# NOTES

## THE SARBANES-OXLEY ACT'S EFFECT ON SECTION 523 OF THE BANKRUPTCY CODE: ARE ALL SECURITIES LAWS DEBTS REALLY NONDISCHARGEABLE?

"Every creditor shall release that which he has lent unto his neighbor."[1]

The "fresh start" dates back to the Bible; unfortunately, so do tales of deceit.[2] Most recently, executives at corporations like Enron and WorldCom subjected Americans to large-scale fraud.[3] These scandals drastically affected the economy and the capital markets which quickened Congress' regulatory response.[4] Just six weeks after viewing the Board of Directors' Official Report on Enron, the House and Senate introduced the Sarbanes-Oxley Act ("SOA") and the Corporate and Criminal Accountability Act ("CCAA").[5] The CCAA, eventually enacted as part of the larger SOA,[6] was designed to punish corporate criminals and hold them accountable for defrauding investors.[7] Included in the CCAA was an amendment to section 523(a) of the Bankruptcy Code. The amendment will except from an individual's discharge

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[1] *Deuteronomy* 15:2.

[2] *See, e.g., id.; Genesis* 27:34–36.

[3] *See, e.g.*, Joann Lublin, Cassell Bryan-Low et al., *How Real Are the Reforms? Corporate-Oversight Bill Will Mean Change, Confusion; Boards to Be 'More Nervous,'* WALL ST. J., July 29, 2002, at B1 (noting the same); Maggie Mulvihill, *At The Bar; With Scandals All Around, Execs Must Bow to SEC Rule*, BOSTON HERALD, July 30, 2002, at 29 (discussing corporate scandals and their effects).

[4] *See* S. REP. NO. 107-146, at 2 (2002), *available at* http://thomas.loc.gov/cgi-bin/cpquery/z?cp107:sr146:; *see also* Ethan G. Zelizer, *The Sarbanes-Oxley Act: Accounting For Corporate Corruption*?, 15 LOY. CONSUMER L. REV. 27, 29–31 (2002) (documenting extent of financial fraud); David Lazarus, *Lazarus at Large*, S.F. CHRON., Jan.18, 2002, at B1 ("[T]his is going to make the S&L scandal look like a child's bed time story.").

[5] On February 1, 2002 Congress received the Official Report on Enron. WILLIAM C. POWERS, Jr., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORPORATION, at 1 (2002). Introduction of the SOA followed on February 14, 2002. H.R. 3763, 107th Cong. (2002). The introduction of the CCAA took place on March 12, 2002. S. 2010, 107th Cong. (2002).

[6] The Sarbanes-Oxley Act, Pub. L. No. 107-204, § 1, 801, 116 Stat. 1, 745, 801 (2002).

[7] S. REP. NO. 107-146, at 2 ("[An Act] to provide for criminal prosecution and enhanced penalties of persons who defraud investors in publicly traded securities . . . to disallow debts incurred in violation of securities fraud laws from being discharged . . . .").

> any debt -- that—
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> (19)(A) is for—
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> (i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or
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> (ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and
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> (B) results from—
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> (i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;
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> (ii) any settlement agreement entered into by the debtor; or
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> (iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.[8]

Some literalists argue that section 523(a)(19)(A)(i) renders any debt arising under the federal securities laws nondischargeable.[9] If this interpretation is correct, securities debts based on strict liability are rendered nondischargeable.[10] The ability to discharge non-culpable debts is, however, a fundamental and rarely disturbed policy of the Bankruptcy Code.[11] This paper asserts that the literalistic interpretation fails to consider carefully the language of paragraph (A)(i). Paragraph (A)(i) only renders nondischargeable debts that are for securities laws violations. Interpreting violation to mean that all debts arising under the securities laws are nondischargeable seems to contravene several canons of statutory interpretation.[12]

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[8] The Sarbanes-Oxley Act § 803.

[9] *See, e.g.*, John C. Coffee, Jr., *A Brief Tour of the Major Reforms in the Sarbanes-Oxley Act*, 97 A.L.I.-A.B.A. 151, 174–175 (2002) (suggesting amendment will discharge all securities debts); Jeannette Filippone, *Clearer Skies for Investors: Clearing Firm Liability Under the Uniform Securities Act*, 39 SAN DIEGO L. REV. 1327, 1328 n.4 (2002) (reading section 523(a)(19)(A)(i) to except from discharge all debts arising under securities laws); G. Ray Warner, *S.2820 Would Increase Wage Priority, Recover "Unjust Compensation"*, 21 AM. BANKR. INST. J. 6, 6 (Oct. 2002) (interpreting amendment to except all securities debts from discharge).

[10] *See* 15. U.S.C. § 77l (2002) (making sellers of nonregistered securities strictly liable for such sales); 15 U.S.C. § 78t (affixing liability to persons who control individuals who are liable under securities laws).

[11] *See* discussion *infra* Parts I, II.

[12] *See* discussion *infra* Parts III.

This paper evaluates the language of section 523(a)(19)(A)(i). Specifically, does the CCAA make all debts nondischargeable that arise under the federal securities laws? Part I examines section 523 prior to the CCAA, in particular, how the lack of a strong government interest in the dischargeability of securities debts ensured innocent debtors a fresh start. Part II demonstrates that a broad interpretation is incongruous and that its effects are undesirable. Part III argues that the Securities and Exchange Commission ("SEC") is the only party that may except from discharge a "debt that is for any violation of the Federal securities laws."[13] Finally, Part IV details the legislative history of the CCAA, which supports the arguments put forth in Parts II and III.

## I. THE FRESH START: EXCEPTIONS FROM DISCHARGE ARE ONLY GRANTED WHEN A DEBT IS BASED ON CULPABLE CONDUCT OR WHEN CONTINUED LIABILITY FURTHERS AN IMPORTANT GOVERNMENT INTEREST

Perhaps the most important policy of the Bankruptcy Code is the "fresh start."[14] The fresh start ensures that an innocent debtor receives "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[15] The ability to discharge debts is not guaranteed.[16] Exceptions from discharge, which are enumerated in section 523, may prevent the debtor from receiving a fresh start.[17] Due to the importance of the fresh start, the creditor must demonstrate that one of the enumerated exceptions applies even though the creditor was the deserving party outside of bankruptcy.[18] To help a debtor receive a fresh

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[13] *See* 11 U.S.C. § 523(a)(19)(A)(i) (2002).

[14] *See, e.g.*, Grogan v. Garner, 498 U.S. 279, 286 (1991) (endorsing fresh start policy of Code); Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (acknowledging central purpose of Bankruptcy Act was to provide debtor with new beginnings).

[15] *Hunt*, 292 U.S. at 244; *see* 11 U.S.C. § 523(a) (listing exceptions to granting discharge for individual debtors). *But see* 11 U.S.C. § 524 (2002) (existing valid liens are not be extinguished by discharge).

For those who are not experienced in the bankruptcy field, this concept is quite elusive. Many believe that discharge does not permit a creditor to collect from a debtor. Discharge, however, only prevents post-bankruptcy collection efforts. 11 U.S.C. § 524. Other times, individuals confuse exceptions from discharge with property exemptions. *See* H.R. CONF. REP. on H.R. 3763, at 148 CONG. REC. H5464 (daily ed. July 25, 2002) (statement of Rep. Kanjorski).

[16] *See* 11 U.S.C. § 523(a) (enumerating exceptions from discharge); *see also* United States v. Kras, 409 U.S. 434, 445–46 (1973) (holding that discharge is not a fundamental right).

[17] *See* 11 U.S.C. § 523(a) (requiring debtors to remain liable for certain debts).

[18] *See, e.g.*, *Grogan*, 498 U.S. at 291 (requiring creditor to prove exception applies by a preponderance of evidence); Century 21 Balfour Real Estate v. Menna (*In re* Menna), 16 F.3d 7, 9 (1st Cir. 1994) ("[T]he claimant must show that its claim comes squarely within an exception enumerated in Bankruptcy Code section 523(a)."). *See generally* FED. R. BANKR. P. 4007 (permitting debtors and creditors to initiate discharge proceedings).

start, courts, with Congress' approval,[19] construe the exceptions narrowly against creditors and liberally in favor of debtors.[20]

### *A. Absent Culpable Conduct All Federal Securities Laws Debts Due the Government or Private Creditors Were Discharged*

As a general rule, most debts are dischargeable.[21] If the debt stems from a culpable act personally committed by the debtor, however, a "conduct exception" may prevent the debtor from discharging the debt.[22] These conduct exceptions focus solely on the debtor's conduct.[23] The type of harm suffered by the creditor, no matter how severe, is irrelevant.[24] For example, section 523 grants a discharge to a debtor who negligently causes severe injury to another, but it does not grant a discharge to a debtor who intentionally causes even minor injuries to another.[25]

Prior to the CCAA, all securities debts were dischargeable unless one of the conduct exceptions applied.[26] In *Wolf v. McGuire*,[27] a creditor argued that a debt, arising from section 12 of the securities act, was nondischargeable.[28] The debtor was strictly liable under section 12 for selling the creditor a third party's security

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[19] *See, e.g., infra* note 157.

[20] *See, e.g.*, Kawaauhau v. Geiger, 523 U.S. 57, 63 (1998) (construing section 523(a)(6) narrowly to discharge debts based on reckless conduct); Whitehouse v. Laroche (*In re* Laroche), 277 F.3d 568, 575 (1st Cir. 2002) (giving effect to fresh start by construing narrowly exceptions from discharge); Lieberman v. Hawkins (In re Lieberman), 245 F.3d 1090, 1092 (9th Cir. 2001) (construing discharge exceptions liberally in favor of debtor); Hoffend v. Villa (*In re* Villa) 261 F.3d 1148, 1152 (11th Cir. 2001), *cert. denied*, 535 U.S. 1112 (2002) (refusing to broaden judicial interpretations of exceptions from discharge).

[21] *See* 11 U.S.C. § 523(a) (limiting discharge of certain debts only).

[22] *See, e.g.*, 11 U.S.C. § 523(a)(2), (4), (6), (11), (13) (granting exceptions for debts based on fraudulent conduct); 11 U.S.C. § 523(a)(9) (rejecting "deep pocket" liability by discharging debtors who were not actually driving while intoxicated). *But see infra* notes 39 & 43 and accompanying text.

Since most exceptions involve culpable conduct, they may appear to act as deterrents. This conclusion is incorrect, however, because exceptions are typically in place to ensure that bankruptcy does not become a haven for criminals. *See, e.g.*, George H. Singer, *Section 523 of the Bankruptcy Code: The Fundamentals of Nondischargeability in Consumer Bankruptcy*, 71 AM. BANKR. L.J. 325, 385 (1997). In this respect, the wrongdoer is deterred from declaring bankruptcy. *See, e.g.*, Stackhouse v. Hudson (*In re* Hudson), 859 F.2d 1418, 1420 (9th Cir. 1988).

[23] *See, e.g.*, 11 U.S.C. § 523(a)(6) (failing to specify particular harm); Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 19 (1st Cir. 2002) (discussing categorization and operation of discharge exceptions).

[24] *See, e.g.*, 11 U.S.C. § 523(a)(6), (9) (making inquiries into creditors' injuries irrelevant).

[25] *See, e.g.*, 11 U.S.C. § 523(a)(6), (9) (qualifying discharge based on debtor's conduct only).

[26] *See, e.g.*, 11 U.S.C. § 523(a)(1)–(18) (providing no specific exception based on federal securities laws). Since the purpose of the securities laws is to ensure public disclosure of all relevant information, strict liability serves as the basis for many federal securities judgments. *See, e.g.*, 15 U.S.C. §§ 77k, l, q, 78j (2002); Dennis R. Corgill, *Insider Information, Price Signals, and Noisy Information*, 71 IND. L. J., 355, 367 n.53 (1996) (detailing legislative history of securities laws). Absent fraud, these debts were dischargeable *per se*. *See, e.g.*, Kinsler v. Pauley, 205 B.R. 501, 502–03 (Bankr. W.D. Mich. 1997) (refusing to find securities fraud claims non-dischargeable *per se*); Arndt v. Hanna, 197 B.R. 413, 423–28 (Bankr. E.D.N.Y. 1996) (requiring prior securities fraud judgment to satisfy all elements of section 523(a)(2)).

[27] 284 B.R. 481 (Bankr. D. Colo. 2002).

[28] *Id*. at 489–90.

that really was a "Ponzi" scheme.[29] Because the debtor was strictly liable under the securities laws, the creditor argued that the debt automatically qualified for a discharge exception.[30] The plaintiff, however, was unable to "offer[] [any] support for his proposition that any violation of [the] securities law[s] will render the debt non-dischargeable."[31] Furthermore, since the debtor had not personally engaged in fraudulent conduct, the creditor could not use the section 523(a)(2) exception from discharge.[32]

The court's opinion, published after the enactment of the CCAA, proposed that "If Congress wishes to create such an exception [for all securities debts], it can do so."[33] Interestingly, the introduction of the CCAA preceded argument on the case.[34] Therefore, the court's statement suggests that the amendment's consideration received little attention from the bankruptcy bar.[35]

Before the enactment of the CCAA, section 523 also discharged securities debts based on "controlling person" status. Under section 20(a) of the Securities Exchange Act of 1934, a controlling person is jointly and severally liable for an employee's securities debt.[36] In two recent cases before the courts of appeals,

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[29] *Id*. at 496.

[30] *Id*. at 490. A seller is strictly liable for the sale of unregistered securities, and liability may only be avoided if the security was exempt from registration. 15. U.S.C. § 77l. *But see* Pinter v. Dahl, 486 U.S. 622, 639 (1988) (allowing section 12 defendant to raise *in pari delicto* defense).

Section 12 is quite troubling for sellers of non-traditional securities, particularly investment contracts. *See* 15 U.S.C. § 77b(1); SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (finding that investment contracts are securities when one "invests his money in a common enterprise and is led to expect profits *solely* from the efforts of the promoter or a third party") (emphasis added). *Compare* Williamson v. Tucker, 645 F.2d 404, 425 (5th Cir. 1981) (examining substance of investment contract to determine if investors can exercise meaningful control) *with* N.Y. Stock Exch., Inc. v. Sloan, 394 F. Supp. 1303 (S.D.N.Y. 1975) (finding for seller because investor bought into general partnership).

As a matter of sound business judgment, issuers seek exemptions from registration. C. Steven Bradford, *Securities Regulation and Small Business: Rule 504 and the Case for an Unconditional Exemption*, 5 J. SMALL & EMERGING BUS. L. 1, 24 (2001). However, a subsequent resale, which otherwise required registration, could cause the initial issuer to be liable under section 12. *See* 15 U.S.C. § 77(c), (d), (e). These debts were also discharged absent proof that the debtor engaged in a fraudulent scheme to avoid registration. *See, e.g.*, Gilligan, Will & Co. v. SEC, 267 F.2d 461, 465 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959) (discussing willful violation of registration procedures); 17 C.F.R. § 230.502(d) (2003) (requiring that no plan to avoid registration was undertaken by issuer).

[31] *McGuire*, 284 B.R. at 490.

[32] *Id*. at 496. The creditor was also unsuccessful in attempting to impute the third party's fraud onto the debtor. *Id*. at 490–91.

[33] *Id*. at 490.

[34] *See supra* note 5. If the issue was presented several weeks later the case would have been more interesting and possibly would have produced a favorable outcome for the creditor. *See* Smith v. Gibbons, 289 B.R. 588, 595 (S.D.N.Y. 2003) (applying section 523(a)(19) retroactively to a securities fraud debt).

[35] *See* Statements on Introduced Bills, 148 CONG. REC. S1783, at S1791 (daily ed. March 12, 2002) (statement of Sen. Leahy), (presenting comments from securities regulators only); *The Dischargeability of "Control Person" Liability for Federal Securities Fraud: Actual Fraud, Vicarious Nondischargeability, and the Vacillating Objects of the 523(a)(2)(A) Discharge Exception*, BANKR. L. LETTER, (May 2002), *available at* 2002 WL 1022151 (failing to mention that proposed bankruptcy amendment could make argument moot).

[36] 15 U.S.C. § 78t (2002). It is often difficult to avoid section 20(a) liability despite the fact that a defense, based on good faith and a showing that the supervisor was not directly or indirectly involved in the violation,

creditors asked to render these debts nondischargeable.[37] The creditors claimed that because the debtors' employees committed securities fraud, section 523(a)(2) should render the debts nondischargeable. Despite support from *Strang v. Bradner*,[38] where the Supreme Court rendered nondischargeable a debt based on the fraudulent conduct of the debtor's partner,[39] both circuits held that the creditors could not overcome the policy of favoring debtors in discharge proceedings.[40]

In *Hoffend v. Villa (In re Villa)*,[41] the Eleventh Circuit was compelled "to construe strictly exceptions to discharge," including the Strang holding.[42] The exception formulated in Strang was based on agency law. Since liability under section 20(a) liability is broader than under agency law, the Hoffend court refused to find an exception.[43] Relying on Hoffend, the Eighth Circuit, in Owens v. Miller (In re Miller),[44] also discharged the debtor's section 20(a) liability despite the debtor's egregious errors in supervision.[45]

The *Hoffend* and *Miller* courts noted that the fresh start requires a discharge when the creditor's claim does not fit squarely within an applicable exception.[46] Both courts noted that extending *Strang* to cover section 20(a) debts would significantly alter the policy of the Code.[47] The courts would have found an exception if the creditors' section 20(a) claims were based solely on facts implicating respondeat superior.[48]

### *B. Type Exceptions Directly Assist the Government and Outweigh the Need for a Fresh Start*

Sometimes, the type of debt that is due determines the outcome of a discharge proceeding.[49] In these situations, the conduct of the debtor is irrelevant.[50] Not all

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exists. *Id.; see, e.g.*, Brown v. Enstar Group, Inc., 84 F.3d 393, 397 (11th Cir. 1996) (noting uncertainties in application of section 20(a)); 17 C.F.R. § 230.405 (2003) (defining control as "the possession, direct or indirect of the power to direct or cause the direction of the management and policies of a person.").

[37] Owens v. Miller (*In re* Miller), 276 F.3d 424, 427 (8th Cir. 2002); Hoffend v. Villa (*In re* Villa), 261 F.3d 1148, 1149 (11th Cir. 2001), *cert. denied*, 535 U.S. 1112 (2002).

[38] 114 U.S. 555 (1885).

[39] *Id*. at 561. *Strang* is often described as a judicially crafted exception from discharge. *See, e.g.*, BancBoston Mortgage Corp. v. Ledford (*In re* Ledford), 970 F.2d 1556, 1561–62 (6th Cir. 1992); Wolf v. McGuire, 284 B.R. 481, 491 (Bankr. D. Colo. 2002).

[40] *See Owens*, 276 F.3d at 429 (holding for debtor despite *Strang* rationale); *Hoffend*, 261 F.3d at 1152 (rejecting to extend *Strang* exception).

[41] 261 F.3d 1148 (11th Cir. 2001), *cert. denied*, 535 U.S. 1112 (2002).

[42] *Id*. at 1152.

[43] *Id*. at 1152 (relying on a series of cases distinguishing agency liability from section 20(a) liability).

[44] 276 F.3d 424 (8th Cir. 2002).

[45] *See id*. at 427–29 ("Miller testified that he 'missed some inconsistencies and red flags in the documents,'" and that he "'knew or should have known about those violations.'").

[46] *Id*. at 429; *Hoffend*, 261 F.3d at 1153.

[47] *Owens*, 276 F.3d at 429; *Hoffend*, 261 F.3d at 1154.

[48] *Owens*, 276 F.3d at 429; *Hoffend*, 261 F.3d at 1154.

[49] *See* 11 U.S.C. § 523(a)(1), (5), (7), (17) (2002).

[50] *See, e.g.*, 11 U.S.C. § 523 (a)(1), (5), (8), (17).

innocent debtors will receive a fresh start from these debts because there is a strong government interest in the continued liability and that payment is generally due the government.[51] Congress is hesitant to create more type exceptions for its benefit since these exceptions do not permit innocent debtors to discharge certain debts.[52]

While most type debts are due the government,[53] the type exceptions for student loans and family support obligations operate for the benefit of private creditors.[54] Notwithstanding collection by private creditors, type exceptions directly advance the government's interests.[55] Because the federal government backs or insures student loans, the student loan exception protects the financial interest of the government and the economic viability of the country's higher education system.[56] Whereas the decision to extend financing is normally volitional, and the lender may incorporate the risk of nonpayment into the lending calculus, student loans are granted to those who would not otherwise qualify for financing.[57] Discharging these debts would penalize lenders for supporting an important government program and continued liability does not violate the equitable principles of section 523.

Under section 523(a)(5), alimony and child support payments are nondischargeable.[58] By requiring a debtor to remain liable for these debts government resources that might be required to support the debtor's family are preserved.[59] The exception's ability to assist private parties is a result of the modification of non-bankruptcy law. In the past, states were charged with collecting alimony payments from debtors, and therefore, Congress found it unnecessary to include the exception upon the Code's adoption.[60] When non-bankruptcy law altered these collection procedures, Congress added the exception

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[51] *See, e.g.*, 11 U.S.C. § 523 (a)(1), (5), (8), (17); Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 19 (1st Cir. 2002) (describing policy behind type exceptions).

[52] *See* 11 U.SC. § 523(a) (causing government units to use certain conduct exceptions); 11 U.S.C. § 523(a)(12) (requiring "malicious or reckless" conduct to except debt due government).

[53] *See* 11 U.S.C. § 523(a)(1), (5), (7), (17).

[54] *See* 11 U.S.C. § 523(a)(5), (8).

[55] *See* 11 U.S.C. § 523(a)(5) (rendering alimony payments nondischargeable); 11 U.S.C. § 523(a)(8) (protecting educational loans backed by government).

[56] *See, e.g.*, Santa Fe Med. Servs., Inc. v. Segal (*In re* Segal), 57 F.3d 342, 348 (3d Cir. 1995) ("[T]he exclusion of educational loans from the discharge provisions was designed to . . . to safeguard the financial integrity of educational loan programs.").

[57] *See, e.g.*, Cazenovia Coll. v. Renshaw (*In re* Renshaw), 222 F.3d 82, 86–87 (2d Cir. 2000) (recognizing loans are extended to undesirable borrowers).

[58] 11 U.S.C. § 523(a)(5); *see also* Friedkin v. Sternberg (*In re* Sternberg), 85 F.3d 1400, 1405 (9th Cir. 1996) (describing section 523(a)(5) as an exception favoring enforcement of family obligations); S. REP. NO. 97-139, at 788–89 (1981), *reprinted in* 1981 U.S.C.C.A.N. 396. Section 523(a)(15) helps maintain equity by ensuring that disguised property settlements do not place an undue burden on a debtor. *See* 11 U.S.C. § 523(a)(15).

[59] *See, e.g.*, Shannon Frank Edelstone, *Filial Responsibility: Can the Legal Duty to Support Our Parents Be Effectively Enforced*, 36 FAM. L.Q. 501 (2002) (documenting government family support programs and lack of responsibility for family obligations).

[60] S. REP. NO. 97-139, at 708, 788–89.

so that private creditors would fill the role that state regulators once occupied.[61] Despite Congress' ability to assist creditors, who like a debtor's family are in need of support, non-culpable damage awards remain dischargeable.[62]

## II. A BROAD INTERPRETATION PRODUCES INCONGRUOUS RESULTS BECAUSE IT TREATS SECTION 523(a)(19)(A)(i) AS A TYPE EXCEPTION FOR PRIVATE CREDITORS

A broad interpretation of section 523(a)(19)(A)(i) renders nondischargeable all debts arising under the securities laws.[63] This interpretation treats the amendment as a type exception for government and private creditors.[64] This construction unjustifiably limits the innocent debtor's opportunity for a fresh start and accords unwarranted special treatment to the financial interests of private securities creditors.[65]

Unlike student loans, the government has no direct financial interest in an exception from discharge for private securities debts.[66] Furthermore, the government did not play a role in creating the debt by instructing an individual to invest money despite their normal risk aversion.[67]

The government does have an interest in promoting private investment through properly functioning securities markets; however, it is difficult to discern how the exception will further this interest.[68] The SEC is charged with regulating the securities markets.[69] When private individuals bring actions, they indirectly help the SEC regulate the securities markets without any cost to the government.[70] One could argue that if individuals are aware that their claims are not subject to discharge they are more likely to bring a private cause of action.[71] The increased number of actions will indirectly help the SEC regulate the securities markets.[72] Although private causes of action do assist the SEC, this argument is tenuous at best: The Bankruptcy Code has never distinguished private securities claims from other causes of action based on their quasi-regulatory function.[73]

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[61] *Id*.
[62] 11 U.S.C. § 523(a)(2), (4), (6), (9).
[63] *See* 11 U.S.C. § 523(a)(19)(A)(i); *See, e.g.*, Coffee, *supra* note 9, at 174–75 (suggesting that amendment will discharge all securities debts); Filippone, *supra* note 9, at 1328n.4 (reading section 523(a)(19)(A)(i) to except from discharge all debts arising under securities laws); Warner, *supra* note 10, at 6 (interpreting amendment to except all securities debts from discharge).
[64] *See supra* notes 49–55.
[65] *See supra* notes 49–55 and accompanying text.
[66] *See supra* note 56.
[67] *See supra* note 56 and accompanying text.
[68] *See* Corgill, *supra* note 26, at 368 n.53.
[69] *See infra* notes 115–20 and accompanying text.
[70] *See id*.
[71] *See infra* note 120 and accompanying text.
[72] *See infra* notes 115–20 and accompanying text.
[73] *See infra* notes 109–11 and accompanying text.

In light of a comparison between securities debts and alimony or child support payments, the broader interpretation appears irrational.[74] Some literalists grant all securities creditors the same remedy as a debtor's child, but even claims for horrific or fatal injuries caused by non-fraudulent conduct do not receive this special protection in bankruptcy.[75]

A broad interpretation also renders debts not directly caused by the debtor's conduct nondischargeable.[76] Individuals are often subject to liability for their relationship to the tortfeasor. Generally, one can discharge these debts.[77] A broad interpretation renders many debts created by the debtor's legal status nondischargeable per se since some securities laws debts stem from the actions of others.[78] The result is that a bankruptcy court is unable to distinguish between the corporate officer who personally commits fraud and one who is strictly liable for the non-fraudulent act of an employee.[79]

The prescriptive effects of rendering all securities laws debts nondischargeable are also problematic. As one author noted:

> If securities liabilities cannot be discharged, this may create an incentive on the part of many creditors to recharacterize ambiguous or manipulable transactions as securities transactions. While notes issued to banks are ordinarily not securities today, creditors could conceivably restructure the transaction to make them resemble securities if doing so improved their position in bankruptcy. Time will tell whether practitioners seek to exploit this possibility.[80]

Section 523 has never permitted a creditor to use an exception in a premeditated manner.[81] The additional protection that some literalists give creditors will administratively burden the SEC because incentives will exist to structure transactions as securities.[82] The SEC was supposed to benefit from the CCAA, rather than have necessary resources drained.[83] Supporters of a broad interpretation recognize the positive effects that their interpretation will have for defrauded

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[74] *See supra* notes 58–62 and accompanying text.
[75] *See* 11 U.S.C. § 523(a) (2002).
[76] *See supra* note 63.
[77] *See, e.g.*, 11 U.S.C. § 523(a)(9) (requiring debtor to be intoxicated while actually driving motor vehicle). *But see* Strang v. Bradner, 114 U.S. 555 (1885) (granting exception from debts based on *respondeat superior*).
[78] *See* 15 U.S.C. § 78t (2002); *supra* notes 63–65.
[79] *See* 11 U.S.C. § 523(a)(19)(A)(i); *supra* notes 63–65.
[80] Coffee, *supra* note 9, at 175.
[81] *See, e.g.*, Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (discharging debt for negligent consequences of intended conduct).
[82] *See* 15 U.S.C. § 77t (a) (granting SEC authority to enforce any violation of securities laws); *see infra* notes 116–18.
[83] *See infra* note 167 and accompanying text.

pension plan participants and shareholders, but fail to consider fully the negative aspects of their interpretation.

## III. IF SECTION 523(a)(19)(A)(i)'S SCOPE IS LIMITED TO DEBTS THAT ARE FOR VIOLATIONS OF THE SECURITIES LAWS UNDESIRABLE RESULTS ARE AVOIDED

Some literalists have correctly identified section 523(a)(19)(A)(i) as a type exception: All debts for securities laws violations are nondischargeable. It is asserted, however, that like most type exceptions paragraph (A)(i) only renders nondischargeable securities debts due government units. Although the exception's scope could have been limited by a phrase such as "due or payable to a government unit," the omission should not preclude a finding that private creditors cannot utilize the exception.[84] Applicable non-bankruptcy law limits the exception's scope to payments due the government.[85]

### *A. Interpreting "Violation" to Mean All Claims Arising Under the Securities Laws Contravenes Several Canons of Statutory Interpretation*

Private creditors cannot use the exception because, as with most type exceptions, non-bankruptcy law limits its applicability to payments due the government. Paragraph (A)(i) will only except from discharge a debt that is for a "violation" of the securities laws. "Violation" is not defined in either the securities laws or the Bankruptcy Code.[86] Some literalists seem to define violation as meaning any debt arising under the securities laws.[87] As a result, they can interpret the exception as one that will render nondischargeable all debts arising under the securities laws.

A court cannot ignore a term or phrase selected by Congress.[88] Therefore, "violation" must be assigned a meaning. If a court were to adopt the literalists' interpretation then it would define violation as a general right of payment. A right of payment, however, is defined in the Code as a "claim" and is one of the Code's most basic and fundamental terms.[89] Similarly, the phrase any payment arising

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[84] *See* 11 U.S.C. § 523(a)(1) (failing to indicate payment must be to government unit).

[85] *See id*. (collecting taxes is necessarily limited by law to government units). In fact, the type exceptions that are available for private creditors clearly indicate that payment is not limited to the government. *See* 11 U.S.C. § 523 (a)(5), (8).

[86] *See* 11 U.S.C. § 101; 15 U.S.C. §§ 77b, 78b.

[87] *See supra* note 63.

[88] *See, e.g.*, Circuit City Stores, Inc. v. Adams, 532 U.S. 105, 115 (2001) (noting each provision within an act must have an intended meaning); United States v. Coward, 296 F.3d 176, 183 (3d Cir. 2002) (meaning should be given to each statutory phrase).

[89] *See* 11 U.S.C. § 101(5)(A) (defining "claim" broadly as any right to payment and "debt[s]" as liabilities on claims). In order to effectively administer the estate and/or rehabilitate the debtor, "claim" was intentionally given a broad definition. *See, e.g.*, Pa. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 558 (1990).

under appears in other section 523 exceptions.[90] "Violation" does not appear elsewhere in section 523.[91] "Violation" is an original term, but defining it as "a right of payment or a payment arising under the securities laws" makes it insignificant. This is problematic because unlike terms within a statute should be given different meanings.[92] If Congress intended to except from discharge all debts arising under the securities laws then it would not have selected an original term.

One may presume that Congress has knowledge of terms that it uses in prior sections of the law, and how those terms affect a new provision.[93] Under section 523(a)(13), "any debt for — any payment of an order for restitution issued under title 18, United States Code" is nondischargeable.[94] If Congress desired to render nondischargeable all securities laws debts, it could have easily drafted paragraph (A)(i) in this manner.[95]

Instead, Congress specified which laws the debt must stem from, then replaced "any payment arising under" with "violation."[96] Presumably, by selecting the term "violation," Congress rejected the interpretation put forth by the literalists.[97] Therefore, accepting a broad interpretation would require a court to invade the domain of the legislative branch by affirmatively disregarding a word selected by Congress.[98]

In addition, the inclusion of the exception in section 523(a)(19)(A)(ii) suggests that "violation" cannot mean "all debts arising under the securities laws." Paragraph

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[90] *See, e.g.*, 11 U.S.C. § 523(a)(13) (using "any payment" due under to describe applicable debt).

[91] *See* 11 U.S.C. § 523(a)(1)–(18).

[92] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 449–50 (1998) (refusing to give "on account of" the same meaning as "in exchange for" because that phrase was specifically used in other Code provisions); Estate of Cowart v. Nicklos Drilling Co., 505 U.S. 469, 479 (1992) ("[B]asic canon[s] of statutory construction [require] that identical terms within an Act bear the same meaning."); Sullivan v. Stroop, 496 U.S. 478, 485 (1990) (rejecting purported interpretation because term was given defined term's meaning).

See *United Savings Ass'n of Texas v. Timbers of Inwood Forest Ass'n*, 484 U.S. 365, 371 (1988), for an interesting discussion regarding the interpretation of ambiguous language in the Bankruptcy Code. In his opinion, Justice Scalia posits statutory interpretation is "a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." *Id*.

[93] *See, e.g.*, Lorillard v. Pons, 434 U.S. 575, 581 (1978) ("Congress normally can be presumed to have had knowledge of" a previously used term and how "it affects the new statute."); United States v. Palozie, 166 F.3d 502, 504–05 (2d Cir. 1999) (applying cannon stated in *Lorillard*).

[94] 11 U.S.C. § 523(a)(13).

[95] *See, e.g.*, BFP v. Resolution Trust Corp., 511 U.S. 531, 546, 556–57 (1994) (presuming Congress acts intentionally when it includes language in one provision, but omits it in another).

[96] 11 U.S.C. § 523(a)(19)(A)(i).

[97] *See, e.g.*, Bd. of Educ. of Westside Cmty. Sch. v. Mergens, 496 U.S. 226, 242 (1990) (holding that when Congress is aware of a term and does not incorporate it into a statute, courts cannot read that meaning into the Act).

[98] *See, e.g.*, Mobil Oil Corp. v. Higginbotham, 436 U.S. 618, 625 (1978) ("There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted."); Senator Linie GMBH & Co. KG v. Sunway Line, Inc., 291 F.3d 145, 167 (2d Cir. 2002) (noting even when judicial power is at its apex courts should not rewrite statutes).

(A)(ii) renders non dischargeable any debt that is for fraud, deceit or manipulation in connection with a securities transaction. If all federal and state securities debts are nondischargeable pursuant to paragraph (A)(i), it is difficult to discern what independent purpose paragraph (A)(ii) serves.[99] It is not proper to interpret a paragraph in a way that will render another paragraph within the same subsection superfluous.[100] Supporters of a broad interpretation have acknowledged this problem, but have only suggested that a court should interpret (A)(ii) broadly in accordance with the interpretation given to (A)(i).[101]

Literalists also ignore Congress' decision to narrow the applicability of section 523(a)(19)(A)(i) to violations per se. In the original draft of the CCAA, paragraph (A)(i) was an exception from discharge for any debt that "arises under a claim relating to" the violation of any federal securities laws and that is "in relation to any claim arising under the laws."[102] The language was then modified: A debt that is "a claim for" any securities law violation and with liability that is "in relation to any claim arising under those laws."[103] The elimination of all modifiers in the final version of the CCAA suggests that Congress did not intend for the exception to apply to all debts arising under the securities laws.[104]

### *B. Violation Most Likely Means a Failure to Abide by the Securities Laws*

Black's Law Dictionary defines a "violation" as "[a]n infraction or breach of the law."[105] Actions for violations are brought to enforce the law, and do not require an actual injury to a member of the public.[106] The idea that a private claim is derivative of, and distinct from, a violation of a public law is a fundamental concept and one that the Code recognizes.[107] When Congress enacted section 362(b)(4), it indicated

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[99] *See, e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (1988) (codified in scattered sections of 15 U.S.C. §§ 77, 78) (preempting certain suits based on state common law or statutory law); *In re* Hanna, 197 B.R. 413, 423–28 (Bankr. E.D.N.Y. 1996) (noting separate claims under federal securities laws and common law fraud will produce one damage award based on actual injury).

[100] *See, e.g.*, Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) ("[W]e are hesitant to adopt an interpretation of" section 523(a)(6) that would render section 523(a)(9) "superfluous."); BFP v. Resolution Trust Corp., 511 U.S. 531, 546, 556–57 (1994) (construing term in a way that would not render another provision superfluous).

[101] *See* Warner, *supra* note 9, at 44.

[102] S. REP. NO. 107–146, at 33 (2002) (emphasis added).

[103] H.R. 5118, 107th Cong. § 5 (2002) (emphasis added).

[104] *See* Sarbanes-Oxley Act, Pub. L. No. 107-204, § 803, 116 Stat. 801 (2002).

[105] BLACK'S LAW DICTIONARY 1564 (7th ed. 1999). *See generally* MODEL PENAL CODE § 1.04(5) (1997) (defining violations as public-welfare offenses).

[106] *See infra* notes 116–18 and accompanying text.

[107] *See, e.g.*, FEC v. Akins, 524 U.S. 11, 21 (1998) (noting statutory violations will not produce private causes of action, and absent injury-in-fact plaintiffs lack standing); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976) (permitting private plaintiffs to bring causes of action based on injuries suffered by Rule 10b-5 violations); RESTATEMENT (SECOND) OF TORTS § 286 (1976) (indicating public laws can derivatively produce private causes of action).

that "where a government unit is suing a debtor to prevent or stop violation of fraud, . . . or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay."[108]

In amending the automatic stay, Congress recognized that actions to enforce violations of the securities laws are necessary proceedings, deserving different treatment than ordinary claims brought by private citizens.[109] A court must presume that Congress was aware of the Code's disparate treatment of regulatory actions, and therefore it is likely that "violation" means government proceedings that are a result of the debtor's failure to abide by the securities laws.[110]

"Violation" also appears in section 362(h), which permits individuals to bring a private right of action for willful violations of the stay.[111] Absent this provision, a debtor harmed by a violation of the stay has no specific remedy.[112] This also demonstrates that the failure to abide by the law will always produce a "violation," but the same conduct cannot always produce a right of payment.

### *C. Since Private Plaintiffs Cannot Have Claims for Violations Per Se, They Cannot Utilize the Exception in Section 523(a)(19)(A)(i)*

The fresh start requires courts to define discharge exceptions and demands that a creditor prove that his claim fits squarely within an exception.[113] For example, the *Hoffend* and *Miller* courts would have granted an exception if the section 20(a) debts were based solely on facts implicating respondeat superior.[114] Implied in these statements is that actions based on respondeat superior would have to be maintainable in law and in fact. As a matter of law and/or fact a private securities creditor cannot base a cause of action solely on securities laws violations. As a result, paragraph (A)(i) will only except from discharge debts that are for violations of the securities laws.

The securities laws provide that the SEC may take action "[w]henever it shall appear to [the SEC] . . . that the provisions . . . have been or are about to be violated . . . ."[115] Under the securities laws only the SEC may bring actions for "violations"

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[108] S. REP. NO. 95-989, at 52 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5838; *see, e.g.*, SEC v. Towers Fin. Corp., 205 B.R. 27, 29–30 (S.D.N.Y. 1997) (exempting from stay SEC actions for securities violations); Bilzerian v. SEC (*In re* Bilzerian), 146 B.R. 871, 873 (Bankr. M.D. Fla. 1992) (fixing of damage awards by SEC not subject to stay).

[109] *See* sources cited *supra* note 108. Private securities plaintiffs are subject to the stay. *See, e.g.*, United States ex rel. Jane Doe 1 v. X, Inc., 246 B.R. 817, 820–21 (E.D. Va. 2000) (providing qui tam plaintiffs relief from stay based on specific statutory authorization).

[110] *See supra* note 95 and accompanying text.

[111] 11 U.S.C. § 362(h) (2002).

[112] *See, e.g.*, Knupfer v. Lindblade (*In re* Dyer), 322 F.3d 1178, 1189 (9th Cir. 2002) (requiring trustee, who does not have standing pursuant to section 362(h), to base damages on section 105).

[113] *See supra* notes 18–19 and accompanying text.

[114] *See supra* notes 46–48 and accompanying text.

[115] 15 U.S.C. § 77t.

and collect on a resulting judgment, order or fine.[116] The ability to maintain an action absent injury is a unique regulatory function expressly limited to the SEC. The SEC can bring a section 5 action whenever a non-registered security is offered for sale, but pursuant to section 12, a private plaintiff may only recover if she actually purchased the security.[117]

The federal securities laws do not permit individuals to plead violations of the law. Instead, an injured party can bring express or implied causes of action.[118] Even though, the threat of private judgments assists the SEC in enforcing securities violations, Congress did not grant individuals "private attorney general" status to enforce actual securities violations.[119] This distinction appears in section 20(a), which affixes "controlling person liability" for any "cause of action or violation."[120]

A private plaintiff can bring an express cause of action under section 11 of the Securities Act.[121] Section 11 provides for "civil liabilities on account of false registration statement."[122] A violation of section 11 is not possible.[123] Section 11 merely describes the elements of a civil cause of action, with any resulting liability considered a debt or a right to payment arising under the securities laws.[124] Consequentially, the debt should be held dischargeable pursuant to section 523(a)(19)(A)(i).

Paragraph (A)(i) cannot assist a section 12 plaintiff either, despite the fact that a section 12 plaintiff must prove that a defendant sold a security in violation of section 5.[125] Section 12 only grants a private plaintiff standing.[126] Even though a violation of the securities laws serves as a direct basis for the debt, a plaintiff could not maintain an action under section 5 per se. Section 12 is most analogous to section 365(h) of the Code:[127] a violation of the underlying law would not produce a private debt absent statutory authority.[128]

Debts for implied securities actions would also not qualify for paragraph (A)(i)'s exception from discharge. Implied causes of action are based upon

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[116] *See, e.g.*, 15 U.S.C. § 77s–v (granting district courts jurisdiction over securities actions brought by SEC and enabling courts to impose civil penalties). The commission and courts receive the same authority under the Securities Exchange Act of 1934. *See, e.g.*, 15 U.S.C. § 78u, u-1, aa.

[117] *Compare* 15 U.S.C. § 77e (permitting SEC to take action if unregistered securities are offered for sale) *with* 15 U.S.C. § 77l (requiring plaintiffs to have purchased unregistered securities).

[118] *See, e.g.*, 15 U.S.C. § 77k, l (authorizing private causes of action); Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 961, 964 (1994) (noting private plaintiffs can only claim damages that are based on violations).

[119] *See, e.g.*, Ernst & Ernst v. Hochfelder, 425 U.S. 185, 196 (1976) ("[Section] 10(b) . . . does not by its terms create an express civil remedy."); Grundfest, *supra* note 118, at 964–65.

[120] 15 U.S.C. § 78t (emphasis added).

[121] *See* 15 U.S.C. § 77k.

[122] *See id*.

[123] *See id*. (establishing standards for private liability).

[124] *See id*.

[125] *See* 15 U.S.C. § 77l.

[126] *See id*.

[127] *Compare id*. *with* 11 U.S.C. § 362(h).

[128] *See supra* notes 111–12 and accompanying text.

common law principles and are derivative of violations of the law. As a result they are also dischargeable pursuant to section 523(a)(19)(A)(i) because the debt is not for a violation per se.[129] Although culpable debtors are generally denied a fresh start, paragraph (A)(i) operates as a "type exception" and therefore, the debtor's mental state is irrelevant.[130]

This analysis may seem overly technical. As stated above, however, if Congress intended to except from discharge all debts arising under the securities laws, it could have clearly done so.[131] Support for this result also comes from Congress' approval of courts construing exceptions from discharge narrowly in favor of the debtor.[132] Under section 523(a)(19)(A)(i), this policy seems most genuinely applied because a broad interpretation renders nondischargeable debts based on strict liability.

### *D. Private Securities Debts Based on Fraud, Deceit, or Manipulation Are Nondischargeable Under Section 523(a)(19)(A)(ii)*

Unlike paragraph (A)(i), paragraph (A)(ii) does not require a "violation" of the securities laws.[133] The exception requires that the debt is for "common law fraud, deceit, or manipulation in connection with" a securities transaction.[134] A private plaintiff has the ability to plead these elements.

Prior to the CCAA, creditors attempted to except from discharge securities debts as fraudulent under section 523(a)(2)(A).[135] This exception required a showing of false pretenses, false representations or actual fraud.[136] The Restatement of Torts was used to determine the elements of "actual fraud," as it is presumed that Congress intends a term to take its dominant common law meaning absent contrary indication.[137] The Supreme Court determined that "actual fraud" required a plaintiff to demonstrate, at the minimum, justifiable reliance on the fraudulent statement.[138]

Since the phrase "common law fraud, deceit, or manipulation," is modified by "in connection with the purchase or sale of any security," its meaning should be

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[129] *See* 15 U.S.C. § 78j (creating fraud action for SEC); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477 (1977) (recognizing implied cause of action exists only if necessary to carryout Congress' purpose for enacting the federal securities laws); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding there is no private action for violation of Rule 10b-5 *per se*).

[130] *See* discussion *supra* Part I.A–B.

[131] *See* discussion *supra* Part III.A.

[132] *See, e.g.*, Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998) (rejecting creditor's claim that an intentional act necessarily produces an intentional injury as this interpretation would violate debtor's fresh start).

[133] 11 U.S.C. § 523(a)(19)(A)(ii).

[134] *Id*.

[135] *See, e.g., supra* Part I.A.

[136] 11 U.S.C. § 523(a)(2).

[137] *See* Field v. Mans, 516 U.S. 59, 70–73 (1995) (interpreting fraud requirement of section 523(a)(2) through its common law meaning).

[138] *Id*. at 73–75.

discerned from the securities laws.[139] The term appears in the securities laws, most notably in Rule 10b-5.[140] When bringing implied securities actions, private plaintiffs are required to demonstrate "fraud, deceit, or manipulation."[141] It is reasonable to presume that Congress intended to import the meaning of this term of art from the securities laws.[142]

As is the case of actual fraud, when proving fraud, deceit or manipulation, a private plaintiff is required to demonstrate that the defendant acted with scienter when making a fraudulent or misleading statement.[143] The complexities of the securities markets, however, have caused federal securities fraud actions to deviate from traditional fraud actions in several important respects. First, courts have relaxed privity requirements in granting option holders standing.[144] Most importantly, the impersonal nature of the securities markets made the reliance component of fraud difficult to prove.[145] In *Basic, Inc. v. Levinson*,[146] the Supreme Court affirmed the use of the "fraud on the market theory," which presumes reliance based on the effect misleading statements have on market price.[147] Paragraph (A)(ii) seems to operate as a conduct exception specifically designed to help securities creditors. The fraud on the market theory assists private plaintiffs tremendously and its use in paragraph (A)(ii) represents a significant departure from actual fraud as found in section 523(a)(2).[148]

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[139] *Id*. at 69–70 (indicating statute's construction dictates importation of term's meaning); Cmty. for Creative Non-Violence v. Reid, 490 U.S. 730, 740–41 (1989) (formulating federal common law definition of "employee" for copyright law because purpose of law was to establish national uniform standards).

[140] 17 C.F.R. § 240.10b-5 (2003)

[141] *See, e.g.*, Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 (1977) (noting Congress drafted Rule 10b-5 to require fraud, deceit, or manipulation); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 192 n.7 (1976) (requiring plaintiff to plead fraud, manipulation or deceit).

[142] *See, e.g.*, Bd. of Educ. of Westside Cmty. Sch. v. Mergens, 496 U.S. 226, 242 (1990) (assuming that Congress has knowledge of judicial terms of art and intends to import their meaning); *Reid*, 490 U.S. at 740 (interpreting "employee" based on agency law because Congress incorporated the term of art, "scope of employment," into act).

[143] *See, e.g., Ernst & Ernst*, 425 U.S. at 216 (requiring plaintiff to demonstrate *scienter*); 4 COLLIER ON BANKRUPTCY ¶ 523.08[1][e] at 523-45–46 (Lawrence P. King et al. eds., 15th ed. rev. 2002) (indicating same for section 523(a)(2)).

[144] *See, e.g.*, Tolan v. Computervision Corp., 696 F. Supp. 771, 772 (D. Mass. 1998) (granting option holders' standing under 10b-5); Deutschman v. Beneficial Corp., 841 F.2d 502, 503 (3d Cir. 1988) (holding same).

[145] *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 242–44 (1988) (noting difficulties of proving reliance in national securities market).

[146] 485 U.S. 224 (1988).

[147] *Id*. at 244 (recognizing individuals rely on market price). The presumption is rebuttable and defendant may seek to reduce damages or dismiss the cause of action entirely. *Id*. at 247.

[148] *Compare id, and* 11 U.S.C. § 523(a)(19)(B) (2002) *with* Field v. Mans, 516 U.S. 59, 70–73 (1995) (requiring creditor to demonstrate justifiable reliance to except "actual fraud" debt).

### *E. The Effects of Such an Interpretation Are Not Problematic and Still Protect Victims of Fraud*

If section 523(a)(19)(A)(i) only excepts from discharge a debt for a violation due the SEC, the policy of the Bankruptcy Code and its interplay with the securities laws are not significantly altered. Paragraph (A)(i) will operate as a true type exception: it will only cover debts due the government and does not require culpability because it furthers a significant government interest.[149] Furthermore, continued liability for securities violations preserves the resources used to regulate the securities markets and to protect investors.[150] The administrative burdens placed on the SEC by the incentive to structure transactions as securities also appreciably diminish.[151]

In comparison, section 523(a)(19)(A)(ii) would require a creditor to base a cause of action on fraud, deceit or manipulation. In this respect, the amendment will conform to the other conduct exceptions.[152] The innocent debtor will have the fresh start preserved, while bankruptcy will not become a haven for criminals.[153] In the past, section 523(a)(2) operated mechanically and the "reliance" component of the exception was difficult to prove because of the nature of securities transactions.[154] Use of the fraud on the market theory will significantly benefit creditors. Creditors also gain from paragraph (B), which has eliminated the need to "reprove" the underlying securities fraud debt.[155]

## IV. THE LEGISLATIVE HISTORY OF THE CCAA DOES NOT SUPPORT A BROAD INTERPRETATION

As the *McGuire* court noted, it is well within Congress' power to create an exception from discharge that would cover all securities debts.[156] The supporters of a broad interpretation have confused ability for intent. There is little evidence that Congress intended for private individuals to except from discharge all securities debts. Absent evidence that Congress intended to change dramatically the

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[149] *See* discussion *supra* Part I.B.
[150] S. REP. NO. 107-146, at 10 (2002).
[151] *See supra* notes 80–82 and accompanying text.
[152] *See supra* notes 18–19 and accompanying text.
[153] *See supra* notes 18–19 and accompanying text; *infra* note 168 and accompanying text.
[154] *See* S. REP. NO. 107-146, at 10 (indicating this "loophole" should be closed); *supra* note 27.
[155] *See, e.g.*, SEC v. Bilzerian (*In re* Bilzerian), 153 F.3d 1278, 1281 (11th Cir. 1998) (documenting lengthy appeals process); Skull Valley Band of Goshute Indians v. Chivers, 275 B.R. 606, 617 (Bankr. C.D. Utah 2002) (refusing to except debt based on jury verdict of Rule 10b-5 violation); Bender v. Tobman, 107 B.R. 20, 23 (S.D.N.Y. 1989) (applying collateral estoppel to preclude litigation of fraud under section 523(a)(2) was improper). *Compare* 11 U.S.C. § 523(a)(2)(A) (2002) *with* 11 U.S.C. § 523(a)(19)(B) (2002).
[156] Wolf v. McGuire, 284 B.R. 481, 490 (Bankr. D. Colo. 2002).

fundamental concept of the fresh start, courts should hesitate to adopt such an interpretation.[157]

For purposes of comparison, first consider the legislative history of section 523(a)(11), added in response to the Savings and Loan Crisis.[158] The legislative record reads like a treatise on bankruptcy discharge.[159] Congress frequently referenced the importance of the fresh start as well as relevant past and pending bankruptcy cases.[160] After much deliberation, Congress created an exception that did not alter the substance of section 523 or its interplay with banking regulations.[161] On its face, section 523(a)(11) renders nondischargeable debts based on defalcation, a standard less stringent than fraud. Despite this fact, courts have refused to interpret the term in a way that is inconsistent with the fresh start.[162]

It appears unlikely that Congress recognized that section 523(a)(19)(A)(i) could alter the fresh start for innocent debtors.[163] Since the CCAA was fast-tracked, the legislative record does not contain the ordinary substantive bankruptcy comments from the House and Senate judiciary committees.[164] When introduced into the House and Senate, the amendment was only described as an exception from

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[157] United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Ass'n, 484 U.S. 365, 380 (1988) ("If it is at all relevant, the legislative history tends to subvert rather than support . . . [an interpretation], since it contains not a hint that" Congress intended such a drastic meaning. Since this is "[s]uch a major change in the existing rules . . . it is most improbable that it would have been made without even any mention in the legislative history."); *see also* Kelly v. Robinson, 479 U.S. 36, 47 (1986) (noting Congress' intention would be clearly expressed and not left to judicial discretion if drastic changes were intended); Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Prot., 474 U.S. 494 (1986) (indicating same).

[158] Crime Control Act of 1990, Pub. L. 101-647, § 2522, 104 Stat. 4865 (1990).

[159] *See* Banking Law Enforcement, 136 CONG. REC. E3684, at 3686 (daily ed. Oct. 2, 1990) (statement of Rep. Schumer) ("[T]he innocent individual should nevertheless receive the full protection of the bankruptcy laws; he should not be held vicariously liable for debts . . . . Congress specifically approves the enunciation of this principle in *Matter of Walker*, 726 F.2d 452, 454 (8th Cir. 1984); *Anderson* v. *Anderson*, 29 B.R. 184, 191 (Bankr. N.D. Iowa 1983); and *Futscher* v. *Futscher*, 58 B.R. 14, 17 (Bankr. S.D. Ohio 1985). These cases . . . are representative of the principles put forth in *Local Loan Co.* v. *Hunt*, 292 U.S. 234, 244 (1934).").

[160] *See supra* note 158.

[161] *See, e.g.*, Banking Law Enforcement, 136 CONG. REC. E3684, at 3686 (daily ed. Oct. 2, 1990) ("[T]he new paragraph (11), . . . in essence, [is] a subset of section 523(a)(4) . . . . Congress intends that the same degree of intentionality and specificity required for acts of fiduciary fraud or defalcation . . . ."); *see also* 11 U.S.C. 523(b)(2002).

[162] *See, e.g.*, Rutanen v. Baylis (*In re* Baylis), 313 F.3d 9, 19 (1st Cir. 2002) (requiring creditor to prove serious degree of fault); Moreno v. Ashworth (*In re* Moreno), 892 F.2d 417 (5th Cir. 1990) (finding defalcation to be willful neglect of duty, even if not accompanied by fraud or embezzlement).

[163] *See* sources cited *infra* notes 165–68.

[164] *See, e.g.*, 148 CONG. REC. H4683, at H4686 (daily ed. July 16, 2002) (statement of Rep. LaFalce)

> ("The President wants a bill passed, and he wants a bill signed into law before we recess in August. The bill [CCAA] was introduced at 6:30 last night. It is brought up on the Suspension Calendar. That means there is hardly a soul in the House of Representatives who has even had the time to read the bill . . . .");

*id*. at H4683 (statement of Rep. Sensenbrenner) (moving to suspend rules to pass the CCAA); Bob Tillman, *Enron Fallout Spurs Securities Fraud Bill*, 36 INFO. MGMT. J. 4 (2002) (passing the CCAA during 2002 was never intended by bill's sponsors).

discharge that would help victims of fraud recover from corporate thieves.[165] It is therefore not surprising that the effects of the literalists' interpretation did not come under consideration.[166]

During the legislative debate, there was hardly a discussion of the Bankruptcy Code and no mention of the fresh start.[167] Statements made throughout the debate, including the sponsors', indicate that the amendment is designed to assist fraud victims, deter criminals from declaring bankruptcy and protect SEC resources.[168]

The surrounding text of the CCAA does not support a broad interpretation either. Title VIII to the SOA reads "Corporate and Criminal Fraud Accountability," section 803 reads "Debts Nondischargeable if Incurred in Violation of Securities Fraud Laws."[169] No other provisions of the CCAA appear to target non-culpable conduct.[170] In fact, the CCAA only increased the statute of limitations for securities fraud suits.[171] If all securities creditors are to benefit from paragraph (A)(i), it only seems logical to increase the period of time for persons to bring these claims. According to some literalists, Congress intended for the only prophylactic measure in the CCAA to appear in the amendment to the Bankruptcy Code.

## CONCLUSION

The Enron scandal and its aftermath were devastating to the United States economy. In the rush to restore public confidence in the capital markets, Congress enacted the SOA. One of its provisions added an exception from discharge to the Bankruptcy Code that many interpret as rendering nondischargeable all debts arising under the securities laws. This interpretation is troubling because Congress has always supported the fresh start. If accepted as correct, a broad interpretation may also significantly alter financial transactions. This interpretation, however, seems flawed, because the literalists have interpreted "violation" to mean any debt arising under the securities laws. Since section 523(a)(19)(A)(i) is an exception from discharge for violations of the federal securities laws, the exception is necessarily limited to debts due the government. Private creditors must rely on paragraph (A)(ii), an exception from discharge debts based on fraud, deceit or

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[165] *See, e.g.*, S. REP. NO. 107-146, at 10 (2002), *available at* http://thomas.loc.gov/cgi-bin/cpquery/z?cp107:sr146:; H.R. CONF. REP. on H.R. 3763, 148 CONG. REC. H5462 (daily ed. July 25, 2002).

[166] *Id*.; *see also* H4685 (statement of Rep. Sensenbrenner), *available at* http://thomas.loc.gov/cgi-bin/query/D?r107:5:./temp/~r107LTXseB:: ("Corporate officers will no longer be able to misuse the bankruptcy laws to discharge liabilities based upon securities fraud.").

[167] *See, e.g.*, sources cited *supra* note 164–66.

[168] *See* S. REP. NO. 107-146, at 10 (indicating loophole in bankruptcy laws should be closed and SEC resources protected); *supra* note 165.

[169] The Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745, 801, 802 (2002) (emphasis added).

[170] *Id*. at §§ 801–07.

[171] *See id*. at § 804 (providing additional time to bring actions for fraud, deceit or manipulation).

manipulation. This interpretation will still benefit private creditors, but maintains the important equitable balance found in section 523.

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