THE SEC IN BANKRUPTCY: PAST AND PRESENT

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On October 8, 2010, the American Bankruptcy Institute Law Review and the St. John's Center for Bankruptcy Studies held their symposium, entitled "The SEC in Bankruptcy: Past, Present and Future." Alistaire Bambach participated in the first panel, entitled "Past and Present," of which an abridged transcription of her remarks follows.

INTRODUCTION

Thank you very much and thank you for inviting me.

We have a small group of dedicated bankruptcy lawyers who work at the Securities & Exchange Commission ("SEC" or "Commission"): fewer than 20, including about four appellate lawyers. I was once an active trial lawyer, and tried securities fraud cases after I was at a major law firm in the corporate reorganization and litigation areas. I was asked to run the bankruptcy program for the Division of Enforcement around 2001, and, at that time, I was allowed to hire some new people, and to actually take part in crafting what the program would look like.

I would like to discuss three important areas. The first is the Commission's traditional role in the corporate reorganization area, and the present duties of the staff therein. The second is our role in enforcement cases, which occupies at least 80 or more percent of my time and comprises the bulk of the work in the bankruptcy and insolvency arena. And the third area I would like to discuss dovetails with Douglas Baird's article[1] because it is a discussion of federal court equity receiverships, which is an alternative regime used to distribute funds to defrauded investors.

I. THE COMMISSION'S ROLES IN CORPORATE REORGANIZATIONS AND ENFORCEMENT CASES

First of all, under the Bankruptcy Act, the Commission had substantial oversight of public company cases, including acting as party in each case, doing valuations, providing oversight, and reviewing, approving and structuring reorganization plans. When the Bankruptcy Code was enacted, the Commission's traditional role was sharply curtailed. And yet I would note that, under the new

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[1] Douglas G. Baird, *Present at the Creation: The SEC and the Origins of the Absolute Priority Rule*, 18 AM. BANKR. INST. L. REV. 591 (2010).

statute, section 1109,[2] the Commission can be heard on any issue in a case in chapter 11, and not necessarily just in a public company case. We do not have the right to appeal, but if an issue needs to be heard on appeal, we can have our views heard as an amicus. When I took responsibility for handling the corporate reorganization program in the New York Regional Office, having come from a large corporate reorganization practice, I believed that the Commission's traditional position was to protect shareholders. But with the burgeoning sales of corporate debt to ordinary investors, it was clear that our responsibility should be to protect public investors as a whole, which was consistent with the Commission's policies and priorities. And so, in my office's review of plans and disclosure statements, we look out for the interest of public bondholders as well; and in many cases, we have been very active in a number of chapter 11 cases where the action was at the corporate debt level rather than the equity level. I note that, in my view, our traditional role was always to protect the interests of public investors, whether debt or equity.

The Commission remains very active in the corporate reorganization program. We try to review each public company chapter 11 plan that is filed. We may not appear in the case, you may not hear about us, but somebody is hopefully looking at the plan and disclosure statement. We also look for third party releases; we are very concerned that the discharge provisions of chapter 11 could be used to release third parties without adequate consideration and thereby cut off the rights of potential litigants. Our traditional mandate is to look at those releases and decide whether or not they comply with the law, and litigate them. We look for fair disclosure, since one of the SEC's founding principles is full and fair disclosure to public investors. We look for disclosure about securities being issued, about the operations of businesses being reorganized, and we try to resolve disclosure issues directly with the debtors' counsel through an informal comment process. We look at whether or not securities issued under a plan comport with the Federal Securities Laws, specifically section 5,[3] and comply with section 1145 of the Bankruptcy Code,[4] which provides for a limited exemption from section 5 for securities issued under a reorganization plan. We work closely with our Division of Corporate Finance on section 1145 issues.

Another traditional practice area that is a precursor to stopping fraud is our program to stop the trafficking of corporate shells. This is where a public company uses chapter 11 to effect a reverse merger with a third party that takes control of the new entity for a pittance, which is earmarked for creditors. Most of these companies have nonexistent businesses and little or no assets. Trafficking in corporate shells and the use of bankruptcy to allegedly clean corporate shells and go public is something for which we are on the lookout. One of the cases I looked at a

[2] 11 U.S.C. § 1109 (2006).
[3] Securities Act of 1933, § 5, 15 U.S.C. § 77e (2006).
[4] 11 U.S.C. § 1145.

number of years ago involved a "Virtual Nanny Cam,"[5] which was allegedly some kind of microphone and camera that floated from room to room to enable parents to spy on their children's nannies. We litigated over whether it was a viable business, and the promoters came to court to show the judge that the technology worked. Needless to say, it did not, and the case was not confirmed on feasibility grounds. But what would have happened if the judge believed the promoters? The third party promoter would have bought authorized, but unissued, stock from a trustee (or debtor-in-possession), donated a pittance to pay creditor claims, and would then tell the judge that this is a good deal for creditors because some money is better than no money. On confirmation, claims would be discharged and the company would emerge from bankruptcy with new shares issued to existing shareholders (namely the third party). The new entity would become a "clean corporate shell," which is often used to facilitate "pump and dump" schemes. These sound complicated until you become experienced with them. They are obviously bad, and we thus object to them.

We have also looked at excessive compensation for chapter 11 professionals and employees. In *Enron*,[6] we looked at the structure of the Chief Restructuring Officer's ("CRO's") compensation and objected because he had no fiduciary obligations to the board or to the estate. We review requests for equity committees. It is fairly common that anybody who wants an equity committee calls us. Although we have a few staff accountants that can assist us on reviewing financial statements, it is never enough manpower. Instead, we review available public reports from the auditors of the companies. It is not a perfect process, but we will recommend to the Department of Justice (United States Trustee) whether or not we think there is sufficient equity to justify appointment of a committee. We also provide input into the selection of Trustees and Examiners. Another aspect of our Enforcement program is to review public Exchange Act filings of companies that go into chapter 11, and, if they are delinquent, we take steps to institute an administrative proceeding to have the securities of the delinquent filer de-registered and a trading suspension issued. Now, what is interesting about that is that the de-registration would only apply to the securities that are in existence when they file, which does not necessarily bar the trading of any post-reorganization securities. However, it could make it very difficult for a public company with prior securities de-registered to have new securities listed. De-registration and trading suspension also aid in our efforts to prevent the trafficking in corporate shells.

We work with debtors. We have waiver provisions that we use to determine if public companies are required to continue to file Exchange Act reports during the pendency of the chapter 11 case. In this regard, I urge you to review The Division

[5] *In re* Village Green Bookstore, Inc., No. 98-20253 (Bankr. W.D.N.Y.).

[6] *See* Leslie Eaton & David Barboza, *Regulators Seek to Block Enron's Hiring of a Chief*, N.Y. TIMES, Mar. 9, 2002, at C3 (examining SEC objection to original employment contract of Stephen F. Cooper because of his possible conflicts and lack of fiduciary duties).

of Corporation Finance Staff Bulletin Number 2.[7] We look at claims trading. For years, we have advocated a claims trading policy under the Federated Case,[8] which enabled businesses that typically traded in securities and also had an investment banking arm to sit on creditors' committees so long as their traders were walled off from the committee member. The Commission's position is now routinely accepted by bankruptcy courts. The most recent evolution of the claims trading issue is proposed legislation that would require unofficial committees to disclose who they represent and their financial interests.[9]

The world has changed in bankruptcy. Players in the big cases invest all over the capital structure, and I believe there should be full disclosure of the investors' positions when they sit at the bargaining table with other investors and creditors. I think we are going to see some changes in this area.

The enforcement staff is also very active in bankruptcy cases involving individuals and private companies where these entities have been sued or are under investigation by the Commission for securities fraud. We look for conflicts of interest, we coordinate discovery, and we have an exception from the automatic stay that allows the Commission to litigate to judgment short of collection. The SEC has provisions in the Bankruptcy Code governing non-dischargeability of penalties and disgorgements.[10] You will see us file protective proofs of claims and object to exemptions in individual debtor cases. We coordinate with chapter 7, 11, and 13 trustees. We have mutual access grants allowing us to share information with them to try to figure out how to maximize the estate for the benefit of the victims of fraud. We also determine in enforcement cases whether the SEC should collect a penalty or disgorgement from chapter 11 debtor to create a victim fund. Recent, high-profile examples include the *Adelphia*, *Enron*, and *WorldCom* cases.[11]

We also assess the feasibility of plans where we expect to collect money from the debtor. We will assess what the chances are that the debtor will be able to make the promised payments and reorganize. We also, at times, rely on a new Bankruptcy Code provision, section 1141(d)(6), which makes our monetary claims non-dischargeable in a chapter 11 corporate case. Consequently, an SEC monetary

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[7] SEC Staff Legal Bulletin No. 2 (Apr. 15, 1997), http://www.sec.gov/interps/legal/slbcf2.txt.

[8] *In re* Federated Dep't Stores, Inc., No. 1-90-00130, 1991 WL 79143 (Bankr. S.D. Ohio Mar. 7, 1991).

[9] *See* Memorandum from the Advisory Comm. on Bankr. Rules on the Report of the Advisory Comm. to the Standing Comm. on Rules of Practice and Procedure, B-21 to -35 (September 2010), http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/jc09-2010/2010-09-Appendix-B.pdf (listing proposed amendments to Fed. R. Bankr. P. 2019).

[10] *See, e.g.*, 11 U.S.C. § 1141(d)(6) (2006).

[11] *See* Litig Release No. 20795, SEC, SEC Files Motion to Authorize Distribution of Fund to Victims of the Fraud Perpetrated by Adelphia Commc'ns Corp. ("Adelphia") in Accordance With Procedures Adopted by U.S. Dep't of Justice in Connection With Adelphia Victim Fund (Oct. 30, 2008), http://www.sec.gov/litigation/litreleases/2008/lr20795.htm; Litig Release No. 20225, SEC, SEC Settles Civil Fraud Charges Against Two Former Enron Execs. (Aug. 6, 2007), http://www.sec.gov/litigation/litreleases/2007/lr20225.htm (discussing SEC's intention to distribute funds to victims of Enron's fraud); Press Release, SEC, SEC Distributions to WorldCom Fraud Victims Top Half-Billion Dollar Mark, Release No. 2007-118 (June 14, 2007), http://www.sec.gov/news/press/2007/ 2007-118.htm.

claim is potentially an overhang on the company's ability to reorganize. In every chapter 11 case, we decide whether to preserve our non-dischargeable claims.

The staff also has authority to disclose the existence of our investigation if it is in the public interest and would protect the SEC's monetary claims. We can go into the bankruptcy court, disclose our investigation, and tell the judge how our investigation could impact the debtor's reorganization.

We also pursue individual debtors. Many bad actors file bankruptcy to evade their victims and the SEC. We seek to get their cases dismissed or converted, or have trustees and examiners appointed. We file objections to discharge and to improper exemptions, and we will work with trustees and examiners extensively in trying to maximize value to the estate. We have also sought to have corporate monitors appointed where a trustee might be draconian, but a DIP would be inappropriate. The *WorldCom* case is an example.[12]

II. EQUITY RECEIVERSHIPS

My next topic is the appointment of equity receivers. For years, the Commission has been able to seek equitable relief in enforcement cases. Equity receiverships are one form of that relief. An equity receivership is an alternative scenario in the district court that exists to marshal assets and pay defrauded investors and creditors. The Sarbanes-Oxley Act, which was passed in 2002, has a specific provision that cements the district court's broad equitable power to impose equitable relief under any case under the Federal Securities Laws.[13] This legislation essentially reaffirms the past principles in case law and allows a judge to appoint a fiduciary to take control of an entity or even a person's assets, under the jurisdiction of the district court. Section 21(d) of the Exchange Act[14] allows the SEC to seek, and any federal court to grant, any equitable relief that may be appropriate or necessary for the benefit of investors. Prior to enactment of this section, under the Investment Company Act of 1940, a trustee could be appointed to bring an investment company into compliance with the law, which was generally interpreted to mean registration. And so we might have sought to put an investment company into bankruptcy and have a trustee appointed to do the actual liquidation of the business, rather than doing it with a 1940 Act trustee. But now an equity receiver can cause compliance with the registration provisions of the Act and also administer the business in a receivership. We can also seek to have other fiduciaries appointed, such as corporate monitors in our Enforcement cases where a full equity receivership might be inappropriate where, for example, appointment of a receiver must cause defaults on existing contracts.

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[12] *See* Complaint, SEC v. WorldCom, Inc., No. 02 Civ 4963 (JSR) (S.D.N.Y. June 26, 2002), *available at* http://www.sec.gov/litigation/complaints/complr17588.htm.

[13] *See* 15 U.S.C. § 78u(d)(5) (2002).

[14] 15 U.S.C. § 78u(d).

Recently, the Second Circuit held that equity receiverships are permissible as an alternative to bankruptcy. The Second Circuit's decision regarding Wextrust Capital reaffirms the proposition that the district court has jurisdiction to enjoin the filing of a bankruptcy.[15] In that case, a group of defrauded investors wanted to convert a receivership that consisted of about 200 separate real estate ventures, a separate investment company, and numerous separate businesses into chapter 11. In our enforcement case, a receiver was appointed to take charge of the entire estate. The investors argued that they were not getting a seat at the table, and that bankruptcy was better for them. We concluded that a chapter 11 case would have been disastrous, since it would have involved, theoretically, perhaps 200 separate filings; substantive consolidation would have to be litigated; there could have been filings in different states; investors were all over the world; and a bankruptcy would have most likely consumed the limited assets available. We were concerned there would be a zero recovery for investors at the end of the day. We repeatedly asked the investors who wanted to file bankruptcy, "What is the benefit?" They could not articulate any clear financial benefit to the victims. The receiver presented the court with an extensive financial analysis to demonstrate the cost of bankruptcy to the victims. We also told the judge that, in an equity receivership, the court could distribute money fairly to all investors and creditors. Based largely on those facts, the Second Circuit affirmed the district court's injunction against the filing of bankruptcy cases.

In some instances, equity receiverships are superior to bankruptcy filings because the receiver is a fiduciary to the estate as a whole, can fashion a plan that is supported by the Commission, and treats investors and creditors fairly. One might argue that by paying investors who are technically "equity" before "creditors" are paid in full, and by proposing a pro rata distribution, we are evading the Bankruptcy Code's absolute priority rule. However, in working with receivers to structure distribution plans, we look at the economic reality of the matter before us and not merely the form of the investments. Equity receiverships in SEC cases typically involve severe financial frauds rather than mere business failures. We do not employ the use of equity receiverships in every situation. Rather, we use a balancing test to determine how best to serve the public interest that we are charged to safeguard. The courts have upheld distribution plans based on principles of overall fairness despite the fact that the plan might subordinate a portion of the unsecured claims or eliminate deficiency claims. The quid pro quo is an Article III court with supervisory jurisdiction and a streamlined process with the appointment of an independent fiduciary, including cost control measures. On the administrative side, we have a very strict set of fee guidelines that we believe are more efficient than the bankruptcy trustee guidelines. On the substantive side, receivers may have the same or similar powers as a trustee. Courts have vested in equity receivers the right to bring summary proceedings, the ability to use state fraudulent conveyance laws, and, in some instances, have actually imported into the receivership specific

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[15] *See* SEC v. Byers, 609 F.3d 87, 91–92 (2d Cir. 2010).

provisions of the Bankruptcy Code, such as sections 544 and 547. To the extent that the courts permit us to use equity receiverships in a way that maximizes value to defrauded investors and the estate as a whole, we will pursue their use.

In closing, I note that the SEC is very active on the insolvency front, both in and out of bankruptcy.