debtor companies are always under the supervision of a bankruptcy court, the U.S. Trustee, and various investor committees, it is not nearly as hard to gain an understanding of a debtor's financial condition. Firms in bankruptcy are subject to far more oversight than non-bankrupt firms, and so SEC oversight becomes much less necessary. Moreover, those supervising the debtor in bankruptcy do so with bankruptcy goals and priorities in mind. They monitor the debtor in order to preserve the debtor's assets for distribution to its creditors according to the priority scheme designed specifically for the resolution of the affairs of a failed firm. That is, they monitor a bankrupt company in a manner consistent with public policies designed to respond to bankrupt companies.

To the extent the SEC monitors the monitors designated by the bankruptcy system or interferes with a distribution of corporate assets according to bankruptcy

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F.2d 1486, 1591–92 (9th Cir. 1993)); *see* SEC v. Asset Mgmt. Corp., 456 F. Supp. 998, 1000 (S.D. Ind. 1978) (positing entire point of SEC enforcement is to guard public interest against securities infractions); SEC v. Petrofunds, Inc., 420 F. Supp. 958, 960 (S.D.N.Y. 1976) (citation omitted) (observing principal reason for SEC enforcement action is to ensure public welfare by preventing breach of securities laws).

[3] *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 4–5 (1986) (describing one purpose of bankruptcy law as allowing creditors to use assets in way most efficient to them as group while dealing with incentives of individual creditor's selfish goals); David Arthur Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 525–26 (1992) (discussing centralization of creditor functions as key to enabling chapter 11 committees to solve collective action problems); Matthew L. Iwicki, Note, *Accounting for Relational Financing in the Creditors' Ex Ante Bargain: Beyond the General Average Model*, 76 VA. L. REV. 815, 821 (1990) (arguing bankruptcy may be necessary to overcome collective action problem to allow use of debtor's assets).

principles and concerns, it risks undermining the bankruptcy system and adding confusion to an already complicated ordeal. SEC efforts should not be duplicative of the work of the U.S. Trustee, the bankruptcy courts, the debtor, the creditors' committee, other ad hoc investor committees, or the examiner. Not only does the SEC have more important work to do on companies that have not yet died, but they are not likely to do the jobs of bankruptcy professionals better than those with more bankruptcy-specific experience and more intimate knowledge of the debtor and the debtor's circumstances. The bankruptcy system should be left to do its best under the mandates of the Bankruptcy Code and the SEC should be available to help within its areas of expertise when asked, but otherwise refrain from taking an active role in corporate bankruptcy cases.

The fact that the SEC has found so much to do with bankrupt companies exposes serious holes in the bankruptcy system. There must be serious concerns that examiners and bankruptcy judges are not doing a good job ensuring that the debtor's financial disclosures are accurate and complete. If the U.S. Trustee and bankruptcy courts are not providing sufficiently strong oversight to prevent debtors from inappropriately releasing officers and directors from their obligations on claims for violations of the securities laws,[4] then the bankruptcy system is not operating as it was designed to. Given the amount of supervision bankruptcy law places over a corporate debtor, if the SEC needs to step in to monitor further, then that says more about what's wrong with bankruptcy than it does about what a healthy role for the SEC would be.

Part I of this essay explains the stated purposes of the SEC and the Bankruptcy Code. It covers what the SEC is supposed to do and what its policy objectives are in enforcing the securities laws against both individuals and companies. It also briefly describes the goals of corporate bankruptcy and some of the reasons for the design of the current system. Part II looks at SEC enforcement actions against corporate debtors. We must not only consider what kinds of violations inspire SEC action against a company that has filed bankruptcy, but also why certain actions are brought and why the SEC pursues certain kinds of remedies. Part II argues that the SEC should not pursue actions against companies in bankruptcy and suggests that the bankruptcy system be responsible for dealing with corporate securities law violations once the company has filed. It suggests that the SEC instead focus its energies on pursuing the corporate officers and directors who caused the corporation to violate the securities laws. Their violations are the important concerns, and consistent punishment of those infractions is more likely to deter future wrongdoing and provide appropriate incentives. Part III offers suggestions for the future of the relationship between the SEC and the bankruptcy system. It

[4] *See In re* Cont'l Airlines, 203 F.3d 203, 205 (3d Cir. 2000) (reversing lower court's approval of officer and director release from claims in restricting plan); *see also* Clifford J. White, III, *Civil and Criminal Contempt in Bankruptcy Court*, U.S. ATTORNEYS' BULLETIN 57, 57–60 (August 1999), *available at* http://www.justice.gov/usao/eousa/foia_reading_room/usab4704.pdf (discussing bankruptcy court's power to hold parties in contempt for noncompliance with court orders).

proposes guidelines for the involvement of the SEC in bankruptcy cases and also suggests ways the bankruptcy system can operate more effectively so that the SEC does not need to intervene.

I. PURPOSES OF THE SEC AND BANKRUPTCY

Despite the fact that corporate law is largely considered the province of the states, the federal laws governing bankruptcy and securities regulation have become part of the corporate law. Companies must abide by the securities laws at all times, and those regulations often define a firm's interaction with the investing public. Bankruptcy and the framework it provides are significant concerns for companies in any kind of financial distress and often shape a company's decisions during such times whether or not the firm files for bankruptcy protection.

When a firm subject to securities laws enters bankruptcy, it must still abide by securities regulations, and the bankruptcy filing does not affect its liability for violations of those regulations.[5] At this point, the interaction of securities laws and bankruptcy law becomes salient. The SEC must still enforce securities law violations, but parties in interest in the bankruptcy case have concerns that may conflict with the SEC's position. The purposes behind bankruptcy laws often drive their interpretation and enforcement by a bankruptcy court during a case. Further, a bankruptcy case is a complex interaction between a number of parties, all fighting for the same very limited assets, under the supervision of a bankruptcy judge and the U.S. Trustee. The SEC may want to bring an enforcement action that would result in a payment of the debtor's assets to the SEC, and that may cause other constituents with claims against the debtor's assets to object.[6] The purposes animating the SEC's enforcement of securities laws matter to how the SEC decides to proceed, and the purposes of bankruptcy law may determine how a bankruptcy court resolves disputes or reacts to the SEC's involvement in a case.

The SEC was created to "maintain[] the integrity of [U.S.] securities markets."[7] It represents the interests of investors in those markets by promoting the public interest in maintaining honest, well-functioning securities markets.[8] The SEC is

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[5] Section 362(b)(4) of the Bankruptcy Code exempts from the automatic stay actions brought by governmental units to enforce their police and regulatory power and judgments, other than money judgments, obtained in such enforcement proceedings. 11 U.S.C. § 362(b)(4) (2006).

[6] *See* SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003) (positing SEC penalty imposed on debtor, despite shareholder objection, is fair and reasonable under circumstances); *see also* SEC v. Fischbach Corp., 133 F.3d 170, 171–72 (2d Cir. 1997) (affirming lower court's judgment dismissing corporate stakeholders challenge of SEC's disgorgement action); SEC v. Wang, 944 F.2d 80, 88 (2d Cir. 1991) (noting purpose of disgorgement is to prevent unjust enrichment of those guilty of securities fraud, and decision to do so is initially left to discretion of SEC).

[7] Bambach & Maizel, *supra* note 2, at 99 ("The [SEC] protects investors and maintains the integrity of the securities markets through its role as the protector of the interests of public investors.").

[8] *See* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 42–45 (2007); *see also* Bambach & Maizel, *supra* note 2, at 99 ("The [SEC] protects investors and maintains the integrity of the securities markets through its role as the protector of the interests of public investors.").

supposed to promulgate securities regulations and enforce those regulations and the underlying securities laws in order to protect investors in American companies from dishonesty or fraudulent conduct that might undermine the integrity of the markets or expose the markets to the risk of significant failure or collapse.[9] In doing so, the SEC's main function is to punish violations so that they are effectively deterred. That usually means requiring wrongdoers to disgorge their gains.[10] If securities violations are not strictly enforced when they are discovered, the entire system could be seriously undermined because violations are often very difficult to find in the first place.[11] The low probability of discovery must correspond to a much higher probability of severe punishment if caught in order for violations to be effectively deterred. If the SEC were not able to enforce securities laws across a bankruptcy filing by either a company or its individual officers and directors, then compliance with the laws would break down in anticipation of possible bankruptcy filings, or with the knowledge that bankruptcy could be filed in the event a violation is detected. That would undermine a significant market protection by removing some of the incentive for companies to make honest disclosures about their financial well-being when that information would be essential to investors.

Nevertheless, the world changes significantly for a company in bankruptcy, and there are new priorities to consider and new systems in place to protect the rights of a few remaining investors. While securities laws still apply to companies in bankruptcy, and pre-bankruptcy violations of securities laws can still be subject to enforcement actions within or after bankruptcy,[12] bankruptcy law is not designed to protect the securities markets. It is designed to facilitate the orderly distribution of very limited assets to a firm's claimants according to a sensible priority system. A company is very closely supervised while under bankruptcy protection. Just about every major decision the debtor makes about its business must be approved by the bankruptcy court.[13] The U.S. Trustee's office oversees the case and ensures that required disclosures and financial statements are filed and that the debtor abides by relevant bankruptcy law.[14] The bankruptcy court may appoint an examiner to investigate the firm's financial affairs, business practices, and capital structures.[15]

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[9] *See* Tafara & Peterson, *supra* note 8, at 42–45 (explaining SEC's legislative mandate).

[10] *See Fischbach Corp.*, 133 F.3d at 175 (authorizing disgorgement remedy for securities violation); *In re* Adelphia Commc'ns Corp., 327 B.R. 143, 162 (Bankr. S.D.N.Y. 2005) (explaining equitable remedy after securities violation); Bambach & Maizel, *supra* note 2, at 100–01 (stating SEC's right to use disgorgement remedy).

[11] *See* Jonathan R. Macey, *The Distorting Incentives Facing the U.S. Securities and Exchange Commission*, 33 HARV. J.L. & PUB. POL'Y 639, 646–48, 651, 667 (2010) (describing SEC's lack of resources as primary reason for failure to find violations and explaining SEC's use of fines to measure its success).

[12] *See* 11 U.S.C. § 362(b)(4) (2006) (exempting governmental enforcement actions from automatic stay); *id.* § 523(a)(19) (exempting obligations arising from violations of securities laws from discharge in personal bankruptcies).

[13] *See, e.g.*, *id.* §§ 327, 363, 364 (noting trustee's involvement in hiring employees on behalf of debtor, trustee's ability to sell business-related property, and trustee's ability to obtain credit on behalf of business).

[14] *See* 28 U.S.C. § 586 (2006) (defining trustee's responsibilities in administration of cases).

[15] *See* 11 U.S.C. § 1104(c) (authorizing court to appoint examiner over debtor's reorganization plan); *see also Bankruptcy Basics – Chapter 11, Reorganization Under the Bankruptcy Code*, U.S. COURTS,

Financial disclosures are an essential part of any bankruptcy case, and the case begins with very detailed disclosures so that the court and all parties in interest know the extent of the debtor's obligations and to whom the debtor owes money. While the government may still enforce non-bankruptcy laws against a bankrupt debtor and its management, the central purpose of bankruptcy is to reorganize the claims against the debtor in an equitable way that allows the company to move forward to become productive again while honoring the claims against it to the extent possible according to a very intentional and purposeful priority scheme. Companies in bankruptcy are much less likely to harm the securities markets than companies outside of bankruptcy protection because the bankruptcy case is relatively well-contained and very carefully supervised by a number of neutral parties. So many other protections are in place that render the debtor itself relatively harmless.

Before the SEC decides to bring an enforcement action against a bankrupt company or becomes very involved in the supervision of a bankruptcy case, it should determine whether SEC action is really necessary, that is, whether its purpose is advanced by interceding. Where the SEC may disrupt bankruptcy goals of distribution according to the absolute priority scheme or may interfere with the functioning of the bankruptcy system by second-guessing the professionals responsible for supervising a case, it is imperative that it make sure that it is absolutely necessary to do so, that is, that the market will be at risk otherwise. As the next Part argues, it is not always clear that SEC intervention is necessary or helpful once a corporation has filed for bankruptcy.

II. SEC ENFORCEMENT ACTIONS AGAINST CORPORATE DEBTORS

One example of an instance in which the SEC is far too involved in the bankruptcy process is the enforcement of securities violations against corporate debtors. In this Part, I argue that bringing enforcement actions against bankrupt corporate debtors is a bit like shooting fish in a bucket.[16] It is not hard to discover securities violations in bankrupt companies, and it is also not very helpful because such companies are now being closely supervised by the bankruptcy system and are unlikely to pose a future threat to the financial markets the SEC is responsible for protecting. Such enforcement actions only disrupt the bankruptcy case and add complexity and confusion to an already challenging process. SEC enforcement resources should be used where they can do more to protect the financial markets from firms that pose much greater risks.

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http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx#role (last visited Nov. 19, 2010) ("The appointment of an examiner in a chapter 11 case is rare.").

[16] The idiom is, of course, "fish in a barrel." I change it here to emphasize the point that a bankrupt firm's activity is particularly constrained.

A. What the SEC Does with Bankrupt Companies

A study conducted by the Deloitte Forensic Center in 2008 reveals that bankrupt firms are three times as likely to have an SEC enforcement action filed against them than non-bankrupt firms, and that those enforcement actions are usually brought *after* the bankruptcy filing.[17] That seems to indicate that the SEC is looking to an obvious place for companies that may have misstated financial disclosures or committed other frauds—firms that have failed. The bankruptcy docket may prove fertile when hunting for firms that may have committed securities fraud, but because enforcement actions tend to be brought after the bankruptcy filings instead of before, that seems to indicate that the damage to the market and investors in the firm has already been done. The firm that committed the violations is no longer a threat; chances are, its management personnel has already changed significantly,[18] its stock is no longer publicly traded, and it is being closely monitored by a bankruptcy court, the U.S. Trustee, secured creditors, an unsecured creditors' committee, probably an examiner, and maybe a bankruptcy trustee. It's hard to see what "benefit" the company could be enjoying from its prior frauds. It is even harder to see how a bankrupt *company* could be unjustly enriched if it is not punished for its prior fraud. Bringing these actions might make it look like the SEC is operating effectively because they are discovering fraud,[19] but the litigation against bankrupt companies also belies a poor expenditure of resources on enforcement actions that are unlikely to bring a substantial recovery rather than on those that are more likely to protect the market from the greatest risk of harm.

According to the Deloitte study, the SEC enforcement actions brought most often against bankrupt companies are for revenue recognition, manipulation of expenses and other financial data, and improper disclosures.[20] These violations center around a theme of hiding the firm's true financial condition, and so financial problems, from the market. Such violations are grave indeed, but it would be much better for the market if they could be discovered as they are happening and before the company in question finishes crashing. Of course, such discovery is very difficult.[21] The SEC must believe, rightly in many instances, that a firm that files bankruptcy has a greater likelihood than non-bankrupt firms of having misstated its financial condition recently. The fish now in the bucket, it would be a shame to let it go.

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[17] DELOITTE FORENSIC CENTER, TEN THINGS ABOUT BANKRUPTCY AND FRAUD: A REVIEW OF BANKRUPTCY FILINGS (2008), http://www.bankruptcyfraud.typepad.com/Deloitte_Report.pdf.

[18] *See* A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 MINN. L. REV. 875, 915 (2009) (reporting empirical data showing most top-level officers replaced before bankruptcy filing or shortly thereafter).

[19] *See* Macey, *supra* note 11, at 644 (arguing number of cases and fines levied are part of SEC's strategy to "maximize its appeal to Congress").

[20] DELOITTE FORENSIC CENTER, *supra* note 17.

[21] *See* Macey, *supra* note 11, at 667 (acknowledging discovering fraud is extremely difficult despite hard work and good faith efforts of SEC).

In cases where the SEC identifies a significant enforcement interest, it monitors the debtor corporation very carefully.[22] In this capacity, it has the potential to add value to the bankruptcy case by ensuring the accuracy of financial disclosures and participating in selecting the creditors to serve on the creditors' committee and deciding whether an equity committee is warranted.[23] In many instances, the SEC acts as another set of eyes, making sure that the conduct of the debtor's affairs and plan of reorganization are consistent with the requirements of the securities laws.[24] In others, the SEC may increase the litigation in the case by bringing actions to recover penalties,[25] or by objecting to professionals chosen to participate in the case,[26] or by objecting to parts of the plan.[27] This additional litigation may be helpful as the SEC may prevent problems with the case or may identify problems other monitors may miss.

The next section of this Part argues that the SEC should not bring enforcement actions against bankrupt corporations for securities violations that occurred before the bankruptcy filing. Individuals cause corporations to violate the securities laws, and by the time a company has filed bankruptcy, it has failed in significant ways and will never be exactly the same again. The bankruptcy filing submits the corporation to close supervision and brings its managers to account before all parties in interest, a bankruptcy court, and a branch of the DOJ dedicated to supervising the bankruptcy system. It is no longer a threat to the public, and those individuals who are responsible for causing the violations can be relatively easily found and held accountable. The bankruptcy system should be well equipped to respond to problems that might still pose a threat to "society" and the markets raised by companies that violate the securities markets. To the extent it cannot, the bankruptcy system should improve. The SEC should not become more involved.

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[22] *See* Bambach & Maizel, *supra* note 2, at 99.

[23] *See id.* at 100 (explaining how SEC aids U.S. Trustee to be sure investors are represented in bankruptcy, review creditors' committee, and make recommendations regarding necessity for equity committee).

[24] *See id.* at 109 (highlighting SEC's role in proposal of plan of reorganization and disclosure statements to ensure compliance with securities law).

[25] *See, e.g.*, SEC v. Brennan, 230 F.3d 65, 67–68 (2d Cir. 2000) (showing SEC initially brought action in 1984 and litigation continued through 2000); SEC v. Fischbach Corp., 133 F.3d 170, 173 (2d Cir. 1997) (initiating action in 1988 to recover profits gained through fraud); SEC v. Rind, 991 F.2d 1486, 1488 (9th Cir. 1993) (commencing civil enforcement action when defendant allegedly engaged in securities fraud and recordkeeping violations); SEC v. Manor Nursing Ctr., 458 F.2d 1082, 1088, 1106 (2d Cir. 1972) (bringing litigation with regard to alleged violations of anti-fraud provisions in order to temporarily freeze appellants' assets); SEC v. Huff, No. 08-60315, 2010 WL 3860721 at *1–2 (S.D. Fla. Sept. 30, 2010) (contending defendant recorded millions of dollars in "bogus Letters of Credit" as assets); SEC v. Conaway, 697 F. Supp. 2d 733, 736 (E.D. Mich. 2010) (filing motion for remedies seeking disgorgement of defendant's $5 million retention loan); SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 432 (S.D.N.Y. 2003) (bringing securities fraud suit and seeking to stabilize and reorganize company).

[26] *See, e.g., In re* First Jersey Sec., Inc., 180 F.3d 504, 507 (3d Cir. 1999) (noting SEC involved in process of selecting professionals responsible for implementation of reorganization plan).

[27] *See, e.g.*, Objection of the U.S. Securities and Exchange Commission to the Confirmation of the Debtors' Joint Plan of Reorganization, *In re* Charter Commc'ns, Inc., No. 09-11435 (JMP) (Bankr. S.D.N.Y. July 13, 2009), *available at* http://www.kcclc.net/documents/0911435/0911435090713000000000014.pdf (challenging plan, which potentially releases nondebtors from liability to creditors).

B. Why the SEC Should Not Be So Involved

Too much activity by the SEC in corporate bankruptcy poses two significant problems. First, it diverts SEC resources from more useful enforcement work. It is more important that the SEC discover violations among companies that have not yet surrendered to bankruptcy court supervision and reorganization by their creditors. Non-bankrupt firms pose a much greater threat to the market and their violations are harder to discover, so they require a greater investment of SEC time and resources.[28] Those resources should be spent where they are most needed and will do the most good. Second, SEC enforcement actions in bankruptcy and SEC supervision of a bankrupt company can interfere with the operation of the bankruptcy system and so exact costs without contributing to the successful reorganization of a bankrupt firm. A payment to the SEC on an enforcement action diverts scarce debtor assets from the debtor's creditors without necessarily compensating those who lost money on account of the violation or advancing the SEC's enforcement goals.[29] The SEC may compensate victims with the recovery, but is not seeking to recover monetary damages on behalf of those victims.[30] Even if victims are compensated, the individuals responsible for the violation have not necessarily been held accountable or deterred from future violations by the punishment of the bankrupt corporations. The SEC can thereby directly undermine bankruptcy goals without advancing its own stated purposes.

1. The SEC Should Not Pursue Actions Against Corporate Debtors

If the SEC were to focus solely on enforcing securities laws and prosecuting violations, it may find that actions against corporate debtors for past violations are not necessarily very fruitful.[31] In bringing enforcement actions against companies that have violated the securities laws, the SEC seeks disgorgement of ill-gotten gains and/or other civil penalties.[32] The penalties are determined either by the financial gain the defendant realized from the violation at issue or are set as a "per violation" penalty.[33] The stated purpose of prosecuting a company for violating securities laws is to "deter violations of the securities laws, not to compensate investor losses."[34] A company cannot be deterred. A company acts through those

[28] *See* Macey, *supra* note 11, at 640–41 (2010) (explaining fraud is difficult to discover and prove).

[29] *See* Bambach & Maizel, *supra* note 2, at 102 (showing disgorgement as example in which investor losses not compensated).

[30] *See id.* at 102, 105 (noting compensation of fraud victims is secondary goal).

[31] If relevant metrics are number of cases brought and recovery realized, bringing actions against bankrupt companies may enhance the former, but not the latter. *See* Macey, *supra* note 11, at 646–47 (pointing out SEC is rationally responding to incentives leading to suboptimal results).

[32] *See* Bambach & Maizel, *supra* note 2, at 108 (positing SEC considers many factors when pursuing disgorgement or penalties against companies).

[33] *Id.* at 101–02 (explaining corporations or individuals can be charged statutory amount per violation or by total monetary gain of defendant at victim’s expense).

[34] *Id.* at 102 (citing SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997)).

controlling it. Humans can be deterred. It may make sense to keep a company from keeping ill-gotten gains if the company is otherwise financially viable so that investors cannot keep value that was fraudulently or inappropriately obtained and managers cannot receive bonuses based on gains the company should not have realized. It makes less sense to punish a company that way if the company is deeply insolvent and has submitted to reorganization in bankruptcy. In that instance, we no longer need to worry that the company is enjoying inappropriate wealth or financial success. Whatever gains were had have been long since lost. The bankrupt company is one that does not pose a significant threat to society through the security markets, so the SEC should not devote significant time and resources to pursuing enforcement actions against those corporations.

One may argue that it makes sense to bring enforcement actions against bankrupt companies because a successful action would move money from creditors to shareholders or from the creditors to the government, and that might give creditors an incentive to monitor the managers of troubled companies more carefully.[35] Creditors already have very strong incentives to do what they can to ensure the accuracy of a company's financial statements as they are relying on those disclosures in lending their capital. While forcing them to essentially pay the company's penalty in an SEC enforcement action by lowering the amount they can collect on their claims, we might give them even stronger incentives to monitor. That may be true, but the enforcement action is only worth pursuing if the value of the added deterrence exceeds the costs associated with pursuing the litigation. Given that the creditors stand to lose so much from the debtor's collapse if the debtor is able to conceal its true financial condition from them, it is doubtful that an enforcement action brought against the company would add meaningful incentives to monitor even more, such that the additional incentives would overcome the costs associated with the litigation, particularly as that litigation would disrupt the bankruptcy case and a significant portion of any monetary recovery may be left unpaid.

2. Focus Enforcement Efforts on Officers and Directors

Still, officers and directors responsible for the company's violations should be punished. It should not be difficult to keep them from recovering from the corporation they caused to violate the securities laws. This is a significant concern

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[35] I am indebted to Professor Barry Adler for bringing this point to my attention. The argument is a standard law and economics point about assignment of the risk of loss to the party best able to avoid it. *See* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 7–8 (Denise Clinton ed., 5th ed., Pearson 2008) ("A rule for [making future behavior more efficient] assigns the losses to the party that could have borne the risk at less cost."). When a company is in financial distress, its creditors are in the best position to monitor its management. *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1211 (2006) (finding loan covenants can give creditors "de facto control rights—such as replacing the CEO of a company—that shareholders of a public company simply do not have").

of the SEC in pursuing enforcement actions against companies—that the managers responsible for the violation will be able to recover more than they ought to from the bankruptcy estate.[36] Where this is a serious concern, two remedies are possible. First, the guilty officers and directors could be prevented from recovering anything from the bankruptcy estate. That result might be extreme because the company may owe officers and directors legitimately earned salary. Second, and perhaps more plausibly, in its enforcement action against the responsible individuals, the SEC could simply recover the ill-gotten gains from the individuals themselves. That still makes more sense than pursuing the corporation directly for its violations because it holds accountable those actually responsible for the infraction, thereby achieving the stated goal of deterrence.

Jonathan Macey argues that the SEC pursues enforcement actions against corporations more than individuals because corporations are more likely to settle insofar as their managers are more likely to cause the firm to settle to avoid suits against them personally.[37] He argues that the SEC prefers quick settlements: it is "largely judged on the basis of the number of cases it wins."[38] Further, because companies are more likely to settle than put up a rigorous defense, it is much less expensive to pursue companies than individuals.[39] The bankruptcy process changes this cost/benefit calculation. In bankruptcy, the debtor corporation would not settle so quickly because many more parties in interest want to prevent the company from having to pay the enforcement penalty. Estate representatives, either management or the trustee, will want to preserve the estate for the benefit of creditors, and creditors themselves will try to keep the SEC from recovering from the estate. The benefits of pursuing the corporation rather than the responsible individuals diminish in bankruptcy, and so does the purpose of SEC enforcement.

3. Concerns About Enhanced Monitoring

SEC enforcement of securities violations in bankruptcy leads to the SEC's enhanced monitoring of the debtor in an effort to prevent future violations.[40] If the bankruptcy system functioned better, SEC monitoring might not be necessary within a bankruptcy case. For instance, the SEC will "assess whether public investors are fairly represented in [the] case . . . [,] will assist the Office of the U.S. Trustee [] in the selection of creditors to sit on the official committee of unsecured creditors . . . [,] will evaluate the debtor's financial condition to ensure that it is viable on a going forward basis . . . [, and] will determine whether an equity

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[36] *See* Bambach & Maizel, *supra* note 2, at 103 (describing SEC power to move to declare debts of bad actors non-dischargeable pursuant to 11 U.S.C. § 523(a)(2)(A) (2006)).

[37] Macey, *supra* note 11, at 646 (citing Zachary Kouwe, *Judge Rejects Settlement Over Merrill Bonuses*, N.Y. TIMES, Sept. 14, 2009, at A1).

[38] *Id.*

[39] *See id.* (suggesting SEC litigation expenditures are less with corporations than with individuals).

[40] *See* Bambach & Maizel, *supra* note 2, at 99–100 (reporting potential SEC involvement throughout every stage of bankruptcy case).

committee should be formed."[41] The SEC may keep an eye on the debtor's transactions with employees and carefully review proposed key employee retention plans.[42] These are all functions that are supposed to be performed by professionals within the bankruptcy system.

For instance, the parties the SEC seeks to represent in bankruptcy are often already well-represented there. It is not clear why the SEC would have better judgment about which creditors should serve on the creditors' committee than the U.S. Trustee does. The debtor has revealed which creditors hold the largest claims against it in its schedules upon filing and those creditors, through their lawyers, argue for spots on the creditors' committee. Bondholders are represented in that fight, and then on the committee, by counsel for the indenture trustee. Indenture trustees often serve on creditors' committees. Significant shareholders are likewise represented by counsel if they have interests they want to advance in the case.[43] Shareholders often manage to have an equity committee appointed even when the corporation is likely insolvent.[44] A bankrupt corporation's stock is not traded publicly. No one party in interest relies on the SEC for representation in bankruptcy, and the investing public is not implicated in the life of a bankrupt company the same way it is in the life of a solvent firm.

Bankruptcy offers a number of protections for investors by providing neutral parties to carefully monitor and/or control the debtor during the bankruptcy case. An examiner is appointed in the bankruptcies of major companies upon the motion of a party in interest.[45] The examiner is responsible for investigating any allegations of wrongdoing or fraud or any kind of mismanagement or financial irregularity in the affairs of the debtor.[46] That means the Bankruptcy Code has provided for the appointment of a neutral party to report to the bankruptcy court about exactly the kinds of issues the SEC is concerned with when monitoring a corporate debtor. Further, section 1104(e) of the Bankruptcy Code, added in 2005, requires that the U.S. Trustee move for the appointment of a chapter 11 trustee whenever there are "reasonable grounds to suspect that current members of the governing body of the debtor . . . participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."[47] When there are concerns that a debtor corporation may still violate securities laws, the U.S. Trustee must move for the appointment of a trustee to manage the debtor's affairs in bankruptcy. The chapter 11 trustee should be able to be as effective, if not more

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[41] *Id.* at 100.

[42] *See id.* at 107.

[43] *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 194–95 (1990) (asserting shareholders often share in distribution of assets due to "quality and aggressiveness of [] representation").

[44] *See id.*

[45] *See* 11 U.S.C. § 1104(c) (2006) ("[A]t any time . . . on request of a party in interest . . . the court shall order the appointment of an examiner.").

[46] *See id.* (explaining examiner shall conduct investigation of allegations of "fraud, dishonesty, incompetence, mismanagement, or irregularity" by debtor).

[47] *Id.* § 1104(e).

effective, in bankruptcy as a corporate monitor appointed by the SEC, particularly when working in concert with an examiner. These monitoring tools are available to debtors that are at high risk of violating securities laws. Of course, such debtors also operate under the close supervision of the bankruptcy court and the watchful eye of very active creditors.

A bankruptcy reorganization tends to be a negotiation among known parties over readily identifiable assets. To the extent there are concerns about investor behavior, the debtor is interested and observing it as are lawyers representing other investors and parties in interest. The U.S. Trustee's office is also monitoring debtor and creditor behavior. Parties identifying problems within the case do not hesitate to bring motions before a serious and attentive bankruptcy court. A bankruptcy case does not suffer for lack of monitoring, so the SEC's scarce resources need not be expended monitoring bankruptcy cases.

III. SUGGESTIONS FOR THE FUTURE

The SEC claims that its goal in participating in bankruptcy cases is "for the protection of the integrity of the bankruptcy process for victims and for security holders to ensure transparency of the debtors' operations during the bankruptcy case."[48] There are problems with both parts of that stated goal. First, the SEC is supposed to be enforcing the law by pursuing recovery for violations by a now-bankrupt company. It claims to seek disgorgement as a form of deterrence.[49] To the extent it is seeking to recover compensation for "victims," it would be subject to the automatic stay and have to act like other creditors seeking to recover damages.[50] Second, the bankruptcy court and U.S. Trustee, as primary monitors of the debtor, are supposed to "ensure transparency of the debtors' operations during the bankruptcy case."[51] The Bankruptcy Code provides many requirements for disclosures by a debtor and requires the debtor to seek court approval of activities outside of the ordinary course of business.[52] The Code also allows the bankruptcy court, the U.S. Trustee, and other parties in interest to raise problems with the debtor's case.[53]

The debtor's operations are very transparent in bankruptcy, at least to the parties responsible for monitoring them. If they are not and important details are kept from the court and other parties in interest, then that reveals serious problems with the bankruptcy case that the court and U.S. Trustee should address. The fact that the SEC feels a need to participate so extensively in bankruptcy cases and supervise the

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[48] Bambach & Maizel, *supra* note 2, at 101.

[49] *See id.* at 105 (citing SEC v. Rind, 991 F.2d 1486, 1490 (9th Cir. 1993)) (discussing theory underlying pecuniary remedy of disgorgement).

[50] *See id.* at 101 (citing 11 § U.S.C. 362(b)(5) (2006)) (noting enforcement of money judgment is subject to automatic stay).

[51] *Id.*

[52] *See, e.g.*, 11 U.S.C. §§ 327, 363, 364 (outlining circumstances for required disclosure).

[53] *See id.* § 1109 (noting SEC, trustee, or any party in interest may raise issue with case).

process of some cases so carefully means that there must be gaps in how the bankruptcy system is operating. The Bankruptcy Code calls for the kind of oversight the SEC has been providing without carving out a role for the SEC. If the SEC feels the need to suggest the appointment of a corporate monitor for a firm that has violated the securities laws, then a bankruptcy trustee should be appointed to administer the case. A request for a corporate monitor[54] implies a fear that the debtor will continue to violate the securities laws. This, in turn, suggests that individuals who have or would either participate in or acquiesce in a violation of securities laws remain in positions of power in the debtor. This is a problem bankruptcy addresses through the appointment of an examiner and the appointment of a trustee.[55] In fact, the U.S. Trustee is required to move for the appointment of a trustee if such a concern exists.[56]

The concerns of the SEC in bankruptcy perhaps reveal that bankruptcy courts are too hesitant to appoint trustees in difficult chapter 11 cases. The appointment of a chapter 11 trustee is rare and is seen as a last resort in the most hopeless cases.[57] In cases where the SEC has a significant enforcement interest, it is hard to see why a trustee would not be required. Such debtors have such troubled histories and have at least incompetent, if not dishonest or fraudulent managers. The Code requires the appointment of a trustee in those instances. If a trustee were appointed, it would be able to do a lot of the work the SEC does in bankruptcy now. The SEC's work in the bankruptcy cases of some particularly troubled companies reveals a serious gap in the governance of those companies in bankruptcy. The hesitance of courts to appoint trustees makes SEC involvement necessary and is contrary to the will of Congress as expressed in the Bankruptcy Code.

It is better to appoint a chapter 11 trustee than to rely on SEC oversight for several reasons. First, the SEC has better things to do than monitor bankrupt companies. We are already investing time and resources in a federal bankruptcy system. It should not need to rely on another part of the federal government to do its job. The SEC should be focusing its attention to those who pose a serious current threat to the securities markets. Second, a chapter 11 trustee can become intimately acquainted with all aspects of a company and has the bankruptcy experience necessary to guide the company through the reorganization. Third, because the chapter 11 trustee is a neutral party, it works to preserve the estate for the benefit of creditors and not trying to recover on behalf of one entity. If the bankruptcy system cannot appropriately manage cases without the SEC's

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[54] Former SEC Chairman Richard Breeden was appointed corporate monitor in the Worldcom case. M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1605 (2007).

[55] 11 U.S.C. § 1104 (explaining circumstances for appointment of trustee or examiner).

[56] *Id.* § 1104(e) (mandating appointment of trustee when "reasonable grounds to suspect . . . actual fraud, dishonesty, or criminal conduct" exist).

[57] *See In re* W.R. Grace & Co., 285 B.R. 148, 158 (Bankr. D. Del. 2002) (recognizing appointment of trustee must be considered "last resort"); John D. Ayer, *Through Chapter 11 With Gun or Camera, But Probably Not Both: A Field Guide*, 72 WASH. U. L.Q. 883 (1994), *reprinted in* CHARLES J. TABB, BANKRUPTCY ANTHOLOGY 670 (2002) (noting Code permits debtor in chapter 11 to remain in possession).

intervention, then that does not bode well for the many in cases in which the SEC does not have, or does not realize it has, an enforcement interest.

Going forward, the SEC should alert the bankruptcy court to problems it sees so that the debtor, the U.S. Trustee, the court, and interested parties can respond accordingly. Courts should not hesitate to appoint chapter 11 trustees in cases in which the SEC thinks it has a significant enforcement interest. That use of the chapter 11 trustee was contemplated by Congress when it amended the Bankruptcy Code in 2005 and shows a clear preference for bringing problems identified in the securities markets within the control of the bankruptcy system once a company files. The Bankruptcy Code and resulting bankruptcy system are well-equipped to deal with the problems faced by corporate debtors, even those corporate debtors who have violated the securities laws. Once a company files bankruptcy, the SEC should step back and allow the bankruptcy system to work as it was designed to. That requires, however, that the bankruptcy system do its job and use the tools at its disposal to adequately monitor the debtor and those controlling it in bankruptcy.