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THE PRECLUSIVE EFFECT OF DISGORGEMENT ORDERS IN NON-DISCHARGEABILITY ACTIONS UNDER § 523(A)(19)

ABSTRACT

In two cases recently decided by the Ninth and Tenth Circuits, the courts independently considered whether a disgorgement order levied by securities regulators against a debtor is excepted from statutory discharge under § 523(a)(19) of the Code. The issue split the panels in both cases, producing vehement dissents. In both circuits, the majority held that § 523 does not except a debt arising from a disgorgement order from statutory discharge under § 727 if the debtor has not been charged with or convicted of violating state or federal securities laws. Thus, a debtor's obligation to disgorge funds acquired through the fraudulent activity of a third party is a dischargeable obligation in bankruptcy.

This Comment argues that the decisions by the Ninth and Tenth Circuits incorrectly construed the plain meaning of § 523(a)(19) and ignored language in the statute that broadens the exception to embrace a debtor's obligation to disgorge funds acquired through the fraudulent misconduct of another individual. The Comment emphasizes that the character of the debt determined by the state courts should have been given preclusive effect by the bankruptcy courts. Deference to the state courts coincides with long-standing doctrines in bankruptcy law, which preserve in bankruptcy the property rights of the debtor defined by state or non-bankruptcy law. This new approach would aid the enforcement of security laws and support a framework for debtor attorneys and regulators preparing for litigation. Finally, lending preclusive effect to disgorgement orders does not threaten misappropriation of § 523 exceptions. Properly construed, § 523(a)(19) should except a debtor's obligation to return fraudulent funds regardless of their culpability for a security violation because there is a legitimate government interest in mitigating the egregious effect of large-scale investment fraud and protecting investors.

INTRODUCTION

On August 23, 2012, *The Wall Street Journal* reported the distribution of $2.4 billion in liquidated assets of Bernard L. Madoff Investment Securities, L.L.C. (Madoff Securities) to 1,229 investors defrauded by Madoff's infamous Ponzi scheme.[1] The distribution represented the latest effort of Irving Picard, the trustee overseeing Madoff Securities' liquidation, to compensate victims of the scheme for nearly $17.3 billion in missing funds.[2]

The devastation wreaked by the fund's collapse in 2008 has earned the Madoff Securities scheme notoriety as the largest Ponzi scheme in history.[3] In the aftermath of Madoff's arrest, the Securities and Exchange Commission (SEC) faced the daunting task of investigating nearly 15,000 claims seeking an estimated total of $64.8 billion.[4] Over five years later, litigation to return the misappropriated funds to their rightful owners continues.[5]

While the SEC denies there has been a "dramatic upswing in terms of the number of [Ponzi cases]," the SEC has noted an upward trend in the magnitude of the schemes filed.[6] As the Madoff Securities scheme demonstrated, investors damaged by fraud are not limited to sophisticated multinational corporations.[7] Many middle-income Americans saw their retirement savings

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1 Jacqueline Palank, *Madoff Trustee Cleared to Return $2.4 Billion*, THE WALL STREET JOURNAL, Aug. 23, 2012, *available at* http://online.wsj.com/news/articles/SB10000872396390444270404577607353850654214.

2 *Id.*

3 *See* Kaja Whitehouse, *Madoff Refund Checks Hitting Mailboxes Soon*, N.Y. POST, July 13, 2011, *available at* http://nypost.com/2011/07/13/madoff-refund-checks-hitting-mailboxes-soon/.

4 *In re* Bernard L. Madoff Inv. Sec. L.L.C., 424 B.R. 122, 124 (Bankr. S.D.N.Y. 2010).

5 *Here and Now: Echoes of the Madoff Scandal on 5 year Anniversary*, NATIONAL PUBLIC RADIO (Dec. 10, 2013) (interview with Wall Street Journal reporter, Jason Bellini, explaining that "there's still a lot of litigation five years later going on"). *See generally* Dan Fitzpatrick & Jean Eaglesham, *J.P. Morgan to Pay Madoff Penalties*, THE WALL STREET JOURNAL, Jan. 5, 2014, *available at* http://online.wsj.com/news/articles/SB10001424052702304617404579303384279905314 (reporting that as of date of the article, trustee would distribute $1.7 billion in settlement funds to victims of the Madoff scheme); Tom Hays, *4 Years In, Madoff Trustees Still Pursuing Assets*, ASSOCIATED PRESS, Dec. 10, 2012, *available at* http://www.usatoday.com/story/news/nation/2012/12/10/madoff-trustee-assets/1759629/ (stating that as of date of the article the pursuit of assets "show[ed] no signs of slowing").

6 Karey Wutowski, *SEC Says Magnitude of Ponzi Schemes Is Growing*, REUTERS, Feb. 6, 2009, *available at* http://uk.reuters.com/article/2009/02/06/us-sec-madoff-idUKTRE5154QR20090206.

7 *See* Robert Frank et al., *Fund Fraud Hits Big Names—Madoff's Clients Included Mets Owner, GMAC Chairman, Country-Club Recruits*, THE WALL Street JOURNAL, Dec. 13, 2008, at A1.

vanish overnight, which constituted portions of feeder funds that contributed to the Madoff scheme.[8]

In addition to illuminating the spectrum of victims affected by Ponzi schemes and the shortcomings of federal regulation,[9] the Madoff scandal also revealed the limitations of investor recovery after the Ponzi scheme's operator enters bankruptcy. Many investors expected their missing funds to be returned to them by the Securities Investor Protection Corporation ("SIPC"), which is regarded as the "first line of defense in the event a brokerage firm fails owing customer cash and securities that are missing from customer accounts . . . ."[10] However, many investors found this avenue of recovery closed to them by statutory limitations, as the SIPC only protects cash and security investments,[11] and does not cover victims who invested in the scheme indirectly through feeder funds.[12] These restrictions, coupled with limited SIPC funding,

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8 *See generally* Joe Bel Bruno, *Not Just Super Rich Caught Up in the Madoff Case*, ASSOCIATED PRESS, Dec. 15, 2008, *available at* http://www.foxnews.com/story/2008/12/14/not-just-super-rich-caught-up-in-madoff-case/ (reporting that pension funds and charities were also affected by Madoff case); James Sterngold, *Madoff Victims Recount the Long Road Back*, THE WALL STREET JOURNAL, Dec. 9, 2013, *available at* http://online.wsj.com/news/articles/SB10001424052702303560204579248221657387860 (reporting on the struggles of individual victims of the Madoff Securities scheme who lost their retirement money, college funds, and life savings); Dan Strumpf, *Madoff Scandal Still Haunts Victims*, THE WALL STREET JOURNAL ONLINE, Dec. 10, 2012, *available at* http://online.wsj.com/news/articles/SB100014241278873243392045781 71422302043906 (reporting the lost retirement savings of a 62-year-old farmer in Colorado).

9 *See* Bruno, *supra* note 8; Kara Scannell, *SEC Had Chances for Years to Expose Madoff's Alleged Ponzi Scheme*, THE WALL STREET JOURNAL, Dec. 15, 2008, at A16.

10 Mallory A. Sullivan, Note, *When the Bezzle Bursts: Restitutionary Distribution of Assets After Ponzi Schemes Enter Bankruptcy*, 68 WASH. & LEE L. REV. 1589, 1593–94 (2011) (citation omitted).

11 *See Securities Investor Protection Corporation (SIPC)*, U.S. SECURITIES & EXCHANGE COMMISSION (Mar. 27, 2012), https://www.sec.gov/answers/sipc.htm.

12 *See* Sullivan, *supra* note 10, at 1594 (explaining that such individuals fail to meet the definition of "customer" in § 78111(2) of SIPA); *see also* Christine Hurt, *Evil Has a New Name (And a New Narrative)*: *Bernard Madoff*, 2009 MICH. ST. L. REV. 947, 971 ("SIPC rules also count only direct customers in [Madoff Securities] as eligible for SIPC compensation . . . [i]ndividual clients of feeder funds must look to that fund for compensation."). SIPC also limits claims to the principal amount that the victim had invested, minus distributions that they might have taken over the years. Hurt provided the following example of these statutory limitations:

> [I]f an investor placed a $100,000 inheritance with Madoff in 1985 and believed that in 2008 it had grown to $400,000, then the investor argues the loss is $400,000, but SIPC argues the loss is $100,000. In addition if that investor took out $50,000 in 2001 to send a child to college, the SIPC argues the loss is $50,000. If the investor sent two children to college at $50,000 each, then SIPC argues that there is no loss and no valid claim, regardless of whether the last statement falsely led the investor to believe that she had a nest egg of $400,000 and regardless of the investor's actions in reliance on that belief. In addition, the loss is estimated at $100,000 regardless of inflation or concepts of the time value of money.

Id. at 970.

transformed many defrauded investors into claimants seeking restitution in the muddled world of bankruptcy.[13] In bankruptcy, a trustee collects and liquidates the debtor's non-exempt assets to distribute to creditors.[14] After distribution, the bankruptcy court must grant the debtor a discharge "from all debts that arose before the date of the order for relief . . . ."[15] However, the collapse of a Ponzi scheme presents the trustee with unique challenges. Among them is the difficulty of negotiating claims for restitution brought by creditors that are victims of the debtor's fraud.[16]

Creditors with restitution claims possess state-law property rights, traditionally known as an "equity," that give claimants the right to recover title or possession of property held unlawfully by a debtor.[17] A claim for restitution restores legal title to the transferor by invalidating the debtor's property rights in the money transferred.[18] However, when a claimant seeks restitution against a debtor in bankruptcy, the "[p]roperty in which the claimant has an equitable interest—a claim to restitution that is valid at state law—is now in the hands of the trustee."[19] If the restitution claim is denied, then ownership of the claimant's property—procured through fraud by the debtor—is now imparted

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13 See In re Bernard L. Madoff Inv. Sec., L.L.C., 424 B.R. 122, 133 (Bankr. S.D.N.Y. 2010) (quoting In re Adler Coleman Clearing Corp., 195 B.R. 266, 269–70 (Bankr. S.D.N.Y. 1996)) ("[A] liquidation proceeding shall be conducted in accordance with, and as though it were being conducted under chapters 1, 3 and 5 and subchapters I and II of chapter 7 of Title 11."); see also Mark T. Cramer & R. Alexander Pilmer, Swindler's List: Formal Dissolution Proceedings Are Usually Necessary to Sort Through the Wreckage of Failed Ponzi Schemes, L.A. Law., June 2009, at 24 (noting failed Ponzi schemes often end up in bankruptcy).

14 11 U.S.C. § 726(b) (2012). The priorities are numerous. Under § 507, claims are prioritized in the following order: 1) unsecured claims for domestic support obligations; 2) administrative expenses related the debtor's estate; 3) unsecured claims allowed under § 502(f); 4) allowed unsecured claims of employees or of the debtor for wages or sales commissions; 5) allowed unsecured claims for contributions to an employee benefit plan; 6) unsecured claims of persons that raise grain against a debtor operating a grain elevator; 7) claims of individuals that deposited money with the debtor before the commencement of the case for lease, purchase, or rental of property; 8) unsecured claims of governmental units for uncollected taxes; 9) claims of a federal depository institution; and 10) claims against the debtor for death or injury resulting from the debtor's negligent operation of a motor vehicle. *Id.* § 507. Chapter 7 provides that only after distribution to claimants under § 507 may the remaining assets of the debtor be used to satisfy claimants under § 726. *Id.* § 726(a)(1). Allowed unsecured claimants are next, followed by claims for fines, penalties, forfeitures or any damages arising before the order for relief. *Id.* § 726(a)(2)–(4). The debtor may then pay any interest on claims sustained under § 726, and retain any residual assets. *Id.* § 726(a)(5)–(6).

15 *Id.* § 727(b).

16 *See, e.g.*, Andrew Kull, *Restitution in Bankruptcy*: *Reclamation and Constructive Trust*, 72 AM. BANKR. L.J. 265 (1998); Sullivan, *supra* note 10.

17 Kull, *supra* note 16, at 265.

18 *Id.* at 277.

19 *Id.* at 282.

to the trustee and will be distributed to the debtor's creditors.[20] The nonconsensual transfer, originally between claimant and debtor has now evolved into a nonconsensual transfer between claimant and the debtor's creditors.[21]

Most victims of a Ponzi scheme will find the restitution remedy unsatisfactory. Though defrauded investors may "obtain restitution from any traceable product" of the property, and they are entitled to claim restitution through a process known as "tracing,"[22] it is nearly impossible to identify *which* of the debtor's comingled funds have been redistributed to other investors or incorporated into the debtor's estate.[23] In such an instance, the burden falls on the lower state courts to determine the interests of the competing claimants using their power in equity. [24]

Other common remedies for securities fraud include the SEC's power to exact investor disgorgement of ill-gotten monetary gains. The SEC obtained express power to seek disgorgement of monetary gains acquired through illegal conduct through the adoption of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990.[25] The SEC has traditionally used disgorgement primarily as a tool for enforcement and not as a means to compensate investors.[26] A disgorgement proceeding is designed to deprive defendants of ill-gotten gains by requiring the wrongdoer to turn over the amount by which they have been unjustly enriched.[27] Unlike an act for restitution, which is brought to compensate fraud victims for their losses, disgorgement is an equitable remedy that "extends only to the amount with interest by which the defendant profited from his wrongdoing."[28]

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[20] *Id.*

[21] *Id.* ("Property obtained by fraud or mistake, like property obtained by theft, has not come into possession of the debtor by a voluntary transaction. To distribute it to creditors would therefore result in an involuntary transfer, accomplished in two stages, from claimant to creditors."). *Id.*

[22] *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT §58(1) (2011).

[23] *See* Kull, *supra* note 16, at 283.

[24] Sullivan, *supra* note 10, at 1600 (citation omitted) ("Once the assets are returned to the estate, the court is given broad power to rule on a plan of distribution, subject only to the requirement that the court 'use its discretion in a logical way to divide the money.'").

[25] Securities Enforcement Remedies and Penny Stock Act of 1990, Pub. L. No. 101-429, 104 Stat. 931; Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. LAW. 317, 320 (2008).

[26] Black, *supra* note 25, at 321.

[27] SEC, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002 3, *available at* http://www.sec.gov/news/studies/sox308creport.pdf [hereinafter *SEC Report*] (citing The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No 101-429, 104 Stat. 931).

[28] *Id.* (quoting SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978)).

In 2002, investors gained an important ally in the effort to recover stolen funds when Congress granted the SEC additional compensatory power under § 308 of the Sarbanes-Oxley Act (SOX).[29] Section 308 creates the Federal Account for Investor Restitution (known as the FAIR Fund) and permits the SEC to distribute monies collected in satisfaction of an enforcement action to investors harmed by the security violation, rather than into the coffers of the U.S. Treasury.[30] With this new authority, the SEC's role extends beyond the traditional role of "enforcing securities law, sanctioning securities laws violators, and deterring future fraud"[31] to embrace a *compensatory* role for defrauded investors.[32] This broader power has also drawn criticism from securities scholars, concerned that the SEC's power under § 308 infringes on an avenue for recovery that was previously available only to private plaintiffs—and not the responsibility of securities regulators.[33] The Bankruptcy Code (Code) embraces the notion that debts incurred through the debtor's malfeasance should not be extinguished in bankruptcy.[34] For example, under § 727(a)(4) a debtor can be denied discharge in its entirety if the debtor received or attempted to obtain the money through fraud.[35] The Code also

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29 *See* Verity Winship, *Fair Funds and the SEC's Compensation of Injured Investors*, 60 FLA. L. REV. 1103, 1118 (2008).

30 *See* Black, *supra* note 25, at 318 (citing Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, § 308, 116 Stat. 745, 784 (codified at 15 U.S.C. § 7246 (2012))); Winship, *supra* note 29, at 1118 (citations omitted) ("Whereas until [the passage of the Sarbanes-Oxley Act of 2002] any civil money penalties had been required to be paid into the U.S. Treasury, the Fair Fund provision of Sarbanes-Oxley allowed penalties paid in enforcement actions to be added to disgorgement funds and paid to the injured investors[.]"). Section 308(a) provides:

> If, in any judicial or administrative action brought by the Commission under the securities laws, the Commission obtains a civil penalty against any person for a violation of such laws, or such person agrees, in settlement of any such action, to such civil penalty, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of a disgorgement fund or other fund established for the benefit of the victims of such violation.

Sarbanes-Oxley Act of 2002, Pub. L. No. 107-24, § 308(a), 116 Stat. 745, 784 (codified at 15 U.S.C. § 7246).

31 Black, *supra* note 25, at 319–20.

32 *Id.* at 318.

33 *See generally id.* at 318–19; Winship, *supra* note 29, at 1138.

34 *See* Anthony Michael Sabino, *Preventing an Alchemy of Evil: Preserving the Nondischargeability of a Debt Obtained by Fraud*, 12 J. BANKR. L. & PRAC. 99, 100 (2003). This wisdom was reaffirmed by Justice Stevens in *Grogan v. Garner* when he explained that "in the same breath that [the Supreme Court Justices] have invoked this 'fresh start' policy, [they] have been careful to explain that the Act limits the opportunity for a completely unencumbered new beginning to the 'honest but unfortunate debtor.'" Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

35 11 U.S.C. § 727(a)(4) (2012).

excepts specific types of debts from discharge under § 523.[36] Examples of debts that can be nondischargeable under these exceptions include debts incurred by the debtor through fraud or embezzlement,[37] student loans,[38] and death or personal injury claims against the debtor for drunk driving.[39] These provisions are instrumental in preventing debtors from abusing the bankruptcy process by using the Code as a shield to avoid payment of debts incurred through nefarious behavior.[40]

The focus of this Comment is the exception to discharge provided under § 523(a)(19). This provision is a recent addition to the laundry list of exceptions added by Congress in 2002, and has received little attention from the federal courts. Specifically, this Comment investigates two opinions published by the Ninth and Tenth Circuit Courts of Appeals construing the scope of § 523(a)(19). In each case, the courts considered whether the exception to discharge under § 523(a)(19) applies to debts incurred by debtors that are not directly liable for a security violation, but acquired funds through the fraudulent acts of a third party.[41]

Ultimately, both courts determined that the money the debtors owed to the security regulators was not excepted from discharge by operation of § 523(a)(19).[42] To support their arguments, the majority opinions examined the statute's legislative history and parsed the language of the statute in an effort to determine the provision's plain meaning.[43] However, the issue sparked strong disagreement in both cases, as each dissenting opinion disagreed with the majority's interpretation of the statute's meaning and its characterization of the underlying debt.[44]

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[36] *See id.* § 523.

[37] *Id.* § 523(a)(2)(A).

[38] *Id.* § 523(a)(8)(B).

[39] *Id.* § 523(a)(9).

[40] *See* Sabino, *supra* note 34, at 101.

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

[42] Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1177 (10th Cir. 2012) (reversing Bankruptcy Court grant of summary judgment to security regulator plaintiffs which had declared that a debt was nondischargeable in bankruptcy when resulting from a violation of a securities law); Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1019 (9th Cir. 2011) (holding "that 11 U.S.C. § 523(a)(19) prevents the discharge of debts for securities-related wrongdoings only in cases where the debtor is responsible for that wrongdoing"), *abrogated by* Bullock v. BankChampaign, N.A.,133 S. Ct. 1754 (2013).

[43] *See Faught*, 691 F.3d at 1175–76; *Sherman*, 658 F.3d at 1012–13, 1016–17, *abrogated by* Bullock v. BankChampaign, N.A.,133 S. Ct. 1754 (2013).

[44] *Faught*, 691 F.3d at 1177, 1181–82 (Briscoe, C.J., dissenting); *Sherman*, 658 F.3d at 1016–17, 1021 (Fisher, J., dissenting), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

This Comment provides additional support for these dissenting opinions by examining inconsistencies with the majority opinions. Specifically, this Comment argues that the majority opinions authored by the Ninth and Tenth Circuits erroneously permitted the debtors to discharge a debt owed to satisfy a disgorgement order secured against them by state securities regulators. The court should have upheld the motion of the securities regulators and declared the debt nondischargeable. The narrow construction of § 523(a)(19) adopted by these courts is flawed because it confuses legal precedent established under § 523(a)(2)(A) with the intended purpose of § 523(a)(19). Contrary to the courts' opinions, § 523(a)(19) embraces state-court orders to disgorge profits obtained by the debtor through unjust enrichment, regardless of whether the debtor has been charged with violating securities laws. The Circuit Court's rationale for adopting a narrow construction of § 523(a)(19) is flawed because it misconstrues the legislative history of the statute and the legal precedent adjudicating the dischargeability of fraudulent debts. Finally, the opinion promotes an inconsistent legal interpretation of the statute and fails to account for significant differences among state courts awarding disgorgement in an action for unjust enrichment. Correctly construed, the statute should recognize state court judgments establishing the debtor's liability for a disgorgement debt and declare such debts nondischargeable.

To support this argument, Part II of this Comment will briefly outline the development of exceptions to discharge for debts incurred through vicarious liability for fraud and discuss scholars' competing constructions of provisions in § 523(a). In Part III, this Comment will examine the opinions of the Ninth and Tenth Circuit Courts and the rationale for adopting a narrow interpretation of § 523(a)(19). Part III also examines inconsistencies in the majority opinion and demonstrates that the opinions gloss over important doctrinal distinctions that should have dissuaded the adoption of a narrow construction of § 523(a)(19). Part IV of the Comment will argue that permitting a bankruptcy court to go beyond the disgorgement order itself and consider the debtor's liability for the underlying violation encroaches on the jurisdiction of non-bankruptcy courts and the power of state courts to award proper remedy for the violations of the securities laws in their respective jurisdictions. The analysis conducted in Part V will demonstrate that awarding preclusive effect to monetary judgments or disgorgement orders for unjust enrichment through securities fraud is consistent with historical practice in the courts efforts to adjudicate securities enforcement actions. Finally, Part V revisits the scholarly construction of § 523(a) exceptions and suggests that § 523(a)(19) is better understood as an exception advancing the government's interest in protecting statutory remedies for securities fraud and would be better cast as a "type" exception rather than a "conduct" exception.

I. BACKGROUND AND LEGAL DOCTRINE

A. The History of Exceptions to Fraud under § 523(a)(2)(A)

The history of imputed liability to debtors for fraud in bankruptcy begins with the statutory predecessor to § 523(a)(19). Before Congress amended the Code in 2002, bankruptcy courts determined the dischargeability of fraudulent debts largely under § 523(a)(2)(A).[45] "Unfortunately, little legislative history exists on the enactment of § 523(a)(2)(A)."[46] The remnants that remain suggest that Congress intended § 523(a)(2)(A) to codify existing case law involving dischargeability.[47] A brief examination of this case law reveals that courts have historically struggled to apply the dischargeability exception as developing theories of agency imputed liability for fraud to third parties. This brief survey of cases demonstrates that claims against a debtor's estate for funds obtained illegally introduces tension in the administration of the estate, as the regulator's interest in preventing individuals from profiting from illegal activity[48] conflicts with the Code's interest of providing relief to the honest, but unfortunate debtor.[49]

The relevant case law involving exceptions to discharge for fraudulent misconduct begin with Justice Harlan's opinion in *Neal v. Clark*.[50] In *Neal*, the Supreme Court considered whether a debtor that purchased and resold

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45 *See* Michael J. Kaufman, 26 SEC. LITIG.: DAMAGES §5D:5 (2013) (explaining that "[s]ection 523(a)(2)(A) . . . has largely been replaced with [s]ection 523(a)(19) for securities law violations"); *see also* Lucian Murley, Note, *Closing A Bankruptcy Loophole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 KY. L.J. 317, 326 (2003) (citations omitted) (referring to § 523(a)(2) as "the most litigated exception to fraud").

46 Theresa J. Pulley Radwan, *Determining Congressional Intent Regarding Dischargeability of Imputed Fraud Debts in Bankruptcy*, 54 MERCER L. REV. 987, 998 (2003).

47 *See id.* at 999 (citing 124 CONG. REC. H11089, *reprinted in* 1978 U.S.C.C.A.N. 6436, 6453 (95th Cong. 2d Sess.)) (explaining that "[s]ubparagraph (A) is intended to codify current case law, e.g. *Neal v. Clark* . . . which interprets 'fraud' to mean actual or positive fraud rather than fraud implied in law").

48 *See* 79A C.J.S. *Securities Regulation* §6 (2014) (citing SEC v. Zandford, 258 F.3d 559 (4th Cir. 2001), *rev'd on other grounds*, 535 U.S. 813 (2002) and SEC v. Southwest Coal and Energy Co., 624 F.2d 1312 (5th Cir. 1980)) ("The prevention of fraud and deceptive practices is also stated to be a major objective of federal securities regulation.").

49 Grogan v. Garner, 498 U.S. 279, 287 (1991).

50 *See generally* Neal v. Clark, 95 U.S. 704 (1877) (articulating that "fraud" as interpreted in the original Bankrupt Act of 1867 means positive fraud, or fraud in fact, involving "moral turpitude" or intentional wrong).

unauthorized bonds from the executor of an estate could discharge a debt imputed to him through a judgment obtained by the purchasers of the bonds.[51] The Virginia Supreme Court determined Neal's debt to the bondholders amounted to debts for constructive fraud that were nondischargeable in bankruptcy.[52] On appeal, Justice Harlan refuted the reasoning of the Virginia Supreme Court and instead likened the fraud committed by the executor to embezzlement.[53] Because embezzlement required the intent to deceive, Harlan reasoned that Neal's debts were dischargeable because Neal's debts lacked the "moral turpitude" necessary to establish actual fraud.[54] Thus, the original perception of dischargeability of fraudulent debts was that the exception to discharge applied only to the debtors that committed actual fraud.[55] Any claim for exception to discharge levied against a debtor under a theory of vicarious liability "require[d] the culpability of the debtor to have risen to the level of committing actual fraud."[56]

However, Justice Harlan effectively reversed the *Neal* precedent a decade later in *Strang v. Bradner*.[57] In *Strang*, the debtor's business partner had induced the plaintiffs to extend nearly $20,000 in credit to the partnership by representing that the partnership had sufficient funds to repay the notes through the sale of wool.[58] The partnership became insolvent, and the partner attempted to discharge its debt to the creditors through bankruptcy.[59] In departure from *Neal*, the Supreme Court held that a partner *was* liable for the misrepresentations made by another partner in the firm according to principles of agency.[60] Justice Harlan added that this is "especially so when . . . the

51 *See id.* at 704–05.

52 *Id.* at 707.

53 *Id.* at 709.

54 *See id.* at 709 ("[W]e remark, that, in the section of the law of 1867 which sets forth the classes of debts which are exempted from the operation of a discharge in bankruptcy, debts created by 'fraud' are associated directly with debts created by 'embezzlement.' Such association justifies, if it does not imperatively require, the conclusion that the 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality.").

55 *See* Radwan, *supra* note 46, at 998–99.

56 W. Brian Memory, *Vicarious Nondischargeability for Fraudulent Debts: Understanding the Dual Purposes of § 523(a)(2)(A)*, 20 EMORY BANKR. DEV. J. 633, 640 (2004). Memory explains, "[b]ecause Neal's vicarious liability under Virginia law imputed only gross negligence, his culpability simply would not merit vicarious nondischargeability for the executor's fraudulent debt." *Id.*

57 *See generally* Strang v. Bradner, 114 U.S. 555 (1885).

58 *Id.* at 557–58.

59 *See id.* at 558.

60 *Id.* at 561 ("[I]f, in the conduct of partnership business . . . one partner makes false or fraudulent misrepresentations of fact to the injury of innocent persons who deal with him as representing the firm, and

partners, who were not themselves guilty of wrong, received and appropriated the fruits of the fraudulent conduct of their associate in business."[61] Thus, *Strang* expands the discharge exception to include certain debts for fraudulent activity imputed to the debtor, and does not treat the debtor's intent to commit, or culpability for the underlying fraud, as dispositive of the debt's nondischargeability.[62]

The confusion generated by the inconsistency of the *Neal* and *Strang* opinions was exacerbated by the adoption of §523(a)(2)(A). Although Congress articulated the specific "inten[t] to codify current case law e.g., Neal v. Clark," the statute lacks any language requiring that debt be "created by the fraud . . . of the bankrupt."[63] Thus, some courts continue to deny discharge to debtors vicariously liable for fraud under the relevant law of agency,[64] as *Strang* is "still good law."[65]

However, inconsistencies in the legislative history and statutory language of §523(a)(2)(A) has made some courts uneasy "about what to do in cases of potential vicarious liability," and compelled courts to create barriers to vicarious nondischargeability claims.[66] For example, some courts have required the creditor to prove the debtor was aware or should have been aware of the fraudulent party's activity before denying a vicariously liable debtor discharge of the fraudulent debt.[67] Others require the creditor to prove that the

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without notice of any limitation upon his general authority, his partners cannot escape pecuniary responsibility therefor upon the ground that such misrepresentation were made without their knowledge.").

61 *Id.*

62 *See id.* ("Whether the claim asserted by plaintiffs is regarded as one arising out of the deceit or fraud of the defendants, or as a debt created by their fraud, the discharges in bankruptcy do not constitute a defense."); Radwan, *supra* note 46, at 1005.

63 Memory, *supra* note 56, at 643 (quoting 124 CONG. REC. S17412 (daily ed. Oct. 6, 1978)).

64 *See generally* Reuter v. Cutcliff (*In re* Reuter), 686 F.3d 511 (8th Cir. 2012); Tummel v. Quinlivan (*In re* Quinlivan), 434 F.3d 314 (5th Cir. 2005); Deodati v. M.M. Winkler & Assocs., (*In re* Winkler & Assocs.), 239 F.3d. 746 (5th Cir. 2001).

65 *Deodati*, 239 F.3d. at 749 (noting the approach exemplified by the Fifth Circuit in *Winkler* has been coined the "absolute" approach, and generally results in denial of discharge in cases dealing with imputed fraud); Sachan v. Huh (*In re* Huh), BAP No. CC-12-1633-En Banc., 2014 WL 936803, at *7 (B.A.P. 9th Cir. Mar. 11, 2014).

66 Memory, *supra* note 56, at 645.

67 *See* Walker v. Citizens State Bank of Maryville, Mo. (*In re* Walker), 726 F.2d 452, 454 (8th Cir. 1984) (holding that more than the mere existence of an agent-principal relationship is required to charge the agent's fraud to the principal and that "[p]roof that a debtor's agent obtains money for fraud does not justify the denial of a discharge to the debtor, unless it is accompanied by proof which demonstrates or justifies an inference that the debtor knew or should have known of the fraud"); *see also* Huh, 2014 WL 936803, at *9 (adopting requirement creditor prove the debtor "knew or should have known of the fraud" before imputing the fraud of the agent to the debtor as principal).

debtor benefited from the fraudulent transaction.[68] The most significant departure from the *Strang* opinion is seen in two decisions published by the Eleventh and Sixth Circuit Courts of Appeals in 2001 and 2002.[69] In these decisions, the courts held that even a debt imputed to a debtor under § 20(a) of the Securities Exchange Act was dischargeable because imputed liability under the Securities Act was more expansive than liability under the common law, rendering the *Strang* opinion inapplicable.[70]

By 2002, the pervasive interpretation of § 523(a)(2)(A) was that the statute created an exception to discharge "for money, property, services . . . to the extent obtained by . . . actual fraud" of *the debtor*.[71] Thus, although Congress adopted § 523(a)(2)(A) to protect victim-claimants from debtors that tricked claimants into loaning the debtor money,[72] that protection extended only to creditors that could make a prima facie case against the debtor for actual fraud at common law. It did not extend to any other types of fraud imputed by statute

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[68] *See* HSSM #7 L.P. v. Bilzerian (*In re* Bilzerian), 100 F.3d 886, 889 (11th Cir. 1996) (quoting Allison v. Roberts (*In re* Allison), 960 F.2d 481 (5th Cir. 1992)) (affirming district court decision to deny debtor discharge under § 523(a)(2)(A) even though the debtor did not directly benefit from the fraud, the debt was still nondischargeable under the receipt of benefits theory because the debtor's connection to the fraud, "placed him in a position to benefit from any infusion of capital to that enterprise"). Although the defendant debtor in *Bilzerian* was found independently guilty of fraud in the U.S. District Court for the Northern District of Texas, the case is illustrative not only of the popularity of the "receipt of benefit" theory incorporated under § 523(a)(2)(A), but also demonstrates that analysis establishing debtor liability for fraud is *distinct* from determining the *dischargeability* of that very same debt. This case illuminates the additional evidentiary proof that must be provided by the plaintiff creditor in a nondischargeability suit under § 523(a)(2)(A), because the Eleventh Circuit decision analyzed the plaintiff-creditor's collateral estoppel claim independently from the dischargeability claim. *Id.* at 889–93; *see* BancBoston Mortg. Corp. v. Ledford (*In re* Ledford), 970 F.2d 1556, 1561 (6th Cir. 1992) (adopting analysis of the Fifth Circuit in *In re Luce*, 960 F.2d 1277 (5th Cir. 1992), to affirm the district court's decision to impute fraud of partner to debtor because "[the debtor] shared in the monetary benefits of the fraud").

[69] *See generally* Owens v. Miller (*In re* Miller), 276 F.3d 424 (8th Cir. 2002); Hoffend v. Villa (*In re* Villa), 261 F.3d 1148 (11th Cir. 2001).

[70] *See Miller*, 276 F.3d at 429 (agreeing with *Villa* court that *Strang* "should not be extended beyond its basis in agency law to include the much broader sweep of § 20(a) liability"); *Villa*, 261 F.3d at 1152 (citing Brown v. Enstar Grp., Inc., 84 F.3d 393, 396 (11th Cir. 1996)) (declining to extend *Strang*'s reach from agency law to the wider net imposed under § 20(a), which would extend liability to a "controlling person").

[71] *See* Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1014 (9th Cir. 2011) ("Even though the text of the statute does not state that the fraudulent conduct must have been the debtor's, we have nonetheless incorporated that assumption into our understanding of the provision."), *abrogated by* Bullock v. BankChampaign, N.A.,133 S. Ct. 1754 (2013); *see also* Ghomeshi v. Sabban (*In re* Sabban), 600 F.3d 1219, 1222 (9th Cir. 2010) (listing as the first factor in the § 523(a)(2)(A) analysis that the "debtor made . . . [the] representations . . . that at the time he knew they were false"); Nunnery v. Rountree (*In re* Rountree), 478 F.3d 215, 219 (4th Cir. 2007) ("A plain reading of this subsection demonstrates that Congress excepted from discharge not simply any debt incurred as a result of fraud but only debts in which the debtor used fraudulent means to obtain money, property, services, or credit.").

[72] *See Nunnery*, 478 F.3d at 219–20.

or common law principles absent additional proof of culpability.[73] While this interpretation satisfied the Code's purpose, which is to supply a fresh start to the "*honest* but unfortunate debtor,"[74] it also obscured avenues of recovery that defrauded investors could pursue to recover stolen funds.

For example, the limitations on the discharge exception proved particularly harsh on creditors who entered settlement agreements with debtors outside of court.[75] In these instances, the parties that settled allegations of fraud with the debtor prior to bankruptcy found themselves struggling to recover payment for the settlement, because the agreement explicitly released the debtor from liability for fraud in exchange for the settled payment.[76] Without litigation before a trier of fact, these victims could not establish the elements of actual fraud necessary to sustain a claim under § 523(a)(2)(A).[77]

Securities regulators faced similar challenges convincing bankruptcy courts to except judgments they obtained against fraudulent debtors from discharge.

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73 *See* 4 COLLIER ON BANKRUPTCY ¶ 523.08 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

> To sustain a prima facie case of fraud, a plaintiff under [§] 523(a)(2)(A) must establish that: 1) the debtor made the representation; 2) the time of the representation, the debtor knew it to be false; 3) the debtor made the representation with the intent and purpose of deceiving the plaintiff; 4) the plaintiff justifiably relied on the representation; and 5) the plaintiff sustained a loss or damage as the proximate consequence of the representation having been made.

Id.; *see also*, Treadwell v. Glenstone Lodge, Inc. (*In re* Treadwell), 637 F.3d 855, 860 (8th Cir. 2011); Tummel v. Quinlivan (*In re* Quinlivan), 434 F.3d 314, 317 (5th Cir. 2005).

74 Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (emphasis added).

75 *See, e.g.*, Key Bar Invs. Inc., v. Fischer (*In re* Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (citing *In re Kelley*, 259 F. Supp. 297 (N.D. Cal. 1965) (holding that an agreement settling allegations of misrepresentation during sale of automotive repair shop in exchange for $10,000 was a novation of the original purchase contract, and that all claims arising out of the sale of [the repair shop] alleging misrepresentation were extinguished by way of the agreement); *In re* West, 22 F.3d 775, 777 (7th Cir. 1994) (holding that a settlement agreement between employee and employer providing for the payment of $75,000 in exchange for a general release of claims for embezzlement was a novation and substituted a contractual obligation for a tortious one, therefore the debt was an unsecured debt on a contract); Archer v. Warner (*In re* Warner), 283 F.3d 230, 237 (4th Cir. 2002) (affirming district court's decision to treat settlement agreement providing $300,000 in exchange for release of all pending and future claims against defendants as a novation "substituting a dischargeable contract debt for a fraud-based tort claim which may not have been dischargeable"). The novation theory adopted by these circuits was eventually rejected in 2003, when the Supreme Court reversed the Fourth Circuit's *Archer v. Warner* decision. In *Archer*, the Court looked to reasoning in *Brown v. Felsen*, 44 U.S. 127 (1979), to require the Bankruptcy Court to look beyond the agreement to see if the debt settled could amount to a "debt for *money obtained by fraud*, within the terms of the nondischargeability statute." Archer v. Warner, 538 U.S. 314, 319 (2003).

76 *See Fischer*, 116 F.3d 388; *In re West*, 22 F.3d 775. *But see* United States v. Spicer, 57 F.3d 1152, 1156 (D.C. Cir. 1995).

77 *See Fischer*, 116 F.3d at 390; *In re West*, 22 F.3d at 777.

Courts often struggled to comport the elements for actionable claims in federal security law with the elements for actual fraud required in § 523(a)(2)(A).[78]

B. Sarbanes-Oxley Act of 2002 and the Adoption of § 523(a)(19)

The challenges of adjudicating securities fraud within the confines of bankruptcy received little attention from Congress until 2001, when the collapse of Enron sent stock prices plummeting, and private and public investment portfolios lost billions in Enron-related investments.[79] In the aftermath of the Enron debacle, Congress recognized that limiting the exception to cases of actual fraud created loopholes in the law that were too forgiving for debtors.[80] In 2002, Congress passed SOX, which represented "the most extensive crackdown on corporate boardroom fraud since the Depression era."[81] SOX sought to:

> [P]rovide for criminal prosecution and enhanced penalties of persons who defraud investors in publicly traded securities or alter or destroy evidence in certain [f]ederal investigations, to disallow debts incurred

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78 *See* Owens v. Miller (*In re* Miller), 276 F.3d 424, 429 (8th Cir. 2002) (refusing to extend § 20(a) liability to § 523 because it expands liability to fraudulent acts not made by debtor); Hoffend v. Villa (*In re* Villa), 261 F.3d 1148, 1152 (11th Cir. 2001) (court adopted a narrow reading of *Strang*); SEC v. Bilzerian (*In re* Bilzerian), 196 B.R. 907, 911 (Bankr. M.D. Fla. 1996) (holding that judgment against debtor for violation of §10(b) of the Security Exchange Act was dischargeable because the judgment did not meet the loss and reliance requirements of § 523(a)(2)(A)), *rev'd*, 153 F.3d 1278, 1281 (11 Cir. 1993).

79 *See* Murley, *supra* note 45, at 318.

> Enron misled investors and regulators by using a variety of complicated transactions with putatively separate business entities designed to bolster purported profits, conceal actual losses, and ultimately boost Enron's share price. These practices eventually caught up with the company and Enron announced a $618 million loss for the third quarter of 2001, reduced shareholder equity by $1.2 billion, and later filed the largest bankruptcy in United States history. As a result, Enron shareholders were left with virtually worthless stock. . . . In reaction to these events, the Sarbanes-Oxley Act created a new bankruptcy provision, section 523(a)(19), that renders debt from judgments for violations of federal or state securities laws and debts incurred through common law fraud, deceit, or manipulation in connection with the purchase or sale of a security nondischargeable in bankruptcy.

Id.; *see also* S. REP. NO. 107-146, at 4 (2002) (referring to the Enron debacle as showing the need for legislation); William Hildbold, L.L.M. Thesis, *Will Section 1141(d)(6) of the Bankruptcy Code Destroy Corporate Chapter 11 Reorganizations by Rendering SEC Claims Non-Dischargeable?*, 17 AM. BANKR. INST. L. REV. 551, 556–58 (2009).

80 *See* S. REP. NO. 107-146, at 10 ("Current bankruptcy law permits wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and other securities violations. This loophole in the law should be closed to help defrauded investors recoup their losses and to hold accountable those who incur debts by violating our securities laws.").

81 *WRAP: Bush Signs Law Cracking Down on Corp. and Acctg. Fraud*, DOW JONES INT'L NEWS, July 30, 2002.

> in violation of securities fraud laws from being discharged in bankruptcy, to protect whistleblowers who report fraud against retaliation by their employers, and for other purposes.[82]

SOX included an amendment to § 523 to "make judgments and settlements arising from state and federal securities law violations brought by state or federal regulators and private individuals [nondischargeable]."[83] The provision subsequently became § 523(a)(19). The language of the statute is as follows:

> **(a)** A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—
> **(19)** that—
> **(A)** is for—
> **(i)** the violation of any of the Federal securities laws (as that term is defined in [§] 3(a)(47) of the Securities Exchange Act of 1934),[84] any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or
> **(ii)** common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and
> **(B)** results, before, on, or after the date on which the petition was filed, from—
> **(i)** any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;
> **(ii)** any settlement agreement entered into by the debtor; or
> **(iii)** any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.[85]

Since its adoption, courts have struggled to reconcile prior case law construing exceptions to discharge with the new statutory provisions.[86] One

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82 S. REP. NO. 107-146, at 2.

83 *Id.* at 12.

84 Securities Exchange Act of 1934 § 3(a)(47), 15 U.S.C. § 78c(a)(47) (2012) (Section 3(a)(47) of the Securities Exchange Act includes the Securities Act of 1933, the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Investor Protection Act of 1970).

85 11 U.S.C. § 523(a)(19) (2012).

86 *Compare* Owens v. Miller (*In re* Miller), 276 F.3d 424, 429 (8th Cir. 2002) (imputing a third party's fraud to an innocent debtor by §20(a) was an overextension of Supreme Court's reasoning in *Strang v.*

such anomaly exists in cases where the debtor has not personally violated any of the state or federal securities laws, but unlawfully benefited through the fraudulent activity of another.[87] In such instances, regulators face the difficulty of convincing the bankruptcy court that liability for a violation of a security law, and subsequent liability for a debt, can be imputed to a debtor that has unlawfully benefited from the fraudulent activity of another.[88] The compelling question at stake in these instances is whether the debt can be properly excepted from discharge as a debt "for the violation" of securities laws as provided in § 523(a)(19).[89]

C. Competing Constructions of § 523(a)(19)

Before embarking on a thorough analysis of the statute, it is prudent to acknowledge existing scholarly attitudes towards § 523(a)(19). Currently, there are two competing interpretations of the statute.

The group referred to here as "literalists" argue for a substantive comparison of § 523(a)(19) to other exceptions in § 523. Such a comparison, the literalists argue, favors a broad interpretation of the statute that embraces exception to discharge for debts imputed to a debtor who is not directly liable for violations of securities laws.[90] Proponents of the literalist interpretation of § 523(a)(19) construe the provision to except all debts arising from the violation of a state or federal securities law.[91]

Bradner, 114 U.S. 555 (1885), and therefore the debt was dischargeable under § 523(a)(2)(A)), *and* Hoffend v. Villa (*In re* Villa), 261 F.3d 1148 (11th Cir. 2001) (relying on *Neal v. Clark*, 95 U.S. 70 (1877), and *Strang v. Bradner* 114 U.S. 555 (1885), to determine that fraud imputed to debtor through § 20(a) of the Securities Exchange Act is not excepted from discharge under § 523(a)(2)(A) and that "an exception for § 20(a) liability should come from Congress and not the judiciary"), *with* Cordius Trust v. Kummerfeld (*In re* Kummerfeld), 444 B.R. 28, 36–40, 43 (Bankr. S.D.N.Y. 2011) (appropriating the Supreme Court's analysis of § 523(a)(2)(A) in *Brown v. Felsen*, 442 U.S. 127 (1979), and *Archer v. Warner*, 538 U.S. 314 (2003), to justify inquiry into underlying grounds for allegations of securities law violations to determine that judgment debt, which resulted from settlement of lawsuit and fraud in the sale of a securities, was nondischargeable under §523(a)(19)).

87 *See generally* Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171 (10th Cir. 2012) (holding state-court judgment against debtor, requiring them to repay profits obtained through Ponzi scheme, was not excepted from discharge under § 523(a)(19)).

88 *Contra id.* at 1175–76 (explaining that "[C]ongress intended to penalize the *perpetrators* of such schemes by denying them relief from their debts") (emphasis added).

89 *Id.* at 1173–74; Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1012 (9th Cir. 2011) (Fisher, J., dissenting), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

90 Keith N. Sambur, *The Sarbanes-Oxley Act's Effect on Section 523 of the Bankruptcy Code: Are All Securities Laws Debts Really Nondischargeable?*, 11 AM. BANKR. INST. L. REV. 561, 562, 568–69 (2003) (citations omitted).

91 *Id.* at 562 (citing John C. Coffee, Jr., *A Brief Tour of the Major Reforms in the Sarbanes-Oxley Act*, 97 A.L.I.-A.B.A. 151, 174–75 (2002)).

In contrast, "narrow constructivists" like to categorize § 523 exceptions in two separate groups: a "conduct exception," which prevents discharge when the debtor engages in reprehensible behavior; and a "type exception" which denies discharge when there is a "strong government interest in the continued liability [of the debtor]."[92] Typically, type exceptions advance a "government interest."[93] Narrow constructivists argue that § 523(a)(19) is a conduct exception, requiring the proven culpability of the debtor before discharge of the debt can be denied. The narrow constructivist approach presupposes that § 523(a)(19) could not be a type exception because there is no government interest in reinforcing the efforts of state and federal security regulators to ameliorate the devastation of securities fraud.[94]

However, willful oblivion to the government's interest in ensuring proper regulation of the securities markets has since fallen out of vogue. In the wake of financial crises like Enron, WorldCom, and Adelphi, it is more evident than ever that the government has a significant interest in helping defrauded investors recover lost assets, and reinforce the authority of securities regulators by ensuring no party unlawfully gains from fraud.[95]

II. REVISITING THE OPINIONS OF THE NINTH AND TENTH CIRCUIT COURTS

A. *A Summary of Arguments in* Sherman *and* Faught

The dueling analysis of § 523 exceptions is manifest in the majority and dissenting opinions of the Ninth Circuit in *In re Sherman* and the Tenth Circuit in *Oklahoma Department of Securities, ex. rel. Faught v. Wilcox.* In *Sherman v. SEC* (*In re Sherman*), the Ninth Circuit considered the discharge of an

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92 *See id.* at 564, 566–67 (citations omitted). Narrow constructivists argue that when a creditor cannot prove any reprehensible conduct on the part of the debtor, the exceptions should not be construed to deny discharge to the innocent. *Id.* at 564–65. Alternatively, if the exception falls under the type exceptions then the debtor's conduct is irrelevant. *Id.* at 566–67.

93 *Id.* at 567 (citation omitted). Examples of such interests include exceptions for discharge of student loans in bankruptcy. The author explains: "Because the federal government backs or insures student loans, the student loan exception protects financial interests of the government and the economic viability of the country's higher education system." *Id.*

94 *See id.* at 568 (explaining that there is no clear government interest served from excluding discharge of "innocent victims" of securities fraud).

95 148 CONG. REC. S6327-06 (daily ed. July 8, 2002) (statement of Sen. Sarbanes) (relying on article by Alex Burton for the statement that Enron, Adelphia and WorldCom have all been facing investigations for serious misstatements in their financial reports); Alex Burton, *Tweaking Numbers To Meet Goals Comes Back To Haunt Executives*, N.Y. TIMES, June 29, 2002, *available at* http://www.nytimes.com/2002/06/29/business/tweaking-numbers-to-meet-goals-comes-back-to-haunt-executives.html).

attorney's debt owed to the SEC to satisfy a disgorgement order obtained against him by a receiver.[96] In its decision, the majority held that § 523(a)(19) only prevented the discharge of a debt for a securities violation when the debtor was responsible for the violation and that construing the exception broadly to prohibit the discharge of a disgorgement order, without proving the debtor's culpability for the violation, was inappropriate.[97]

A year later, the Tenth Circuit considered the dischargeability of a disgorgement debt levied against debtors that had profited from early investment in a Ponzi scheme.[98] After the Oklahoma Department of Securities discovered the scheme, the Department charged the defendants with unjust enrichment and obtained summary judgment against the defendants in Oklahoma District Court.[99] The defendants subsequently declared bankruptcy, and the Department brought an action in bankruptcy court to render the debt nondischargeable.[100]

In both cases, the majority opinions embrace the narrow statutory interpretation of § 523(a)(19), restricting the exception from discharge to debts that caused the violation of any state or federal securities law *by the debtor*.[101] Conversely, the dissenting opinions in both cases adopted the literalist interpretation of the statute,[102] espousing the view that Congress intended to

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96 Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1010 (9th Cir. 2011) (citations omitted), *abrogated by* Bullock v. BankChampaign, N.A.,133 S. Ct. 1754 (2013).

97 *Id.* at 1024. In *Sherman*, the court stated:

> For example, § 523(a)(2)(A) creates an exception to discharge for debts 'for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by . . . actual fraud.' Even though the text of the statue does not state that the fraudulent conduct must have been the debtor's, we have nonetheless incorporated that assumption into our understanding of the provision.

Id. at 1014 (citing Ghomeshi v. Sabban (*In re* Sabban), 600 F.3d 1219, 1222 (9th Cir. 2010); Citibank v. Eashai (*In re* Eashai), 87 F.3d 1082, 1086 (9th Cir. 1996)).

98 Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1173 (10th Cir. 2012); Okla. Dep't of Sec. *ex rel*. Faught v. Blair, 231 P.3d 645, 650 (Okla. 2010). The debtors had received payments with money obtained from other investors.

99 *See Blair*, 231 P.3d at 650–51.

100 *Faught*, 691 F.3d at 1173.

101 *See Faught*, 691 F.3d at 1175–76 (using the term "narrow construction" to distinguish from a reading of the statute that included debtors who were not charged with securities violations); *Sherman*, 658 F.3d at 1019.

102 *See Faught*, 691 F.3d at 1182 (Briscoe, J., dissenting) (reasoning that the ordinary meaning of the terms "debt", "for" and "violation", as used in § 523(a)(19), means "every enforceable obligation of the debtor to another that represents or is representative of an infringement or breach of 'any . . . of the securities laws"); *Sherman*, 658 F.3d at 1019 (Fisher, J., dissenting) (discussing that the majority opinion failed to give effect to

"render nondischargeable *all debts* arising under the securities laws."[103] The broader interpretation embraces debts to satisfy a disgorgement action resulting from the securities fraud of another.

1. *Majority Opinions and the Argument for a Narrow Construction of § 523(a)(19)*

Although there are significant differences in the facts of each case, the majority opinions in *Sherman* and *Faught* used many of the same arguments to support their conclusions.[104] In *Sherman* the opinion began by recognizing the debtor as a "nominal defendant"[105] who faced enforcement actions by the SEC not because he had committed fraud, but because he held funds in trust that were the subject matter of litigation.[106] The defendant was an attorney representing a group of defendants in a securities enforcement action and received funds as an advance of his contingency fee.[107] The SEC established the attorney did not earn the fee and the court subsequently ordered him to return the money in compliance with the California Rules of Professional Conduct.[108]

The majority opinion did not refute the legitimacy of the disgorgement order against the debtor, but instead focused on the dischargeability of the claim in bankruptcy.[109]Writing for the majority, Judge Bybee first sought to establish the plain meaning of § 523(a)(19) by investigating the dictionary definition of key terms.[110] Initially, the analysis focused on determining the proper meaning of the word "for" because, as the Judge explained, "[t]he question is whether a debt can be 'for' one of the violations listed in

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the ordinary meaning of § 523(a)(19) by giving alternate meaning to the term "for", and by reading words into the statute).

[103] *See* Sambur, *supra* note 90, at 568 (emphasis added); *see also* Sabino, *supra* note 34, at 147–48; Coffee, *supra* note 91, at 174–75 (explaining that because the statute renders nondischargeable judgments, resulting from a "violation of any federal securities laws," creditors can re-characterize transactions).

[104] *See generally Faught*, 691 F.3d 1171; *Sherman*, 658 F.3d 1009.

[105] *Sherman*, 658 F.3d at 1012 (citation omitted). Nominal defendants are parties who "[hold] the subject matter of the litigation in a subordinate or possessory capacity as to which there is no dispute." SEC v. Colello, 139 F.3d 674, 676 (9th Cir. 1998) (quoting SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991)).

[106] Nominal defendants are "not a real party in interest because [they have] no legitimate claim to the disputed property." *Sherman* 658 F.3d at 1012 (quoting SEC v. Ross, 504 F.3d 1130, 1141) (9th Cir. 2007) (internal quotation marks omitted).

[107] *Id.* at 1015.

[108] *Id.* at 1010, 1019.

[109] *Id.* at 1012.

[110] *Id.*

§ 523(a)(19)(A) when the debtor has not committed any of those violations."[111] After considering the conflicting definitions of the term in various dictionaries, the opinion concluded that the "plain language of the statute alone [did] not clearly resolve the interpretive question before [the court]."[112]

The opinion then examined one of the chief arguments proffered by the securities regulators in favor of a literalist interpretation of the statute.[113] The SEC argued that in the "absence of any explicit textual indication that the underlying violation must be committed by the debtor . . . [t]he exception must be given its broadest natural reading."[114] The court rejected this argument, reasoning that such a limitation could be read into § 523(a)(19) because the same limitation has been read into many other discharge exceptions that lacked explicit language.[115]

After concluding that an examination of the text and structure of the statute was unsatisfying, the *Sherman* court found that rules of statutory construction adopted by the Supreme Court favored the narrow interpretation.[116] Chief among them the rule that "[i]n determining whether a particular debt falls within one of the exceptions of § 523, the statute should be strictly construed against the objecting creditor and liberally in favor of the debtor."[117]

Finally, the opinion determined that the legislative history of the statute indicated that Congress intended to "target those parties who are guilty of securities violations, in order to ensure that judgments for securities violations are treated, in bankruptcy, like judgments for fraud."[118] This interpretation countered the interpretation proffered by the SEC emphasizing Congressional intent to have the exception "further the independently important goals of punishment and compensation."[119]

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[111] *Id.* The definitions for the word "for" considered by the Judge included, "[a]s the price of, or the penalty on account of"; "[i]n requital of"; or "[i]n order to obtain"; and "[i]n consequence of, by reason of, as the effect of." *Id.* at 1012–13 (alteration in original) (citation omitted).

[112] *Id.*

[113] *Id.* ("The government encourages us to focus on the absence of any explicit textual indication that the underlying violation must be committed by the debtor.").

[114] *Id.* The court initially recognized the validity of this argument, conceding that a number of the discharge exceptions in § 523 specifically target debts resulting from the conduct of the debtor. *Id.* at 1013 (9th Cir. 2011).

[115] *Id.* at 1014 (stating that interpreting the statute broadly would extend the discharge exceptions to the "honest but unfortunate debtor").

[116] *Id.* at 1015.

[117] *Id.* (quoting 4 COLLIER ON BANKRUPTCY ¶ 523.05 (Alan N. Resnick & Henry J. Sommer eds., 2009)).

[118] *Id.* at 1016.

[119] *Id.*

In *Faught*, the Tenth Circuit considered whether debtors could discharge their obligation to disgorge funds the debtors received as payments from investment in a Ponzi scheme.[120] In its reasoning, the circuit court recycled many of the same arguments presented by the Ninth Circuit in *Sherman*, eventually holding that the debtor's obligation to pay securities regulators was dischargeable.[121] The Tenth Circuit reasoned that the failure to charge the debtors with a security violation precluded any attempt to except the debt from discharge under § 523(a)(19).[122]

2. *Dissenting Opinions and the Argument for a Broad Interpretation of § 523(a)(19)*

In his dissent from the *Sherman* court, Judge Fisher took issue with the majority's interpretation of the statute's plain meaning.[123] Judge Fisher believed that the statute plainly used the preposition "for" to mean, "'because of,' 'on account of,' 'as a result of,' [or] 'having (the thing mentioned) as a reason or cause.'"[124] Like most literalists, Fisher countered the majority's interpretation by arguing that using "for" to connote causation gave the terms in the statute the most ordinary and natural meaning, and that when such meaning does not lead to an absurd outcome, it should be chosen.[125] Therefore, Fisher concluded, Congress's chosen words should not be "softened."[126]

In his dissent from the Tenth Circuit majority in *Faught*, Judge Briscoe also attacked the majority's interpretation of the statute's plain meaning and legislative history predating § 523(a)(19).[127] Judge Briscoe reasoned that the definition of "debt," supplied in the Code itself,[128] coupled with the common

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120 Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1172–73 (10th Cir. 2012).
121 *Id.* at 1176–77.
122 *Id.*
123 *Sherman*, 658 F.3d at 1019 (Fisher, J., dissenting).
124 *Id.* (footnotes omitted) (citations omitted).
125 *Id.* (citations omitted) (quotations omitted).
126 *Id.*; *see also Faught*, 691 F.3d at 1181 (Briscoe, C.J., dissenting) ("Statutory construction must begin with the language employed by Congress and the assumption that the ordinary meaning of that language accurately expresses the legislative purpose.").
127 *Faught*, 691 F.3d at 1181–82 (Briscoe, C.J., dissenting).
128 *Id.* at 1181 (alteration in original) (quoting Penn. Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 559 (1990)) (internal quotation marks omitted) (citing Cohen v. de la Cruz, 523 U.S. 213, 218 (1998)) ("The word debt is defined in the Code as liability on a claim, § 101(12), a claim is defined . . . as a right to payment, § 101(5)(A), and a right to payment, [the Supreme Court has] said, is nothing more nor less than an enforceable obligation.").

meaning of the word "for,"[129] produced an interpretation of the statute that easily embraced "every enforceable obligation of the debtor to another that represents or is representative of," a violation of federal or state securities laws.[130] Judge Briscoe found support for his interpretation in the 2002 Congressional Record detailing the purpose of SOX.[131] The Judge pointed out that "the overall focus of that Act . . . was to 'restore [corporate] accountability' by 'provid[ing] prosecutors with new and better tools to effectively prosecute and punish those who defraud our nation's investors . . . .'"[132] The Judge believed that the restrictive interpretation offered by the majority threatened this express purpose and essentially permitted a windfall to wily debtors.[133]

Ultimately, the dueling analyses at play in these opinions demonstrates that courts should be wary of relying too heavily on the statutory construction of either camp. The discussion reveals the futility of ascertaining any single, proper "plain meaning," and the insufficiency of plain meaning doctrine to produce a reliable statutory interpretation.[134] The conflicting results of statutory analysis conducted by opposing sides should destroy confidence in the plain meaning analysis of either party.[135]

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[129] *See id.* (citation omitted) ("In turn, the word 'for' means 'representing' or 'as representative of.'").

[130] *Id.* at 1181–82.

[131] *Id.* at 1182.

[132] *Id.* at 1181 (alteration in original) (quoting Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 803(3), 116 Stat. 745).

[133] *Id.* at 1182–83.

> As I see it, it is entirely consistent with the Act to treat as nondischargeable any debts that arose from violations of federal or state securities law, regardless of whether or not the debtor was personally involved in those violations. Indeed, to hold otherwise would result in a windfall to the debtor.

Id.

[134] *See* Eric S. Lasky, Note, *Perplexing Problems with Plain Meaning*, 27 HOFSTRA L. REV. 891, 909–10 (1999). Lasky demonstrates that problems with accepting the "plain meaning" include the assumption that Congress could at any time have a single intended meaning for every word that is uses, and that it is difficult to determine which meaning is "plain." *Id.* at 910.

[135] *See* KARL N. LLEWELLYN, THE COMMON LAW TRADITION: DECIDING APPEALS 521–35 (1960). For similar reasons, the narrow constructivist arguments regarding the legislative history of § 523(a)(19) are also suspect. In the brief prepared by appellants in *Sherman*, counsel argued that statements made throughout the legislative record demonstrated Congressional intent to prevent "wrongdoers" from profiting through bankruptcy. *See* Brief For Appellant at 26, Sherman v. SEC (*In re* Sherman), 658 F.3d 1009 (2011) (No. 09-55880) (quoting S. REP. NO. 107-146 at 12 (2002)) ("Current bankruptcy law may permit such wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and other securities violations."). However, the brevity with which Congress adopted the legislation left few statements or reports to corroborate this claim. A subsequent paragraph of the same report cited by the appellants suggests that

Moreover, there are relevant facts in *Faught* that distinguish it from the *Sherman* opinion. For example, the debtor in *Sherman* held funds that he had received but not earned as a contingency fee for defending clients in an enforcement action brought by the SEC.[136] The court easily calculated the amount the debtor was responsible for disgorging and the judgment was enforced under the California Rules of Professional Conduct—*not* a state or federal security law.[137] This is different from the debt owed to the state securities regulators in *Faught*, where the disgorgement was an estimation of the profits the investor gained from the Ponzi scheme in the form of payments drawn from many commingled accounts.[138] Furthermore, the debtors in *Faught* had a direct interest in the funds that were the subject of the original SEC enforcement suit against the Ponzi organizer, rather than an interest in separate funds set aside for the purpose of litigation, as in *Sherman*.[139] While the *Faught* opinion relies on *Sherman* as authority for the limitation on the scope of the discharge exception,[140] the opinion of Judge O'Brien fails to address important distinctions between the respective debt obligations that would render the Tenth Circuit's reliance on *Sherman* dicta inappropriate.

B. Problems with Majority Interpretation of Innocent Debtor

In addition to the conflicting constructions of "plain meaning," the majority opinions of *Sherman* and *Faught* fail to fully address important doctrinal differences between § 523(a)(2)(A) and § 523(a)(19). This Section addresses two important distinctions that dissuade from the adoption of a narrow statutory construction by demonstrating that the narrow construction arbitrarily excludes debts that meet the statutory requirements of § 523(a)(19). Namely, this section takes issue with the *Sherman* majority's conflation of claims for

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Congress intended the amendment to help state securities regulators, "[b]y ensuring [that] securities law judgments and settlements in state cases are [nondischargeable] . . . ." S. REP. NO. 107-146, at 16. This statement makes no distinction between judgments against violators or non-violators and suggests that Congress intended the provision to apply broadly. *See id.* Moreover, there is commentary sufficient to suggest that this was how the final language in § 523(a)(19) was expected to operate. *See* C. Thomas Mason, *Nondischargeable in Bankruptcy: Investors Claims Against Brokers After the Sarbanes-Oxley Act of 2002*, PRACTICING L. INST., 467 (August 2003). Courts have also suggested this. *See Faught*, 691 F.3d at 1182–83 (Briscoe, C.J., dissenting) ("To the extent that the legislative history is relevant, it is . . . more supportive of my interpretation than the majority's."). *But see* Sabino, *supra* note 34, at 147–48.

136 Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1010 (9th Cir. 2011), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

137 *Id.*

138 *See* Okla. Dep't of Sec. *ex rel.* Faught v. Blair, 231 P.3d 645, 649–50 (Okla. 2010).

139 *Sherman*, 658 F.3d at 1010; *Blair*, 231 P.3d at 649–50.

140 *Faught*, 691 F.3d at 1176.

dischargeability arising under § 523(a)(2) without acknowledging that a disgorgement order levied against a debtor is different from a contractual debt procured through fraud and that § 523(a)(19) contains specific attribution language that the majority opinions wholly ignore. This Section also attempts to illuminate the variety of instances in which an order for disgorgement may arise against the debtor in an effort to demonstrate that debtor culpability for securities violations is an inappropriate precondition to the application of § 523(a)(19).

1. Bringing a Cause of Action Under § 523(a)(19)

One particular problem with the majority reasoning in *Sherman* and *Faught* resides in the opinions' conflation of a cause of action for actual fraud under § 523(a)(2)(A) with a cause of action for violation of a securities law under § 523(a)(19). In *Sherman*, the SEC argued that the lack of any explicit language in § 523(a)(19), requiring *the debtor* to violate securities laws, permitted a broad interpretation of the exception that covered debts for which the debtor was not directly liable.[141] In response, the court reasoned that interpreting the provision as the government regulators suggested would lead to absurd results and inappropriately deny the "honest but unfortunate debtor" the full relief of the bankruptcy process.[142] To illustrate, Judge Bybee used the following example of outcomes under § 523(a)(2)(A):

> [S]uppose [the Court] had not construed § 523(a)(2)(A) to apply only in those cases where the debtor committed fraud. Suppose, further, that a bank loaned money to an innocent person under the express condition that the loan be guaranteed by a third party who had greater assets. If the third party lies about his assets in order to qualify to be the guarantor, then the borrower will have, in effect, obtained 'money . . . by . . . false pretenses, a false representation, or actual fraud,' even if she did not know or have reason to know about the guarantor's misconduct. If she is subsequently unable to repay her loan and is driven to bankruptcy, we think it would contravene the "fresh start" purposes of the system to deny her a discharge on the basis of a third party's misconduct.[143]

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141 *Sherman*, 658 F.3d at 1013 ("Essentially, the government supports a bright-line interpretive rule: if the text of a discharge exception does not contain the limiting words 'by the debtor' (or equivalent language), then the exception must be given its broadest natural meaning.").

142 *See id.* at 1014–15 (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

143 *Id.*

While this example illustrates the majority's policy reasons for rejecting the government's broad interpretation, it glosses over important procedural distinctions that make this a poor example of why a narrow construction of § 523(a)(19) is inappropriate. The real reason that the hypothetical debtor in Judge Bybee's example could escape the discharge exception under § 523(a)(2)(A) is because the statute prohibits the discharge of a debt "*to the extent obtained by* . . . false pretenses, false representations or actual fraud."[144] The Judge's scenario loses sight of this nuance when it assumes that the creditor (in this case the bank that extended the loan) would pursue an action for fraud against the individual that signed the promissory note. Rather, the promissory note signed by the debtor merely establishes a contractual debt between the debtor and the bank that is fully dischargeable in bankruptcy. Any energy spent by the bank attempting to except the debt under § 523(a)(2)(A) would be futile because the signor of the promissory note never made a fraudulent representation.

Rather, the party that faces the creditor's challenge to discharge is the guarantor that made the false representations. Unlike the signor of the promissory note to the bank, the guarantor has made false representations that afford the bank-creditor the opportunity to challenge the dischargeability of the debt because the *guarantor's* debt was a debt obtained through actual fraud. The language of § 523(a)(2)(A) essentially presupposes what the majority opinion sought to prove: that without imputing actual fraud to the debtor, no creditor can expect to except a debt from discharge under § 523(a)(2)(A).

Analyzing this same scenario under § 523(a)(19) leads to a different result. The language in § 523(a)(2)(A) that references debts "*to the extent obtained by . . . actual fraud*"[145] relegates that exception to those debts produced from a claim for actual fraud levied by the creditor. No such similar language appears in § 523(a)(19).[146] Rather, § 523(a)(19) should except from discharge debts for securities violations that are attributable directly to the debtor as well as debts resulting from a securities violation that is not attributable to the debtor. A quick comparison of § 523(a)(19)(A) and § 523(a)(19)(B) supports this conclusion.

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144 11 U.S.C. § 523(a)(2)(A) (2012) (emphasis added).

145 *Id.* (emphasis added).

146 *See generally id.* § 523(a)(19) (excepting from discharge "any debt . . . that . . . is for . . . the violation of the Federal Securities laws . . . and of the State securities laws, or any regulation or order issued under such Federal or State securities laws").

Section 523(a)(19)(A) provides that a discharge under chapter 7, 11, 12 or 13 "does not discharge an individual debtor from any debt that is for the violation of any of the Federal securities laws."[147] The majority opinions of *Sherman* and *Faught* insert a limitation in § 523(a)(19)(A) that narrows the exception to include only those debts incurred *by the debtor's* violation of a securities law.[148] The interpretation posited by the majority opinions would thus constrict § 523(a)(19)(A) in much the same manner that § 523(a)(2)(A) is restricted—as an exception that covers only debts that are imputed directly to the debtor.[149] But such an interpretation ignores additional criteria that qualify the debt for exception under § 523(a)(19)(B). Part (B) provides that the debt excepted from discharge be a debt that inter alia, "*results* . . . from . . . any court or administrative order for any damages, . . . disgorgement payment, attorneys fee, cost, or other payment *owed by the debtor*."[150] Read in comport with § 523(a)(19)(A), the language in § 523(a)(19)(B) suggests that in a dischargeability suit under § 523(a)(19), the creditor is *not* required to prove the debtor's liability for a securities violation to qualify the debt for exception from discharge. Rather, the language of Part (B) brings within the ambit of § 523(a)(19) debts *owed by the debtor* that *result* from such violations.[151] By its own terms, the language of § 523(a)(19) specifies only that the resulting disgorgement payment be attributable to the debtor.[152] Notwithstanding the opinions of *Faught* and *Sherman*, no such additional requirement that the *violation* be attributable to the debtor is articulated in the statute.

This alternative interpretation to § 523(a)(19) renders the debtor-guarantor scenario contemplated by the *Sherman* opinion inappropriate. Although Judge Bybee created the scenario to illustrate the absurdity of preserving a contractual debt against a debtor that was not liable for actual fraud, the Judge mistakenly assumed that the avenue for nondischargeability asserted by the creditor under § 523(a)(2)(A) would be the same for a debt for a disgorgement in § 523(a)(19). The key distinction between § 523(a)(19) and the claim against the debtor in § 523(a)(2)(A), is that the debtor in § 523(a)(19) does *not*

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147 *Id.* § 523(a)(19)(A).

148 *See* Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1177 (10th Cir. 2012); *Sherman*, 658 F.3d at 1019.

149 *See generally Faught*, 691 F.3d at 1176–77 (holding that as the debtors were never charged with violation of any securities law, the debt for disgorgement was dischargeable); *Sherman*, 658 F.3d at 1014 (using § 523(a)(2)(A) as an example of a statute that incorporates the assumption that the debt must be that of the debtor without stating so explicitly).

150 11 U.S.C. § 523(a)(19)(B)(iii) (emphasis added).

151 *See id.*

152 *See id.*

owe a contractual debt to the creditor, but has liability for a *disgorgement*, which is a debt entirely unlike the contractual debt incurred by the signor of a promissory note. A disgorgement is an equitable remedy that affords the court the discretion to deprive defendants of proceeds from fraud.[153] The language of § 523(a)(19) specifically allows for "disgorgement payments . . . *owed by the debtor*" to be excepted from statutory discharge.[154] It does not identify to whom the underlying violation for securities fraud must be imputed. Thus, a debtor liable for a contractual debt secured by the fraud of a third party should be treated differently in § 523 than a debtor who owes a debt pursuant to a disgorgement order. Contrary to the reasoning of the court, the prevailing issue in enforcing the § 523(a)(19) exception is not the debtor's culpability for violating securities laws, but rather who is responsible for the debt attributable to that violation. Regardless of any culpable activity of the debtor, § 523(a)(19) addresses the obligation of the debtor to satisfy a disgorgement order—and the statute clearly states that such an obligation is excepted from discharge.[155]

Such a construction of the distinct language in § 523(a)(19)(A) and (B) resolves another problem with the plain meaning of the statute proffered by the *Faught* and *Sherman* majorities. By incorporating "by the debtor" into the reading of § 523(a)(19), the courts conflict with a cannon of statutory interpretation established by the Supreme Court in *Keene Corp. v. United States.*[156] In *Keene Corp.*, the Supreme Court held: "[W]here Congress includes particular language in one section of a statute but omits it in another . . ., it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."[157] To construe the statute in the manner that the majority describes not only disregards this cannon of construction, but also invites dissonance in the adjudication of § 523(a)(19) nondischargeability claims.

2. Establishing Debtor Culpability for Violations of State Securities Laws

Similar to the majority in *Sherman*, the *Faught* majority reasoned that as the debtors were never formally prosecuted for a securities law violation, the disgorgement order obtained by the Oklahoma Department of Securities was not a debt for the violation of federal securities laws, such as would be

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153 *See* 69A AM. JUR. 2D, *Sec. Regulation—Federal* § 1616 (2013).
154 11 U.S.C. § 523(a)(19)(B)(iii) (emphasis added).
155 *Id.*
156 Keene Corp. v. United States, 508 U.S. 200, 208 (1993).
157 *Id.* (quoting Russello v. United States, 464 U.S. 16, 23 (1993)).

excepted under § 523(a)(19).[158] As Judge O'Brien wrote in his opinion, "Although the Department claims these debtors are not innocent parties, it declined to prosecute them for securities laws violations. Had it done so successfully, any judgment it obtained would no doubt be considered nondischargeable under § 523(a)(19)."[159]

The problem with this statement is that it mischaracterizes the nature of the debt imposed on the debtors by the Oklahoma state courts. A brief examination into the procedural history of the case would have revealed that the debtors seeking relief in *Faught* were *not* innocent debtors, and that the equitable relief sought by the Department was authorized by the Oklahoma Uniform Securities Act.[160]

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[158] Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1176 (10th Cir. 2012); Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1019 (9th Cir. 2011), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

[159] *Faught*, 691 F.3d at 1176.

[160] *See* Okla. Dept. of Sec. *ex rel* Faught v. Blair, 231 P.3d 645, 658 (Okla. 2010) (holding that § 1-603 of the Act provides authority for the Department of Securities to bring an action against innocent investors in a Ponzi scheme and that the Oklahoma District Court has subject matter jurisdiction to adjudicate competing claims of ownership of funds that were part of an investment scheme). The procedural history of the *Faught* decision is as follows: from December 1999 to October 2004, Marsha Schubert operated a Ponzi scheme disguised as an investment firm known as Schubert & Associates. *Id.* at 650. After discovery of the Ponzi scheme, the Oklahoma Department of Securities brought an action against 158 people that profited from the Ponzi scheme. *Id.* The Department's Petition asserted claims against the defendants on grounds of unjust enrichment. *Id.* The trial court granted summary judgment in favor of the Department. *Id.* The Oklahoma Court of Civil Appeals affirmed the judgments. *Id.* at 648. The Supreme Court of Oklahoma granted certiorari. *Id.*

The Oklahoma Supreme Court held that the Oklahoma Uniform Securities Act granted the Department authority to bring an action against innocent investors in a Ponzi scheme. *Id.* at 658. The Court also agreed with the Department that a Ponzi-scheme profit received by an innocent investor may represent unjust enrichment, but rejected the existence of an equitable right to restitution of the funds acquired through the scheme. *Id.* at 663. The Court instead determined that a claim for unjust enrichment against innocent investors was "appropriate only if the early investors had received an unreasonable rate of return." *Faught*, 691 F.3d at 1173 n.3. The Court explained: "Our holding is based upon the principle that the Department possesses a public interest in seeking restitution for investors who did not receive the return of their initial investment, and that the Department's unjust enrichment claim is brought against investors who received unreasonable high dividends in a Ponzi-scheme." *Blair*, 231 P.3d at 663.

On remand, the trial judge granted summary judgment for the Department and found that the Wilcoxes were liable for unjust enrichment, and that by virtue of their participation in Schubert's check-kiting scheme, the Wilcoxes were not "innocent investors." Okla. Dept. of Sec. *ex rel* Faught v. Wilcox, 267 P.3d 106, 109 (Okla. 2011). As the Wilcoxes were not "innocent", the trial court reasoned that the standard adopted in *Blair* regarding the demonstration of an unreasonable rate of return did not apply. *Id.* On appeal, the Supreme Court of Oklahoma affirmed the trial court determination that the Wilcoxes were not "innocent" investors as would require the application of *Blair*, and that therefore it would be inequitable to allow the Wilcoxes to keep any of the profits collected from the Ponzi scheme. *Id.* at 111.

Under the Oklahoma securities laws, the Oklahoma Department of Securities may bring an action against a person that: 1) has engaged or is about to engage in an act or practice that violates the Oklahoma Uniform Securities Act of 2004; 2) violates a rule or order of the act constituting a dishonest or unethical practice; 3) has engaged in an art, practice or course of business that materially aids a violation of the act, a rule, or order, or that constitutes a dishonest or unethical practice.[161] The law further allows the court to issue, upon a proper showing, an injunction or order another type of ancillary relief that the court deems appropriate.[162] The power of the Department of Securities to seek prohibitory injunctions includes orders of disgorgement.[163] As such, the laws of Oklahoma permit disgorgement only when the individual holding the funds offends the rules, orders, or provisions of the state securities laws.[164]

Thus, the order for disgorgement entered by an Oklahoma court in their discretion presupposes a demonstration that there has been a proper showing of an infraction against the state securities laws. Illustrative of this point is the reasoning in *Oklahoma Department of Securities ex rel. Faught v. Blair*, predecessor to the Tenth's Circuit's opinion.[165]

In *Blair*, the Oklahoma Supreme Court determined the scope of the equitable relief sought by the Oklahoma Department of Securities.[166] The court initially rejected the Department's argument that the Oklahoma Uniform Securities Act conferred authority on the Department to seek disgorgement action against innocent investors.[167] The Department based its argument on a case previously decided by the Oklahoma Supreme Court demonstrating that § 1-603 permitted the Department to seek restitution from innocent investors.[168] The *Blair* court differentiated the precedent by emphasizing that a

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161 OKLA. STAT. ANN. tit. 71, § 1-603 (West 2014).

162 *Id.*

163 *See* State *ex rel.* Day v. Sw. Mineral Energy, Inc., 617 P.2d 1334, 1338 (Okla. 1980).

164 Furthermore Oklahoma case law incorporates liability for fraud under a theory of "constructive fraud" which "has the very same legal consequence as actual fraud" and imposes liability on the defendant even though there was no intent to deceive. *See* Faulkenberry v. Kansas City S. Ry. Co., 602 P.2d 203, 206 (Okla. 1979). The court explained that constructive fraud does not require an intent to deceive, and that liability for constructive fraud may be based on negligent or even innocent misrepresentation. *Id.* at 206 n.8 (citing U.S. Fibres v. Proctor & Schwartz, Inc., 358 F. Supp. 499, *aff'd*, 509 F.2d 1043, 1047 (6th Cir. 1975)).

165 *See generally Blair*, 231 P.3d at 654 n.16.

166 *Id.* at 668.

167 *See id.* at 653.

168 *Id.* The court was referring to *Day*, 617 P.2d 1334. In *Day*, the court held that the Administrator of the Department of Securities has the power to seek mandatory as well as prohibitory injunctions, including orders of "disgorgement," against violators of the Oklahoma Securities Act. *Id.* at 1338.

disgorgement is a remedy rewarded by courts in equity "to deprive the wrongdoer of his ill-gotten gain."[169] However, the court also recognized that the distinguishing characteristic behind a disgorgement action and an action for restitution resided in the express purpose of restitution, which is to "compensate *victims of the securities fraud for their losses*," while the action for disgorgement was an exercise of the state's police and regulatory powers in furtherance of the public interest.[170]

Although the Department argued that an innocent investor is unjustly enriched by profits obtained through a Ponzi scheme as a matter of law and should be liable for restitution for all of the profits received,[171]the *Blair* court reasoned that the claim for unjust enrichment requires demonstration that the "party against whom the relief is sought has engaged in wrongful conduct."[172] However, the court recognized that under the common law of Oklahoma, the Department can prove that possession of profits of a Ponzi-scheme investment is per se an act of wrongdoing if the innocent investor has not exchanged "reasonably equivalent value."[173] Ultimately, the court's analysis concluded that the statutory authority of the Department embraced the right to seek relief against Ponzi investors who received profits that were "artificially high" because the "Department possesses a public interest in seeking restitution for investors who did not receive the return of their investment."[174]

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[169] *Blair*, 231 P.3d at 654 (quoting SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978) (citing SEC v. Commonwealth Chem. Sec., Inc., 574 F.2d 90, 102 (2d Cir. 1978))).

[170] *Id.* at 654–55 (emphasis added).

[171] *Id.* at 658.

[172] *Id.* at 659. The court notes that this is an element to the claim for unjust enrichment "which does not receive uniform treatment by courts" and that the "elements of unjust enrichment claims differ markedly from state to state." *Id.* (citations omitted).

[173] *Id.* The court based its conclusion on a line of cases adjudicating suits to recover payments to investors pursuant to the fraudulent transfer provisions of the Code. *Id.* at 660–61. The court found persuasive dicta holding that while a transfer is avoidable "if the debtor made the transfer 'without receiving reasonably equivalent value in exchange for the transfer,'" such reasonably equivalent value *is* received if the innocent investor received interest pursuant to a contractual obligation of the investor. *Id.* at 661 (citations omitted). The court ultimately applied the reasoning to a claim in equity for restitution holding that it was inequitable to grant relief against Ponzi-investors who received a profit without a showing that the profits received are artificially high. *Id.* at 663. With a nod toward the justification for awarding full restitution of profits in equity, Chief Justice Edmondson noted: "We are aware that [Ponzi schemes] may create a significant hardship when an innocent investor . . . is informed that he must disgorge profits he earned innocently, often years after the money has been received and spent. Nevertheless, courts have long held that it is more equitable to attempt to distribute all recoverable assets among the defrauded investors who did not recover their initial investments rather than to allow the losses to rest where they fall." *Id.* at 661 (citing Scholes v. Lehman, 56 F.3d 750, 757 (7th Cir. 1995)).

[174] *Id.* at 663.

Thus, the *Blair* opinion establishes that to the extent that the profits exceeded the reasonable returns on an investment, the state law and common law impose the debtor's wrongdoing and permit the state security regulators to pursue equitable relief for a violation of the State's security laws.[175] As such, the *Faught* opinion does an injustice to the Oklahoma Department of Securities by ignoring the analysis supplied by the Oklahoma Supreme Court. As Chief Judge Briscoe explained in his dissent:

> Although the state district court did not make any findings that [the debtor] was directly involved in the underlying violations of Oklahoma state securities laws, it is *beyond dispute* that the judgment entered against [the debtor] was intended to be representative of the infringement of Oklahoma state securities laws . . . . Consequently, that judgment falls within the scope of § 523(a)(19) . . . .[176]

The decision in *Blair* reveals the potential for troubling inconsistencies in the position adopted by the Tenth Circuit in the *Faught* opinion. In its efforts to determine the debtor's culpability for fraud to support the debt, the court failed to consider the nature of a disgorgement debt and the variety in elements of proof required by various state courts.[177] It is evident from the Oklahoma statute that at least one state does not require regulators to prove the defendant's intent to obtain the stolen funds to secure a disgorgement order.[178] As explained by *Blair*, the Oklahoma Securities Act permitted the Department to bring an action against innocent investors in a Ponzi scheme simply by receiving the unreasonably high returns on their investment.[179] Consequently, this distinction problematizes the *Faught* opinion by demonstrating that the Department had not "declin[ed] to prosecute [the debtors] for securities law violations," as Judge O'Brien stated.[180] Rather, in exercise of the authority granted to them in the Oklahoma Uniform Securities Act, the Department had pursued a claim for equitable relief authorized by the Act but for which no

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175 *Id.* at 648.

176 Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1183 (10th Cir. 2012) (Briscoe, C.J., dissenting) (emphasis added).

177 *See Blair*, 231 P.3d at 658 (explaining "elements of unjust enrichment claims differ markedly from state to state").

178 *Faught*, 691 F.3d at 1183 (Briscoe, C.J., dissenting) (explaining that a review of the opinion of the Oklahoma state court showed that it is of "no legal consequence" that debtors were innocents caught in a fraudulent scheme because Oklahoma law does not require intent); *see* OKLA. STAT. ANN. tit. 71, § 1-603 (West 2014).

179 *Blair*, 231 P.3d at 670.

180 *Faught*, 691 F.3d at 1176.

proof of a violation was required.[181] In this context, Judge O'Brien's insistence on prosecuting debtors for securities violations is under-inclusive of the variety of claims that establish an investor's liability for securities fraud—regardless of the debtor's wrongdoing.

Anecdotally, upon remand from the Oklahoma Supreme Court, the Department returned to the Supreme Court in *Oklahoma Department of Securities ex rel. Faught v. Wilcox* and proved that the defendants and subsequent debtors in bankruptcy, Marvin and Pam Wilcox, were actually partners with the original violator.[182] All justices on the Oklahoma Supreme Court concurred in the decision determining that there was no dispute of material fact warranting a trial on the trial court's determination that the Wilcoxes were not innocent investors in the Ponzi scheme.[183]

III. ESTABLISHING THE PRECLUSIVE EFFECT OF JUDGMENTS AWARDED IN NON-BANKRUPTCY COURT

The analysis of the proceedings in the Oklahoma state courts poses a lingering question concerning the validity of state court judgments adjudicated before a bankruptcy court. While the majority opinions in *Faught* and *Sherman* insist that liability for violations of securities laws must be imputed directly to the debtor for the exception to discharge to apply,[184] the opinions say nothing about lending preclusive effect to the judgments established by state courts. While bankruptcy courts generally enjoy exclusive jurisdiction to determine the dischargeability of a debt brought under § 523(a)(2),[185] recent analysis of

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181 *Blair*, 231 P.3d at 658–59 (explaining that among the elements for unjust enrichment observed by the Oklahoma court, a demonstration of wrongful conduct by the defendant is not universal).

182 Okla. Dept. of Sec. *ex rel* Faught v. Wilcox, 267 P.3d 106, 111 (Okla. 2011).

183 *Id.* The court stated:

> In this case, the trial court determined that there was no dispute as to the material fact that the Wilcoxes were not "innocent" investors entitled to the equitable treatment provided to innocent investors in *Blair*. In *Blair*, we held that the district court had jurisdiction to determine equitable claims to ownership of funds that were part of the Ponzi scheme. The trial court in this case determined that it would be inequitable to allow the Wilcoxes to keep any of their profits from the Ponzi scheme. Having reviewed the evidentiary materials presented to the trial court, we find that there is no dispute of material fact justifying trial on this issue.

Id.

184 *See Faught*, 691 F.3d at 1176; Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1019 (9th Cir. 2011), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

185 This exclusive jurisdiction is asserted through operation of § 523(c) which is described as delegating to the bankruptcy court "exclusive jurisdiction" of nondischargeability claims under § 523(a)(2), (4), or (6). *In re*

§ 523(a)(19) conducted by bankruptcy courts suggests that Congress did not intend to grant such exclusive jurisdiction to bankruptcy courts for debts brought under § 523(a)(19).[186]

Rather, by excluding debts arising under § 523(a)(19) from the debts requiring separate determinations of dischargeability under § 523(c),[187] bankruptcy courts share jurisdictions with other federal and state courts that will determine dischargeability based on the claims for violations of state and federal non-bankruptcy statutes.[188] Unlike dischargeability determinations for fraudulent debts under § 523(a)(2), "there is no task in the § 523(a)(19) determination committed exclusively to the bankruptcy courts,"[189] as federal or state district courts may determine dischargeability simply by finding whether a defendant has violated federal or state securities laws.[190]

However, bankruptcy courts disagree on whether § 523(a)(19) grants similar co-extensive jurisdiction to determine the debtor's liability for underlying security law violations.[191] In *In re Chan*, Judge Frank, of the Bankruptcy Court for the Eastern District of Pennsylvania, considered an

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Chan, 355 B.R. 494, 503 (Bankr. E.D. Pa. 2006) (citing Whitehouse v. LaRoche, 277 F.3d 568, 578 (1st Cir. 2002); Spilman v. Harley, 656 F.2d 224, 226 (6th Cir. 1981)).

186 *See* Jordan Factor, *Making Crooks Pay: The Path to Nondischargeable Securities Judgments*, 41 COLO. LAW., 47, 49 (2012).

187 Section 523(c)(1) provides that "the debtor shall be discharged from a kind specified [under § 523(a)(2), (4), or (6)] unless on request of the creditor to whom such debt is owed . . . the court determines such debt to be excepted from discharge under [§ 523(a)(2), (4), or (6)]." 11 U.S.C. § 523(c)(1) (2012).

188 *Chan*, 355 B.R. at 503 ("[Another] significant aspect of § 523(a)(19) is that determination of dischargeability under the provision is not committed exclusively to the bankruptcy court by 11 U.S.C. § 523(c). Other courts, state and federal, have concurrent jurisdiction to determine dischargeability."); *see also*, Factor, *supra* note 186.("Two significant facets of § 523(a)(19) distinguish it from § 523(a)(2), (4), and (6). First, the elements of liability and dischargeability are co-extensive under § 523(a)(19), but are distinct in (a)(2), (4), and (6). A debtor may be liable for both common law fraud and common law breach of fiduciary duty, and yet the [plaintiff] in an adversary proceeding may be unable to prove all the elements required for nondischargeability under § 523(a)(4), for example. By contrast, liability for violation of the federal securities laws is sufficient, by itself, for nondischargeability under § 523(a)(19). . . . To determine nondischargeability under § 523(a)(19), therefore, a court does not interpret and apply elements unique to bankruptcy statutes; rather, a court merely determines the elements of liability under federal or state securities statutes or common law fraud. A second feature of § 523(a)(19) that distinguishes it from § 523(a)(2),(4) and (6) is that § 523(c)(1) does not confer exclusive jurisdiction on bankruptcy courts to determine § 523(a)(19) nondischargeability. Rather, '[o]ther courts, state and federal, have concurrent jurisdiction to determine dischargeability.'") (citations omitted).

189 Factor, *supra* note 186.

190 *Id.*

191 Dicta authored by Judge Frank sitting in the Bankruptcy Court for the Eastern District of Pennsylvania and Judge Brown of the Bankruptcy Court for the District of Colorado illustrate the conflicting theories. Faris v. Jafari (*In re* Jafari), 401 B.R. 494, 497 (Bankr. D. Colo. 2009); *Chan*, 355 B.R. at 503.

unsecured creditor's motion for relief from stay to pursue a claim against the debtor for securities fraud in the U.S. District Court.[192] Recognizing that the creditor's claims concerned debts that may be nondischargeable under § 523(a)(19), Judge Frank reasoned that the creditor's motion for relief from stay should be denied because language in § 523(a)(19)(B) did not expressly "mandate that all liability and dischargeability determinations take place in a non-bankruptcy forum."[193] Judge Frank construed the phrase "before, on, or after the date on which the petition was filed" appearing in Part (B)[194] to merely remove a temporal barrier to claims for nondischargeability under § 523(a)(19),[195] as it did not relegate determination of liability to non-bankruptcy courts.[196]

In decided opposition to Judge Frank, Judge Brown, of the U.S. Bankruptcy Court of the District of Colorado, determined in *Faris v. Jafari* (*In re Jafari*) that § 523(a)(19) does not grant co-extensive jurisdiction to the bankruptcy courts to determine the underlying liability for securities violation.[197] In *Jafari*, the plaintiffs filed an adversary proceeding against the debtor alleging violations of numerous securities laws and requesting that the debt resulting from the plaintiffs' investment be declared nondischargeable.[198] At the time that the plaintiffs filed the adversary proceeding, no pending action against the debtor existed in another forum and the plaintiffs had not obtained an order or judgment against the debtor.[199] Judge Brown began her analysis by recognizing that § 523(a)(19) incorporated two independent preconditions to

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192 *Chan*, 355 B.R. at 496.

193 *Id.* at 504.

194 See 11 U.S.C. § 523(a)(19)(B) (2012).

195 *Chan*, 355 B.R. at 504. Judge Frank explained:

> The phrase "before, on, or after the date on which the petition was filed" was not added to § 523(a)(19) to provide creditors with an unfettered right to proceed in a nonbankruptcy forum, notwithstanding a defendant's commencement of a bankruptcy case. Rather, the phrase was intended to make it clear that a debt arising under the federal securities laws or as a result of fraud in connection with the sale of a security may be determined nondischargeable under § 523(a)(19) even if the liability was not fixed prior to the commencement of the bankruptcy case. In other words, the phrase was added to the statute to remove a temporal limitation from the elements of the § 523(a)(19) discharge exception.

Id.

196 *Id.* at 505 ("Based on the concurrent jurisdiction which exists, it is perfectly appropriate for either the bankruptcy court or another court to make a dischargeability determination under § 523(a)(19).").

197 *See* Factor, *supra* note 186, at 50 (discussing Judge Brown's opinion in Faris v. Jafari (*In re* Jafari), 401 B.R. 494 (Bankr. D. Colo. 2009)).

198 *Jafari*, 401 B.R. at 495.

199 *Id.*

dischargeability: under § 523(a)(19)(A) the plaintiffs must establish the debt is for violation of the securities laws; and under § 523(a)(19)(B), the debt must be memorialized in a judicial administrative order or settlement agreement.[200] The plaintiffs argued that language in subsection (B) authorized the bankruptcy court to determine both the liability and nondischargeability of a debt, and to rely on its own finding of liability to satisfy the memorialization requirement under § 523(a)(19)(B).[201]

Judge Brown refuted this argument, and instead reasoned that by including the separate memorialization requirement under (B), Congress intended to distinguish § 523(a)(19) from other provisions of § 523 which do not contain the additional requirement that a judgment, order, decree, or settlement agreement finding fraud has occurred.[202] Rather, Judge Brown looked to the legislative history of the statute as an articulation of Congress's efforts to "ensure that judgments and settlements from state securities fraud cases are [nondischargeable] without the need to re-litigate the matter in the bankruptcy court."[203] Congress must have intended that one of the required elements for finding nondischargeability under § 523(a)(19) is that the liability determination be made outside the bankruptcy court because permitting the bankruptcy court to issue its own order or judgments under (B) would essentially read the requirement out of the statute.[204] Thus, Judge Brown concluded, "Subsection B evidences a conscious choice to have *the liability determination* occur outside the bankruptcy forum."[205]

In light of the jurisdictional limitations illustrated by *In re Chan* and *Jafari*, the configuration of § 523(a)(19) adopted by the *Faught* and *Sherman* courts is

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200 *Id.* at 496.
201 *Id.*
202 *Id.* at 497–98.

> For example, in § 523(a)(2)(A), the statute renders nondischargeable debts arising from fraud. It contains no requirement of a judgment, order, decree or settlement agreement finding that fraud has occurred. If no prior determination has been made, the bankruptcy court itself may hear and determine liability for fraud. . . . Similarly, if the parties entered into a settlement agreement, admitting fraud, the bankruptcy court might not give collateral estoppel effect if the matter had not been "actually litigated." If the admission or prior determination is not entitled to preclusive effect, then nothing in the statute prevents the bankruptcy court from hearing and determining if the debt arises from fraud, without regard to the prior determination.

Id.
203 *Id.* at 498.
204 *Id.* at 499.
205 *Id.* (emphasis in original).

problematic because it vitiates the judgment and characterization of the underlying debt that has already been determined by non-bankruptcy courts. For example, in *Sherman*, Judge Fisher recognized that by characterizing the debtor as a "nominal defendant"[206] the non-bankruptcy court had essentially prohibited the debtor from forming any legitimate claim to the disputed property.[207] The judge reasoned: "A nominal defendant's lack of legitimate claim to the money subject to disgorgement has powerful consequences in bankruptcy. If a debtor does not own an equitable interest in property . . . [it] is not 'property of the estate,' and therefore is not available to creditors."[208] Similarly, the dissenting opinion of Judge Briscoe in *Faught* emphasizes that judgment against the debtor for participation in a scheme that violated Oklahoma state securities laws had already been determined by the Oklahoma state courts.[209]

Thus, a key flaw in the majority's reasoning, as identified by Judge Fischer and Judge Briscoe, is that by permitting the debtor to discharge debts owed for disgorgement actions, the court is not only infringing on the jurisdiction of other courts but also sanctioning a transfer of investor funds to which the debtor has no equitable interest to the trustee for disbursement to other creditors.[210] The decision effectively permits an involuntary transfer of the funds—initially procured from the victims through fraud—from the victims to the creditors of the debtor.[211]

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[206] Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1012 (9th Cir. 2011) (citing Sherman v. SEC (*In re* Sherman), 491 F.3d 948, 959 (9th Cir. 2007)), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

[207] *Id.* at 1022 (Fisher, J., dissenting).

[208] *Id.* (alteration in original) (citations omitted) (internal quotation marks omitted).

[209] Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1177 (10th Cir. 2012) (Briscoe, C.J., dissenting).

[210] *See* Kull, *supra* note 16, at 279–80. Kull explains:

> Restitution in bankruptcy involves a kind of "second-order" restitution, meaning that the transfer at issue is once removed from the transfer in which the restitution claim originates. The transaction begins with a nonconsensual transfer from the claimant to the debtor. With the debtor's insolvency, however, the transfer at issue . . . is no longer between the claimant and the debtor, but between the claimant and the creditors of the debtor.

Id. Among the scenarios identified to qualify as "nonconsensual transfers" is a "transfer of property induced by fraud, mistake, coercion, or undue influence[.]" *Id.* at 279.

[211] *Id.* at 282.

A. The Preclusive Treatment of Disgorgement Orders Prior to § 523(a)(19)

Determining the proper preclusive effect a bankruptcy court should give to disgorgement orders secured by regulators like the SEC is informed in part by the treatment such orders have received in the past.[212]

Under the statutory precursor to § 523(a)(19), bankruptcy courts considered an exception to discharge for a disgorgement order when the judgment upon which it was based satisfied the elements of actual fraud.[213] In the case of the purchase and sale of securities, courts would sometimes substitute elements of securities violations for elements of common law fraud.[214]

For example, in *SEC v. Bilzerian* (*In re Bilzerian*), the court considered the disgorgement action brought against an investor who failed to file certain required disclosures in a timely fashion and made certain misrepresentations in the disclosures.[215] The district court found the investor guilty of violating § 10(b) of the Securities Exchange Act of 1934 and ordered the debtor to disgorge $33 million to the SEC.[216] The investor filed for bankruptcy during the litigation in district court and the SEC sought to have the debt excepted from discharge under § 523(a)(2)(A).[217] The bankruptcy court awarded summary judgment to the investor, permitting discharge by reasoning that the

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212 *See, e.g.*, SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1249 (E.D.N.Y. 1976) (ordering disgorgements of profit defendant received for acquiring distributorship without paying for it, but declining disgorgement of salary he was paid in his capacity as company executive), *aff'd without opinion*, 556 F.2d 559 (2d Cir. 1977); SEC v. Penn Cent. Co., 425 F. Supp. 593, 599 (E.D. Pa. 1976) (explaining that the SEC claims for disgorgement are not punitive but remedial relief to deprive defendants of the rewards they obtained for violating the securities laws); *see also* SEC v. Happ, 295 F. Supp. 2d 189, 197 (D. Mass. 2003) (explaining that disgorgement "does not serve to punish or fine the wrongdoer, but simply serves to prevent the unjust enrichment"); *SEC Report*, *supra* note 27, at 2–3 (describing disgorgement as an equitable remedy designed to deprive defendants of ill-gotten gains and that in contrast to actions for restitution which is brought to compensate fraud victims for their loses, disgorgement order requiring defendants to give up the amount by which they were unjustly enriched).

213 Kasey T. Ingram, *The Interface Between the Bankruptcy Code and a Disgorgement Judgment Held by the Securities and Exchange Commission*, 5 TRANSACTIONS: TENN. J. BUS. L. 31, 46 (2003). This meant that the "creditor must prove that 1) the debtor made false representation to deceive the creditor, 2) the creditor relied on the misrepresentation, 3) the reliance was justified, and 4) the creditor sustained a loss as a result of the misrepresentation." *Id.* at 47 (citing SEC v. Bilzerian (*In re* Bilzerian), 153 F.3d 1278, 1281 (11th Cir. 1998)).

214 *See* Ingram, *supra* note 213, at 47–48 (quoting *Bilzerian*, 153 F.3d at 1282). *See generally* Hildbold, *supra* note 79, at 567 (differentiating between the SEC's enforcement claims for nondischargeability and the requirements for fraud under § 523(a)(2)(A) prescribed in *Field v. Mans*, 516 U.S. 59 (1995)).

215 *Bilzerian*, 153 F.3d at 1280.

216 *Id.*

217 *Id.* at 1281.

disgorgement judgment did not meet the loss and reliance requirements of § 523(a)(2)(A).[218] On appeal, the Eleventh Circuit overruled the bankruptcy court, finding the disgorgement order had estoppel effect and was nondischargeable because the "materiality" element supplied in a Rule 10(b)(5) action satisfied the element of actual reliance required in § 523(a)(2)(A).[219]

Historically, the courts have also permitted SEC disgorgement actions against individuals who are not participants in the scheme to defraud, but who are "nominal defendants."[220] In *SEC v. Colello*, the Ninth Circuit considered whether the SEC could recover investor funds traced to a party that was a non-participant in the fraud.[221] The defendant received nearly $2.9 million of $21 million that the company obtained by defrauding nearly 700 public investors.[222] Unable to obtain an injunction against the defendant, the SEC named him as a defendant "solely for the purpose of obtaining full relief."[223] The court determined that equitable authority of the federal courts was broad enough to "recover ill gotten gains for the benefit of the victims of wrongdoing, whether held by the original wrongdoer or by one who has received the proceeds after the wrong."[224] Generally, a creditor seeking to add a nominal defendant must demonstrate that the defendant received ill-gotten funds and that he does not have a legitimate claim to the funds.[225] Here, while the SEC in *Colello* was not able to prove that the defendant's claim to the funds was illegitimate, the defendant was equally unable (actually, unwilling) to prove that his claim was legitimate.[226] The court upheld the disgorgement order and excepted the debt from discharge.[227]

These cases are instrumental in demonstrating that prior to § 532(a)(19), federal courts permitted the SEC considerable latitude in securing disgorgement actions against defendants and observed the collateral effect of

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218 *Id.*

219 *Id.* at 1282.

220 SEC v. Colello, 139 F.3d 674, 676 (9th Cir. 1998) (citations omitted).

221 *Id.* at 675 (stating that a nominal defendant "holds the subject matter of the litigation in a subordinate or possessory capacity as to which there is no dispute") (quoting SEC v. Cherif, 933 F.2d 403, 414 (7th Cir. 1991)).

222 *Id.*

223 *Id.*

224 *Id.* at 676.

225 *Id.*

226 *Id.* at 678.

227 *Id.* at 679.

those disgorgement orders when securing exceptions to discharge in bankruptcy. Read together, the cases demonstrate that the SEC historically has not been required to establish the debtor's culpability or directly show that the debtor committed the fraud to secure the nondischargeability of a disgorgement order.

B. Closing the "Loopholes" and Upholding Congressional Intent

Despite the significant historical and doctrinal evidence to support the argument that a state-awarded disgorgement order should be preserved through discharge, the *Sherman* and *Faught* courts elected to go beyond the judgment and looked to the underlying liability of the debtor to determine the dischargeability of the debt.[228] This approach is reminiscent of case law addressing the debtor's discharge of debts pursuant to prepetition settlements.[229] These cases are relevant to a discussion concerning § 523(a)(19) because a debtor will often enter a settlement agreement to avoid defending allegations of fraud in court.[230] Thus, like the debtors in *Sherman* and *Faught*, the debtors that enter settlement agreements have never been formally charged with, or held liable for, a violation for security fraud.

Debts incurred by debtors in prepetition settlements for fraud are generally denied preclusive effect in bankruptcy court. In *Brown v. Felsen*, the Supreme Court found that the prior judgment did not bar the creditor from re-litigating under the principles of res judicata because the debtor had essentially asserted a "new defense" by filing for bankruptcy, which the creditor was entitled to

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228 *See* Okla. Dep't of Sec. *ex rel.* Faught v. Wilcox, 691 F.3d 1171, 1176–77 (10th Cir. 2012); Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1016 (9th Cir. 2011), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013) ("[W]e do not think Congress wanted to immunize these debts from discharge in bankruptcy, when the debtor has not been found guilty of any wrongdoing.").

229 *Compare, e.g.*, Greenberg v. Schools, 711 F.2d 152, 156 (11th Cir. 1983) (reasoning that a debt that originates from the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement and that the Bankruptcy Court should look into the factual circumstances behind the settlement agreement to ascertain whether the debt should not be discharged in the bankruptcy proceeding), *and* United States v. Spicer, 57 F.3d 1152, 1157 (D.C. Cir. 1995) (going beyond the form of the settlement agreement to look at the fraudulent conduct of the debtor), *with* Key Bar Invs. v. Fischer (*In re* Fischer), 116 F.3d 388, 390 (9th Cir. 1997) (holding that a prepetition agreement settling claims for fraud extinguished the underlying tort action and transformed it into a dischargeable contract debt), *and In re* West, 22 F.3d 775 (7th Cir. 1994) (holding that a note given and received as substitute to the old obligation does not fully discharges the original debt and the nondischargeability of the original debt does not affect the dischargeability of the obligation under the note), *disagreed with by* Archer v. Warner, 538 U.S. 314 (2003).

230 *See* Brown v. Felsen, 442 U.S. 127, 128 (1979); Key Bar Invs. v. Fischer (*In re* Fischer), 116 F.3d 388, 390 (9th Cir. 1997); *In re* West, 22 F.3d 775, 778 (7th Cir. 1994).

answer through the submission of additional evidence.[231] The court concluded that a prior judgment and record in a state court proceeding did not confine a bankruptcy court considering the *dischargeability* of the debt.[232] The Seventh and Ninth Circuits deviated from this holding by adopting the position that a creditor's acceptance of a prepetition settlement was a "novation,"[233] which is a contractual debt that is fully dischargeable in bankruptcy.[234] The Supreme Court rejected this reasoning in *Archer v. Warner*.[235] In *Archer*, the parties settled a lawsuit by releasing the debtors from all fraud claims against them except for a $100,000 promissory note.[236] When the debtors failed to make a payment on the note, the petitioners sued in state court.[237] The bankruptcy court, the district court, and the Court of Appeals for the Fourth Circuit found the note dischargeable.[238] The Supreme Court, applying *Brown*, reversed the decisions of the lower courts.[239] In his opinion, Justice Breyer revisited many of the points made by the *Brown* court, emphasizing that the statutory language adopted by Congress in § 523(a)(2)(A) demonstrated an intent to "ensure that all debts arising out of fraud are excepted from discharge, no matter their form."[240]

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231 *Brown*, 442 U.S. at 133.

232 *Id.* at 138–39. To support their decision, the court considered the language of § 17(a)—precursor to § 523(a)(2)(A)—as indication that Congress intended inquiry into exceptions to the fullest extent possible. *Id.* at 138.

233 A novation is "[t]he act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party." BLACK'S LAW DICTIONARY (9th ed. 2009).

234 *See Fischer*, 116 F.3d at 390; *West*, 22 F.3d at 777.

235 Archer v. Warner, 538 U.S. 314, 323 (2003).

236 *Id.* at 318.

237 *Id.* at 317–18.

238 *Id.* at 318.

239 *Id.* at 319, 323.

240 *Id.* at 321 (internal quotation marks omitted) (citing Brown v. Felsen, 442 U.S. 127, 138 (1979)). In *Archer*, the Supreme Court noted Congress's preference for a broad interpretation of § 523(a)(2)(A). *Id.* (quoting *Brown*, 442 U.S. at 138). Over the course of twenty years, the Court returned to the presumption in *Brown* twice, restating that the intent of the statute is to permit the fullest possible inquiry into the nature of the debt and that all debts arising out of fraudulent conduct should be excepted from discharge. *See* Grogan v. Garner, 498 U.S. 279, 287 (1991); *see also Archer*, 538 U.S. at 321 (quoting *Brown*, 442 U.S. at 138). Allowing a broad inquiry into the nature of the debt is compelling evidence that in the long history of fraudulent claims preceding *Sherman* and *Faught*, the Supreme Court preferred to interpret discharge provisions broadly in pursuance of a congressional policy favoring the interests of reinforcing securities regulators even though such decision may not give debtors a fresh start. *See Grogan*, 498 U.S. at 287; Howard B. Kleinberg, *U.S. Supreme Court to Consider Whether a Prepetition Settlement Affects the Dischargeability of a Claim*, 11 J. BANKR. L. & PRAC. 381, 388 (2002) (predicting that in ruling on *Archer v. Warner*, the Supreme Court would eschew the "novation theory" adopted as justification to discharge agreement settling allegations of fraud under § 523(a)(2)(A) in favor of making the "fullest possible inquiry" into the dischargeability of the underlying debts); *see also* Memory, *supra* note 56, at 633, 660. Scholars have argued

In *Mollasgo v. Tills (In re Tills)*, the Bankruptcy Court for the Southern District of California considered whether a debtor's obligation to pay a creditor $241,000 in accordance with an agreement settling allegations of securities fraud was excepted from discharge under § 523(a)(19).[241] In *Tills*, the creditor brought claims against the debtor alleging fraud and negligent misrepresentation after the debtor's real estate development venture failed.[242] In the agreement, neither party admitted fault or liability, but exchanged "mutual releases" after establishing that the $241,000 equated to full payment of damages in arbitration.[243] Prior to signing the agreement, the debtor's counsel assured him the debt would be dischargeable in bankruptcy and the debtor apprised the creditor of his intention to file for bankruptcy.[244]

The court reasoned that the settlement agreement was not sufficient to confer collateral estoppel effect as to dischargeability because the agreement contained no express agreement to fault or liability of the debtor.[245] Rather, the agreement stated the debtor did not concede liability.[246] As such, the agreement did not provide a sufficient basis for establishing nondischargeability because there was no judgment evidencing that the debtor committed securities violations.[247] Thus, the court attempted to render the culpability of the debtor, as it was stipulated in the securities agreement, to be the controlling issue when determining dischargeability under § 523(a)(19).[248]

Yet, the court's opinion seems to eschew legal form over substance. The opinion ignores significant facts—chief among them the debtor's intention to discharge his debt prior to signing the settlement agreement.[249] Senator Leahy's comments in the Senate Report on SOX indicate that it was precisely

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that § 523(a)(2)(A) serves a dual purpose: namely, that the § 523(a)(2)(A) exception to discharge is as much about fairness to creditors and the compensation to victims as it is about providing the debtor a fresh start. *See* Kleinberg, *supra*, at 390; Memory, *supra* note 56, at 660.

241 Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 447–48 (Bankr. S.D. Cal. 2009).

242 *Id.* at 448.

243 *Id.*

244 *Id.*

245 *Id.* at 452–53 (explaining that as the "Settlement Agreement contained no discussion of the basis for [nondischargeability] and, instead contain[ed] a provision expressly stating that fault and liability are not conceded," the agreement was not sufficient to independently establish that the Debtor committed securities violations).

246 *Id.*

247 *Id.* at 453.

248 *Id.* at 451 (explaining that the plain text of § 523(a)(19) suggested that an actual violation of securities laws was required before a debt could be excepted from discharge).

249 *See id.* at 448.

the attempts of fraudulent debtors to use bankruptcy law as a shield[250] that prompted the passage of § 523(a)(19) to remedy the discharge of obligations to settlement agreements and "to help defrauded investors recoup their losses."[251] Moreover, the *Tills* opinion misconstrues *Archer v. Warner*. Like the settlement agreement in the *Tills* case, the settlement agreement in *Archer* released the debtors "from any and every right, claim, or demand" that the creditors can bring against them, and added that parties did not "admit any liability or wrongdoing."[252] The *Archer* court held that such language "completely addressed" every outstanding state law claim of the parties *except* the claim for the money promised in the agreement itself.[253] As such, the *Archer* analysis concluded that preclusive effect should not be given to a settlement agreement to prevent the creditor from litigating the dischargeability of the debt.[254]

It is widely accepted that SOX operates as the Congressional response to confusion in the courts regarding the dischargeability of settlement agreements.[255] The congressional record expressly states that Congress intended § 523(a)(19) to close the "loophole" in bankruptcy law that permitted debtors to discharge debts incurred through default on prepetition settlement agreements related to securities laws violations.[256] However, courts interpreting § 523(a)(19) are losing sight of the significant jurisprudence that pre-dated the statute's adoption and are morphing the provision's language to deny creditor's nondischargeability actions even when the creditor's right to access the debtor's funds has been established in state court.[257]

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250 148 CONG. REC. S7418-01 (daily ed. July 26, 2002) (statement of Sen. Leahy).

251 PATRICK LEAHY, THE CORPORATE AND CRIMINAL FRAUD ACCOUNTABILITY ACT OF 2002, S. REP. NO. 107-146, at 10 (2002).

252 Archer v. Warner, 538 U.S. 314, 317 (2003).

253 *Id.* at 318–19.

254 *Id.* at 323 (holding that although the releases may have been a novation, there could still be a showing that the settlement arose under false pretenses and thus could be nondischargeable).

255 Mason, *supra* note 135 (arguing Congress enacted § 523(a)(19) in part to prevent dischargeability of settlement agreements).

256 LEAHY, *supra* note 251.

257 *See, e.g.*, Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 452–53 (Bankr. S.D. Cal. 2009) (applying California contract law to an agreement settling creditor's claims against debtor for securities fraud to hold that the agreement is not excepted from discharge under § 523(a)(19) because rules of statutory construction and legislative history demonstrate that the provision "focuses on securities violations rather than resolutions of allegations of securities violations"). The cases decided under § 523(a)(2) are not irrelevant to this discussion even though they regard a different statute. This interpretation of § 523(a)(19) overlaps § 523(a)(2) to the extent that the § 523(a)(19) exception arises from fraud. 4 COLLIER ON BANKRUPTCY ¶ 523.27 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009).

IV. THE POSSIBILITY OF A "TYPE" EXCEPTION FOR SECURITIES FRAUD?

Given the alternate textual interpretation of § 523(a)(19) and the analysis of the statute's relevant legislative and legal history, there is at least some room to argue that § 523(a)(19) covers debts for disgorgement levied against debtors unjustly enriched by the fraud of a third party. However, the alternate interpretation still fails to thwart the literalist construction of the statute as a "conduct" exception. Part I.C of this Comment briefly outlined the two categories of exceptions observable in § 523.[258] The first are categorized as "conduct exceptions" and "stem[] from [the] culpable act[s] personally committed by the debtor."[259] These are distinct from the "type exceptions," which promote a government interest in the continued liability of the debtor but to which the debtor's culpability is irrelevant.[260]

An important question raised by the analysis of the *Sherman* and *Faught* opinions is whether § 523(a)(19) was properly categorized by the courts as a "conduct" exception.[261] Courts construing the exception readily assume that because the exception references malfeasance of an individual, Congress intended it to exist beside and be interpreted in accordance with other conduct exceptions provided in the provision. For this reason, the § 523(a)(19) exception is commonly compared to other exceptions in the Code that require malfeasance to be directly imputed to the debtor.[262] Some examples of conduct exceptions include: § 523(a)(2), which excepts from discharge the moneys obtained by, inter alia, actual fraud;[263] § 523(a)(4), which excepts debts for fraud or defalcation while the debtor was acting as a fiduciary;[264] and § 523(a)(6), the exception for willful and malicious injury committed by the debtor.[265]

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258 *See supra* Part I.C. Proper credit for originally articulating this distinction is due to Keith Sambur, who described the differences between "conduct" and "type" exceptions in his article. Sambur, *supra* note 90, at 568.

259 Sambur, *supra* note 90, at 562, 564 (citations omitted).

260 *Id.* at 562, 566–67.

261 *See generally* Okla. Dept. of Sec. *ex. rel.* Faught v. Wilcox, 691 F.3d 1171, 1175 (10th Cir. 2012) (emphasizing that the § 523(a)(19) was intended to penalize perpetrators); Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1013 (9th Cir. 2011) (citing 11 U.S.C. § 523(a)(2)(B)), *abrogated by* Bullock v. BankChampaign, N.A., 133 S. Ct. 1754 (2013).

262 *See Sherman*, 658 F.3d at 1014.

263 11 U.S.C. § 523(a)(2) (2012).

264 *Id.* § 523(a)(4).

265 *Id.* § 523(a)(6).

However, after conducting a thorough analysis of the language in § 523(a)(19), there is reason to believe that § 523(a)(19) may just as easily be categorized as a "type" exception created by Congress to further the government's interest in providing American investors the opportunity to recover their lost savings and earnings from other investors that had no right to possess their property in the first place. Such a policy lends stability to the market for securities by improving the effectiveness of the SEC in the effort to enforce regulations and redistribute moneys in the wake of a fraudulent scheme's collapse. Likewise, the policy also lends stability to the national economy by mitigating the amount of losses sustained by victims of massive fraudulent schemes.

In considering a characterization of § 523(a)(19) that is meant for investor protection, it is prudent to remind scholars that the exception was created by Congress in the context of broad legislative reform expressly intended to "restore[] trust in the financial markets by ensuring that corporate fraud and greed may be better detected, prevented and prosecuted."[266] The legislative history of SOX suggests Congress recognized that private investors were not the only parties injured by securities fraud. Rather, the government had an interest in ensuring that victims of security fraud were not excluded from an opportunity to recover their funds even if private litigation was cost prohibitive.[267] Situated in the broad reform of SOX, it appears that § 523(a)(19) was not drafted with the sole intention of punishing nefarious debtors, like the other conduct exceptions in § 523. Rather, it is apparent from the history of the Act and the other statutes contained in the legislation that § 523 was intended to widen the avenues of recovery available to defrauded

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[266] *See* LEAHY, *supra* note 251, at 2. Other reforms in SOX enacted simultaneously with § 523(a)(19) are also persuasive of Congress's intent to promote the government interest in protecting the investors and the market from the havoc created by fraudulent schemes. For instance, § 308 of SOX enacted a Fair Fund which permitted the SEC to recover funds on behalf of defrauded investors. *See* Winship, *supra* note 29, at 1118 & n.69. Since its inception, the business community has begun to perceive the Fair Fund as a substitute for a private cause of action against fraudulent securities companies. *See* Black, *supra* note 25, at 320, 336–37.

[267] *See* LEAHY, *supra* note 251, at 9.

> In short, by the time a victim learns enough facts to file a complaint under a heightened pleading standard, survives a motion to dismiss, begins discovery, and learns that an additional wrongdoer or theory should be added to the case, that claim is likely to be time barred, then the wrongdoer is able to avoid liability and the victim is left holding the proverbial bag. Moreover, current law sets up a perverse incentive for victims to race into court, so as not to be barred by time, and immediately sue. Plaintiffs who wish to spend more time investigating the matter or trying to resolve the matter without litigation are punished under the current law.

Id.

investors. Although the Oklahoma Supreme Court recognized this nuance,[268] the government interest furthered by the SEC in seeking disgorgement was unfortunately lost on the judges sitting in the federal appellate courts. Had the Department argued that § 523(a)(19) was a "type" exception, any discussion concerning the culpability of the debtor would have been avoided, and the debt properly preserved. Thus, the circuit courts' opinions soften the laudable goal of SOX. The exception to discharge created to close loopholes and help regulators recover assets for defrauded investors is thwarted by the narrow interpretation of § 523(a)(19).

CONCLUSION

The analysis conducted in this Comment indicates that there are two significant problems with the narrow construction of § 523(a)(19) adopted by the majority opinions in *Faught* and *Sherman*. The first issue relates to the difficulty of preserving the differences in the type of debt covered under § 523(a)(2)(A) and the type of debt covered by § 523(a)(19). Comparing the language between the two statutes indicates that § 523(a)(19) ostensibly excepts the debtor's obligation to pay disgorgement judgments because that debt is explicitly described in § 523(a)(19)(B) and must merely "result" from a violation of state or federal securities laws irrespective of the debtor's culpability.

Moreover, the narrow construction adopted by these opinions does nothing to assuage the disjunction between state securities legislators and the vast array of disparate claims that may arise under state and federal securities laws. The court's opinions leave unanswered the issue of what preclusive effect state securities regulators should receive for the disgorgement orders awarded to them by state tribunals. While the majority opinions thoroughly addressed the question of *who* must violate the state and federal security laws, they neglected the determination of which judicial entity—state or federal tribunal—should be permitted to establish the violation and the nondischargeability of the debt. The standard established by the majority lessens the amounts securities regulators might recover because it effectively narrows the exception to direct violations of securities fraud. The opinions disappointingly fail to consider the vast array

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[268] *See* Okla. Dep't of Sec. *ex rel*. Faught v. Blair, 231 P.3d 645, 655 (Okla. 2010). The court in *Blair* understood that the disgorgement debts pursued by the SEC should be looked at in a more holistic manner. The court recognized the disgorgement as an exercise of a state's police and regulatory powers. "When the SEC seeks disgorgement, it is acting in a sovereign governmental capacity." *Id.*

of cases that involve nominal defendants in possession of funds to which they have no legitimate claim.

This last point is particularly troubling, both in policy and practice. While it is difficult to prove that the narrow construction of § 523(a)(19) frustrates the duties of the SEC as an enforcer, by extrapolating the effect of the discharge into bankruptcy, it is apparent that the narrow interpretation leads to dissatisfying results. Specifically, by permitting the debtor to discharge his obligation to disgorge funds to which he had no legitimate claim, the court is effectively allowing the debtor to retain those funds to pay off other creditors. Thus, the narrow interpretation of § 523(a)(19) threatens the balance of rights preserved in the bankruptcy process, and invites future attack on the scope of the bankruptcy court's authority to encroach on the ownership rights of investors. The Ninth and Tenth Circuit Courts could have avoided such unpleasantness had they adopted the broad interpretation of § 523(a)(19), as was recommended by securities regulators.

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* Managing Editor, *Emory Bankruptcy Developments Journal*; J.D. Candidate, Emory University School of Law (2014); B.A., Trinity University (2010). To see my name in print for the very first time is a dream come true, and I am tremendously grateful for the friendship, encouragement, and guidance that made this dream possible. First and foremost, I would like to thank Professors Nancy Daspit and Rafael Pardo who offered helpful feedback on my research and helped me hone my comment topic. I would also like to thank Assistant United States Attorneys Scott Hulsey and Glenn Baker in the U.S. Department of Justice for giving me a crash course in securities regulation and enforcement. I was also particularly fortunate to work briefly with Ronald E. Barab of Smith, Gambrell & Russel, LLP who donated significant time helping me parse through the Bankruptcy Code. Special gratitude is also due to my distinguished colleagues on the *Emory Bankruptcy Developments Journal* that have helped me at every step of the drafting and editing process. Sincerest thanks go to every member of the EBDJ Executive Board and special thanks to Notes and Comments Editor Samantha Kidd who endured countless emails, phone calls, and impromptu meetings as I prepared this comment for submission. Finally, I would like to thank my mother, father, and younger sister for their endless love and encouragement. No accomplishment will make me as proud as I am to be a daughter and older sister to such kind and loving people.