APPENDIX F-4

Issues Identified by the Division of Enforcement and Office of General Counsel of the Securities and Exchange Commission
The Securities and Exchange Commission ("SEC") is responsible for the administration and enforcement of the federal securities laws. In its enforcement actions in federal court, the SEC seeks a variety of remedies, including asset freezes to prevent dissipation of investor funds obtained through a defendant's securities fraud, injunctions halting an unregistered or fraudulent offering of securities and prohibiting future securities law violations, disgorgement of unlawfully obtained profits, and civil penalties. In appropriate cases the SEC also seeks orders placing corporate defendants into receivership. In administrative proceedings brought before the SEC, the Division of Enforcement seeks remedies that include a suspension or bar of a person from the securities business, the revocation of the registration of a broker-dealer, investment company or investment advisor, and orders imposing various safeguards on the scope or method of a respondent's securities-related activities.

The caseload of the SEC's Division of Enforcement has been steadily rising. In the past two years, the Division has brought nearly 1,000 cases involving approximately 2,200 defendants and respondents. 1/

1/ See Testimony of SEC Chairman Arthur Levitt before the House of Representatives Subcommittee on Telecommunications and (continued...
higher. The rising tide of bankruptcy filings affects the SEC's enforcement program at every stage -- in investigations, litigation, and post-judgment collection. The Division estimates that between 15% and 20% of its cases are affected by a bankruptcy filing, although the percentage varies greatly by region. 2/ Defendants in SEC actions have filed bankruptcy to undermine asset freezes, 3/ stop law enforcement actions and contempt proceedings, 4/ and to seek discharge of nondischargeable claims. 5/ The increasingly scarce resources of SEC trial counsel have been expended in litigating bankruptcy injunction and discharge issues in addition to their enforcement cases. Thus, the SEC has a strong interest in ensuring that the bankruptcy courts are not used as a "haven for wrongdoers" in

1/ (...continued)
Finance at 12 (February 28, 1996).

2/ About 30% of the litigating cases in the SEC's Fort Worth District Office involve a bankrupt defendant. The Southeast Regional Office, which includes Florida, has a similarly high percentage of bankrupt defendants.


4/ Bilzerian v. SEC, 146 B.R. 871 (M.D. Fla. 1992); In re Wolf Financial Group, Inc., No.94B 440009/44010 (Bankr. S.D.N.Y. 1994); In re Weil, No. 95-21470-BKC-RBR (July 21, 1995) (denying motion to enjoin contempt proceeding after bankruptcy filed on day contempt trial began).

subversion of congressional intent, 6/ and that scarce
enforcement resources are not diverted into unnecessary or
duplicative litigation in bankruptcy court.

The SEC's interest in the functioning of the bankruptcy
system extends beyond the protection of its enforcement remedies.
Section 1109(a) of the Bankruptcy Code grants the SEC party-in-
interest status in any chapter 11 case. 7/ The Office of General
Counsel, together with lawyers in four SEC field offices, handles
this aspect of the SEC's bankruptcy practice, which in general is
limited to corporate reorganization cases under Chapter 11 of the
Bankruptcy Code involving large public companies that are not
implicated in Commission law enforcement investigations or
proceedings. The SEC's goal in these Chapter 11 cases is to
protect the interest of public investors who hold securities of
these companies, ensure adequate disclosure of reorganization
plans that provide for the issuance of unregistered securities,
and prevent the misuse of the Bankruptcy Code's exemption from
Securities Act registration. During 1995, the SEC was a party in
about 100 such chapter 11 cases, involving stated assets of $63
billion and almost one million investors. In this area, the SEC

805 F.2d 1039 (9th Cir. 1981).

7/ The SEC also has party-in-interest status in municipal
bankruptcies under chapter 9 and has been an active
participant in the Orange County bankruptcy to protect holders
of the County's public debt and the municipal securities
markets generally.
also has seen the need for certain reforms to ensure that the bankruptcy process is not abused. 8/

This submission identifies issues of concern to law enforcement that we believe this Commission should address. These issues are not unique to the SEC. Federal and state law enforcement agencies face similar drains on their resources in litigating the scope of the police power exception to the automatic stay, the power of the bankruptcy court to enjoin excepted actions, and duplicative dischargeability actions, among others. These issues, which are unique to governmental agencies, merit consideration in a forum devoted exclusively to them. The SEC's Division of Enforcement and Office of General Counsel therefore strongly urge this Commission to schedule a meeting devoted solely to governmental issues in bankruptcy at which these important law enforcement concerns could be aired and a dialogue begun between the Commission members and the affected federal and state agencies.

ISSUES

TOPIC ONE: THE AUTOMATIC STAY

1. Clarify the scope of the governmental police or regulatory exception. The exception to the automatic stay for the enforcement of a governmental unit's police or regulatory

8/ In this advisory capacity, the SEC may make substantive recommendations on issues unrelated to law enforcement in a subsequent submission.
power found in §§362(b)(4) and (5) excepts such enforcement actions from the stay imposed by §362(a)(1) (commencement or continuation of legal proceeding on prepetition claim) and §362(a)(2) (enforcement of a prepetition judgment). It does not by its terms except such governmental actions from the stay imposed by §362(a)(3), which applies to "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." The lack of exception to the stay against exercising control over estate property appears to have been an oversight, as that language was not part of the Code when the governmental exceptions were enacted, but was added to §362(a)(3) by the 1984 amendments. 9/ There is no legislative history for the amendment.

The courts have divided over whether the revocation of a license or permit by a governmental unit is stayed by §362(a)(3). 10/ As a matter of policy, the exception of §362(b)(5) for enforcement of a judgment that is not a money judgment is drained of much of its meaning if license and permit revocation is nonetheless stayed as an act to exert control over property of the estate under §362(a)(3). Nonetheless, cautious agencies have

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moved to lift the stay before proceeding with the actual act of revocation. 11/ This delays the regulatory process, diverts the resources of government agencies from their main mission, and effectively transfers the revocation decision from the regulatory agency to the bankruptcy court.

Other governmental regulatory actions arguably fall within §362(a)(3), although this may not have been Congress' intent. Some courts therefore have given the existing governmental exceptions broad scope, holding that the imposition of an equity receivership or the continuation of an asset freeze in a governmental regulatory action is excepted from the automatic stay by §362(b)(4) and (5). 12/ These courts found that appointing a responsible fiduciary to manage corporate assets, or restraining unauthorized transfers of funds, served the interests of both the regulatory process and the creditor body.

Amending §§362(b)(4) & (5) to expressly state that they also except actions encompassed by §362(a)(3) would provide certainty and guidance in this area, eliminating time-consuming and resource-intensive stay litigation. It also would have the salutary effect of discouraging bankruptcy filings based on unfavorable rulings in law enforcement cases. With respect to


license revocation, such an amendment would place regulatory decisions where they belong -- with the appropriate regulatory authority. Any fear that this would lead to abuse by regulatory agencies should be dispelled by the existence of §525 of the Code, which prohibits discriminatory governmental action based on the filing of a bankruptcy petition.

2. **Clarify standard for enjoining acts within police/regulatory exception.** The Bankruptcy Code does not state whether acts subject to the police/regulatory power exception may nonetheless be enjoined pursuant to the bankruptcy court's equitable powers under §105. The legislative history indicates that in general, all excepted actions (both governmental and nongovernmental) could be enjoined under §105 under traditional equitable standards, but does not specifically discuss the governmental exceptions. 13/ In fact, the traditional equitable standard is quite different for enjoining governmental, as opposed to private action. Federal courts will not enjoin criminal or civil regulatory action by a governmental entity unless it is undertaken for the purpose of harassment, in bad faith, or is clearly illegal. 14/


Some courts have recognized and applied this principle in the bankruptcy context, 15/ but others have not. 16/ To conform with nonbankruptcy principles and to effectuate congressional policy that bankruptcy courts not be a haven for wrongdoers, excepted governmental actions should not be enjoined unless they pose a serious conflict with the provisions of the Bankruptcy Code, and the traditional criteria for injunctive relief (i.e., irreparable injury, balance of harms in favor of movant, public interest favors movant) are met. 17/ To stem the tide of litigation over this issue, and the delay and waste of resources it causes, this standard could be codified in a new subsection in §362(b).

3. Clarify grounds for lifting stay. What constitutes cause for lifting the stay for an unsecured creditor, unlike a secured creditor, is not delineated in the Code, and there is not a great deal of guidance in the case law. Compare §362(d)(1) with §362(d)(2). One area of importance to law enforcement agencies in individual chapter 7 and 11 cases is the ability to execute on non-estate (and nonexempt) assets to satisfy nondischargeable claims. The automatic stay by its terms applies


16/ E.g., In re Hunt, 93 B.R. 484 (Bankr. N.D. Tex. 1988).

17/ In re Amsterdam Equities, supra; In re Compton, 90 B.R. 798 (N.D. Tex. 1988); In re Brennan, No. 95-6543 (D.N.J. Feb. 8, 1996).
to property of the debtor, not just property of the estate, although creditors with dischargeable claims have no interest in the debtor's non-estate property.

A governmental agency that holds a nondischargeable judgment should not have to await the outcome of an individual's bankruptcy case before executing on property of the debtor that is not property of the estate. Litigious debtors can cause their bankruptcies to drag on for years, while the debtor may be earning a large income that is not property of the estate. Governmental claims should not be held hostage to unrelated litigation while the debtor is earning and spending new and unencumbered income. Authorizing such actions also benefits creditors with dischargeable claims, since it lessens the size of the claim by the nondischargeable creditor against estate assets (to the extent the latter claim is not a penalty subject to subordination).

TOPIC TWO: EXEMPTIONS

4. Establish a ceiling for the homestead exemption. During the course of a governmental investigation, or after litigation is commenced, a potential or actual defendant has the incentive to engage in "bankruptcy planning," which may include forum shopping. Current law permits enormous disparities in the amount of property an individual is entitled to claim as exempt solely on the basis of the individual's state of domicile for 180 days preceding bankruptcy, or for a longer portion of the 180 days.
In re Davidson, 164 B.R. 782 (Bankr. S.D. Fla. 1994). This situation has improved with the passage in 1993 by the Florida legislature of a statute denying exemptions where a conversion from non-exempt to exempt assets was done with the intent to hinder or defraud creditors. See id. It is not clear yet where the line will be drawn between permissible and impermissible conversions, a dispute that is likely to give rise to substantial litigation.
5. **Exclude disgorgement/restitution funds from property of the estate.** In securities fraud cases, the SEC often obtains a judgment requiring the defendant to pay money to a disgorgement fund. The money in the fund may be distributed to defrauded investors or paid to the United States Treasury. Numerous courts have found disgorgement to be a necessary remedy for deterring violations of the federal securities laws by depriving a violator of the fruits of his wrongdoing and for achieving equity by preventing unjust enrichment. Additionally, in criminal securities fraud cases, a criminal restitution fund may be ordered. If these funds are property of the estate, subject to turnover and avoidance powers, the important securities law enforcement policy they implement would be subverted; indeed a bankruptcy could be filed for that very purpose. 19/

The bankruptcy policy of equality of distribution is not a strong counterforce in such circumstances, as a law violator's creditors do not have a right to reap the fruits of a securities fraud any more than does the violator. This argument is equally applicable to regulatory actions brought by federal and state agencies outside the specific context of the federal securities laws. Therefore, this Commission should consider whether §541(b) should be amended to provide specifically that property of the estate does not include any civil disgorgement or restitution

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19/ Satellite litigation over this issue in the bankruptcy court would be costly and difficult.
fund established in an action brought by a governmental entity pursuant to its police or regulatory power.

6. **Exclude disgorgement/restitution funds from turnover provisions.** The above argument applies even more forcefully to the turnover provisions in §543, which apply not just to property of the estate, but also to property of the debtor, in which creditors do not even have an interest. Therefore, this Commission should consider whether §543 should be amended to exclude from its provisions any civil disgorgement or restitution fund established in an action brought by a governmental entity pursuant to its police or regulatory power.

7. **Exclude disgorgement/restitution funds from preference provisions.** These same policy reasons militate in favor of protecting disgorgement/restitution funds from preference actions. Therefore, this Commission should consider whether §547(c) should be amended to prevent the recovery as a preference of any transfer that was a bona fide payment of a debt to a governmental unit incurred in the exercise of its police or regulatory powers.

**TOPIC FOUR: DISCHARGE EXCEPTIONS**

8. **Amend §523(a)(7) to include disgorgement.** Under current law, different parts of the same governmental judgment may be subject to different discharge exceptions, with material consequences in terms of cost and delay. For example, a typical judgment in an intentional fraud case (whether settled or
litigated) might include an injunction against future violations, disgorgement of the proceeds of the fraud, and civil penalties. The injunction, since it is not a claim, passes through bankruptcy unaffected (§101(5)). The disgorgement, as a debt for money obtained by fraud, is dischargeable only after an adversary proceeding is litigated in the bankruptcy court (§523(a)(2)(A)). Such a proceeding is not required, however, to except the civil penalties from discharge (§523(a)(7)). See §523(c).

Disgorgement is not a fine, penalty or forfeiture subject to §523(a)(7). It does, however, serve regulatory purposes (deterrence and prevention of unjust enrichment) as important as the regulatory purpose served by the punitive sanctions. Why should the Bankruptcy Code make it more costly and time-consuming to determine the dischargeability of a debt for the disgorgement of proceeds derived from unlawful activity than of a debt for fines, penalties or forfeitures arising from the same unlawful activity? Neither type of debt represents compensation for actual pecuniary loss, and both serve important goals of effective law enforcement. (The fact that fines are typically subordinated in a bankruptcy distribution, while disgorgement is not, is irrelevant, since both types of debt are excepted from discharge.) Thus, disgorgement, like fines, penalties and forfeitures, should be treated as automatically nondischargeable.

Additional policy reasons favor such an amendment. First, in our experience, notice of deadlines to file adversary
complaints historically has been poor. Individual debtors often omit or give incomplete addresses for the SEC (such as omitting the names of the responsible attorneys even when they know them). Even when the Division of Enforcement learns of a bankruptcy and files an appearance and request for notice, the courts often omit the SEC from service of the notice of the §341 meeting. However, the Bankruptcy Rules and case law place the onus on the creditor to discover the bar date, so that claims can be lost even where a debtor has intentionally omitted a creditor from his schedules, so long as the creditor learns of the fact of the bankruptcy in time to file a pleading. 20/ Second, forcing a governmental agency to litigate an adversary proceeding to except portions of its judgments consumes time and resources that are increasingly scarce, without providing any offsetting benefit to the bankruptcy estate. The resulting delays (and possibility of lost claims) benefit only the personal interest of the dishonest debtor. Accordingly, the SEC staff urges this Commission to recommend amending §523(a)(7) to include disgorgement. Furthermore, since disgorged funds are often, although not always, distributed to defrauded investors, any amendment should clarify that it applies regardless of the ultimate disposition of the funds received by the governmental unit.

20/ Bankruptcy Rule 4007(c); In re Williamson, 15 F.3d 1037 (11th Cir. 1994).
9. **Amend §1328 to include §523(a)(7) discharge exceptions.**

The discharge exceptions of §523(a)(7) should be made applicable to chapter 13 cases. The important public policies vindicated by law enforcement actions outweigh the stated rationale for the chapter 13 "superdischarge" -- to make chapter 13 more attractive to debtors and encourage them to complete the payments under their plans. 21/ The absence of many discharge exceptions in a chapter 13 and the debtor's retention of control and possession over estate property provide sufficient incentive to filing under chapter 13. Given that a chapter 13 plan with the same or only marginally better distribution than a chapter 7 plan may be confirmed (and possibly no payment at all on the discharged claims), the superdischarge tilts the playing field too far in favor of the debtor. It is poor public policy to encourage bankruptcy filings by the prospect of discharging debts to governmental entities premised on serious misconduct that harms society, as Congress recognized in enacting §1328(a)(3).

**TOPIC FIVE: NONDEBTOR DISCHARGES**

10. **Amend §1129 to preclude nondebtor discharges.** The SEC has been active in its advisory role under §1109(a) in objecting to chapter 11 plans that purport to extinguish the liability of persons or entities who are not in bankruptcy. This is usually accomplished by providing for an injunction in the plan enjoining

21/ *Ravenot v. Rimgale (In re Rimgale)*, 669 F.2d 427 (7th Cir. 1982).
litigation against specified persons or entities (generally insiders or insurers of the debtor), or by incorporating into the plan a non-opt out class action settlement that releases class claims against specified nondebtors. 22/ The courts are divided on whether such orders are permitted by the Bankruptcy Code. The SEC has agreed with the courts holding they are not, and additionally asserts that permitting such orders is bad public policy.

The legal controversy centers on the effect of §524(e), which provides that the discharge of a debt of a debtor does not affect the liability of any other entity or that entity's property for the debt. 23/ Courts holding that §524(e) prohibits the discharge of creditor claims against nondebtors have held that this section embodies the bankruptcy policy that one who does not undertake the burdens of bankruptcy may not obtain the benefits of a bankruptcy discharge by riding on the coattails of a debtor. 24/ Some courts, however, have carved out exceptions to §524(e) based on the perceived necessity of the nondebtor


23/ The 1994 amendments provided for a limited exception to this section in §524(g) in cases where a trust has been established to pay asbestos related personal injury claims and the claimants to be paid from the trust vote in favor of the plan by a 75% majority.

discharges to the reorganization, reasoning that §524(e) serves simply to codify the effect of a bankruptcy discharge without limiting the bankruptcy court's power under §105 to discharge a nondebtor's debts in appropriate circumstances. 25/ These latter cases, in turn, have encouraged insiders of debtors, joint tortfeasors and codebtors of every description to seek to have the debtor include a discharge of their liability in the plan, whether or not they have made a contribution to the plan that is necessary for the reorganization, a token contribution, or any contribution at all. 26/

Such nondebtor discharges are rife with the potential for abuse. In the nonbankruptcy context, nondebtor discharges cannot force unwilling creditors to settle with them. Debtors may do so as a result of submitting to the disclosure requirements and restrictions on the use and control of their assets imposed by the Bankruptcy Code, a burden not shared by nondebtor. The SEC has participated in bankruptcy cases where nondebtor have attempted to use the bankruptcy process to discharge their liability for intentional misconduct, including (as yet unsuccessful) attempts to eliminate liability to regulatory entities that were not even receiving a payment from the bankruptcy estate.


26/ Starr, supra note 21 at 500.
To end such abusive practices, §1129 should be amended to provide that no plan may be confirmed that contains an injunction that enjoins litigation against a nondebtor or that purports to release or discharge the liability of nondebtor. We recognize that reorganizations have been effected where nondebtor contribute funds to the estate and creditors voluntarily release their claims against the nondebtor in a tripartite settlement. 27/ These consensual releases are not discharges imposed on unwilling creditors, but are essentially voluntary settlement contracts that should be enforceable. Therefore, the proposed amendment would also specify that it does not preclude a nondebtor from being released voluntarily as part of a multiparty settlement among the debtor, nondebtor and consenting creditors. A voluntary release would be defined as one where each creditor was entitled to vote (separate and apart from its vote on the reorganization plan) on whether to provide a release to the nondebtor in exchange for a payment provided by the nondebtor, or to opt out of the settlement and pursue the nondebtor on its own.

27/ See Starr, supra note 21 at 500-01.
TOPIC SIX: MISCELLANEOUS ISSUES

11. **Improve the reporting system.** Currently, appeals from bankruptcy courts are taken to the district courts. In the majority of cases, the district court decision is unpublished. As there is no reporting system for results of appeals similar to the tables in the Federal Reporter, reversals of bankruptcy decisions often do not get reported. This is a particular problem where the bankruptcy court published its decision and it is erroneously being cited as precedent. As the SEC has had two such cases occur within the last three years, the problem is potentially significant. A table system should be established in the Bankruptcy Reporter to publish the outcomes of bankruptcy appeals.

12. **Improve notice to government agencies.** Some debtors schedule governmental creditors in a manner calculated to look complete but that is calculated to ensure that any notice will not be correctly routed, such as omitting the name or even division of the attorney known to be handling the case. This can produce huge delays or even a complete failure to reach the appropriate person. The Bankruptcy Rules should specifically require that the debtor schedule the name of the responsible individual at the governmental agency creditor or such identifying information about the case or investigation from which the debt is alleged to arise as is known to the debtor.
13. **Study eligibility standards for Chapter 11.** The Commission should study whether individuals should be eligible to file chapter 11, and if so, whether eligibility standards should be promulgated for them. As many of the reorganization provisions are not really applicable to individuals, there is a clear lack of standards for such cases. The Commission should also examine whether it is time to adopt eligibility standards for corporate chapter 11s. Under current law, even the most hopeless debtor usually is given at least one chance, and often multiple chances, to reorganize before the case is converted to a Chapter 7 liquidation. 28/ Conversion often results in a pyrrhic victory for creditors, as the estate has been consumed by administrative and/or operating expenses. 29/ Creditors, of course, are always worse off in converted cases than they would have been if a liquidation had been filed initially, as the administrative expenses in the chapter 11 diminish the amount that is available for distribution. The Commission should solicit information and comments on the feasibility of rectifying this problem through the adoption of eligibility standards.

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28/ For a discussion of the extremely low success rates of chapter 11 reorganizations, and the high costs these unsuccessful attempts have on creditors, see both the majority and dissenting opinions in *In re Timbers of Inwood Forest Assoc., Ltd.*, 808 F.2d 363 at 374, 382 (5th Cir. 1987) (en banc), aff'd, 484 U.S. 365 (1988).

29/ See id.