# THE FAIR FUNDS FOR INVESTORS PROVISION OF SARBANES-OXLEY: IS IT UNFAIR TO THE CREDITORS OF A BANKRUPT DEBTOR?

ZACK CHRISTENSEN*

*In the wake of the stock market decline in early 2000, many major corporations announced fraudulent accounting errors, sought bankruptcy protection, or both. In rapid response, Congress enacted the Sarbanes-Oxley Act of 2002 in order to strengthen the Securities and Exchange Commission and enhance penalties for violations of securities laws.*

*In its haste, Congress overlooked an important conflict between Sarbanes-Oxley and the Bankruptcy Code. The Fair Funds for Investors provision, contained in section 308(a) of Sarbanes-Oxley, allows the SEC to place a civil penalty obtained from violators of the federal securities laws into a disgorgement fund to be distributed to injured investors. On the other hand, section 510(b) of the Bankruptcy Code subordinates investors' securities-related claims to those of all other creditors.*

*As a result, the SEC and common stockholders may work an end-run around section 510(b) of the Bankruptcy Code and elevate the stockholders' claims by resorting to the Fair Funds for Investors provision. Further, as corporate malfeasance increases public outrage, the SEC will face increasing pressure to divert funds to defrauded investors, leaving creditors to collect from a depleted bankruptcy estate. The author concludes that Congress should address this conflict by amending section 308(a) of Sarbanes-Oxley to comport with section 510(b) of the Bankruptcy Code and maintain its established distributional scheme.*

## I. INTRODUCTION

During the 1990s, the U.S. economy experienced an unprecedented level of growth.[1] That record growth generated unabashed—and irra-

* J.D. Candidate, 2005, University of Illinois College of Law; B.S. in Accountancy, 2000, University of Illinois.

1. According to the National Bureau of Economic Research (NBER), the strong expansion in the U.S. economy during the 1990s began in March 1991 and did not end until March 2001. BUS. CYCLE DATING COMM., NAT'L BUREAU OF ECON. RESEARCH, THE BUSINESS-CYCLE PEAK OF MARCH 2001 (2001), http://www.nber.org/cycles/november2001/recessions.pdf (last visited Aug. 19, 2004). That ten-year expansion was the longest in NBER's chronology. *Id.*

tional[2]—optimism among investors, both individual and institutional, in the U.S. capital markets. Unfortunately for the economy, investors, and the public in general, the robustness of the economy and, consequently, the stock market, began to wither early in 2000.[3]

In the ensuing period, newspaper headlines and other news sources reported with disturbing regularity that giant, previously well-respected U.S. companies were announcing the discovery of accounting irregularities—which frequently turned out to be the result of fraud—or an intention to file for bankruptcy protection, and oftentimes both. Examples include, among many others, the well-documented cases of Enron,[4] WorldCom,[5] Adelphia,[6] and Global Crossing.[7] During the investigations of those companies by both the media and government regulators, reports surfaced of egregious abuses by corporate executives and complicity or inattention by passive boards of directors.[8]

Congress responded to the outraged public's call to "do something" by enacting far-reaching legislative reforms.[9] Most notably, Congress

2. Federal Reserve Chairman Alan Greenspan is credited with coining the term "irrational exuberance" during a speech in December 1996 to describe the prevailing attitude in the U.S. capital markets during the 1990s. *See* Chris Farrell, *How the Fed Responds to Stock Market Moves*, THE NBER DIG., September 2001, at 1, http://www.nber.org/digest/sep01/sep01.pdf.

3. As discussed *supra* note 1, the longest economic expansion in U.S. history did not officially end until March 2001. However, the stock market indices began to decline well before that date and continued to do so into 2002. For example, the Dow Jones average dropped from 11,497 on December 29, 1999 to 8712 on August 8, 2002 and the NASDAQ composite index declined from 5046 on March 9, 2000 to 1316 on August 8, 2002. HAROLD S. BLOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE § 1, at 4 (2002).

4. *See generally* WILLIAM C. POWERS, JR. ET AL., REP. OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002), *available at* 2002 WL 198018 (documenting in exhaustive detail the facts of the Enron case, including the accounting frauds perpetrated and the general passivity of the board of directors in exercising its oversight responsibilities).

5. *See generally* Jared Sandberg et al., *Disconnected: Inside WorldCom's Unearthing of a Vast Accounting Scandal*, WALL ST. J., June 27, 2002, at A1.

6. *See generally* Sallie Hofmeister, *Adelphia Submits Bankruptcy Filing*, L.A. TIMES, June 26, 2002, at 3-1; Andrew Ross Sorkin & Geraldine Fabrikant, *Weighed Down by Its Troubles, Adelphia Nears Bankruptcy*, N.Y. TIMES, June 24, 2002, at C1.

7. *See generally* Simon Romero, *5 Years and $15 Billion Later, A Fiber Optic Venture Fails*, N.Y. TIMES, Jan. 29, 2002, at A1.

8. *See*, *e.g.*, POWERS ET AL., *supra* note 4, at 18–24, 148–78.

9. The legislative response by Congress was certainly expected based on Congress' past responses to corporate scandals. In the 1920s, unabashed speculation and manipulation in the stock market led to a disastrous stock market crash that contributed to the Great Depression. Congress responded by enacting several significant pieces of legislation—most importantly the Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74, and the Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881. In the 1970s, the Securities and Exchange Commission discovered that over 400 U.S. companies admitted making questionable or illegal payments, totaling more than $300 million, to foreign government officials, politicians, and political parties. *See* U.S. DEP'T OF JUSTICE, FOREIGN CORRUPT PRACTICES ACT ANTIBRIBERY PROVISIONS (2002), *at* http://www.usdoj.gov/criminal/fraud/fcpa/dojdocb.htm. In response, Congress passed the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494, in an effort to stop the bribery of foreign officials and to restore public confidence in the integrity of U.S. business. *See id.* In the 1980s, the U.S. public became familiar with the term "insider trading." Congress attempted to curb insider-trading abuses by passing two statutes—the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, and the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677.

enacted the Sarbanes-Oxley Act of 2002 (the Act or Sarbanes-Oxley),[10] which President George W. Bush labeled "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[11] President Bush was correct to label Sarbanes-Oxley as far-reaching. The Act established the Public Company Accounting Oversight Board,[12] imposed rules to enhance auditor independence,[13] enhanced financial disclosures,[14] addressed analyst conflicts of interest,[15] granted additional resources and authority to the Securities and Exchange Commission (SEC),[16] and enhanced criminal sanctions for violations of the securities laws.[17]

Interestingly, despite the Act's tremendous breadth and importance, it passed through Congress very quickly.[18] The House bill[19] was first introduced in the House Committee on Financial Services on February 14, 2002,[20] was considered for the first time by the full House on April 24, 2002, and passed by the House that same day.[21] The Senate later passed its version of the bill on July 15, 2002.[22] Both the House and Sen-

10. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15, 18 U.S.C. (2002)).

11. Press Release, President George W. Bush, Signing Statement of George W. Bush (July 30, 2002), *available at* http://www.whitehouse.gov/news/releases/2002/07/200207030-1.html. One leading commentator has similarly labeled Sarbanes-Oxley "the most sweeping federal law concerning corporate governance since the adoption of the initial federal securities laws in 1933 and 1934." Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2002).

12. Sarbanes-Oxley Act of 2002 § 101(a).

13. *Id*. §§ 201–209.

14. *Id*. §§ 401–409.

15. *Id*. § 501.

16. *Id*. §§ 601–604.

17. *Id*. §§ 802, 807, 902–906.

18. The short timeframe in which Congress enacted Sarbanes-Oxley is particularly noteworthy when compared to the time that Congress used to pass the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, which comprehensively reformed well-established federal bankruptcy law in the United States. *See* CHARLES J. TABB, THE LAW OF BANKRUPTCY 37 (1997). The reform process that culminated in the enactment of the Bankruptcy Reform Act took a decade to complete. *Id*. That process began in 1968 when a subcommittee of the Senate Judiciary Committee held hearings to decide whether to form a bankruptcy review commission. *Id*. In 1970, Congress created the Commission on the Bankruptcy Laws of the United States, which filed a two-part report on existing bankruptcy laws with Congress in 1973. *Id*. Part two of that report consisted of a draft revised bankruptcy statute, which was introduced as a bill in both the House and Senate later in 1973. *Id*. Competing bills were later introduced, and over the next five years Congress held numerous hearings and subjected the bankruptcy reform bills to extensive commentary and debate and made numerous revisions. *Id*. at 38. The decade-long process came to a close on November 6, 1978 when President Carter signed the Bankruptcy Reform Act of 1978 into law. *Id*. at 39.

19. H.R. 3763, 107th Cong. (2002) ("A bill to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.").

20. 148 CONG. REC. H523 (daily ed. Feb. 14, 2002).

21. 148 CONG. REC. H1544 (daily ed. Apr. 24, 2002).

22. 148 CONG. REC. S6734 (daily ed. July 15, 2002).

ate passed the final version of the Act on July 25, 2002.[23] President Bush signed the bill into law just five days later.[24]

Despite the optimism of President Bush and members of Congress regarding the benefits Sarbanes-Oxley is intended to generate for investors, the capital markets, and the economy in general, whether the Act will succeed in restoring integrity to American business and confidence in the capital markets remains uncertain.[25] One certain effect of the Act, however, given its far-reaching provisions, is that it will generate a significant amount of commentary, regulation, and litigation, particularly as companies begin to implement its mandates over the next few years. During the course of that commentary, regulation, and litigation, novel legal issues will likely arise. In fact, within the first year of the Act's effective date, WorldCom's accounting fraud and bankruptcy cases highlighted a potential conflict between the Act and the Bankruptcy Code.[26]

The specific conflict involves section 308(a) of Sarbanes-Oxley, known as the Fair Funds for Investors provision,[27] and section 510(b) of the Bankruptcy Code. Section 308(a) of Sarbanes-Oxley provides that the SEC may, at its discretion, add any civil penalty obtained from a company that violates the securities laws to the disgorgement fund to be distributed to injured investors.[28] Section 510(b) of the Bankruptcy Code provides that a claim for damages arising from the purchase or sale of common stock has the same priority as common stock—i.e., such a claim is subordinated to the claims of all other creditors.[29]

Essentially, section 308(a) of Sarbanes-Oxley bypasses the rule set forth in section 510(b) of the Bankruptcy Code that a defrauded shareholder may not recover damages from a bankrupt debtor simply by filing a securities fraud claim against the debtor. Section 308(a) has this effect because it enables stockholders to recover indirectly from the bankrupt debtor's estate via civil penalties obtained by the SEC from the bankrupt debtor in an enforcement action. Although this conflict has thus far surfaced in only one case,[30] it is likely to continue to arise in many others as

23. 148 CONG. REC. H5480 (daily ed. July 25, 2002); 148 CONG. REC. S7365 (daily ed. July 25, 2002).

24. 148 CONG. REC. D866 (daily ed. July 31, 2002).

25. *See* Ribstein, *supra* note 11, at 3 (noting that the most recent corporate frauds occurred despite the seventy years of comprehensive securities regulation and arguing that the recent frauds do not justify more corporate regulation because of the significant costs of regulation and because contract and market-based approaches are better than regulation at reaching efficient results).

26. The Bankruptcy Code is title 11 of the United States Code. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, created the Bankruptcy Code, which today governs bankruptcy law in the United States. TABB, *supra* note 18, at 37.

27. The title of section 308 of Sarbanes-Oxley is "Fair Funds for Investors." Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246 (2002).

28. Sarbanes-Oxley Act of 2002 § 308(a), 15 U.S.C. § 7246(a).

29. 11 U.S.C. § 510(b) (2002).

30. Nearly the same issue arose in the Enron Corp. bankruptcy proceedings. In that case, former Enron executive Michael Kopper pleaded guilty to money laundering and conspiracy to commit wire fraud and agreed to pay $12 million in penalties. Mitchell Pacelle, *Enron Creditors Claim Funds from Settlement*, WALL ST. J., Aug. 27, 2002, at C13. Prosecutors stated that the $12 million would be dis-

the SEC more aggressively pursues civil actions against companies suspected of violating securities laws,[31] seeks increasingly large civil penalties in those cases,[32] and as the public becomes more aware of the SEC's ability to direct money away from corporate wrongdoers and into the hands of defrauded investors.[33] Therefore, resolving this conflict is an important concern.[34]

This note will examine the conflict between section 308(a) of Sarbanes-Oxley and section 510(b) of the Bankruptcy Code. Part II briefly discusses the relevant procedural mechanics of a bankruptcy proceeding and an SEC enforcement action seeking civil penalties from an alleged corporate wrongdoer. It explains how the SEC may use section 308(a) of Sarbanes-Oxley to provide compensation to defrauded investors. It then discusses the procedural mechanics of an SEC enforcement action against a debtor involved in a bankruptcy proceeding. Finally, it provides a brief overview of the WorldCom case, which serves as an example of the previously discussed procedures in action.

Part III analyzes the purpose and history of the two competing statutory provisions. Part IV then analyzes the conflict between those provisions in light of their histories and purposes, and concludes that section 308(a) of Sarbanes-Oxley impermissibly circumvents section 510(b) of the Bankruptcy Code. Part IV also discusses the potential judicial approaches to achieving the proper resolution of the conflict in the absence

tributed by the SEC to injured investors via section 308(a) of Sarbanes-Oxley. *Id.* In response, the Official Committee of Unsecured Creditors of Enron Corp. filed a complaint against Kopper in federal bankruptcy court arguing that the funds belonged to the estate and requesting a temporary restraining order to bar transfer of the funds. *Id.* The issue was whether creditors or shareholders of the debtor were entitled to the money. *Id.* However, that case differs from the case discussed here because it involved a fine obtained from a non-debtor that was a former employee of the debtor rather than from the debtor itself.

31. As previously mentioned, an important component of Sarbanes-Oxley was its grant of additional resources to the SEC. Section 601 of Sarbanes-Oxley authorized an appropriation of $776 million for the SEC for fiscal year 2003. 15 U.S.C. § 78kk (Supp. 2004). Prior to the passage of Sarbanes-Oxley, the SEC's targeted budget amount for 2003 amounted to only $435 million. BLOOMENTHAL, *supra* note 3, § 66, at 122. Those additional resources enabled the SEC to implement a pay parity plan for its staff and to hire additional "qualified professional personnel" to, inter alia, enhance its investigative and disciplinary efforts. *Id*.

32. For example, the $2.25 billion civil penalty imposed by the SEC against WorldCom was the largest civil penalty ever imposed by the SEC against a registrant. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 435 (S.D.N.Y. 2002).

33. It is reasonable to expect that the SEC will be under pressure from both the public and Congress to seek civil penalties from corporate wrongdoers that are large enough to provide meaningful compensation to ordinary Americans who lost money on their investments in those corporations. *See* Brooke A. Masters & Christopher Stern, *WorldCom Agrees to Pay $500 Million; Settlement with SEC Would Benefit Investors*, WASH. POST, May 20, 2003, at A1 (noting that Nell Minow, editor of the Corporate Library, was critical of the $500 million civil fine to be paid by WorldCom because "[i]t is a drop in a very, very big bucket," considering that the value of WorldCom's stock lost nearly $100 billion during its scandal).

34. Because the conflict between section 308(a) of Sarbanes-Oxley and section 510(b) of the Bankruptcy Code involves a question of the priority of distributions from a bankrupt debtor's estate, the bankruptcy courts initially will, in the absence of legislative action, be responsible for addressing this conflict. *See* 28 U.S.C. § 157(b)(1) (2002) (providing that bankruptcy judges are authorized to hear and determine all core proceedings in a bankruptcy case arising under title 11).

of legislative action and concludes that because of the obstacles courts face in achieving the proper resolution, Congress should amend section 308(a) of Sarbanes-Oxley to clarify that it does not circumvent section 510(b) and does not otherwise alter the well-established distributional priorities of bankruptcy law.

## II. UNDERSTANDING THE BASICS

The conflict between sections 308(a) and 510(b) cannot be fully understood by simply reading the two provisions in isolation. Rather, they must be viewed in the context in which the conflict between them arises—when the SEC files a civil enforcement action against a debtor involved in a bankruptcy proceeding. Therefore, a general understanding of the basics of a bankruptcy proceeding and an SEC civil enforcement action is critical to an in-depth understanding of the conflict discussed in this note.

### *A. The Basics of a Bankruptcy Proceeding*

A corporation may voluntarily enter reorganization bankruptcy proceedings[35] by filing a bankruptcy petition under chapter 11 of the Bankruptcy Code.[36] Filing the petition immediately commences the bankruptcy case.[37] The commencement of a bankruptcy case initiates two important events—the creation of a bankruptcy "estate"[38] and the imposition of an "automatic stay" against creditor collection actions.[39] The bankruptcy estate initially consists of all the debtor's property interests.[40] During the pendency of the case, certain property is added to the estate,[41] while other property is removed.[42] In addition, creditors may not proceed against property of the estate without leave from the bankruptcy court,[43] and debtors may not use, sell, or lease estate property unless such activities are either within the ordinary course of the debtor's business or the bankruptcy court has granted permission.[44] The provisions of chapter 11 foster the coordinated administration of the debtor's property, which is held by the estate, under the supervision of the bankruptcy court.[45]

35. This note focuses only on bankruptcies in which the debtor seeks to reorganize under chapter 11 of the Bankruptcy Code.
36. 11 U.S.C. § 301 (2002).
37. *Id*.
38. 11 U.S.C. § 541(a).
39. *Id.* § 362(a).
40. *Id.* §§ 541(a)(1)–(2).
41. *Id.* §§ 541(a)(3)–(7).
42. *Id.* §§ 522, 554.
43. *Id.* §§ 362(a)(2)–(4), (d).
44. *Id.* § 363.
45. TABB, *supra* note 18, at 141.

The automatic stay operates as a temporary injunction precluding any of the debtor's creditors from attempting to collect on their claims[46] against the debtor's assets.[47] Without the automatic stay, creditors would engage in a "self-help scramble" for the debtor's assets.[48] The stay preserves the status quo from the commencement date of the case and enables the bankruptcy court to deal with the creditors' claims on the debtor's assets in an orderly manner.[49] The stay thus protects debtors, by granting them "a breathing spell from . . . creditors," and protects creditors by precluding other creditors from acting on their own to "obtain payment of the claims in preference to and to the detriment of other creditors."[50] A stay is necessary for the effective implementation of the two primary functions of a bankruptcy case: the equitable treatment of multiple creditor claims and the provision of a financial fresh start for the debtor.[51]

The stay operates to "block attempts to collect pre-bankruptcy debts by individual creditors and efforts to interfere with property of the bankruptcy estate."[52] Thus, the stay explicitly prevents the following actions: (1) formal proceedings against the debtor to recover prepetition claims; (2) the enforcement of a prepetition judgment; (3) the enforcement of liens against property of the estate or the debtor; (4) the set-off of prepetition debts; and (5) any act to collect a prepetition claim.[53] The prohibition on formal proceedings against the debtor includes not only proceedings to recover a prepetition claim, but also proceedings against

46. The Bankruptcy Code defines a claim as: "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5)(A). Congress intended this definition of a "claim" to be the "broadest possible definition," with the result "that all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy case." S. REP. NO. 95-989, at 22 (1978); H.R. REP. NO. 95-595, at 309 (1977). It is important to note that "claim" has a broader meaning than "debt" in the bankruptcy context, as a "debt" is merely a "liability on a claim." 11 U.S.C. § 101(12) (2002). Whether a claim will participate in the bankruptcy proceeding depends on whether "the operative events giving rise to the claim have taken place prior to the filing of the bankruptcy case." TABB, *supra* note 18, at 471. Thus, determining whether a claim arising from an alleged tort of the debtor will participate in the bankruptcy proceedings can oftentimes prove difficult. *Id*. at 472; *see*, *e.g.*, Grady v. A.H. Robins Co., 839 F.2d 198 (4th Cir. 1988). Claims arising from alleged violations of the securities laws, however, should generally not present a timing problem because the "operative events giving rise to the claim"—i.e., the alleged securities law violations, such as material misstatements in the financial statements—usually play a major role in forcing a company to seek bankruptcy protection. *See* SEC v. WorldCom, 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003) ("[T]he exposure of the [securities] fraud often creates liquidity pressures that can drive the company into bankruptcy . . . ."). For example, one month after WorldCom disclosed its accounting problems, the company filed for bankruptcy. *See* Jared Sandberg et al., *supra* note 5.

47. 11 U.S.C. § 362(a).

48. TABB, *supra* note 18, at 146.

49. *Id*.

50. H.R. REP. NO. 95-595, at 340 (1977).

51. TABB, *supra* note 18, at 146.

52. *Id*. at 152.

53. 11 U.S.C. § 362(a)(1)–(7) (2002).

the debtor "that either were commenced prepetition or that could have been commenced prepetition."[54]

Even if an action falls within the scope of the automatic stay provisions it may, nevertheless, be exempt from the stay. Section 362(b) specifies a list of exceptions to the automatic stay.[55] A broad array of policy objectives underlie the exclusions from the automatic stay, the most significant of which is the belief that a bankruptcy case should not obstruct the operation of vital governmental functions.[56] Therefore, section 362(b)(4) exempts from the automatic stay "the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's . . . police and regulatory power."[57]

Courts have used section 362(b)(4) to exclude a wide variety of governmental actions from the automatic stay.[58] For instance, under the automatic stay exception for police power activities by a governmental unit, the SEC may enforce the securities laws even if the alleged wrongdoer is in bankruptcy.[59] However, despite this general exemption for enforcement actions, a government unit may not attempt to enforce a money judgment.[60] Thus, the government may not attempt to seize the assets of a bankrupt debtor against which it has obtained a money judgment in order to enforce that judgment.[61] The money judgment is subject to the automatic stay and may only be recovered through the final bankruptcy distribution.[62]

Two other important concepts related to bankruptcy proceedings are discharge of claims and priority. When a debt is discharged in a bankruptcy case, the debtor no longer has to pay the debt and creditors

54. TABB, *supra* note 18, at 153.

55. If the action falls within an exception in § 362(b), the burden is on the debtor to obtain an injunction against that action. *Id.* at 172.

56. *Id*.

57. 11 U.S.C. § 362(b)(4).

58. *See*, *e.g.*, Bd. of Governors of the Fed. Reserve Sys. v. MCorp Fin., Inc., 502 U.S. 32 (1991); NLRB v. P*I*E Nationwide, Inc., 923 F.2d 506 (7th Cir. 1991); Brock v. Rusco Indus., Inc., 842 F.2d 270 (11th Cir. 1988), *cert. denied*, 488 U.S. 889 (1989).

59. SEC v. First Fin. Group, 645 F.2d 429 (5th Cir. 1981) (holding that the SEC's continuing enforcement action and the enforcement of a preliminary injunction against the debtor were not subject to the stay imposed by § 362(a)).

60. 11 U.S.C. § 362(b)(4). The relevant language of this section states that the commencement of a bankruptcy case does not operate as a stay "of the commencement or continuation of an action or proceeding by a governmental unit . . . to enforce such governmental unit's . . . police and regulatory power, including the enforcement of a judgment *other than a money judgment*, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's . . . police or regulatory power." *Id*. (emphasis added).

61. *See* Penn Terra, Ltd. v. Dept. of Envtl. Res., 733 F.2d 267 (3rd Cir. 1984) ("Quite separate from the entry of a money judgment, however, is a proceeding to *enforce* that money judgment. The paradigm for such a proceeding is when, having obtained a judgment for a sum certain, a plaintiff attempts to seize property of the defendant in order to satisfy that judgment. It is this seizure of a defendant-debtor's property, to satisfy the judgment obtained by a plaintiff-creditor, which is proscribed by subsection 362(b)(5).") (citations omitted).

62. Final bankruptcy distribution payments in a chapter 11 case are generally "made to creditors over an extended period of time, out of the debtor's future earnings, in accordance with the terms of the confirmed plan of reorganization." TABB, *supra* note 18, at 535.

may not attempt to recover the debt.[63] In a chapter 11 proceeding, the confirmation of the plan of reorganization immediately discharges the debtor from all debts that arose prior to the plan confirmation.[64] Preconfirmation debts are replaced by the obligations assumed in the plan of reorganization.[65]

The concept of priority is relevant to the distribution of the debtor's assets to creditors, which is one of the core functions of bankruptcy proceedings.[66] Because it is the rare case in which the bankruptcy estate has sufficient assets to satisfy creditor claims in full, rules must be in place that determine how the limited pool of assets will be distributed among the competing creditors. A fundamental rule governing the distribution of a bankruptcy estate is the absolute priority rule.[67] The basic premise of that rule, first established by the U.S. Supreme Court in 1913, is that creditors must be paid in full before any payment can be made to holders of equity interests.[68] Secured creditors are the first to be paid—they are entitled to receive either their property or its value.[69] General unsecured creditors are entitled to the remaining assets of the estate and typically are entitled to receive a share equal to that of other unsecured creditors—that is, there exists an equality of distribution principle.[70]

Despite the general applicability of the equality of distribution principle, the Bankruptcy Code contains several provisions that alter it and

63. 11 U.S.C. § 524(a).

64. *Id.* § 1141(d)(1).

65. TABB, *supra* note 18, at 883. It is important to note that the plan of reorganization, which establishes the debtor's financial obligations to creditors upon its emergence from bankruptcy, is a "product of consensus," the terms of which "are arrived at through negotiations [by the debtor] with the various classes of creditors and equity security holders." *Id*. at 807. Thus, the plan of reorganization can be viewed as a "contract between the debtor, creditors, and equity." *Id*. at 806. In large bankruptcy cases, the debtor negotiates with multiple committees representing various interests, the most prominent of which generally is the unsecured creditors' committee. *Id*. at 783. The unsecured creditors' committee generally ensures that the interests of unsecured creditors are fairly represented in the formulation of the plan of reorganization. *See generally* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995 (1993). Most reorganization plans are consensual, meaning that the terms are agreed to by the necessary majorities of the different classes of claimants. TABB, *supra* note 18, at 73. However, sometimes the plan must be "crammed down"—i.e., forced upon—dissenting classes of claimants. *Id*.

66. TABB, *supra* note 18, at 493.

67. *See generally* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963 (1989); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988).

68. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913). In this case, the Court invalidated a foreclosure sale that gave stock in a new company to stockholders of the old company. *Id*. The Court stated: "[The issuance of stock] was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever." *Id*. at 508. *See also* John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 261 (1973) ("Not many doctrines have passed more fully into the collective consciousness of the legal and commercial communities than the absolute priority rule, which states this prohibition: in bankruptcy, stockholders seeking to recover their investments cannot be paid before provable creditor claims have been satisfied in full.").

69. 11 U.S.C. § 725; United States v. Speers, 382 U.S. 266 (1965).

70. TABB, *supra* note 18, at 494.

entitle certain unsecured claims to be paid in full before other unsecured claims can be paid. Specifically, priority unsecured claims[71] are entitled to be paid in full before any payments are made to nonpriority unsecured creditors.[72] Additionally, section 510 of the Bankruptcy Code provides that certain unsecured claims must be subordinated to other unsecured claims, meaning that such claims will not receive any distributions from the estate until unsecured claims at a higher level are paid in full.[73] One type of subordination is set forth in section 510(b), which provides:

> [A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such security . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.[74]

These claims generally arise where the debtor defrauded the purchaser or seller of securities.[75] Under section 510(b), these claims have a lower priority status for distribution purposes than all claims or interests that are senior to or equal the claim or interest represented by the security. Further, if the security to which the claim relates is an equity security, then the claim shares the same status as an equity security interest. For example, a tort claim by a purchaser of equity securities of the debtor that results from the debtor's fraudulent activity would not achieve the same status as general unsecured creditors even though, generally, a holder of a tort claim would obtain the status of a general unsecured creditor. Instead, that claim would merely have the same priority as a general equity claim. Because only rarely are all creditors paid in full,[76] section 510(b) effectively precludes an equity holder with a securi-

71. The following nine categories of unsecured claims are afforded the status of "priority" unsecured claims: (1) administrative expenses; (2) claims that arise in an involuntary case that arise between the time the petition is filed and bankruptcy relief is ordered; (3) employee wage claims up to $4,000 each; (4) certain unpaid contributions to employment benefit plans; (5) grain producer and fishermen claims, up to $4,000 each; (6) consumer layaway deposits, up to $1,800 each; (7) alimony, maintenance, and child support; (8) prepetition taxes; and (9) commitments to maintain the capital of insured depository institutions. 11 U.S.C. § 507(a)(1)–(9) (2002).

72. 11 U.S.C. § 726(a).

73. The term "subordination" is not defined in the Bankruptcy Code. Bank of Am. v. N. LaSalle St. Ltd. P'ship (*In re* 203 N. LaSalle St. P'ship), 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000). However, it has "a common understanding in the law" as meaning "[t]he act or process by which a person's rights or claims are ranked below those of others." *Id*. (quoting BLACK'S LAW DICTIONARY 1426 (6th ed. 1990)).

74. 11 U.S.C. § 510(b). The other types of subordination in section 510 are subordination pursuant to an agreement between creditors, *id.* § 510(a), and equitable subordination, *id.* § 510(c), which allows a bankruptcy court to use its equitable powers to "subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." Equitable subordination is discussed later in this note. *See infra* Part IV.B.2.

75. TABB, *supra* note 18, at 531; *see also infra* Part III.A.2. (discussing how courts have applied this section).

76. TABB, *supra* note 18, at 493.

ties fraud claim from recovering damages from the debtor's estate for that claim.

The bankruptcy court makes the determination of whether section 510(b) applies to a particular claim.[77] However, the court lacks discretion in applying section 510(b) because it is a mandatory provision,[78] so that "if an action fits within the purview of section 510(b), that section *must* apply."[79] Therefore, the court's role is to determine whether the claim falls within the coverage of section 510(b). If it does, then the court must subordinate the claim, and if it does not, then the court cannot subordinate the claim. Whether section 510(b) applies to a particular claim can be decided either by a motion to subordinate or as part of the court's plan-confirmation determination.[80]

### *B. The Basics of SEC Civil Enforcement Actions*

In order to fully comprehend the conflict between section 308(a) and section 510(b), it is necessary to understand SEC enforcement actions because only the SEC can initiate a proceeding under section 308(a).[81] Therefore, the conflict discussed in this note will not exist in a bankruptcy case involving a debtor unless the SEC has initiated an enforcement action.

Under federal securities law, the SEC has broad investigatory and enforcement powers.[82] The SEC has the authority to pursue either temporary or permanent injunctive relief in the courts "whenever it shall ap-

77. See *supra* note 34 for a brief discussion of a bankruptcy court's jurisdiction.

78. COLLIER ON BANKRUPTCY ¶ 510.04[7] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2004).

79. *In re* Lenco, Inc., 116 B.R. 141, 144 (Bankr. E.D. Mo. 1990) (emphasis in original).

80. FED. R. BANKR. P. 7001(8). *Compare* Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 303 B.R. 710 (Bankr. D. Mass. 2003) (confirming debtors' First Amended Joint Plan of Reorganization, which proposed subordinating former employees' claims on Stock Redemption Notes under either section 510(b) or 510(c), over objections to plan filed by former employees), *and In re* Stern-Slegman-Prins Co., 86 B.R. 994, 1001 (Bankr. W.D. Mo. 1988) (denying debtors' Second Amended Plan of Reorganization because the plan improperly subordinated a claim under section 510), *with* Baroda Hill Inv., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133 (3d Cir. 2002) (affirming the bankruptcy court's written opinion and order subordinating shareholders' claims upon the debtor's filing of an objection to shareholders' claims), *and In re* Granite Partners, L.P., 208 B.R. 332 (Bankr. S.D.N.Y. 1997) (granting bankruptcy trustee's motion to subordinate investors' fraudulent inducement and fraudulent retention claims pursuant to section 510(b)).

81. *See* Sarbanes Oxley Act of 2002 § 308(a), 15 U.S.C. § 7246(a) (2002) ("If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person . . . or such person agrees in settlement of any such action to disgorgement, and the Commission also obtains . . . a civil penalty against such person, the amount of such civil penalty shall, *on the motion or at the direction of the Commission*, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.") (emphasis added).

82. THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION §16.2, at 443–44 (4th ed. 2002). *See generally* Thomas L. Hazen, *Administrative Enforcement: An Evaluation of the Securities and Exchange Commission's Use of Injunctions and Other Enforcement Methods*, 31 HASTINGS L.J. 427 (1979); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149 (1990).

pear to the [SEC] that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation [of the federal securities laws]."[83] Although the securities laws only explicitly grant the SEC the power to enjoin violations, the SEC and federal courts have used "the general equitable powers of the federal courts" to create additional remedies in enforcement actions.[84]

One such additional remedy is disgorgement of ill-gotten profits.[85] The main purpose of disgorgement is to ensure that a violator of the securities laws will not profit from a violation.[86] A secondary goal of disgorgement is to provide restitution for injured investors.[87] Thus, an order for disgorgement of ill-gotten profits will frequently be followed by a distribution to injured investors.[88] However, distribution of disgorged profits to injured investors is not required; rather, the district court possesses broad discretionary power to determine whether disgorged funds will be used to provide restitution to injured investors.[89] If disgorged funds are not distributed to injured investors, the SEC distributes them to the U.S.

83. HAZEN, *supra* note 82, § 16.2[2][A], at 447 (quoting Securities Act of 1933 § 20(b), 15 U.S.C.A. § 77t(b)). Because an SEC injunction is considered to be a "drastic remedy," *id*. § 16.2[2][C], at 451, courts generally require a showing of more than mere negligence. *See* SEC v. Pros Int'l, Inc., 994 F.2d 767, 770 (10th Cir. 1993) (holding that a violation based merely on negligence and not resulting in a profit or other undue benefit to the defendant may not be sufficient to support an injunction).

84. HAZEN, *supra* note 82, § 16.2[4][A], at 456; s*ee also* James R. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 HARV. L. REV. 1779 (1976); Arnold S. Jacobs, *Judicial and Administrative Remedies Available to the SEC for Breaches of Rule 10b-5*, 53 ST. JOHN'S L. REV. 397 (1979).

85. HAZEN, *supra* note 82, § 16.2[4][A], at 456.

86. *Id*. § 16.2[4][B], at 460. One court explained that "[d]isgorgement wrests ill-gotten gains from the hands of a wrongdoer . . . [and thus] is an equitable remedy meant to prevent the wrongdoer from enriching himself by his wrongs." SEC v. Huffman, 996 F.2d 800, 802 (5th Cir. 1993); s*ee also* SEC v. First Pac. Bancorp, 142 F.3d 1186, 1191 (9th Cir. 1998) ("Disgorgement is designed to deprive a wrongdoer of unjust enrichment, and to deter others from violating securities laws by making violations unprofitable."); SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1474 (2d Cir. 1996) ("The primary purpose of disgorgement as a remedy for violation of the securities laws is to deprive violators of their ill-gotten gains, thereby effectuating the deterrence objectives of those laws.").

87. HAZEN, *supra* note 82, § 16.2[4][B], at 460; *see* SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) ("The primary purpose of disgorgement orders is to deter violations of the securities laws by depriving violators of their ill-gotten gains. . . . Although disgorged funds may often go to compensate securities fraud victims for their losses, such compensation is a distinctly secondary goal.").

88. HAZEN, *supra* note 82, § 16.2[4][B], at 459. The SEC has stated that its policy "wherever possible [is] to recommend a distribution plan by which a defendant's unlawful gains are paid out to defrauded investors . . . ." *Fischbach*, 133 F.3d at 174 (2d Cir. 1997) (quoting SEC Memorandum in Support of Motion for Order Directing Payment of Posner Disgorgement to the United States Treasury 2 (Dec. 20, 1996)).

89. *Fischbach*, 133 F.3d at 175 ("Once the profits have been disgorged, it remains within the court's discretion to determine how and to whom the money will be distributed, and the district court's distribution plan will not be disturbed on appeal unless that discretion has been abused."); *see also* SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991) (holding that "once the district court satisfies itself that the distribution of proceeds in a proposed SEC disgorgement plan is fair and reasonable, its review is at an end").

Treasury.[90] It is important to note that disgorgement of ill-gotten gains is strictly a remedial, rather than a punitive, measure.[91]

In 1990, Congress added to the SEC's arsenal of ancillary remedies by allowing it to seek civil penalties in civil enforcement actions brought in federal court against alleged violators of federal securities laws or the rules promulgated thereunder.[92] Generally, the amount of civil liability that the SEC seeks to impose on an alleged wrongdoer is discretionary.[93] In determining the appropriate amount for a civil penalty, a court may consider several factors, including the following: (1) the egregiousness of the defendant's conduct; (2) the degree of the defendant's scienter; (3) whether the defendant's conduct created substantial losses or the risk of substantial losses to others; (4) whether the defendant's conduct was isolated or recurrent; and (5) the defendant's current and anticipated future financial condition.[94] Regardless of the factors considered, however, the civil penalty sought may not exceed "the gross amount of pecuniary gain to such defendant as a result of the violation."[95] The SEC may seek both disgorgement and civil penalties in the same enforcement action.[96]

Prior to the enactment of Sarbanes-Oxley in 2002, injured investors could only be compensated by funds obtained by the SEC from securities law violators through a disgorgement order.[97] That is, civil penalties were not available to compensate injured investors, as those funds were simply paid to the U.S. Treasury.[98] However, section 308(a) of Sarbanes-Oxley, known as the Fair Funds for Investors[99] provision, fundamentally alters the ability of injured investors to receive funds recovered by the SEC in civil enforcement suits. Under this provision, the SEC, at its dis-

90. HAZEN, *supra* note 82, § 16.2[4][B], at 461.

91. SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978). Disgorgement is limited to the amount "by which the defendant profited from his wrongdoing" and "[a]ny further sum would constitute a penalty assessment." *Id*.

92. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (codified as amended in scattered sections of 15 U.S.C. §§ 77, 78 (2002)). The relevant section provides: "Whenever it shall appear to the Commission that any person has violated any provision of this title, the rules or regulations thereunder . . . the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, upon proper showing, a civil penalty to be paid by the person who committed such violation." *Id*. § 101, 15 U.S.C. § 77t(d) (2002).

93. HAZEN, *supra* note 82, § 16.2[5], at 467; *see* SEC v. Moran, 944 F. Supp. 286, 296–97 (S.D.N.Y. 1996) (noting that the civil penalty framework is of a "discretionary nature" and that "[e]ach case, of course, has its own particular facts and circumstances which determine the appropriate penalty to be imposed").

94. SEC v. Kane, 2003 U.S. Dist. LEXIS 5043 at *11 (S.D.N.Y. Apr. 1, 2003); s*ee also* SEC v. Credit Bancorp, Ltd., 2002 U.S. Dist. LEXIS 20597 at *9–10 (S.D.N.Y. Oct. 31, 2002).

95. 15 U.S.C. § 78u(d)(3)(B).

96. HAZEN, *supra* note 82, § 16.2[4][D], at 465.

97. However, disgorgement may only be paid to victims in cases "where they can establish an equitable claim to the funds." HAZEN, *supra* note 82, § 16.2[4][B], at 461. If the SEC determines that injured investors are not entitled to disgorgement funds, then it transmits those funds to the U.S. Treasury. *See supra* notes 88–90 and accompanying text.

98. SEC, REP. PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002, at 4 (2003), *available at* http://www.sec.gov/news/studies/sox308creport.pdf.

99. Sarbanes-Oxley Act of 2002 § 308, 15 U.S.C. § 7246.

cretion, may file a motion requesting that the court add any civil penalties paid by a defendant pursuant to an SEC enforcement action to a distribution fund earmarked for injured investors, but only if the defendant has also been ordered to pay disgorgement.[100] The use of the Fair Funds for Investors provision should increase the funds available to compensate victims of securities law violations. In the months immediately following the enactment of Sarbanes-Oxley, the SEC demonstrated its willingness to use the Fair Funds for Investors provision in a variety of enforcement actions.[101]

### *C. SEC Civil Enforcement Actions in Bankruptcy Proceedings*

Perhaps not surprisingly, companies that seek protection under chapter 11 of the Bankruptcy Code also frequently face civil enforcement actions by the SEC for alleged violations of the federal securities laws.[102] In fact, the SEC's filing of a civil action against a company typically plays a significant role in pushing a company into bankruptcy because the enforcement action makes the acquisition of additional capital difficult, resulting in potentially debilitating liquidity pressure.[103] The detrimental impact of an SEC enforcement action has become even more acute in recent years due to the large number of high-profile accounting fraud cases.[104] Therefore, it is important to understand how the Bankruptcy Court administers an SEC civil enforcement action against the debtor for an alleged violation of the securities laws.

As discussed in Part II.A., the commencement of a bankruptcy case imposes an automatic stay, or temporary injunction, against creditor collection actions.[105] The stay prohibits creditors from acting unilaterally to collect on their claims. Instead, the bankruptcy court supervises the orderly administration of creditor claims. Certain governmental enforcement actions are exempt from the automatic stay, but a governmental unit's effort to enforce a money judgment is subject to the stay.[106] Therefore, the SEC may enforce an injunction obtained in a civil action against a company during bankruptcy proceedings, but may not enforce a monetary penalty obtained in the same action. The penalty may only be recovered through the final bankruptcy distribution.

In the final bankruptcy distribution, the debtor's assets are distributed to creditors based on the priority of the creditors' claims. When the

100. SEC, *supra* note 98, at 22. The Commission has requested that Congress amend the Fair Funds for Investors provision to provide that civil penalties may be distributed to injured investors even in cases in which the Commission does not order disgorgement. *Id*. at 34.

101. *Id.* at 22.

102. *See, e.g.*, SEC v. WorldCom, Inc., 273 F. Supp 2d 431, 433–34 (S.D.N.Y. 2003).

103. *See id.* at 431. ("[T]he exposure of the fraud often creates liquidity pressures that can drive the company into bankruptcy, leaving unsecured creditors with little and shareholders with nothing.").

104. *See supra* notes 4–7.

105. *See supra* notes 46–51 and accompanying text.

106. *See supra* notes 58–62 and accompanying text.

SEC obtains a civil penalty against a company, it becomes a general unsecured creditor and occupies no favored position over other general unsecured creditors.[107] Therefore, the SEC generally does not collect from the debtor unless the claims of the secured creditors and priority unsecured creditors are paid in full. If those claimants are paid in full, then the SEC and other general—i.e., nonpriority—unsecured creditors are entitled to share the remaining assets of the bankruptcy estate. Those creditors typically receive a specified percentage of the total amount of their claims. For example, each general unsecured creditor might receive one-third of its total claim against the debtor. The specified percentage is set forth in the plan of reorganization.[108]

In the case of an SEC enforcement action, the debtor is discharged from the SEC's monetary penalty upon confirmation of the plan of reorganization.[109] However, the debtor must nevertheless pay the SEC a percentage of the penalty equal to the percentage to be received by general unsecured creditors as set forth in the plan of reorganization.[110] Monetary damages obtained by the SEC in a civil action for a securities law violation stand in a superior position to monetary damages obtained by a shareholder-plaintiff in a private action for a securities law violation against the same company. This is because section 510(b) of the Bankruptcy Code automatically subordinates securities fraud claims to all claims or interests senior to or equal to the claim represented by the security.[111] For example, claims for damages by equity security holders will be subordinated to all creditor claims—i.e., those claims will be treated the same as the equity security interest. Therefore, shareholders who obtain damages from securities fraud claims will not receive any compensation unless assets remain in the bankruptcy estate after all secured and unsecured creditors, including the SEC, have received full payment of their claims.

Generally, funds paid in the final bankruptcy distribution to satisfy the SEC's civil penalty claim will be directed to the U.S. Treasury.[112] However, if the SEC's civil action involves an order of disgorgement

107. *See* United States v. Kalishman, 346 F.2d 514, 520 (8th Cir. 1965). Generally, a debt owed to the U.S. government must be paid first when the person is insolvent—i.e., does not have sufficient assets to pay its liabilities. 31 U.S.C. § 3713(a)(1) (2002). However, that general rule does not apply to cases arising under title 11. *Id.* § 3713(a)(2). Therefore, claims of the U.S. government against a bankrupt debtor do not take priority over any of the debtor's other unsecured claims unless explicitly provided for in the Bankruptcy Code. The civil penalty imposed by the SEC does not qualify for one of the nine categories of priority for unsecured claims. *See supra* note 71 and accompanying text.

108. As discussed above, the terms in the plan of reorganization result from negotiations between the debtor, creditors, and equity holders. *See supra* note 65. Thus, the specified percentage is the product of negotiations between the debtor and creditors; it is not established by the court.

109. *See supra* notes 63–65 and accompanying text.

110. *See supra* text accompanying note 70.

111. 11 U.S.C. § 510(b) (2002). *See supra* notes 73–76 and accompanying text.

112. S.E.C. v. Lange, No. 97-6018, 2002 WL 475130 (E.D. Pa. Mar. 28, 2002) (mem.) (citations omitted); SEC v. Drexel Burnham Lambert, Inc., 956 F. Supp. 503, 507 (S.D.N.Y. 1997); SEC v. Dimensional Entm't Corp., No. 77 CIV. 5290 (JFK) 1996 WL 107290 at *2 (S.D.N.Y. Mar. 12, 1996).

against the defendant, then the Fair Funds for Investors provision of Sarbanes-Oxley permits the SEC to file a motion requesting that the district court add civil penalties imposed by the SEC on the defendant to a distribution fund that will compensate injured investors.[113] If the SEC decides to request the use of the Fair Funds for Investors provision, and the district court grants its motion, then funds paid in the final bankruptcy distribution to satisfy the SEC's judgment ultimately will be distributed to defrauded shareholders rather than to the U.S. Treasury.

Historically, a substantial majority of SEC civil actions are resolved via a settlement agreement between the parties.[114] In order to be binding on the parties, the court must approve the proposed settlement agreement.[115] The court's standard of review in assessing the proposed settlement agreement is whether the settlement is fair, reasonable, and adequate.[116] The district court must give substantial deference to the SEC's determination as to how and why the settlement advances the public interest.[117]

When the SEC enters into a settlement agreement with a company involved in a bankruptcy proceeding, Bankruptcy Rule 9019(a) provides that the bankruptcy court has the authority to approve the settlement.[118] In determining whether to approve the settlement, the court must assess whether the settlement is fair and equitable and in the best interests of the estate.[119] The court does not need to conduct a mini-trial.[120] Rather, the court must determine only whether the settlement "falls below the lowest point in the range of reasonableness."[121] One of the factors that the court should consider in making that determination is "the para-

113. 15 U.S.C. § 7246(a) (2002). Note that individual shareholder-plaintiffs only recover via the civil monetary penalty obtained by the SEC. The SEC determines how those funds are allocated to shareholders. Individual shareholder-plaintiffs do not pursue their claims against the debtor and then recover their judgment, if any, from the SEC. Even if individual shareholder-plaintiffs were to pursue their securities fraud claims against the debtor and ultimately obtain a money judgment, those claims would be subordinated under section 510(b) of the Bankruptcy Code. *See supra* notes 73–76 and accompanying text.

114. KIRKPATRICK & LOCKHART LLP, THE SECURITIES ENFORCEMENT MANUAL 181 (Richard M. Phillips ed., 1997) (noting that over ninety percent of all SEC enforcement actions end in settlement). However, as Congress continues to grant the SEC power to seek increasingly severe sanctions, settlements are becoming slightly less common as defendants more frequently choose to litigate rather than settle. *Id*.

115. *See* 46 AM. JUR. 2D *Judgments* § 207 (2004) ("Courts have the general power of entering judgment by consent of the parties for the purpose of executing a compromise and settlement of an action. . . . A consent decree is not simply a contract entered into between private parties. . . . A consent decree is a judicial act.").

116. *See* SEC v. Wang, 944 F.2d 80, 85 (2d Cir. 1991); United States v. Cannons Eng'g Corp., 899 F.2d 79, 84 (1st Cir. 1990) (citations omitted).

117. *See* FTC v. Std. Fin. Mgmt. Corp., 830 F.2d 404, 408 (1st Cir. 1987); SEC v. Randolph, 736 F.2d 525, 530 (9th Cir. 1984) ("The initial determination whether the consent decree is in the public interest is best left to the SEC and its decision deserves our deference.").

118. Lambert Brussels Assocs. v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 140 B.R. 347, 349 (Bankr. S.D.N.Y. 1992).

119. *In re* Drexel Burnham Lambert Group, Inc., 134 B.R. 493, 496 (Bankr. S.D.N.Y. 1991).

120. *In re* Mrs. Weinberg's Kosher Foods, Inc., 278 B.R. 358, 362 (Bankr. S.D.N.Y. 2002).

121. *In re* W.T. Grant Co., 699 F.2d 599, 608 (B.A.P. 2d Cir. 1983).

mount interest of creditors with proper deference to their reasonable views" of the settlement.[122]

### *D. Example:* SEC v. WorldCom, Inc.

The recent *SEC v. WorldCom, Inc.*[123] case provides a specific example of how an SEC civil action proceeds through a bankruptcy case. On June 25, 2002, WorldCom's audit committee announced that it had uncovered a $3.8 billion accounting irregularity.[124] The next day, the SEC filed a civil action in the United States District Court for the Southern District of New York alleging that WorldCom engaged in massive accounting fraud by overstating its pretax income and minority interests by approximately $3.055 billion in 2001 and $797 million during the first quarter of 2002.[125] The SEC sought court orders permanently enjoining WorldCom from violating both section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and imposing civil monetary penalties on WorldCom pursuant to section 21(d) of the Exchange Act.[126] On July 21, 2002, WorldCom filed for chapter 11 bankruptcy protection.[127] Shareholders' estimated losses in WorldCom stock amounted to approximately $200 billion.[128]

On November 26, 2002, the SEC obtained the injunctive relief it sought against WorldCom.[129] The court's order, however, left open the determination of the amount of monetary penalties to be imposed.[130] On May 19, 2003, the SEC filed a proposed settlement with the court under which WorldCom would be required to pay a civil penalty of approximately $1.5 billion.[131] As a result of WorldCom's bankruptcy case, the civil penalty would be satisfied by a payment of $500 million from the bankruptcy estate.[132] Under the terms of the proposed settlement, the funds distributed from the bankruptcy estate were to be paid to the vic-

122. Conn. Gen. Life Ins. Co. v. United Cos. Fin. Corp. (*In re* Foster Mortgage Corp.), 68 F.3d 914, 917 (5th Cir. 1995) (citing Drexel v. Loomis, 35 F.2d 800, 806 (8th Cir. 1929)).

123. 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

124. Michael Schroeder, *Agency Moves Quickly After Company Disclosures; A $3.8 Billion Scheme*, WALL ST. J., June 27, 2002, at A3.

125. SEC v. WorldCom, Inc., Litigation Release No. 17588, 77 SEC Docket 3013 (June 27, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17588.htm. On November 1, 2002, the SEC filed an amended complaint against WorldCom, broadening its charges to allege that WorldCom misled investors from early 1999 through the first quarter of 2002 by overstating income reported on its financial statements by approximately $9 billion. SEC v. WorldCom, Inc., Litigation Release No. 17829, 78 SEC Docket 2451 (Nov. 5, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17829.htm.

126. SEC v. WorldCom, Inc., Litigation Release No. 17829, 78 SEC Docket 2451 (Nov. 5, 2002), *available at* http://www.sec.gov/litigation/litreleases/lr17829.htm.

127. Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3.

128. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 431 (S.D.N.Y. 2003).

129. SEC News Digest (May 20, 2003), *available at* http://www.sec.gov/news/ digest/dig052003.txt.

130. *Id*.

131. *Id*. This penalty would have been fifty times larger than any civil penalty previously imposed by the SEC. *WorldCom*, 273 F. Supp. 2d at 435.

132. SEC News Digest, *supra* note 129.

tims of WorldCom's fraud pursuant to the Fair Funds for Investors provision.[133]

The court held a lengthy public hearing on the proposed settlement on June 11, 2003, at which interested parties could raise their concerns.[134] In response to issues raised at that hearing, the SEC filed a revised proposed settlement on July 2, 2003, under which WorldCom would be required to pay a civil penalty of $2.25 billion.[135] Under the terms of WorldCom's plan of reorganization, the civil penalty would be satisfied by a total payment of $750 million from the bankruptcy estate—$500 million in cash and $250 million in the company's new common stock.[136] The revised proposed settlement retained the provision from the initial proposal to use the Fair Funds for Investors provision to direct the judgment paid from the bankruptcy estate to defrauded shareholders.[137]

On July 7, 2003, the district court approved the revised settlement agreement.[138] In its written order, the court noted several unprecedented aspects of the settlement. One such aspect was that the settlement provided for the modest compensation of defrauded shareholders, who otherwise would have recovered nothing in the bankruptcy distribution, via the use of the Fair Funds for Investors provision.[139] The court acknowledged that the matter of determining the proper monetary penalty was "further complicated"[140] by the uneasy relationship between the Fair Funds for Investors provision and the bankruptcy laws. The court explicitly approved the use of the Fair Funds for Investors provision to provide some recovery for defrauded shareholders, stating that there was no reason "that the [SEC] cannot give its penalty recovery to the shareholders, as section 308(a) so laudably prescribes."[141] The court warned, though, that the SEC must be cautious about the extent to which the justification for the penalty amount relies on the amount of defrauded shareholders' losses that will be recompensed. The court reasoned that "a penalty that was premised primarily on that basis might arguably run afoul of the provisions of the Bankruptcy Code that subordinate shareholder claims below all others" and "would not only be adverse to the priorities estab-

133. *Id*.

134. *WorldCom*, 273 F. Supp. 2d at 435.

135. *Id*.

136. *Id*. Even after reducing the penalty amount in the plan of reorganization, the penalty was still seventy-five times greater than any penalty previously imposed by the SEC. *Id*.

137. *Id*.

138. *Id*. at 436.

139. *Id*. at 434. Defrauded shareholders would not have been able to obtain compensation from the bankruptcy estate via private causes of action against WorldCom because § 510(b) of the Bankruptcy Code would subordinate those claims to other general unsecured claims.

140. *Id*.

141. *Id*. Note, however, that in approving the settlement, the district court did not have to resolve the conflict between the Fair Funds for Investors provision and § 510(b) or the Bankruptcy Code. Rather, its role was solely to determine whether the settlement was fair, reasonable, and adequate. *See supra* notes 116–17 and accompanying text.

lished under the bankruptcy laws but also would run contrary to the primary purposes of the SEC fraud penalties themselves."[142]

Despite the court's cautionary language, it did not prohibit the SEC from "rationally tak[ing] account of shareholder loss as a relevant factor" in formulating the size and nature of the penalty.[143] Ultimately, the court approved the settlement because it was satisfied that the SEC did not use shareholder loss as the primary basis for its penalty proposal; rather, the court reasoned that the SEC "carefully reviewed all relevant considerations" and formulated a penalty that took "adequate account of the magnitude of the fraud and the need for punishment and deterrence" while "fairly and reasonably reflect[ing] the realities of [the] complex situation."[144]

The settlement was also subject to approval by the bankruptcy court pursuant to Bankruptcy Rule 9019(a).[145] On August 6, 2003, the bankruptcy court approved the settlement agreement.[146] The court noted that objectors to the settlement argued that the ultimate distribution to defrauded shareholders via the Fair Funds for Investors provision violated the subordination of shareholder claims provision in section 510(b) of the Bankruptcy Code,[147] but the court refused to rule conclusively on this contention.[148] Instead, it stated that the objectors' claim raised several corollary issues that created sufficient doubt about the outcome of any litigation seeking to reduce the status of the SEC penalty below other general unsecured claims.[149] The court expressed concern that such doubt could have a negative impact on the overall outcome of the case.[150] Therefore, the court concluded that "the settlement falls within the range of reasonableness and is fair and equitable and in the best interests of the Debtors' estates."[151]

On October 31, 2003, the bankruptcy court approved WorldCom's plan of reorganization.[152] Consequently, the SEC's $2.25 billion penalty

142. *WorldCom*, 273 F. Supp. 2d at 434. The court observed that a general rule of bankruptcy law is that defrauded shareholders cannot expect to recover any amount and "nothing in section 308(a) suggests that Congress intended to give shareholders a greater priority in bankruptcy than they previously enjoyed." *Id*.

143. *Id*.

144. *Id*. at 436.

145. *See supra* notes 118–22 and accompanying text.

146. *In re* WorldCom, Inc., Ch. 11 Case No. 02 B 13533, (AJG), Docket #8125 (Bankr. S.D.N.Y. Aug. 6, 2003) (http://www.elawforworldcom.com/worldcomdefault.asp).

147. *In re* WorldCom, Inc., Ch. 11 Case No. 02 B 13533 (AJG), Docket #8125 Exhibit A, at 3–4 (Bankr. S.D.N.Y. Aug. 6, 2003) (http://www.elawforworldcom.com/worldcomdefault.asp).

148. The court noted that it was not required to resolve the issue because it is only required to "canvas the issues and determine whether the settlement 'falls below the lowest point in the range of reasonableness.'" *Id.* at 4.

149. *Id*. Those corollary issues include the identity of the claimant, the SEC's permissible discretion setting penalty proposals, and the overall impact of Sarbanes-Oxley. *Id*.

150. *Id*.

151. *Id*.

152. *In re* WorldCom, Inc., No. 02-13533, 2003 Bankr. LEXIS 1401 (Bankr. S.D.N.Y. Oct. 31, 2003).

imposed on the company was discharged and defrauded shareholders became entitled to distributions from the bankruptcy estate of $500 million in cash and $250 million in common stock of the reorganized company.[153]

## III. PURPOSES AND HISTORY OF THE CONFLICTING PROVISIONS

In order to resolve the apparent conflict between sections 510(b) and 308(a), it is necessary to understand the history and purposes of those provisions.

### *A. Section 510(b) of the Bankruptcy Code*

#### *1. Policy Rationale*

As discussed in Part II.A., section 510(b) of the Bankruptcy Code provides that a claim for damages "arising from the purchase or sale" of a security must be subordinated to all claims senior or equal to claims represented by the security.[154] That subordination provision became part of bankruptcy law with the passage of the Bankruptcy Code in 1978.[155] The theoretical basis for section 510(b) came from a prominent law review article entitled, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*[156] by Professors John J. Slain and Homer Kripke.[157]

Slain and Kripke noted that, under then-existing bankruptcy law, a dissatisfied shareholder could avoid the absolute priority rule by rescinding his purchase of stock if he could prove that the original sale violated federal or state securities laws.[158] In such circumstances, the shareholder's claim would either share *pari passu* with claims of general unsecured creditors or even take preference over them.[159] Slain and Kripke noted two problems with such cases:

153. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 435 (S.D.N.Y. 2003) (stating that the SEC's proposed settlement with WorldCom provides that "if the Bankruptcy Court approves both the settlement and the plan of reorganization, the actual penalty payment will be $750 million" and that "of the $750 million, $500 million will be paid in cash and the other $250 million in the form of the company's new common stock, as valued in accordance with the plan of reorganization").

154. *See supra* notes 74–75 and accompanying text.

155. TABB, *supra* note 18, at 531.

156. Slain & Kripke, *supra* note 68.

157. *See* Baroda Hill Inv., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133, 139 (3d Cir. 2002) (noting that H.R. REP. NO. 95-595, at 196, states that "[t]he bill generally adopts the Slain/Kripke position" and then discussing the Slain and Kripke analysis); *In re* Betacom of Phoenix, Inc., 240 F.3d 823, 829 (9th Cir. 2001) ("Congress relied heavily on the analysis of two law professors [Slain and Kripke] in crafting the statute."); *In re* Granite Partners, L.P., 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1997) ("Any discussion of section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke . . . .").

158. Slain & Kripke, *supra* note 68, at 261.

159. *Id*.

> [F]irst, they disappoint the general creditor's expectation that in bankruptcy his claims will be paid out ahead of equity claims; secondly, they assume that the interests protected by federal and state securities regulation should take precedence over all other interests normally taken into account when dealing with claims against a distressed enterprise.[160]

To avoid those problems, Slain and Kripke argued that claims of rescinding shareholders should generally be subordinated to the claims of general unsecured creditors.[161] They conceptualized the issue as one of risk allocation,[162] arguing that "the situation with which we are concerned involves two risks: (1) the risk of business insolvency from whatever cause; and (2) the risk of illegality in securities issuance."[163] They argued that the absolute priority rule allocates the risk of business insolvency to shareholders because, under that rule, "stockholders seeking to recover their investments cannot be paid before provable creditor claims have been satisfied in full"[164] and "no obvious reason exists for reallocating [the risk of business insolvency]."[165] Discussing the rationale for the absolute priority rule, they noted:

> In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency . . . .[166]

Regarding the risk of illegality in securities issuance, Slain and Kripke argued that it should also be born by shareholders, since "[i]t is difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and not to the creditor, that the stock is offered."[167]

In sum, considering that the legislative history of section 510(b) indicates that Congress consciously adopted the underlying premise of the Slain and Kripke argument,[168] a reasonable interpretation of section

160. *Id*.

161. *Id*. at 294.

162. *See generally* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) ("[B]ankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'").

163. Slain & Kripke, *supra* note 68, at 286.

164. *Id*. at 261; *see supra* notes 67–70 and accompanying text for discussion of the absolute priority rule.

165. Slain & Kripke, *supra* note 68, at 287.

166. *Id*. at 286–87; *see also* Warren, *supra* note 162, at 792 ("An almost axiomatic principle of business law is that, because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the business's collapse—up to the full amount of their investment.").

167. Slain & Kripke, *supra* note 68, at 288.

168. *See* H.R. REP. NO. 95-595, at 195–96 (1977) (summarizing the argument in the Slain and Kripke article and stating that "the bill generally adopts the Slain/Kripke position"); *id.* at 194 ("The argument for mandatory subordination is best described by Professors Slain and Kripke."). It must be noted, however, that commentators do not unanimously support the Slain and Kripke position. For

510(b) is that it intends to "prevent disappointed shareholders from recovering the value of their investment by filing bankruptcy claims predicated on the issuer's unlawful conduct at the time of issuance, when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments."[169] Further, section 510(b) appears to "represent[ ] a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy."[170]

### *2. Interpretation and Application by Courts*

Even though the underlying policy rationale of section 510(b) is well-settled, courts continue to disagree as to its precise scope. Section 510(b) explicitly applies to claims "arising from rescission of a purchase or sale" of a security or "for damages arising from the purchase or sale" of a security.[171] The words "arising from" are the source of judicial disagreements about exactly what types of claims must be subordinated under section 510(b).[172] Some courts hold the view that section 510(b) should be construed narrowly, while others reason that the provision must be afforded a broad construction.

---

example, one commentator challenged Slain and Kripke's view, arguing that unsecured creditors bear a variety of risks and there is no basis for distinguishing the risk to them caused by fraud in the issuance of securities. Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders In Corporate Bankruptcy*, 1983 DUKE L.J. 1. Consequently, Davis argues that "blanket" subordination is not the proper result—instead, the shareholder should be compensated for the amount of loss in value of his stock due to issuer fraud, but not for the loss in value due to other business losses. *Id.* at 41. Thomas H. Jackson, a leading bankruptcy law scholar, criticizes section 510(b) for altering the status afforded to defrauded shareholders by traditional state law. THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 64 (1986). He argues that the status of securities law claims vis-à-vis other claims "ultimately comes down to whether certain shareholders (including those holding fraud claims) should be allowed to assume the attributes of creditors," which is determined by non-bankruptcy law. *Id*. Further, he remarks:

> Once nonbankruptcy law has decided on the ordering, it is improper to insist on a different result in bankruptcy based on whether a particular party agreed or did not agree to bear a particular risk. In all cases the risks that any party bears have been set by nonbankruptcy law. There is no reason to reorder priorities—to reallocate the relative value of such claims—simply because the process of disbursement has been collectivized. For that reason, whether or not section 510(b) is good policy, it is not good bankruptcy policy.

*Id*. Regardless of the attractiveness of those arguments, the issue discussed here must be analyzed according to the theoretical underpinnings of section 510(b) as adopted by Congress. The issue of whether section 510(b) is good bankruptcy policy is beyond the scope of this note.

169. Baroda Hill Inv., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133, 141 (3d Cir. 2002); *see* Slain & Kripke, *supra* note 68, at 268 ("[I]nvestors in stock or in subordinated debentures may be able to bootstrap their way to parity with, or preference over, general creditors even in the absence of express contractual rights.").

170. *In re* Telegroup, Inc., 281 F.3d at 141.

171. *See supra* note 74 and accompanying text.

172. Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173, 1178 (10th Cir. 2002); *In re* Telegroup, Inc., 281 F.3d at 138; *In re* Granite Partners, L.P., 208 B.R. 332, 339 (Bankr. S.D.N.Y. 1997); *see also In re* Angeles Corp., 177 B.R. 920, 927 (Bankr. C.D. Cal. 1995) ("Everyone who took a contracts class in law school knows that the words 'arising from' are broad. However, those words are not limitless.").

A narrow construction of section 510(b) would limit its application to only those claims arising at the time of the sale or purchase of stock.[173] Under that interpretation, section 510(b) would typically apply only when there was some illegal conduct in the issuance of stock. Consequently, claims predicated on the debtor's conduct occurring after the claimant's purchase of debtor's stock would not be subject to subordination under section 510(b). For example, in *In re Amarex, Inc.*,[174] the district court refused to subordinate under section 510(b) a claim for damages resulting from breach of a partnership agreement because the plaintiff's claim was predicated on conduct that occurred after the issuance of the partnership units.[175] The bankruptcy court had originally ordered subordination of the plaintiff's claims, reasoning that the plaintiffs "would have no claims against the debtor but for their purchase of the securities, and had the purchase not occurred they would not have the pendent common law claims."[176] In reversing the bankruptcy court, the district court labeled the bankruptcy court's construction of section 510(b) as "expansive" and criticized it for "ignor[ing] the clear language of section 510(b), its underlying policies and the purposes for which it was enacted."[177] In the district court's view, the congressional purpose in enacting section 510(b) was "to shift to the shareholders the risk of fraud in the *issuance* and *sale* of a security—no more."[178] Further, it stated:

> Section 510(b) pertains only to claims based upon the alleged wrongful issuance and sale of the security and does not encompass claims based upon conduct by the issuer of the security which occurred after this event. Such construction gives expression to the legislative comment that it is the nature of the claim, and not the status of the claimant, that is significant.[179]

A recent case also applying a relatively narrow construction of section 510(b) is *In re Montgomery Ward Holding Corp*.[180] In that case, the debtor sought to subordinate a claim predicated on the debtor's nonpayment of a promissory note issued to a former shareholder in a stock repurchase transaction.[181] The bankruptcy court refused to subordinate the former shareholders' claim under section 510(b), reasoning that the

173. *See In re* Telegroup, Inc., 281 F.3d at 135 ("Claimants argue that § 510(b) should be construed narrowly, so that only claims for actionable conduct—typically some type of fraud or other illegality in the issuance of stock—that occurred at the time of the purchase or sale of stock would be deemed to arise from that purchase or sale.").

174. Ltd. Partners' Comm. of Amarex, Inc. v. Official Trade Creditors' Comm. of Amarex, Inc. (*In re* Amarex, Inc.), 78 B.R. 605, 608 (W.D. Okla. 1987).

175. *Id.* at 610; *see also In re* Angeles Corp., 177 B.R. at 927 (relying on *In re Amarex, Inc.* and holding that claims for breach of fiduciary duty do not arise from the purchase or sale of limited partnership interests where the wrongful conduct occurred after the sale of those interests).

176. *In re* Amarex, Inc., 78 B.R. at 608.

177. *Id*. at 610.

178. *Id*. at 609–10.

179. *Id*. at 610.

180. 272 B.R. 836 (Bankr. D. Del. 2001).

181. *Id*. at 841.

plain language indicates that the provision "applies only to a claim that directly concerns the stock transaction itself, i.e., the actual purchase and sale of the debtor's security must *give rise* to the contestable claim."[182] The court concluded that a claim seeking recovery on a promissory note received in exchange for the sale of stock is not the type of claim that Congress was addressing when it enacted section 510(b).[183]

Despite the court's refusal to subordinate the former shareholder's claim under section 510(b), its holding is not as restrictive as that in *Amarex*. For example, while the *Amarex* court explicitly stated that section 510(b) applies only to "claims based upon the alleged wrongful issuance and sale of the security,"[184] the court in *Montgomery Ward* sets forth the following limit on the application of section 510(b): "claims that directly concern the stock transaction itself."[185] That limit is arguably less restrictive than the limit set forth in *Amarex*. Specifically, the *Amarex* limit precludes the possibility of a claim predicated on post-issuance conduct from being subject to subordination under section 510(b). However, the *Montgomery Ward* limit does not go that far, as it would apparently not preclude a claim based on post-issuance conduct being subject to section 510(b). For example, a stockholder who purchased a debtor's shares on the open market after reading a fraudulent press release by the debtor and later sought to recover damages possibly would not be able to avoid subordination under section 510(b) because such a claim arguably directly concerns the stock transaction.

Although some support exists in the case law for a narrow construction of the term "arising from," a broad reading is the prevailing approach.[186] Significantly, three courts of appeals[187] and the U.S. Bankruptcy Court for the Southern District of New York[188] have adopted a broad construction of the term. Those courts applying a broad interpretation recognize that claims arising from the purchase or sale of a security include those predicated on post-issuance conduct[189] and generally

182. *Id*. at 842.

183. *Id*. Similar to the discussion above regarding the policy behind section 510(b), *see supra* notes 158–70 and accompanying text, the court stated that the congressional policy behind section 510(b) is to "allocate[ ] the risk of securities fraud onto the investor" and that "[a]llowing an equity holder to share *pari passu* with unsecured creditors by asserting a rescission or tort damage claim defeats this goal." *Id*. at 843.

184. *In re* Amarex, Inc., B.R. at 610.

185. 272 B.R. at 842.

186. COLLIER ON BANKRUPTCY, *supra* note 78, at ¶ 510.04[3]; *see* Allen v. Geneva Steel Co. (*In re* Geneva Steel Co.), 281 F.3d 1173 (10th Cir. 2002); Baroda Hill Inv., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133 (3d Cir. 2002); Frankum v. Int'l Wireless Communications Holdings, Inc. (*In re* Int'l Wireless Communications Holdings, Inc.), 279 B.R. 463 (D. Del. 2002), *aff'g In re* Int'l Wireless Communications Holdings, Inc., 257 B.R. 739 (Bankr. D. Del. 2001); *In re* NAL Fin. Group, Inc., 237 B.R. 225 (Bankr. S.D. Fla. 1999).

187. *See In re* Geneva Steel Co., 281 F.3d 1173; *In re* Telegroup, Inc., 281 F.3d 133; *In re* Betacom of Phoenix, Inc., 240 F.3d 823 (9th Cir. 2001).

188. *In re* Granite Partners, L.P., 208 B.R. 332 (Bankr. S.D.N.Y. 1997).

189. *See*, *e.g.*, *In re* Geneva Steel Co., 281 F.3d at 1174–75 (holding that claims alleging that the debtor fraudulently induced the claimants to retain securities after issuance fall within the purview of

apply a but-for test in determining whether a claim arises from the purchase or sale of a security, which requires the court to assess whether the claim would exist but-for the purchase of the debtor's securities by the claimants.[190] Thus, the term "arising from" requires some "nexus or causal relationship"[191] between the claim and the claimant's purchase of debtor's securities, but that nexus is not so limiting as to require illegality in the purchase itself.[192]

The Third Circuit opinion in *Baroda Hill Investments, Ltd. v. Telegroup, Inc. (In re Telegroup, Inc.)*,[193] elucidates the justification behind broadly construing the term "arising from." In that case, shareholders of the debtor filed proofs of claims in the bankruptcy proceeding seeking damages for the debtor's alleged breach of a prebankruptcy agreement to use its best efforts to register its stock and ensure that its shares became freely tradeable by a specified date.[194] The debtor argued that the shareholders' claims should be subordinated under section 510(b) because, even though the actionable conduct occurred after the shareholders' purchase of debtor's securities, the shareholders' claims "would not have arisen but for the purchase of [debtor's] stock."[195] Further, the debtor argued that subordinating the shareholders' claims advanced the underlying policy of section 510(b) "by preventing disappointed equity investors from recovering a portion of their investment in parity with bona fide creditors in a bankruptcy proceeding."[196] The shareholders, however, argued that their claims did not fall within the coverage of section 510(b) because the debtor's actionable conduct occurred after their purchase of debtor's stock and section 510(b) only applies to "actionable conduct . . . that occurred at the time of the purchase or sale of stock."[197] The court thus had to determine whether to give section 510(b) a broad or narrow interpretation.

section 510(b)); *In re* Betacom of Phoenix, Inc., 240 F.3d at 823, 829 (holding that a claim for breach of a merger agreement falls within the purview of section 510(b)); *In re* Kaiser Group Int'l, Inc., 260 B.R. 684, 687–89 (Bankr. D. Del. 2001) (holding that claims for breach of a merger agreement are covered by section 510(b)), *aff'd*, No. 01-508-JJF, 2001 U.S. Dist. LEXIS 25574 (D. Del. Nov. 29, 2001); *In re* NAL Fin. Group, Inc., 237 B.R. at 225 (holding that claims or breach of debtor's agreement to use its best efforts to register its securities are covered by section 510(b)); *In re* Granite Partners, L.P., 208 B.R. at 333–34 (holding that claims alleging that the debtor fraudulently induced the claimants to retain securities after issuance fall within the coverage of section 510(b)).

190. *See*, *e.g.*, *In re* Telegroup, Inc., 281 F.3d at 143 (applying section 510(b) to claim because "the claim would not exist but for claimants' purchase of debtor's stock"); *accord In re* Int'l Wireless Communications Holdings, Inc., 68 Fed. Appx. 275, 278 (3d Cir. 2003).

191. *In re* Telegroup, Inc., 281 F.3d at 138.

192. *Id.*; *see also In re* Granite Partners, 208 B.R. at 339 (suggesting that "the purchase or sale must be part of the causal link although the injury may flow from a subsequent event" in order for the claim to be deemed "arising from" the purchase or sale of a security).

193. 281 F.3d 133.

194. *Id*. at 135.

195. *Id*.

196. *Id*.

197. *Id*.

The court ultimately agreed with the debtor and held that the claim for breach of the best efforts provision in the stock purchase agreement arose from the purchase of the stock and thus must be subordinated in accordance with section 510(b).[198] Because the court believed that the text of the statute was ambiguous, it looked to the statute's legislative history to discern the congressional policy behind enacting section 510(b) in order to reach its decision.[199] The court noted that the shareholders' distinction between actionable conduct occurring at the time of issuance and post-issuance actionable conduct "lack[ed] any meaningful basis as a matter of congressional policy" because Congress enacted section 510(b) to prevent shareholders from using fraud claims to "bootstrap their way to parity with, or preference over, general unsecured creditors" in a bankruptcy proceeding.[200] The court reasoned that it would be senseless to allow shareholders to gain parity with unsecured creditors simply because their claims were predicated on post-issuance conduct.[201] Moreover, the court noted that refusing to subordinate the shareholders' claims under section 510(b) would enable them to recover a portion of their equity investment, which would be in derogation of congressional intent that "disaffected equity investors [be prevented] from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy."[202] In sum, the Third Circuit believed that the shareholders, as equity investors, must bear the risk, in the event of bankruptcy, of a decline in value of their stock due to the debtor's unlawful conduct.[203]

Two similar, and equally important, cases applying a broad interpretation of the term "arising from" are *Allen v. Geneva Steel Co.* (*In re Geneva Steel Co.*)[204] and *In re Granite Partners, L.P.*[205] Both cases presented the question of whether an equity holder's claim that is predicated on a fraud-in-the-retention theory—i.e., where the debtor's post-investment fraud induced the equity holder to retain, rather than sell, its securities—arises from the purchase of a security and thus must be subordinated under section 510(b).[206] In both cases, the equity holders argued that their fraudulent retention claims were independent tort claims that did not arise from the purchase of the debtor's securities and should thus share *pari passu* with general unsecured creditors.[207] However, the courts in

198. *Id*. at 136.

199. *Id*. at 138–41. For a discussion of the statute's legislative history that parallels the court's discussion, see *supra* notes 158–70 and accompanying text.

200. *In re* Telegroup, Inc., 281 F.3d at 141.

201. *Id*. at 142.

202. *Id*.

203. *Id*. at 143.

204. 281 F.3d 1173 (10th Cir. 2002).

205. 208 B.R. 332 (Bankr. S.D.N.Y. 1997).

206. *In re* Geneva Steel Co., 281 F.3d at 1174; *In re* Granite Partners, L.P., 208 B.R. at 334.

207. *In re* Geneva Steel Co., 281 F.3d at 1175; *In re* Granite Partners, L.P., 208 B.R. at 334.

both cases rejected the equity holders' arguments and held that section 510(b) reaches fraud-in-the-retention claims.[208]

The *Geneva Steel* and *Granite Partners* courts, like the *Telegroup* court, concluded that the language of section 510(b) was ambiguous and thus looked to its legislative history to discern the congressional policy behind the statute's enactment.[209] In reaching its decision, the *Geneva Steel* court based much of its analysis on the *Granite Partners* court's opinion.[210] The principle foundation of those courts' opinions was that section 510(b)'s language, legislative history, and legislative policy choices "reflect strong congressional disapproval of investor fraud claims in bankruptcy."[211] There was, therefore, no justification for subordinating fraud-in-the-inducement claims while allowing fraud-in-the-retention claims to share *pari passu* with general unsecured creditors.[212]

The courts also discussed three other policy reasons for subordinating the equity holders' fraud-in-the-retention claims. First, creditors rely on the equity cushion of an investment regardless of whether the investor was the victim of fraud-in-the-inducement or fraud-in-the-retention.[213] Second, because a fraud-in-the-retention claim "involves the wrongful manipulation of the information needed to make an investment decision,"[214] only the investors should bear the risk of such manipulation. Third, the courts expressed concern that allowing the equity holders to use their fraud-in-the-retention claims to obtain equal status with general unsecured creditors weakens the absolute priority rule.[215] Specifically, the *Granite Partners* court stated: "When an investor seeks *pari passu* treatment with the other creditors, he disregards the absolute priority rule[,] and attempts to establish a contrary principle that threatens to swallow up this fundamental rule of bankruptcy law."[216] These three considerations bolstered the courts' conclusions that fraud-in-the-retention claims, like fraud-in-the-inducement claims, can fall within the coverage of section 510(b).

As previously discussed, a broad construction of both the term "arising from" and the scope of 510(b) is now the predominant approach.[217] The few cases applying a narrow construction have been considered and rejected by many courts. Further, the courts appear to be in significant agreement that a broad construction best effectuates the policy considerations underlying section 510(b). Therefore, when analyzing

208. *In re* Geneva Steel Co., 281 F.3d at 1174–75; *In re* Granite Partners, L.P., 208 B.R. at 334.
209. *In re* Geneva Steel Co., 281 F.3d at 1178–81; *In re* Granite Partners, L.P., 208 B.R. at 336–37, 339 n.8.
210. *In re* Geneva Steel Co., 281 F.3d at 1179.
211. *Id*.
212. *Id*.
213. *Id*. at 1180.
214. *Id*.
215. *Id*.
216. *In re* Granite Partners, L.P., 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997).
217. *See supra* notes 186–88 and accompanying text.

whether section 308(a) of Sarbanes-Oxley impermissibly circumvents section 510(b) of the Bankruptcy Code, it is important to remember that section 510(b) can be a far-reaching provision.

### *B. Section 308(a) of Sarbanes-Oxley*

In contrast to section 510(b), the legislative history of section 308(a) does not evidence congressional consideration of any theoretical or scholarly basis for the provision. The original House bill did not include the Fair Funds for Investors provision.[218] It did, however, include a provision requiring the SEC to contribute any funds obtained via a disgorgement order or civil penalty in an administrative or judicial proceeding brought against either Enron or Arthur Andersen to a "disgorgement fund."[219] Further, the provision required the SEC to "establish an allocation system for the disgorgement fund" which shall give "the first priority . . . to individuals who were employed by the Enron Corporation, or a subsidiary or affiliate of such Corporation, and who were participants in an individual account plan established by such Corporation."[220] This proposed section was likely drafted in response to frequent media accounts of Enron employees who lost substantially all of their retirement savings because they were invested almost exclusively in the Enron employee retirement plan, which placed restrictions on employees' ability to sell Enron stock.

The original Senate bill, like the original House bill, did not contain the Fair Funds for Investors provision.[221] It did not, in fact, even include the provision in the original House bill requiring funds obtained by the SEC from either Enron or Andersen to be paid to Enron employees.[222] The Fair Funds for Investors provision finally became part of the proposed Act when it was amended in the conference committee.[223] The conference committee filed its report on July 24, 2002.[224] The next day both the House[225] and the Senate[226] passed the revised bill. On July 30, 2002, President Bush signed the bill into law.[227]

Although the conference report does not contain an explanation or discussion of the Fair Funds for Investors provision, a review of the proceedings of the House's floor debate during its consideration of the conference report provides some insight into Congress's purpose behind including that provision in Sarbanes-Oxley. Congressman Richard Baker

218. *See* H.R. REP. NO. 107-414 (2002).
219. *Id*. § 13(a).
220. *Id*. § 13(b).
221. *See* S. REP. NO. 107-205 (2002).
222. *See id*.
223. *See* H.R. REP. NO. 107-610, at 31 (2002).
224. 148 CONG. REC. H5393 (2002).
225. 148 CONG. REC. H5480 (2002).
226. 148 CONG. REC. S7365 (2002).
227. 148 CONG. REC. D866 (2002).

from Louisiana, the Chairman of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises and sponsor of the Fair Funds for Investors provision, first praised the enhanced criminal sanctions imposed by Sarbanes-Oxley, but added:

> It is not enough that after we catch you we put you away for a long time. We want to go after those ill-gotten gains, that profit you made by misrepresenting the material facts of your corporation while manipulating the books and profiting for your own best interests. We want to make sure those mansions, those benefits, those golden parachutes are collapsed, folded up neatly, put into a closet and sold off so that the shareholders back home can get their hands on their money. That is what has been lost in all of this.
>
> A corporate executive takes capital from individual investors, hard-working investors saving for their first home, their child's education or their retirement, and thus has a fiduciary responsibility to manage that money for the mutual good of those investors. What has happened in actuality is that they have taken that money and put it in their pockets.
>
> I do not know how we are going to ultimately get to all of the State bankruptcy protections that allow these corporate mansions to be built, the extreme levels of financial worth, to allow a CEO to escape all of his liabilities and move into the home, live there 6 months, sell it and take the money and move to the south of France, but we are going to get there. This bill does not go quite that far, but over the next Congresses we are going to continue the work to make sure that no one who is defrauded by an irresponsible act of corporate abuse does not get full recompense for the wrong.[228]

Many other members of Congress expressed their support for the Fair Funds provision, and most of them, like Congressman Baker, expressed their outrage at wealthy corporate executives who had committed securities fraud and led their companies into bankruptcy. For example, Congresswoman Barbara Lee stated: "CEOs and high-ranking executives should forego their golden parachutes and multimillion-dollar-year bonuses while their companies are going bankrupt, and instead give workers and investors first rights to these funds."[229] Congressman Ed Royce also expressed disdain for corporate executives, stating: "By including Chairman Baker's [Federal Account for Investor Restitution] language, we have ensured that wronged shareholders whose hard-earned savings are stolen from them by pinstriped crooks have those funds returned to their retirement accounts, and not used to build a $100 million retirement mansion in Bermuda for an expatriate executive."[230] Congressman Harold Ford stated that the Fair Funds provision was an important component of the new Act because "white-collar

228. 148 CONG. REC. H5463 (daily ed. July 25, 2002).
229. *Id*. at H5468.
230. *Id*. at H5477.

thieves should not be allowed to walk off with the money they have stolen from investors and employees."[231] Additionally, Congressman Todd Tiahrt proclaimed:

> I believe Congress must act to ensure that investors are able to reclaim their losses which are due to corporate fraud. And after the corrupt executives return the hard earned money of employees and investors, they need to get out of their mansions and yachts, and get into a jail cell.[232]

This sample of comments indicates that, by including the Fair Funds for Investors provision in Sarbanes-Oxley, Congress' primary objective was to promote a sense of fairness to the general public by requiring that corporate executives surrender their ill-gotten gains, and property obtained with those gains, to the shareholders that were harmed by the executives' actions.[233]

## IV. THE PROPER RESOLUTION OF THE CONFLICT

The discussion in Part II, by discussing the basics of a bankruptcy proceeding, an SEC civil enforcement action, and the interaction between those two events, makes it clear that a conflict exists between section 308(a) of Sarbanes-Oxley and section 510(b) of the Bankruptcy Code. The brief discussion of the WorldCom case in Part II.D., which provides a real-world example of an SEC enforcement action operating within a bankruptcy proceeding, further highlights that conflict. Part III analyzed the purposes and histories behind the conflicting provisions, as well as the prevailing application of section 510(b) in the federal courts, in an effort to establish a foundation for addressing the ultimate issue—how best to resolve the conflict. This Part analyzes that issue and offers a recommendation. Section A addresses the related issues of whether the application of section 308(a) of Sarbanes-Oxley in a bankruptcy case infringes on the purpose and policy of section 510(b) of the Bankruptcy Code and, if so, whether either the explicit language or the underlying purpose of section 308(a) justify that infringement. Section A also addresses a potential counterargument against this note's conclusion that the Fair Funds for Investors provision impermissibly circumvents section 510(b) of the Bankruptcy Code. Section B then discusses the potential judicial responses to prevent the circumvention of section 510(b). Fi-

231. *Id*. at H5478.

232. *Id*.

233. Even without the Fair Funds for Investors provision, corporate executives would still be subject to surrendering their ill-gotten gains under established securities laws and other provisions within Sarbanes-Oxley. The Fair Funds for Investors provision does nothing to increase the likelihood that corrupt corporate executives will be forced to pay disgorgement and civil penalties. Rather, it merely provides that instead of the U.S. Treasury receiving those funds, shareholders may now receive them if the SEC deems it appropriate in the particular case.

nally, Section C concludes that legislative action is necessary to resolve the problem.

### *A. Does the Fair Funds for Investors Provision Impermissibly Circumvent Section 510(b) of the Bankruptcy Code?*

#### *1. Does the Fair Funds for Investors Provision Infringe upon the Purpose and Policy of Section 510(b) of the Bankruptcy Code?*

Part III.A.1. of this note provides an extensive discussion of the purpose and policy of section 510(b). As noted in that section, the basic problem that Congress was attempting to remedy by enacting section 510(b) was that under pre–Bankruptcy Code law, dissatisfied shareholders could avoid the absolute priority rule and share *pari passu* with the claims of general unsecured creditors by proving that they were the victims of federal or state securities law violations.[234] This was perceived as a problem because it disturbed the proper allocation of the risk of business insolvency and illegal securities issuance between creditors and equity holders.[235]

Since the enactment of section 510(b), the federal courts have shaped the contours of that provision and have further expounded the policy supporting it.[236] The prevailing view is that section 510(b) covers even those claims predicated on post-security-issuance conduct and generally holds that section 510(b) applies to any claim that would not exist but for the purchase of the debtor's securities by the claimants.[237] Additionally, courts have recognized that a claim predicated on a fraud-in-the-retention theory is also within the reach of section 510(b).[238] Those courts have premised their conclusions on their belief that Congress strongly disapproved of investor fraud claims in bankruptcy[239] and wanted to prevent shareholders from "bootstrapping their way to parity" with unsecured creditors.[240]

The use of the Fair Funds for Investors provision in a bankruptcy proceeding plainly contradicts those policies and purposes. The predicate offense for an SEC civil penalty is a securities law violation by the debtor. Such penalties, if they were being pursued by private plaintiffs rather than a governmental agency, would clearly be within the ambit of section 510(b). However, governmental penalties are not subject to subordination under that provision.[241] Therefore, the SEC is able to share

234. *See* text accompanying *supra* notes 158–60.
235. *See* text accompanying *supra* notes 162–67.
236. *See* discussion *supra* Part III.A.2.
237. *See* text accompanying *supra* notes 189–203.
238. *See supra* notes 204–16 and accompanying text.
239. *See supra* note 211 and accompanying text.
240. *See supra* notes 200–01 and accompanying text.
241. The plain language of section 510(b) makes it clear that that provision does not cover governmental penalties. Rather, it covers only claims "arising from rescission of a purchase or sale of a

*pari passu* with general unsecured creditors and enable equity holders to also share *pari passu* with general unsecured creditors, in derogation of section 510(b), via use of the Fair Funds for Investors provision. When defrauded shareholders recover from a bankrupt debtor, even when such recovery first passes through the SEC, the very problem that Congress attempted to eliminate with its enactment of section 510(b)—avoidance of the absolute priority rule—reemerges. The result might be acceptable if Congress had explicitly stated in Sarbanes-Oxley that such result was intended. However, as the district court judge noted when approving WorldCom's settlement with the SEC, "nothing in section 308(a) suggests that Congress intended to give shareholders a greater priority in bankruptcy than they previously enjoyed."[242]

### 2. *Does the Language or Purpose of Section 308(a) of Sarbanes-Oxley Justify Infringement on Section 510(b) of the Bankruptcy Code?*

As discussed in Part IV.A.1., section 308(a) of Sarbanes-Oxley infringes on the purpose and policy of section 510(b). Certainly, Congress possesses the authority to enact a statute that overrides or amends, either explicitly or implicitly, an existing statute. Thus, section 308(a)'s infringement on section 510(b) can be justified if the language or purpose of section 308(a) provides clear evidence that Congress intended such result.[243] However, such evidence does not exist.

First, as previously noted, neither the plain language of section 308(a) nor the language of the other sections of Sarbanes-Oxley indicate that Congress intended to give shareholders a greater priority in bankruptcy than they previously had.[244] Second, section 803 of Sarbanes-Oxley explicitly amends the Bankruptcy Code, which provides evidence that Congress knew how to amend the Bankruptcy Code when it deemed it necessary to do so and was cognizant of potential conflicts with Sarbanes-Oxley.[245] Third, a review of various Congressmen's comments during floor debates about section 308(a) does not reveal any intention to override traditional bankruptcy priorities. As discussed in Part III.B., Congress' primary motivation behind implementing the Fair Funds for Investors provision was to promote a sense of fairness in the general public by requiring that corporate executives surrender assets to the shareholders who were harassed by the executives' conduct. Such a purpose

security of the debtor . . . [or] for damages arising from the purchase or sale of such a security." 11 U.S.C. § 510(b) (2002).

242. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 434 (S.D.N.Y. 2003).

243. *See* United States v. Estate of Romani, 523 U.S. 517, 530–31 (1998) (noting that the Court has concluded, on several occasions, that "a specific policy embodied in a later federal statute" can implicitly amend, and control the interpretation of, an earlier federal statute).

244. *See supra* note 242 and accompanying text.

245. *See* Sarbanes-Oxley Act of 2002 § 803, 11 U.S.C.A. § 523(a)(17)–(19) (Supp. 2004). Section 803 of Sarbanes-Oxley makes debts incurred by individuals in violation of securities fraud laws nondischargeable in bankruptcy. *Id.*

does not justify disrupting the well-established distributional priorities of the Bankruptcy Code. Therefore, nothing in Sarbanes-Oxley justifies the infringement on section 510(b)'s subordination requirement.

### *3. What If the SEC Distributes Fines to Defrauded Shareholders Rather than to the U.S. Treasury?*

The foregoing discussion has made it clear that section 510(b) was enacted to prevent dissatisfied shareholders from avoiding the absolute priority rule and sharing *pari passu* with the claims of general unsecured creditors simply by proving fraud claims.[246] The problem with shareholders sharing *pari passu* with the claims of general unsecured creditors is that the bankruptcy estate consists of a limited pool of assets which is rarely, if ever, large enough to fully satisfy the claims of all creditors. Therefore, claimants to the fund are involved in a zero-sum game—the more that one claimant receives from the bankruptcy estate, the less that the other claimants will receive. If section 510(b) did not exist and shareholders were able to bootstrap their way to parity with general unsecured creditors by filing, for example, securities fraud claims, creditors would be adversely affected. Section 510(b) thus has the effect of protecting the bankruptcy estate from the shareholders and preserving the estate's funds for distribution to creditors.

It can be argued that section 308(a)'s policy of allowing the SEC to distribute civil penalties to shareholders does not adversely impact creditors because, even if the civil penalties could not be distributed to shareholders, they would be directed to the U.S. Treasury and consequently unavailable for distribution to creditors.[247] A question exists, therefore, about whether it even matters to creditors that the SEC directs civil penalties to shareholders instead of the U.S. Treasury because, regardless of who ultimately receives the funds, they are unavailable to satisfy the claims of other creditors.

While it is true that creditors are technically in no worse a position if civil penalties are distributed to shareholders rather than to the U.S. Treasury, the reality is that the Fair Funds for Investors provision of Sarbanes-Oxley will likely motivate the SEC to seek larger civil penalties in order to provide more compensation for shareholders. Larger civil penalties will, of course, have an adverse impact on the other general creditors of a bankrupt debtor by decreasing the assets in the bankruptcy estate that are available for distribution to them. Such large penalties can be expected to result from the Fair Funds for Investors provision because, although the SEC has a tradition of being the most independent of

246. *See supra* text accompanying notes 158–59.
247. *See supra* note 112 and accompanying text.

federal agencies,[248] it nevertheless is a political body which is susceptible to significant influence from both the legislative and executive branches as well as the general public.[249]

Indeed, the SEC's role as an enforcer of the securities laws is one area in which political interference is extensive. One commentator has noted that "Presidential interference with the Commission's prosecutorial function has become an anathema."[250] Due to the recent explosion of corporate fraud cases, coupled with the struggling economy, it is reasonable to expect that the SEC is under pressure from the President and the rest of the Executive Branch to take aggressive action against corporate wrongdoers and to seek large civil penalties, some of which will be used to compensate defrauded investors, in order to generate some political goodwill among the President's constituency. For example, President Bush discussed the need for more rigorous enforcement of the securities laws in his 2002 State of the Union address.[251] Additionally, on March 6, 2002, President Bush announced a ten-point program to reform securities enforcement and charged then SEC Chairman Harvey Pitt with implementing that program.[252]

The primary mission of the SEC is to protect investors and to preserve the integrity and efficiency of the securities markets.[253] The SEC frequently issues press releases publicizing the enforcement actions it undertakes in order to inform investors that the agency is working hard to carry out its mission.[254] Additionally, particularly in recent years, the actions of the SEC and its Chairman have been the subject of intense scrutiny from the financial press.[255] That intense scrutiny ultimately led to the resignation of SEC Chairman Harvey Pitt late in 2002. Because of the scrutiny under which the SEC operates, it has a strong interest in undertaking enforcement actions that the general public will perceive as being tough on corporate America. One such action is seeking large civil penalties against companies charged with violating the securities laws.

248. ROBERTA S. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 86–87 (1982).

249. *Id.*; *see also* ANNE M. KHADEMIAN, THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE 206 (1992) ("Yet, these claims to the contrary, the SEC—like any agency—is indeed a very political organization.").

250. KARMEL, *supra* note 248, at 88.

251. *See* BLOOMENTHAL, *supra* note 3, § 2, at 4.

252. *Id*. § 2, at 4 and § 3, at 5.

253. 2002 S.E.C. ANN. REP, *available at* http://www.sec.gov/pdf/annrep02/ar02full.pdf.

254. *See, e.g*., Press Release, Securities and Exchange Commission, SEC's Division of Enforcement Announces Agreement to Settle Civil Fraud Charges Against Fleet's Columbia Mutual Fund Adviser and Distributor for Undisclosed Market Timing (Mar. 15, 2004), http://www.sec.gov/news/press/2004-34.htm; Press Release, Securities and Exchange Commission, SEC Obtains Federal Court Order to Protect Shareholders and Preserve Corporate Assets of Hollinger International Inc. (Jan. 16, 2004), http://www.sec.gov/news/press/2004-8.htm.

255. *See, e.g*., Editorial, *Harvey Pitt's Credibility*, WALL ST. J., May 8, 2002; Editorial, *The SEC and Its Chairman*, FIN. TIMES, May 7, 2002; *see also* Brooke A. Masters & Christopher Stern, *supra* note 33 (noting that Nell Minow, editor of the Corporate Library, was critical of the civil penalty amount imposed by the SEC upon WorldCom because "[i]t is a drop in a very, very big bucket").

Some may argue that civil penalties will not significantly increase, despite the SEC's interest in providing greater compensation for defrauded shareholders, because judicial standards do not allow the SEC to formulate penalties based primarily upon loss to shareholders.[256] However, the district court judge in *SEC v. WorldCom, Inc.*, while acknowledging that the amount of the SEC's civil penalty cannot be premised primarily on the amount of the defrauded shareholders' losses that will be recompensed, explicitly approved of the SEC's "rationally tak[ing] account of shareholder loss as a relevant factor" in formulating the size and nature of the penalty.[257]

In light of the above considerations, the enactment of the Fair Funds for Investors provision will likely result in the SEC seeking increasingly large civil penalties against companies charged with violations of the securities laws. As a result, when the company is also involved in a bankruptcy proceeding, the limited pool of assets available for distribution to other general creditors will be further depleted.

### *B. Potential Judicial Reponses*

#### *1. Subordination of Securities Claims—Section 510(b)*

Even though section 308(a) impermissibly circumvents section 510(b), civil penalties obtained by the SEC in enforcement actions against a bankrupt debtor do not technically fall within the language of section 510(b). The plain language of section 510(b) states that it applies only to claims "arising from rescission of a purchase or sale of a security of the debtor . . . [or] for damages arising from the purchase or sale of such a security."[258] That language does not cover penalties imposed by the government and, as one court has noted, "the equity powers of [the court] do not permit [the judge] to override [the] specific statutory language."[259] Therefore, judges cannot simply use section 510(b) to subordinate SEC civil penalties.

#### *2. Equitable Subordination—Section 510(c)*

Section 510 provides two other statutory provisions for subordination of claims other than security purchase and sale claims. Important to the instant discussion is section 510(c), which permits the court to subordinate claims under principles of equitable subordination.[260] A claim that

256. *See supra* notes 93–95 and accompanying text.
257. *See supra* notes 142–43 and accompanying text.
258. 11 U.S.C. § 510(b) (2002).
259. Montgomery Ward Holding Corp. v. Schoeberl (*In re* Montgomery Ward Holding Corp.), 272 B.R. 836, 845 (Bankr. D. Del. 2001).
260. 11 U.S.C. § 510(c).

does not fit within the language of section 510(b) may nevertheless be subject to subordination under section 510(c).[261]

Equitable subordination is a remedial action that is used infrequently.[262] The traditional elements of equitable subordination, as developed through case law, are: (1) the claimant must have engaged in some type of inequitable conduct; (2) the creditors must have been injured by the conduct or the conduct must have given the claimant an unfair advantage; and (3) equitable subordination must not be inconsistent with the provisions of the Bankruptcy Code.[263] However, some courts have held that inequitable conduct on the part of the claimant is not always a necessary element for equitable subordination and have equitably subordinated claims where no such conduct was shown.[264]

Despite the fact that inequitable conduct on the part of the claimant might no longer be a necessary element for equitable subordination, a bankruptcy court likely cannot subordinate a SEC civil penalty claim under section 510(c) because of the U.S. Supreme Court's holding in *United States v. Nolan*.[265] In that case, the Court disallowed categorical subordination—i.e., automatically subordinating a claim simply because of the specific type of claim that it is—reasoning that "(in the absence of a need to reconcile conflicting congressional choices) the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the [Bankruptcy] Code."[266] Under that rule, courts probably would be precluded from using section 510(c) to subordinate all SEC civil penalty claims simply because of their status as such.

### *C. Legislative Action Needed*

As discussed in Part IV.A., section 308(a) of Sarbanes-Oxley impermissibly circumvents section 510(b) of the Bankruptcy Code. However, as discussed in Part IV.B., it appears that no methods exist by which courts could correct that problem. Therefore, congressional action to fix the problem is necessary. Congress should amend section 308(a) of Sarbanes-Oxley to explicitly state that the Fair Funds for Investors provision cannot be used by the SEC in a case in which the company from which it obtains a civil penalty is involved in a bankruptcy proceeding. Such an amendment would remedy the current conflict between section 308(a) and section 510(b) and prevent the impermissible abrogation of the mandatory subordination provision of securities fraud claims.

261. Audre Recognition Sys. v. Casey (*In re* Audre), 210 B.R. 360, 365 (Bankr. S.D. Cal. 1997).
262. COLLIER ON BANKRUPTCY, *supra* note 78, ¶ 510.05[1].
263. *Id.*; Benjamin v. Diamond (*In re* Mobile Steel Corp.), 563 F.2d 692, 700 (5th Cir. 1977).
264. *See, e.g.*, SPC Plastics Corp. v. Griffith (*In re* Structurlite Plastics Corp.), 224 B.R. 27 (B.A.P. 6th Cir. 1998).
265. 517 U.S. 535 (1996).
266. *Id*. at 543.

## V. CONCLUSION

The fact that a conflict between a provision in Sarbanes-Oxley and another major federal statute, such as the one discussed in this note, exists is not surprising given the hasty manner in which Congress passed Sarbanes-Oxley. As Sarbanes-Oxley matures, more conflicts are likely to arise. When those conflicts arise, they must be analyzed and properly resolved. This note analyzes the conflict between section 308(a) of Sarbanes-Oxley and section 510(b) of the Bankruptcy Code which was highlighted by *SEC v. WorldCom, Inc.* and concludes that section 308(a) impermissibly frustrates the purpose and policy of section 510(b) of the Bankruptcy Code. Therefore, Congress should amend Sarbanes-Oxley to make it clear that section 308(a) should not be used to alter the well-established distributional priorities of the Bankruptcy Code.