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SEC V. Creditors: Why SEC Civil Enforcement Practice Demonstrates the Need for A Reprioritization of Securities Fraud Claims in Bankruptcy

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NOTES

SEC V. CREDITORS: WHY SEC CIVIL ENFORCEMENT PRACTICE DEMONSTRATES THE NEED FOR A REPRIORITIZATION OF SECURITIES FRAUD CLAIMS IN BANKRUPTCY

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INTRODUCTION

For over forty years there has been a growing tension between the Securities and Exchange Commission's civil enforcement mission to protect defrauded securities holders and bankruptcy law's treatment of those claimants. Bankruptcy Code § 510(b) generates this tension by subordinating defrauded securities holders' claims, giving them the same priority as shareholders generally and a lower priority than creditors—leaving no practical opportunity to recover in bankruptcy. In response, the SEC utilizes mechanisms in and out of bankruptcy like fair funds and equitable receiverships to elevate would-be subordinated securities fraud claims over those of creditors.

This Note examines how this tension has motivated the SEC to use receiverships as a preferred vehicle to maximize recovery for defrauded security holders and, in the process, create what amounts to an SEC-run bankruptcy proceeding. The use of these receiverships has triggered a high-stakes race to the courthouse among the SEC and creditors, where mere hours can be the difference between millions in recovery and nothing at all. To end this costly race, this Note proposes a solution that seeks to harmonize securities fraud enforcement with bankruptcy law, which starts with revisiting Bankruptcy Code § 510(b) to reprioritize securities fraud claims in bankruptcy.

Part I explains how securities fraud claims are treated in bankruptcy under § 510(b), illustrating when such claims are subordinated and the rationale for doing so. Part II provides an

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overview of the SEC's influence in the bankruptcy context from the Agency's restricted role in the Code to its empowerment by Sarbanes-Oxley. Next, Part III.A explains how Sarbanes-Oxley empowers the SEC to use fair funds to compensate defrauded security holders in bankruptcy. Similarly, Part III.B explains how the SEC acts alternatively, out of bankruptcy, through equitable receiverships to recover for securities fraud victims.

Part IV demonstrates how § 510(b) has motivated the SEC to avoid bankruptcy altogether, and instead utilize equitable receiverships as a primary civil enforcement tool to compensate securities fraud victims of insolvent and near-insolvent entities. Part IV further illustrates the SEC's influence over this process, culminating in receiver distributions that disadvantage creditors. Accordingly, this use of receiverships has started a race to the courthouse between the SEC and creditors.

Finally, Part V proposes a solution to harmonize SEC civil enforcement policies with the Code. This Part offers objectives for Congress to better integrate securities fraud claims back into the bankruptcy process. In addition, it suggests practical means to achieve integration like elevating the United States Trustee to allow for more coordination with the SEC and the creation of a receivership-focused SEC position to benefit all securities fraud victims of insolvent entities—security holders and creditors alike.

I. THE TREATMENT OF SECURITIES FRAUD CLAIMS IN BANKRUPTCY: § 510(B) AND THE CODE

When an entity collapses, two types of bankruptcy are available to the insolvent entity: liquidation or reorganization. Liquidation permits individuals or entities to liquidate their assets and distribute the proceeds to creditors under Chapter 7 of the Code.[1] Reorganization allows high-income individuals and business entities to reorganize their debts and continue operations upon filing under Chapter 11.[2] In Chapter 7 and Chapter 11 cases, the Bankruptcy Code provides a fundamental ordering of payment distributions between equity owners and creditors that prioritizes creditor claims, ensuring those claims will be paid in full before equity owners receive any distribution.[3]

[1] 11 U.S.C. §§ 701–784 (2012).

[2] *Id.* §§ 1101–1174.

[3] Chapter 7 priority is set under § 726(a). *Id.* § 726. Chapter 11 reorganization is set under § 1129(a). *Id.* § 1129. This ordering in a reorganization, collectively set by

Thus, "at its core, bankruptcy solves a collective action problem among [self-interested] creditors" that eliminates strategic costs associated with a race to the courthouse.[4]

A. *Section 510(b): Mandatory Subordination*

Section 510 is an integral part of Bankruptcy Code §§ 501 through 511, which establish an allocation of estate assets among claimants in liquidation or reorganization cases.[5] Within that section, Congress asked the difficult policy question concerning the status of a defrauded security-holding claimant who has sought to rescind a purchase of a security or to sue for damages based on the purchase: "Should he be treated as a general unsecured creditor based on his tort claim . . . or should his claim be subordinated?"[6] The answer was mandatory subordination, embodied in § 510(b), of three types of claims: (1) claims arising from rescission of a purchase or sale of a security issued by the debtor or its affiliate; (2) claims for damages arising from the purchase or sale of such a security; and (3) claims for reimbursement or contribution on account of these claims.[7]

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§§ 1129 and 510(b) of the Code, is called the absolute priority rule. *Id.* § 1129; *id.* § 510(b).

[4] Douglas G. Baird, *Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy*, 165 U. PA. L. REV. 785, 789 n.11 (2017). The collective action problem occurs when investors of a firm with value as a going concern lands in financial distress and causes "each individual investor [to] find it in her [own] self-interest to try to recover what she is owed without paying attention to the consequences for everyone else." *Id.* at 789. Such efforts tear the firm apart because "investors are too dispersed to reach an agreement that would put a stop to a destructive race to the assets[.]" *Id.*

[5] COLLIER ON BANKRUPTCY ¶ 510.01 (16th ed. 2009) [hereinafter COLLIER].

[6] H.R. REP. NO. 95-595, at 194 (1977).

[7] 11 U.S.C. § 510(b).

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under § 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

Id. For the seminal article criticizing Congress' decision to favor subordination and create § 510(b), see Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1 (1983).

Section 510(b) mandates that security-holding claimants will be unable to elevate their interests from the level of equity to general claims.[8] Instead, such claims are subordinated to all claims senior or equal to the claim represented by the security.[9] And if the defrauded security claim is common stock, the claim assumes the same priority as common stock.[10] "Put simply, 'creditors stand ahead of the investors on the receiving line.' "[11]

B. Section 510(b): Theory of Risk Allocation

"Any discussion of section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke . . . ."[12] Congress generally adopted Slain and Kripke's theory of risk allocation as the foundation for § 510(b).[13] The professors argued that "allowing a person to assert a claim in bankruptcy as an unsecured creditor based on the purchase of an equity interest impermissibly permitted the buyer of a risky security to bootstrap himself into a less risky class."[14]

Slain and Kripke presented a problem rooted in two risks: insolvency and illegality.[15] Both creditor and security holder share the first risk of insolvency, but, the professors argued, only

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[8] COLLIER, *supra* note 5, ¶ 510.04[1].

[9] *Id.* Mandatory subordination affects all claims arising from transactions involving "securities." The Bankruptcy Code provides fifteen examples of securities in § 101(49)(A). 11 U.S.C. § 101(49)(A).

[10] COLLIER, *supra* note 5, ¶ 510.04[1].

[11] *In re* Geneva Steel Co., 281 F.3d 1173, 1179 (10th Cir. 2002) (quoting *In re* Granite Partners, L.P., 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997)).

[12] *In re Granite Partners, L.P.*, 208 B.R. at 336 (citing John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy—Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261 (1973)).

[13] H.R. REP. NO. 95-595, at 194, 196 (1977).

[14] THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 63 (1986). *See, e.g.*, *In re Geneva Steel Co.*, 281 F.3d at 1179 ("[I]t is clear that Congress embraced Professors Slain and Kripke's theory of risk allocation, namely, that general creditors assume a different type of risk with respect to the debtor's insolvency than do investors. And not only are general creditors unable to share in the potential benefits flowing from company success, they rely on the equity cushion created by the investors' capital contributions for payment. While Slain and Kripke focused primarily on shareholder rescission claims, their larger concerns sprang from what they termed the 'disaffected stockholder's efforts to recapture his investment from the corporation.' " (citations omitted)); *In re* Telegroup, Inc., 281 F.3d 133, 142 (3d Cir. 2002) ("Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding.").

[15] Slain & Kripke, *supra* note 12, at 286.

security holders—who join in the opportunity to enjoy profits of the entity—assume the risk of illegality in securities issuance.[16] Thus, permitting securities fraud claimants to share priority with general creditors wrongly allocates the risk of illegality to creditors. In addition, mandatory subordination of the claims of security holders is supported by creditor reliance on an equity cushion[17] and, since the establishment of the Code, creditor reliance on subordination to maintain priority over security holders if bankruptcy occurs.[18]

By accepting Slain and Kripke's proposal for mandatory subordination in § 510(b), Congress, in turn, rejected opposing arguments—the most vocal of which was from the SEC.[19] The Commission posited that defrauded security holders never bargained for the securities they received and, consequently, never actually took on that risk of insolvency.[20] Instead, the SEC argued that "general maxims of bankruptcy give a debtor's unsecured creditors equal footing in recovery, whether their claims sound in tort, breach of contract, or some other cause of action," and so posed the question: "[W]hy should shareholder fraud victims receive different treatment from that accorded other tort claimants, such as a pedestrian hit by the bankrupt's delivery truck?"[21] The SEC unsuccessfully argued that defrauded security holders should be treated like any other tort victim of the debtor—as a general unsecured tort creditor.[22]

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[16] COLLIER, *supra* note 5, ¶ 510.04[2].

[17] *Id.* For a critique of this equity cushion analysis, see Davis, Jr., *supra* note 7, at 20; Douglas A. Henry, Comment, *Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy*, 21 EMORY BANKR. DEV. J. 259, 282–83 (2004).

[18] COLLIER, *supra* note 5, ¶ 510.04[2] (citing Jezarian v. Raichle (*In re* Stirling Homex Corp.), 579 F.2d 206, 213 (2d Cir. 1978) ("When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion.") (internal quotation and citation omitted)).

[19] H.R. REP. NO. 95-595, at 195–96 (1977). Ironically, it was the SEC that argued for principles of absolute priority in the early part of the twentieth century. *See generally* Douglas G. Baird, *Present at the Creation: The SEC and the Origins of the Absolute Priority Rule*, 18 AM. BANKR. INST. L. REV. 591 (2010).

[20] H.R. REP. NO. 95-595, at 195 (1977).

[21] Davis, Jr., *supra* note 7, at 2 (citing U.S. SEC. & EXCH. COMM'N, REPORT ON S.235 AND S.236, *reprinted in The Bankruptcy Reform Act: Hearings Before the Subcomm. on Improvements in Judicial Mach. of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess. 738–79 (1975)).

[22] H.R. REP. NO. 95-595, at 196 (1977). The SEC argued that "[m]andatory subordination would result in different treatment to security holders whose fraud

The priority rule embodied in § 510(b) is clear: subordination is mandatory, regardless of the equities, and any security holder's claim under this section will be subordinated until the claims of general unsecured creditors have been satisfied.[23] The Code's rigid prioritization rule "makes it unlikely that securities fraud plaintiffs will receive any distribution" in bankruptcy, with the practical effect of deterring securities fraud plaintiffs from pursuing claims against insolvent companies.[24] Section 510(b) protects creditors, and "its language, its legislative history, and most important, its embodied legislative policy choices, reflect strong congressional disapproval of investor fraud claims in bankruptcy."[25]

II. THE SEC AND THE CODE

When Congress overhauled the bankruptcy laws in 1978, it rejected the SEC's position that the Agency's oversight was essential to protecting investors in bankruptcy, almost entirely excluding it from the process.[26] But the Agency's demotion would not be permanent.[27] The SEC's ability to protect public investors in and out of bankruptcy would be revived in part by Congress'

claims were reduced to judgment before bankruptcy, and those security holders whose claim had not reached that point." *Id.*

[23] COLLIER, *supra* note 5, ¶¶ 510.04[1], [7].

[24] John M. Wunderlich, *Bankruptcy's Protection for Non-Debtors from Securities Fraud Litigation*, 16 FORDHAM J. CORP. & FIN. L. 375, 390–91 (2011) (citing In re ComDisco, Inc., 271 B.R. 273, 278 (Bankr. N.D. Ill. 2002) ("[U]nder § 510(b) the securities fraud claims are likely to be subordinated to creditor claims, and dealt with on the same priority as the shareholder interests . . . . The effect of that subordination is not possible to predict with certainty. But one very real possibility is that the plaintiff class claims will be discharged by the plan without any payment. That will happen if the confirmed plan makes no distribution at the equity level. In other words, if the reorganization value of the Debtor is insufficient to pay all of the $4 billion in claims (and if the creditors do not agree to a distribution at the equity level), then by operation of law the plaintiff's claims against the Debtor will be discharged without any possibility of a recovery.")).

[25] *In re* Geneva Steel Co., 281 F.3d 1173, 1179 (10th Cir. 2002) (citing *In re* Granite Partners, L.P., 208 B.R. 332, 344 (Bankr. S.D.N.Y. 1997)).

[26] David A. Skeel, Jr., *The Rise and Fall of the SEC in Bankruptcy* 13 (Univ. of Pa. L. Sch. Inst. for L. and Econ., Working Paper No. 267, 1999), https://ssrn.com/abstract=172030 [hereinafter *Rise and Fall*].

[27] David A. Skeel, Jr., *Welcome Back, SEC?*, 18 AM. BANKR. INST. L. REV. 573, 573–74 (2010).

response to the massive accounting fraud scandals that rocked the country in the early 2000s, and with that came the sustained restoration of the SEC as an influential party in bankruptcy.[28]

A. A Loss of Influence: The Bankruptcy Code

Congress empowers the SEC to protect investors and to oversee the integrity of the market.[29] In the bankruptcy context, the SEC played a vital role under the Bankruptcy Act, the Bankruptcy Code's predecessor.[30] But its function under the Code's Chapter 11 reorganization was clearly circumscribed so that, in practice, the SEC would not play a significant role in the vast majority of cases.[31] Instead, "Congress adopted the view that . . . equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or [governmental agencies such as] the SEC."[32]

Congress did expressly recognize the role of the SEC in bankruptcy by including it in the "Right to be Heard" section of the Code.[33] That said, the legislative history of § 1109 confirms that Congress intended a substantially modified role for the Commission.[34] Congress explained that the SEC's tapered role would enable the Bankruptcy Court to better evaluate all sides of a position to determine the public interest, unlike under the Bankruptcy Act, where SEC influence made that determination

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[28] *Id.* at 578; Alistaire Bambach & Samuel R. Maizel, *The SEC's Role in Public Company Bankruptcy Cases Where There Is a Significant Enforcement Interest*, 2005 ANN. SURV. OF BANKR. L. 3 (2006). Alistaire Bambach is the Assistant Regional Director and Chief Bankruptcy Counsel to the Division of Enforcement of the SEC. Her expressed views do not necessarily reflect the views of the Commission, but as the SEC's top bankruptcy lawyer since 2001, her views are highly influential in the Commission's enforcement strategy in bankruptcy.

[29] The SEC's stated mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." *What We Do*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/Article/whatwedo.html.

[30] COLLIER, *supra* note 5, ¶ 1109.03[4].

[31] *Id.*

[32] *Id.* ¶ 1109.LH[1][d] (quoting Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 n.28 (1999)).

[33] *Id.* ¶ 1109.LH[1][d]. The legislative history makes clear that the SEC is not a party in interest under § 1109(b), meaning the Commission may not file a reorganization plan. *Id.* Under the Code, § 1109(a) provides that the SEC "may raise and may appear and be heard on any issue" in a Chapter 11 case, but "may not appeal from any judgment, order, or decree entered in the case." 11 U.S.C. 1109(a) (2012).

[34] COLLIER, *supra* note 5, ¶ 1109.LH[1][d].

"only in terms of the interest of public security holders."[35] To complete the Agency's diminished role in bankruptcy, Congress created the United States Trustee, an arm of the Department of Justice, to act as the watchdog of bankruptcy and subsume much of the SEC's function prior to the Code.[36]

B. A Provision of Power: Sarbanes-Oxley

The SEC's bankruptcy revival began with the massive accounting fraud cases that ended in bankruptcy, like WorldCom and Enron.[37] These "mega-cases" precipitated Congress' passage of the Sarbanes-Oxley Act in 2002 and, by extension, led to the SEC's resurgence as an important participant in bankruptcy proceedings.[38] In brief, Sarbanes-Oxley resulted in a broad grant of power that allowed the SEC to "ratchet[] up" financial penalties to reinject faith in the markets and "enhance deterrence and accountability."[39]

The SEC recognized Sarbanes-Oxley as an innovative legislative response to the financial and legal obstacles that hampered its ability to compensate defrauded security holders.[40] Three provisions of the Act helped clear those obstacles. First, § 305(b) authorized federal courts in actions brought by the SEC to grant any equitable relief that may be appropriate to benefit

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[35] *Id.* (The modified "advisory role of the SEC will enable the court to balance the needs relating to the economy.").

[36] 28 U.S.C. § 586 (2012); H.R. REP. NO. 95-595, at 109 (1977) (The U.S. Trustee will "operate much as the Securities and Exchange Commission operates under current Chapter X of the Bankruptcy Act, protecting the public interest and ensuring that bankruptcy cases are conducted according to the law.").

[37] Bambach & Maizel, *supra* note 28.

[38] Skeel, Jr., *supra* note 27, at 578.

[39] NICOLE A. BAKER ET AL., SECURITIES ENFORCEMENT MANUAL: TACTICS AND STRATEGIES 197 (2007) [hereinafter ENFORCEMENT MANUAL] (citing Stephen M. Cutler, Dir., Div. of Enf't, U.S. Sec. & Exch. Comm'n, Speech at the 24th Annual Ray Garrett Jr. Corporate & Securities Law Institute (Apr. 29, 2004)).

[40] U.S. SEC. & EXCH. COMM'N, REPORT PURSUANT TO SECTION 308(C) OF THE SARBANES OXLEY ACT OF 2002 1 (2003) [hereinafter SECTION 308(C) REPORT].

> As required by Section 308(c) of the Sarbanes-Oxley Act, the staff of the Commission has conducted a review and analysis of its enforcement actions over the five years preceding the enactment of the Sarbanes-Oxley Act to identify how such proceedings may best be utilized to provide restitution for injured investors. This report summarizes the findings and conclusions of that review.

Id.

investors.[41] Next, in providing the link between securities fraud actions and bankruptcy, "[s]ection 803 . . . amended the . . . Bankruptcy Code to make debts incurred for federal securities law violations"—including penalties and disgorgement—"non-dischargeable in bankruptcy."[42] Finally, the Federal Account for Investor Restitution ("FAIR") Fund provision[43] in § 308(a) authorized the SEC to take civil penalties collected in enforcement actions—previously required to be paid to the United States Treasury—and add them to disgorgement funds to benefit victims of securities law violations.[44] Collectively, Sarbanes-Oxley and these specific provisions significantly improved the capabilities and altered the strategy of SEC civil enforcement authority.[45]

III.A. SEC CIVIL ENFORCEMENT STRATEGY TO COMPENSATE SECURITIES FRAUD CLAIMANTS IN BANKRUPTCY: FAIR FUNDS

Section 308(a) of Sarbanes-Oxley, the Fair Fund Provision, was a direct response to the large discrepancy created by corporate fraud cases between the amount in dollars lost and the amount that regulators could ever hope to collect in disgorgement alone.[46] The SEC saw the Fair Fund provision as a powerful

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41 ENFORCEMENT MANUAL, *supra* note 39, at 184–85. This provision would provide the statutory underpinning for the broad authority provided to SEC receivers. *See infra* Part III.B.

42 ENFORCEMENT MANUAL, *supra* note 39, at 207. The bankruptcy provision in § 803 of the Sarbanes-Oxley Act prohibits individuals from obtaining discharge of the Commission's disgorgement claims; previously, only penalties were automatically nondischargeable. *Id.* The new provision enables the Commission to preserve its claims for both disgorgement and penalties, and thereby increases potential assets for collection. *Id.*

43 Urska Velikonja, *Public Compensation for Private Harm: Evidence from the SEC's Fair Fund Distributions*, 67 STAN. L. REV. 331, 333 n.4 (2015) (citing Pub. L. No. 107-204, §308, 116 Stat. 745, 784-85 (codified as amended at 15 U.S.C. § 7246 (2012))).

44 SECTION 308(C) REPORT, *supra* note 40, at 29–30; ENFORCEMENT MANUAL, *supra* note 39, at 197. Disgorgement is an equitable remedy that accounts for any "ill-gotten gain[s]" stemming from the fraud. *Id.* at 203.

45 Zack Christensen, *The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to the Creditors of a Bankrupt Debtor?*, 2005 U. ILL. L. REV. 339, 340–41 (2005). Sarbanes-Oxley has been labeled "the most sweeping federal law concerning corporate governance since the adoption of the initial federal securities laws in 1933 and 1934." *Id.* at 375 n.11 (quoting Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 3 (2002) (internal quotation marks omitted)); SECTION 308(C) REPORT, *supra* note 40, at 1.

46 ENFORCEMENT MANUAL, *supra* note 39, at 207–08.

vehicle to supplement its enforcement initiatives and significantly increase compensation for defrauded security holders.[47] But to creditors, § 308(a) worked a "sea change" in the SEC's powers and responsibilities, changing its focus from deterrence of securities fraud to after-the-fact compensation for defrauded security holders.[48]

The Fair Fund provision enabled the SEC to increase collections in enforcement actions by combining penalty and disgorgement amounts into a fair fund used to compensate injured investors at the discretion of the Commission.[49] Accordingly, the SEC—a government agency treated as an unsecured creditor in the Code's priority—used § 308(a) to compensate securities fraud claimants in bankruptcy who were otherwise subordinated pursuant to § 510(b). This end run on § 510(b) created a tension between the Bankruptcy Code and Sarbanes-Oxley that came to a head in the highly publicized WorldCom bankruptcy case.[50]

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[47] SECTION 308(C) REPORT, *supra* note 40, at 22 ("Making appropriate distributions to investors, by applying the Fair Fund provision, is a desirable and important objective. The Commission intends to use the provision whenever reasonably possible, consistent with its mission to protect investors."). One past SEC enforcement director described the Fair Fund provision as " '[o]ne of the most frequently used tools' created by the Sarbanes-Oxley Act." Velikonja, *supra* note 43, at 334 n.14 (quoting Linda Chatman Thomsen & Donna Norman, *Sarbanes-Oxley Turns Six: An Enforcement Perspective*, 3 J. BUS. & TECH. L. 393, 411 (2008)).

[48] Barbara Black, *Should the SEC Be a Collection Agency for Defrauded Investors?*, 63 BUS. L. 317, 342 (2008) (citing Official Comm. of Unsecured Creditors of WorldCom, Inc. v. SEC, 467 F.3d 73, 83 (2d Cir. 2006) [hereinafter *WorldCom*]) (The Second Circuit rejected the "sea change" argument, instead viewing the Fair Fund provision as a tool that increased available funds for the SEC to distribute at its discretion).

[49] SECTION 308(C) REPORT, *supra* note 40, at 22. "Because section 308(a) only permit[ted] penalty amounts to be distributed to investors if there [was] also a disgorgement . . . the [SEC] adopted the practice of ordering $1 in disgorgement in [accounting fraud] cases where there [was] no identifiable unjust enrichment but the Commission want[ed] to distribute a penalty to investors." ENFORCEMENT MANUAL, *supra* note 39, at 208 n.134. This practice, used in *WorldCom*, has not continued in a significant way since then. Velikonja, *supra* note 43, at 392–93.

[50] The *WorldCom* court itself recognized the tension between the Fair Fund provision and § 510(b). 467 F.3d at 85 ("We recognize . . . that there is tension between the priority assigned to claims under the Bankruptcy Code and the Fair Fund provision[.]"). Indeed, the *Enron* court even noted "that some have argued that Congress effectively created an exception to the absolute priority rule and the priority regime under the Bankruptcy Code when it enacted [Sarbanes-Oxley]." *In re* Enron Corp., 341 B.R. 141, 169–70 n.25 (Bankr. S.D.N.Y. 2006).

Official Committee of Unsecured Creditors of WorldCom, Inc. v. SEC presents the definitive clash between the Fair Fund provision and § 510(b).[51] In brief, WorldCom entered into Chapter 11 bankruptcy after revealing fraud on a multibillion-dollar scale.[52] As a result, the SEC brought a civil action as an unsecured creditor for $2.25 billion that, under the terms of the reorganization plan, would be satisfied by the bankruptcy estate for $500 million in cash and $250 million in the company's new common stock.[53] Thus, the Fair Fund provision permitted the SEC to recover and distribute $750 million—which would normally go to creditors—to defrauded security holders otherwise automatically subordinated under § 510(b).[54]

WorldCom garnered much "scholarly and popular criticism."[55] However, Professor Urska Velikonja, in a first-ever empirical review of the SEC's use of fair funds, determined that "WorldCom is the exception, not the rule, for fair fund distributions" in accounting fraud cases.[56] The study revealed that the SEC instead used fair funds more often to compensate victims from individual and third-party defendants separate from the bankruptcy estate.[57] Accordingly, the WorldCom bankruptcy

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[51] The *WorldCom* discussion that follows should be taken as a cursory overview only, meant to provide a background for what led the Commission to adopt a strategy that avoids bankruptcy altogether. For a full analysis of the interaction and competition between competing principles and purposes of the Fair Fund provision and § 510(b) through an in-depth analysis of the *WorldCom* case, see Christensen, *supra* note 45 (concluding that Congress should amend the Fair Fund provision to prevent it from making an end run on § 510(b) and Bankruptcy Code priority). *Cf.* Henry, *supra* note 17, at 262 (concluding that the Fair Funds provision's effect on the distribution of funds in bankruptcy is the "appropriate response to our evolving financial markets").

[52] Christensen, *supra* note 45, at 355.

[53] *Id.* at 356.

[54] *Id.*

[55] Velikonja, *supra* note 43, at 367 (citing Black, *supra* note 48, at 332–33; Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235, 1285–86 (2013) (explaining that fair fund distributions "directly contradict[]" bankruptcy priority)); Skeel, Jr., *supra* note 27, at 584 ("The bankruptcy laws ordinarily subordinate a shareholder's securities claims, but the SEC has evaded this rule and ignored the priority framework[.]"); Christensen, *supra* note 45, at 375 (arguing that Congress should amend the Fair Fund provision to prevent it from "alter[ing] the well-established distributional priorities of the Bankruptcy Code").

[56] Velikonja, *supra* note 43, at 367. "There is no empirical support for the allegation that the SEC's fair fund distributions systematically overcompensate defrauded shareholders." *Id.* at 368.

[57] *Id.*

estate's payment to the SEC does not represent a widespread enforcement practice in handling similar accounting fraud cases.[58]

Still, for the SEC, *WorldCom* represents "the one published decision on point [that] makes clear that the SEC's goal of returning money to defrauded investors trumps those concerns about bankruptcy priorities."[59] The Commission's transcendental view of its noble mission to protect defrauded security holders through compensation, and its corresponding indifference toward the Bankruptcy Code, continues to pervade the Agency's civil enforcement strategy. That view came to a high-water mark in *SEC v. Spongetech Delivery Systems, Inc.*,[60] where the SEC argued that the court should find its disgorgement claim had priority over a secured creditor's claim in a Chapter 11 bankruptcy proceeding—an argument in direct contravention of the Code.[61]

III.B. SEC CIVIL ENFORCEMENT STRATEGY TO COMPENSATE SECURITIES FRAUD CLAIMANTS OUT OF BANKRUPTCY: THE EQUITABLE RECEIVERSHIP

An additional response to the massive accounting frauds that led to Sarbanes-Oxley was the SEC's implementation of a " 'real-time' enforcement initiative."[62] To carry out this initiative, the SEC more frequently sought: (1) temporary restraining orders and asset freezes to identify and stop fraudulent activity, and (2) the appointment of receivers to effectively compensate security holders.[63] Section 308(c) of Sarbanes-Oxley required the SEC to analyze its enforcement actions involving civil penalties or disgorgement in order to identify the most efficient methods to provide restitution to injured investors.[64] The report found that its real-time enforcement initiative and, notably, the appointment of a receiver, "enhance[d] the Commission's ability to maximize investor recovery."[65] And because implementing a distribution plan for amounts deposited into a fair fund in large

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[58] *Id.*
[59] Bambach & Maizel, *supra* note 28.
[60] 98 F. Supp. 3d 530, 530 (E.D.N.Y. 2014).
[61] *Id.* at 535.
[62] SECTION 308(C) REPORT, *supra* note 40, at 22.
[63] *Id.*
[64] *Id.* at 1.
[65] *Id.*

and complex cases was proving cumbersome,[66] equitable receiverships developed as an alternative to bankruptcy to allow the SEC to more effectively compensate defrauded security holders.[67]

A receivership's authority stems from the inherent equitable powers of federal courts to craft remedies that supplement Congress' grant of statutory authority to the SEC.[68] Here, § 305(b) of Sarbanes-Oxley provided the statutory underpinning that supplements the use of receiverships in securities fraud actions.[69] It allows the SEC to frequently seek receivers in situations of insolvency or near insolvency to wind down distressed, fraudulent entities and to compensate defrauded security holders.[70]

The appointed receiver, the person who runs an equitable receivership, is an agent of the court, intended to act independently of the SEC in carrying out its prescribed duties.[71] Accordingly, the receiver must seek the court's approval for specific actions.[72] And because the SEC requests receivers under the court's equitable authority, SEC receiverships are, by definition, equitable receiverships, meaning that the receiver's powers and duties are set by a district court's appointment order.

A typical receiver appointment order includes standard powers and duties needed to execute the receivership. The following is an example from an appointment order for Platinum

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[66] ENFORCEMENT MANUAL, *supra* note 39, at 208.

[67] Alistaire Bambach, *The SEC in Bankruptcy: Past and Present*, 18 AM. BANKR. INST. L. REV. 607, 611 (2010) [hereinafter *Past and Present*]. Judge Posner noted in *Scholes v. Lehmann* that "[c]orporate bankruptcy proceedings are not famous for expedition . . . and whatever advantages they may have over receiverships in a case such as this—if any, and none has been pointed out to us—are not ones that the defendants in these fraudulent conveyance actions should be heard to trumpet." 56 F.3d 750, 755 (7th Cir. 1995).

[68] Keith Miller, *Regulatory Litigation with the SEC*, 7 BUS. & COM. LITIG. FED. CTS. § 79:47 (4th ed. 2017).

[69] *Id.* Section 305(b) of Sarbanes-Oxley amended 15 U.S.C. § 78u(d)(5) to add, "In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." 15 U.S.C. § 78u(d)(5) (2012).

[70] ENFORCEMENT MANUAL, *supra* note 39, at 217. The SEC's authority to request and select a receiver can be found in § 20(b) of the Securities Act of 1933 and § 21(d) of the Securities Exchange Act of 1934.

[71] Miller, *supra* note 68, § 79:48.

[72] *Id.*

Management.[73] The order first finds the appointment "necessary and appropriate for the purposes of marshaling and preserving all assets" of the entity, with enumerated goals that include "an orderly wind down," "a responsible liquidation of assets[,] and orderly and fair distribution of those assets to investors."[74] In addition, the appointed receiver is granted "all powers, authorities, rights and privileges" to assume management and control of the receivership entities' claims and property.[75] This general language illustrates a district court's broad grant of power and authority to SEC receivers[76] and provides insight into why the SEC would prefer a receivership to bankruptcy—a preference further analyzed in Part IV.

IV. INEQUITABLE RECEIVERSHIPS

When the question arises whether bankruptcy or liquidation through an equity receivership is appropriate,[77] the SEC knows the receivership advantage—"no absolute priority rule."[78] As a result, receiverships have evolved to become the preferred vehicle for the SEC to compensate securities fraud victims of insolvent

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[73] Order Appointing Receiver at 1–2, SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-KAM (E.D.N.Y. Dec. 19, 2016), ECF No. 6 [hereinafter Platinum Receiver Order].

[74] *Id.* at 1–2. Additional enumerated responsibilities of the receiver include:

> to (i) preserve the status quo, (ii) ascertain the extent of commingling of funds among the Receivership Entities; (iii) ascertain the true financial condition of the Receivership Entities and the disposition of investor funds; (iv) prevent further dissipation of the property and assets of the Receivership Entities; (v) prevent the encumbrance or disposal of property or assets of the Receivership Entities; (vi) preserve the books, records and documents of the Receivership Entities; (vii) be available to respond to investor inquiries; [and] (viii) protect investors' assets[.]

Id. at 2.

[75] *Id.* at 2–3.

[76] The remaining, pertinent section headings illustrate the SEC receiver's powers: "II. Access to Information . . . III. Access to Books, Records and Accounts . . . IV. Access to Real and Personal Property . . . V. Notice to Third Parties . . . VI. Injunction Against Interference with Receiver . . . VII. Stay of Litigation . . . VIII. Managing Assets . . . IX. Investigate and Prosecute Claims . . . X. Bankruptcy Filing . . . XI. Liability of Receiver . . . XII. Recommendations and Reports . . . XIII. Fees, Expenses and Accountings." *Id.* at 5–17.

[77] Alistaire Bambach, *Issues That the SEC Confronts in the Liquidation of Hedge Funds*, 22 AM. BANKR. INST. L. REV. 125, 127 (2014) [hereinafter *Hedge Funds*].

[78] *Id.* The SEC also recognizes that "[t]he benefit of bankruptcy is established case law that governs the liquidation of an entity, an experienced judge whose primary responsibility is to oversee liquidations and reorganizations, and the participation of the United States Trustee and other key constituents." *Id.*

entities outside of the Code's strictures: "To the extent that the courts permit [the SEC] to use equity receiverships in a way that maximizes value to defrauded investors and the estate as a whole, [the SEC] will pursue their use."[79]

Thus, the same distribution system that aimed to prevent the race to the courthouse among self-interested creditors—§ 510(b)[80]—has led to the SEC's strategic use of receiverships out of bankruptcy and the start of a new race to the courthouse: SEC v. Creditors. This Part aims to show how and why the SEC utilizes receiverships that disadvantage creditors through the Agency's pervasive influence over the process—from the receiver's initial nomination and appointment to the proposed and accepted distribution plans—and concludes with an analysis of a recent case to exemplify the high stakes in this race.

A. SEC Influence Over SEC Receivers

A receiver is procedurally and nominally an independent officer of, and appointed by, the court.[81] That said, it is the SEC who nominates the receiver and exerts significant influence over the receiver in subsequent proceedings.[82] In fact, a stated SEC advantage of a receiver over a bankruptcy trustee is that receivers are mandated to cooperate with law enforcement, facilitating greater SEC staff oversight in receivership proceedings.[83] A recent example from the Platinum Management[84] receivership illustrates the Commission's influence over a receiver's decision-making.

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[79] *Past and Present*, *supra* note 67, at 612–13. "In some instances, equity receiverships are superior to bankruptcy filings because the receiver is a fiduciary to the estate . . . [who] can fashion a plan that is supported by the Commission, and treats investors and creditors fairly." *Id.* at 612.

[80] *See supra* Part I.B.

[81] *See supra* Part III.B.

[82] This Note's research into active receiverships has failed to find an instance where the SEC-nominated receiver was not accepted by the court. Further, many receivers will be appointed to multiple SEC receiverships.

[83] *Hedge Funds*, *supra* note 77, at 127.

[84] On December 19, 2016, the SEC "charged the founder of Platinum Partners and the investment managers of two of its flagship hedge funds with conducting a fraudulent scheme to inflate asset values and illicitly move investor money to cover losses and liquidity problems." Litigation Release, Sec. & Exch. Comm'n, SEC Charges Platinum Funds and Founder with Defrauding Investors (Dec. 20, 2016), https://www.sec.gov/litigation/litreleases/2016/lr23704.htm. The receiver was appointed the same day the SEC brought its complaint against Platinum.

Just six months after appointment, the SEC-nominated receiver for Platinum Management resigned due to differing views with agency staff on how the receivership should progress.[85] Notably, after the receiver's resignation, the SEC proposed an amended order appointing a substitute receiver that highlighted the Agency's view of how the independent receivership should proceed.[86] In the "Managing Assets" section of the order, the SEC proposed an entirely new paragraph that mandated: "The Receiver may engage in [any liquidation transaction that involves Receivership Property whose valuation is $1 million or more] *only upon submission of such transactions for review and comment by the SEC staff* and upon motion and approval of the Court."[87] This rejected language would have allowed the SEC to hijack the receivership proceeding.[88] Such proposals diminish confidence in the receiver to act as an independent officer of the court in the best interests of security holders and creditors alike, and instead transform an equitable receivership into a functional arm of the SEC.[89]

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[85] According to the receiver, SEC staff pressured the receiver, an independent officer of the court, to implement a quick liquidation of all positions, rather than the receiver's plan to also invest limited, additional funds to make potential returns for investors and creditors. Letter from Celia Goldwag Barenholtz, Counsel, Cooley LLP, to Dora L. Irizarry, Chief Judge, U.S. Dist. Court, E. Dist. of N.Y., Exhibit 1 (June 23, 2017) (on file with the U.S. Dist. Court, E. Dist. of N.Y.) (requesting approval of resignation of Receiver Bart Schwartz in the case of SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-BMC (2016)). Lawrence Delevingne, *Platinum Receiver Asks to Resign over Disagreements with SEC*, REUTERS (June 26, 2017, 12:38 PM), https://www.reuters.com/article/us-hedgefunds-platinum/platinum-receiver-asks-to-resign-over-disagreements-with-sec-idUSKBN19H216.

[86] Blacklined Proposed Second Amended Order Appointing Receiver, SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-BMC (June 26, 2017), ECF No. 174-2 [hereinafter Blacklined Proposed Receiver Order].

[87] *Id.* at 12 (emphasis added).

[88] The blacklined, second amended substitution proposal included two more problematic suggestions. First, in the "Bankruptcy Filing" section, the authorization to file voluntary petitions for relief under Chapter 11 now hinged "upon consultation with the SEC staff." *Id.* at 15. Next, in the "Recommendations and Reports" section that authorizes the Receiver to develop a "Liquidation Plan," the amended order stipulated that authorization hinged "upon consultation with the SEC staff." *Id.* at 16–17.

[89] Non-party shareholders and creditors expressed concern over the amended order. *See, e.g.*, Response to Dkt. No. 173 Motion to Appoint Substitute Receiver, SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-BMC (E.D.N.Y. June 29, 2017), ECF No. 186; Indep. Inv'rs' Response to Sec. & Exch. Comm'n's Application for an Order to Show Cause (Dkt. No. 174), SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-BMC (E.D.N.Y. June 30, 2017), ECF No. 201; Statement of Position by Non-Parties Beechwood Re Ltd. & Beechwood Bermuda Int'l Ltd. Concerning

B. The "Sea Change": SEC v. Byers *and the Anti-Bankruptcy Injunction*

In *SEC v. Byers*, the Second Circuit affirmed the district court's acceptance of SEC language to "Enjoin the Filing of Bankruptcy" in a proposed receiver appointment order,[90] effectively foreclosing use of the involuntary bankruptcy provision in § 303 of the Bankruptcy Code.[91] This anti-bankruptcy injunction is critical to the SEC receiver's effectiveness; it provides relief from involuntary bankruptcy petitions by creditors and acts like an automatic stay in a true bankruptcy proceeding.[92] This Section shows how the *Byers* holding empowers SEC receivers with broad discretion to conduct a quasi-bankruptcy proceeding.[93]

The creditors committee of Wextrust—the insolvent entity at issue in *Byers*—challenged the district court's authority to enter the proposed anti-bankruptcy injunction, arguing that § 303 of the Code granted creditors an absolute right to commence an involuntary bankruptcy proceeding against the debtor.[94] But the court held that "district courts may issue anti-litigation injunctions barring bankruptcy filings as part of their broad equitable powers" in an SEC receivership.[95] This holding entrenches the receivership, forsaking creditors' reliance on the Bankruptcy Code: "Simply put, there is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were,

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SEC's Application for Appointment of New Receiver, SEC v. Platinum Mgmt. (NY) LLC et al., No. 16-cv-06848-BMC (E.D.N.Y. June 30, 2017), ECF No. 205-1.

[90] SEC v. Byers, 609 F.3d 87 (2d Cir. 2010).

[91] 11 U.S.C. § 303(a) (2012) ("An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced.").

[92] Wunderlich, *supra* note 24, at 386 ("The automatic stay is a fundamental aspect of the Code because it provides the debtor a 'breathing spell' from creditors and collection actions.").

[93] The underlying facts: "[The SEC] filed a complaint against Stephen Byers, Joseph Shereshevsky, [and five Wextrust entities]. The SEC complaint alleged a massive Ponzi scheme that involved some 240 Wextrust affiliates operating in the United States, Middle East and Africa, and that reportedly defrauded investors of approximately $255 million." *Byers*, 609 F.3d at 89–90.

[94] *Id.* at 91.

[95] *Id.* In addition, the court affirmed the district court's order permitting the Receiver to continue to serve as manager should a bankruptcy proceeding be commenced—acknowledging that the receiver automatically becomes debtor in possession by operation of law. *Id.* at 93.

the receivership accomplishes what a bankruptcy would. The receivership protects the assets of the estate, just as a stay would in bankruptcy."[96]

While the court stressed that these anti-bankruptcy provisions should be "exercised cautiously" and "sparsely," these provisions are a staple in SEC receiver requests, providing a crucial parallel to an automatic stay in bankruptcy.[97] The result in *Byers* arguably promoted a "sea change" in SEC civil enforcement strategy, leading to bankruptcy-like liquidations by SEC receivers without the Code's uniformity, structure, or creditor protections.

The full extent of the SEC's strategy is evidenced in active SEC receiver distribution plans.[98] For example, in *Byers*, the Wextrust receiver set forth a pro rata distribution of funds to each security holder and unsecured creditor, explaining the

[96] *Id.* at 92. The differences in the bankruptcy stay and the anti-bankruptcy injunction in receivership illustrate the comparative pros and cons of the two systems. The bankruptcy stay allows a company the breathing room to reorganize and potentially come out of bankruptcy. If the fraud is so pervasive that the company cannot be made out of reorganization, then a Chapter 7 bankruptcy proceeding might be the better option. In the anti-bankruptcy injunction—which operates as a bankruptcy stay for the receivership proceeding—the receiver does not maintain the power to reorganize. Thus, the SEC utilizes the injunction to provide the receivership the ability to quickly ascertain the state of the entity, make the appropriate liquidations, and distribute the recovered funds to defrauded investors.

[97] *Id.* at 89, 91. The court emphasized that this was not a broad power to be exercised. In a separate part of the opinion, in stating its holding that the court disagreed with the creditors' argument that the district court lacked authority to subvert their right to petition for involuntary bankruptcy by issuing the anti-litigation injunction, the court held: "while it should be sparsely exercised, district courts possess the authority and discretion to enter anti-litigation orders, including those that bar the filing of involuntary bankruptcy petitions absent the district court's permission." *Id.* at 89. Similarly, in considering that a receiver may not be equipped, experienced, or prepared for the administration of a complex liquidation, the Second Circuit instructed the SEC to inform district courts of the circuit court's view that equity receiverships should not be used to effect the liquidation of defendants in actions brought under the securities laws. SEC v. Am. Bd. of Trade, Inc., 830 F.2d 431, 436–38 (2d Cir. 1987).

[98] "To the extent that the courts permit [the SEC] to use equity receiverships in a way that maximizes value to defrauded investors and the estate as a whole, [the SEC] will pursue their use." *Past and Present*, *supra* note 67, at 613. This Note's findings are based on the listed links that were either active or included a receiver's specific website that was active. *Receiverships*, U.S. SEC. & EXCHANGE COMMISSION, https://www.sec.gov/divisions/enforce/receiverships.htm (last visited Feb. 22, 2019). This Note does not address, discuss, or explain the different types of methods employed by receivers. For a more insightful analysis on the subject, see Kathy Bazoian Phelps, *Handling Claims in Ponzi Scheme Bankruptcy and Receivership Cases*, 42 GOLDEN GATE U. L. REV. 567, 572–77 (2012).

similar treatment in a footnote: "In this regard, defrauded investors may be viewed as tort creditors with contingent, unliquidated, and potentially disputed claims."[99] The Wextrust receiver's reprioritization of claims to treat defrauded security holders on a pro rata basis with unsecured creditors is not uncommon—it is widespread practice.[100] Indeed, every active receivership listed on the SEC's website treats the claims of defrauded security holders on an equal-to[101] or preferred basis to creditors.[102] Thus, the SEC—through its receiver—has perfected

[99] Receiver's Proposed Plan of Distribution at 7, 27 n.29, SEC v. Byers et al., No. 08 Civ. 7104 (DC) (S.D.N.Y. Mar. 27, 2009).

[100] *See, e.g.*, Receiver's Motion (I) to Set Amount of Disputed Claims & (II) Establish Procedure to Calculate Claims Distribution at 11, SEC v. Estate of Kenneth Wayne Mcleod et al., No. 10-22078-cv-FAM (S.D. Fla. Oct. 4, 2013) (distributing claims to defrauded security holders and creditors on a pro rata basis); Receiver's Final Report & Proposed Distribution at 9–10, SEC v. Secure Inv. Servs., Inc. et al., No. 2:07-Cv-01724 Geb Cmk (E.D. Cal. Mar. 2, 2015) (same); Motion to Approve Plan of Distribution at ¶ 17, SEC v. Brian A. Bjork, No. 4:11-Cv-2830 (S.D. Tex. 2013) (same); Order Approving Receiver's Interim Distribution Plan at 6, SEC v. Stanford Int'l Bank, Ltd. et al., No. 3:09-CV-0298-N (N.D. Tex. May 30, 2013) (same); Report of the Receiver Dated November 29, 2012 & Request for Interim Distribution at 11, SEC v. Millennium Bank et al., No. 7:09-CV-050-O (N.D. Tex. Nov. 11, 2012) (same); Plan for Claims Admin. & Distribution of Proceeds at 10, SEC vs. Travis E. Correll et al., No. 4:05-Cv-472 Ras (E.D. Tex. 2008) (same); Receiver's Motion for Authorization to Make an Initial Distribution to Creditors with Undisputed Claims & Request to Set a Hearing to Resolve Disputed Claims at 7 n. 10, SEC v. John P. Utsick, et al., No. 06-20975-CIV-HUCK/O'Sullivan (S.D. Fla. Dec. 10, 2008) (same); Receiver's Motion for Approval of Interim Distribution Plan & Entry of Claims Bar Date at 12, SEC v. James G. Temme, No. 4:11-Cv-655 (E.D. Tex. Dec. 29, 2014) (same).

[101] *See, e.g.*, Receiver's Motion to Approve Plan of Distribution & Memorandum of Law in Support at 18, 2017 WL 4174217 (N.D. Ga. 2017), SEC v. Angelo A. Alleca et al. (No. 1:12-CV-3261-WSD), 2017 WL 5953189 ("Allowed Claims of investors and of trade creditors are proposed to stand on equal footing, and therefore the Receiver proposes no classes of Claims."); Receiver's Motion to Establish Claims Procedure Plan & to Approve Claim Forms & Brief in Support at 13, SEC v. Edward T. Stein (S.D.N.Y. Aug. 4, 2010) (No. 1:09-cv-03125-RJS) ("The treatment of claims by creditors on equal footing with defrauded investors was specifically considered and approved by the *Byers* court under similar circumstances . . . . The Receiver believes that the limitation of Creditor claims to amounts originally owed, exclusive of interest, late fees or penalties, is equitable and appropriately places Creditors on equal footing with Investors for recovery from the Estate's limited assets."); Plan for Claims Admin. & Distribution of Proceeds at 10, SEC vs. Travis E. Correll et al. (E.D. Tex. Nov. 14, 2008) (No. 4:05-Cv-472 Ras) ("Approved Claims of Investors and unsecured Creditors are general unsecured claims against the Receiver Estate and shall be paid with equal priority.").

[102] *See, e.g.*, Amended Joint Plan of Distribution for Atlantic Asset Mgmt., LLC Filed by Sec. & Exch. Comm'n & Marti P. Murray, as Receiver at 12–13, SEC v. Atlantic Asset Mgmt., LLC, No. 15 Civ. 9764 (WHP) (S.D.N.Y. 2016) (establishing a general distribution that included investor claims, and only allowed unsecured creditors to participate on a pro rata basis with investors in any supplemental

an end run around the Code's mandatory subordination and § 510(b), answering its own question from forty years earlier—securities fraud victims should not "receive different treatment from that accorded . . . a pedestrian hit by the bankrupt's delivery truck."[103]

If the *Byers* court had not affirmed the exercise of an anti-bankruptcy injunction that foreclosed § 303 of the Code, then creditors would have the right to force an insolvent entity into bankruptcy. So many, if not most, of these distribution plans would be vastly different where, now under the Code, defrauded security holders would be automatically subordinated under § 510(b).[104] Such is the critical importance of the combined receiver and anti-bankruptcy injunction to the SEC. It creates a

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distribution thereafter); Receiver's Motion for Court Approval of Proposed Claims Process at 6, SEC v. Commodities Online, LLC et al., No. 11-60702-Civ-Cooke/Torres (S.D. Fla. Oct. 6. 2015) (basing priority on the available money for distribution, and since the available money was insufficient to fully compensate the defrauded investors, subordinating all non-investor claims); Receiver's Motion to Authorize First Interim Distribution, Establish Record Dates & Set First Interim Distribution Date at 5, 5 nn.3–5, SEC v. Rex Venture Group, LLC et al., No. 3:12-CV-519 (W.D.N.C. 2014) ("[T]here will be no distribution to . . . Class 2, 4 or 5 Claims," which include "claims . . . secured by collateral," "[c]laims asserted by taxing authorities," and "[c]laims asserted by general unsecured creditors."); Receiver's Unopposed Motion to (1) Approve First Interim Distribution, (2) Establish Reserves, & (3) Approve Revisions to Certain Claim Determinations at 5–6, SEC v. Arthur Nadel et al.; No. 8:09-cv-87-T-26TBM (M.D. Fla. Apr. 27, 2012) (placing investors first in line, before secured creditor claims, and unsecured creditor claims third in line—*only if* all allowed amounts for defrauded investor claims had been satisfied in full); Receiver's Motion for Approval of Plan of Distribution of Receivership Estate at 7, SEC v. Mutual Benefits Corp. et al., No. 04-60573-Civ-Moreno (S.D. Fla. 2009) (determining that no trade creditors would receive distributions "[b]ecause there [would] be insufficient funds to satisfy the investor claims"); Plaintiff Sec. & Exch. Comm'n's Plan for Distribution of Receivership Assets at 4–5, SEC v. Cobalt Multifamily Inv'rs I, LLC et al., No. 06 Civ. 2360 (KMW) (MHD) (S.D.N.Y. 2008) (submitting a distribution plan on a pro rata basis giving 50% to investors, 25% to unsecured creditors, and 25% to the Receiver and the Receiver's law firm, with future recoveries to be distributed as follows: 33.3% to investors, 33.3% to unsecured creditors, and 33.3% to the Receiver Group).

[103] Davis, Jr., *supra* note 7, at 2 (citing U.S. SEC. & EXCH. COMM'N, REPORT ON S.235 AND S.236, *reprinted in The Bankruptcy Reform Act: Hearings Before the Subcomm. on* S.235 and S.236 on Improvements in Judicial Mach. of the Senate Comm. on the Judiciary, 94th Cong., 1st Sess. 738–79 (1975)); *see supra* Part I.B. This Section discusses the SEC's argument against § 510(b) because "mandatory subordination would result in different treatment to security holders whose fraud claims were reduced to judgment before bankruptcy, and those security holders whose claim had not reached that point." H.R. REP. NO. 95-595, at 196 (1977).

[104] 11 U.S.C. § 510(b) (2012).

powerful enforcement tool to carry out the Agency's mission to protect defrauded security holders through compensation, without regard for the Bankruptcy Code, its priority, or creditors.

C. The Race Resumed: SEC v. Creditors

The Wextrust creditors committee argued that the district court should not have been "permitted to write Section 303 out of the Bankruptcy Code . . . merely because the SEC, which has no financial stake in the case, prefers receiverships to bankruptcy."[105] That said, the Second Circuit's decision in *Byers* reinvigorated the collective action problem the Bankruptcy Code sought to end—the race to the courthouse. But, as the same creditors recognized in briefing, the race is no longer among self-interested creditors; it now pits creditors against the SEC.[106] The high stakes of this renewed race, as evidenced in receiver distribution plans, were exemplified in *SEC v. Spongetech Delivery Systems, Inc.*, a case filed in 2010 where the SEC lost the courthouse race by mere hours.[107]

The SEC charged Spongetech with orchestrating a massive pump-and-dump scheme that deceived investors into believing they were buying stock in a highly successful company.[108] The Agency's civil enforcement action began in a familiar fashion: by installing its receiver.[109] On June 18, 2010, the Commission moved for the appointment of a receiver—equipped with an anti-bankruptcy injunction[110]—over Spongetech, its subsidiaries, and its affiliates, including its wholly owned subsidiary Dicon Technologies, LLC.[111] The SEC took what appeared to be an early lead.

[105] Reply Brief for Interested Party-Appellants Int'l Ad-Hoc Comm. of Wextrust Creditors & Int'l Consortium of Wextrust Creditors at 20, SEC v. Byers, 609 F.3d 87 (2d. Cir. 2010) (Nos. 09-0234-cv(L), 09-0284-cv(CON)).

[106] *Id.* at 4 ("[T]he SEC takes the position that it may foreclose the statutory rights of Wextrust's creditors to file involuntary bankruptcy cases simply because it beat those creditors to the courthouse.").

[107] SEC v. Spongetech Delivery Systems, Inc., 98 F. Supp. 3d 530 (E.D.N.Y. 2014).

[108] *Id.* at 543.

[109] Notice of Plaintiff Sec. & Exch. Comm'n's Motion for Appointment of a Receiver over Defendant Spongetech Delivery Systems, Inc. at 2, SEC v. Spongetech, 98 F. Supp. 3d 530 (E.D.N.Y. 2014) (No. 10-CV-02031 (DLI)), ECF No. 44.

[110] [Proposed] Order Granting Appointing a Receiver over Defendant Spongetech Delivery Systems, Inc. at 9–10, SEC v. Spongetech, 98 F. Supp. 3d 530 (E.D.N.Y. June 18, 2014) (No. 10-CV-02031 (DLI)), ECF No. 44-3.

[111] *Id.* at 2.

But while the Agency hurried to appoint its receiver in Brooklyn, just three hours earlier, in a Bankruptcy Court in Savannah, Georgia, three Dicon Technologies creditors sprinted to file an involuntary bankruptcy petition under § 303 and move for the immediate appointment of a Chapter 11 bankruptcy trustee.[112] Those creditors succeeded, and a trustee was appointed over Dicon on July 9, 2010.[113] Unlike in *Byers*, the Dicon creditors won the race to the courthouse. Accordingly, Dicon's parent, Spongetech, eventually entered its own Chapter 11 bankruptcy with a trustee appointment.[114] The loss forced the SEC to withdraw its receiver request[115] because, as the Agency pointed out, "the bankruptcy trustee would undertake many of the same functions as a Receiver."[116]

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[112] Letter from Jeffrey T. Tao, Assistant Chief Litig. Counsel, U.S. Sec. & Exch. Comm'n, to Dora L. Irizarry, Chief Judge, U.S. Dist. Court, E. Dist. of N.Y. (June 21, 2010) (on file with the U.S. Dist. Court, E. Dist. of N.Y.) (informing court of Dicon creditors' involuntary bankruptcy petition and motion for appointment of a bankruptcy trustee in the United States Bankruptcy Court for the Southern District of Georgia) [hereinafter Tao Letter]. The Bankruptcy Code allows the Court to appoint a Chapter 11 trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case," or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a)(1), (2) (2012).

[113] Tao Letter, *supra* note 112.

[114] Following the Dicon petition, Spongetech filed for bankruptcy in the Bankruptcy Court for the Southern District of New York. In addition, the United States Trustee appeared, and filed an expedited motion supporting the immediate appointment of a Chapter 11 trustee over Spongetech. Motion of the U.S. Trustee for Order Directing the Appointment of a Chapter 11 Trustee or, in the Alternative, Converting the Case to Chapter 7 of the Bankruptcy Code, SEC v. Spongetech, 98 F. Supp. 3d 530 (E.D.N.Y. July 16, 2010) (No. 10-CV-2031 (DLI)) ECF No. 91-4. Even so, the SEC continued to argue for a receivership instead of bankruptcy. Plaintiff Sec. & Exch. Comm'n's Reply Memorandum in Support of Motion for Appointment of a Receiver, SEC v. Spongetech, 98 F. Supp. 3d 530 (E.D.N.Y. July 16, 2010) (No. 10-CV-02031 (DLI)), ECF No. 91. But the Bankruptcy Court accepted the United States Trustee's request and directed the appointment of a bankruptcy trustee over Spongetech. Letter from Jeffrey T. Tao, Assistant Chief Litig. Counsel, U.S. Sec. & Exch. Comm'n, to Dora L. Irizarry, Chief Judge, U.S. Dist. Court, E. Dist. of N.Y. (July 20, 2010) (on file with the U.S. Dist. Court, E. Dist. of N.Y.).

[115] Letter from Jeffrey T. Tao, Assistant Chief Litig. Counsel, U.S. Sec. & Exch. Comm'n, to Dora L. Irizarry, Chief Judge, U.S. Dist. Court, E. Dist. of N.Y. (July 20, 2010) (on file with the U.S. Dist. Court, E. Dist. of N.Y.).

[116] Plaintiff Sec. & Exch. Comm'n's Reply Memorandum in Support of Motion for Appointment of a Receiver at 2, SEC v. Spongetech, 98 F. Supp. 3d 530 (E.D.N.Y. 2014) (No. 10-CV-02031 (DLI)), ECF No. 91.

Spongetech's Chapter 11 trustee's interim report illustrates the immediate effect of winning this race: "Pursuant to the priority rules established by the Bankruptcy Code, unsecured creditors must be paid in full before any funds or returns can be received by shareholders."[117] The critical nature of who wins this race to the courthouse between the SEC and creditors rests in that one sentence. Had the SEC won and a receiver been installed, security holders would have been on equal-to or better footing with creditors.[118] By winning the race to the courthouse, creditors beat the *Byers* anti-bankruptcy injunction, forced the entity into bankruptcy, and pushed themselves ahead of security holders under § 510(b).

The importance of just a few hours in this race is further embodied in the *Spongetech* court's decision to maintain the Code's priority for a secured creditor's claim over an SEC disgorgement claim.[119] The Spongetech bankruptcy resulted in the disbursement of the entire $1.046 million estate to Solution Funding, a secured creditor, because creditors won the race to the courthouse.[120] Had those creditors acted a few hours later and the SEC—holding a $5.19 million disgorgement claim—installed its receiver, it is unlikely, as the SEC argued, that any creditor—secured or not—would have seen any compensation.[121]

V. REINTEGRATION OF SECURITIES FRAUD CLAIMS IN BANKRUPTCY

Interestingly, many parallels exist between Slain and Kripke's seminal article that led to mandatory subordination and the integration issues facing securities fraud enforcement and bankruptcy today. Regarding the SEC's use of receiverships to avoid bankruptcy and promote its own mission above others, Slain and Kripke's conclusion proves salient: "The policies of state and federal securities regulation are important; they are not transcendental."[122] Still, the Bankruptcy Code's treatment of

[117] Trustee's First Interim Report at 11, In re Spongetech Delivery Systems, Inc., No. 10-13647 (SMB) (Bankr. S.D.N.Y. July 29, 2010), ECF No. 69. 11 U.S.C. §§ 510(b), 1129(a).

[118] *See supra* notes 98–102 and accompanying text.

[119] SEC v. Spongetech Delivery Systems, Inc., 98 F. Supp. 3d 530, 540 (E.D.N.Y. 2014).

[120] *Id.*

[121] *Id.* at 535.

[122] Slain & Kripke, *supra* note 12, at 299 ("In case of corporate bankruptcy, the public interest favoring private remedies for the violation of these laws must be

defrauded security holders under § 510(b) gives the SEC little choice in acting to avoid the Code's priority. So, just as Slain and Kripke wrote in 1973: "The time has come for a reconsideration . . . ."[123]

This Part seeks to provide the start to a solution that realigns SEC civil enforcement strategy with the Bankruptcy Code while furthering the interests of security holders and creditors. Furthermore, it aims to end the collective action problem that has evolved between the SEC and creditors in and out of bankruptcy. Ironically, in order to better protect creditors, the first step is to revisit the Code's provision that was intended to protect them: § 510(b).[124]

A. *Revisiting § 510(b)*

The Code's treatment of defrauded security holders under § 510(b) gives the SEC few alternatives to avoid or ameliorate the Code's broad subordination of defrauded security holder claims. Thus, Congress must revisit § 510(b). In doing so, Congress should consider three objectives: (1) permit securities fraud victims fair representation in bankruptcy cases; (2) incentivize creditors to act as more effective fraud monitors; and (3) remove the SEC's primary motivation to use receiverships, which conflict with the Code's priority scheme.[125]

First, providing defrauded securities holders a voice in bankruptcy and improving their prospects for recovery would significantly impact a number of cases where victims of a debtor's fraud have no economic incentive to participate in the bankruptcy process.[126] Any change should aim to allow private enforcement to help deter wrongdoing and provide "an indispensable tool with which defrauded investors can recover their losses without having to rely upon government action."[127] Permitting defrauded security holders to act as private attorneys general would free up valuable SEC resources, supplement the

balanced against other interests worthy of protection—notably the reliance interests of . . . lenders and trade creditors.").

[123] *Id.* at 285.

[124] *See* COLLIER, *supra* note 5, ¶ 510.04[1].

[125] *See Hedge Funds*, *supra* note 77, at 127.

[126] *See* James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547, 582–83 (2013) (finding that a significant percentage of securities class actions involve failed companies and that there are many cases in which a company has not formally filed for bankruptcy but is in financial distress).

[127] H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.).

Commission's enforcement objectives, and allow the SEC to bring more selective actions against individuals, effectively achieving greater overall deterrence.[128]

Next, also in the spirit of deterrence, improving defrauded security holders' ability to recover in bankruptcy should incentivize creditors to better monitor entities to which they decide to extend credit. This would be the case, in particular, if defrauded investors were entitled to some recovery from the proceeds of the debtor's unlawful activity, even in situations where a secured creditor is asserting a lien on that property. The increased attentiveness of creditors, effectively acting as fraud monitors, may promote the early detection of serious securities law violations.

Finally, and above all, Congress must revisit § 510(b) to reduce the SEC's incentive to use receiverships and avoid the Code's priority. Such action puts the SEC at odds with creditors, leads to conflicts within the federal system, and results in insolvency proceedings lacking the certainty and structure of bankruptcy proceedings.[129] With defrauded security holders empowered to assert their rights, the SEC no longer has a direct need to use receiverships—especially when a bankruptcy proceeding would be more appropriate.

B. *In Bankruptcy: Empowering the United States Trustee*

In a second step to integrate securities fraud enforcement in bankruptcy, the United States Trustee should be empowered to carry out its statutorily prescribed duties to better coordinate its efforts with the SEC. The U.S. Trustee is responsible for overseeing the administration of bankruptcy cases and private trustees; its mission is to promote the integrity and efficiency of the bankruptcy system for debtors, creditors, and the public.[130]

But with respect to SEC regulation of insolvent firms accused of defrauding investors, the U.S. Trustee's authority is not sufficient to fulfill its intended and self-described purpose to

[128] *See* Park, *supra* note 126, at 585. Focusing securities fraud liability on these individuals could better deter securities fraud, and so bankruptcy cases are a setting where individuals, rather than the company, should be the focus of liability. Wunderlich, *supra* note 24, at 376.

[129] *See Hedge Funds*, *supra* note 77, at 127 (recognizing bankruptcy benefits such as established case law, experienced judges, and the participation of the United States Trustee).

[130] 28 U.S.C. § 586 (2012); *U.S. Trustee Program*, U.S. DEP'T OF JUST., https://www.justice.gov/ust/about-program.

act as the "watchdog over the bankruptcy process."[131] The U.S. Trustee lacks the proper influence to work in coordination with—or to challenge—the SEC when necessary to protect the Code. For example, the U.S. Trustee was absent in the *Byers* litigation that stripped creditors of the Code's grant of power in § 303.

To better integrate the SEC's mission with the Bankruptcy Code, the U.S. Trustee needs the ability to act as a counterweight to SEC influence. Furthermore, for the SEC's part, the Agency must have faith in an equitable distribution in bankruptcy. Accordingly, the U.S. Trustee should be reequipped with the tools needed to realize its mission as Congress intended: to "serve as bankruptcy watch-dogs to prevent fraud, dishonesty, and overreaching in the bankruptcy arena"[132] and to operate like the SEC under the Bankruptcy Act, "protecting the public interest and ensuring that bankruptcy cases are conducted according to the law."[133]

C. Out of Bankruptcy: Receivership Oversight and Fairness

It is possible that even a wholesale repeal of § 510(b) would not provide a persuasive incentive for the SEC to prefer a bankruptcy over a receivership in which it exerts significant influence to directly benefit the security holders the Agency seeks to protect. But, like Slain and Kripke wrote, federal securities law policy is not transcendental to all other interests—here, the interests of creditors.[134] Win or lose, this continued race to the courthouse will only end in diminished SEC enforcement resources.

The creation of an SEC position focused on promoting fairness in receiverships and equipped with oversight capabilities to establish certainty within the process could result in a more effective, efficient distribution process that benefits defrauded

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[131] *U.S. Trustee Program*, U.S. DEP'T OF JUST., https://www.justice.gov/ust/about-program. "[T]he U.S. Trustee's powers are strictly circumscribed, and the program has been embattled from its inception." *Rise and Fall*, *supra* note 26, at 45.

[132] H.R. REP. NO. 95-595, at 88 (1977). *See Rise and Fall*, *supra* note 26, at 45 (citing Peter C. Alexander, *A Proposal to Abolish the Office of United States Trustee*, 30 U. MICH. J.L. REFORM 1 (1996) as a critical assessment of the U.S. Trustee's performance).

[133] H.R. REP. NO. 95-595, at 109 (1977). *See Rise and Fall*, *supra* note 26, at 45 ("In large bankruptcies, the U.S. Trustee's principal role often is to quibble about requests for attorney's fees—a far cry from the majestic role that William Douglas had carved out for the SEC in the Chandler Act of 1938.").

[134] Slain & Kripke, *supra* note 12, at 299.

security holders and creditors alike. In addition, a position like this could ensure satisfaction of the Second Circuit's past instructions admonishing the receivership replacement of the bankruptcy process.[135]

This position could also act to coordinate with the U.S. Trustee to integrate the Agency's goals back into bankruptcy. With a bridge between SEC receiverships and the bankruptcy process, the Commission and the U.S. Trustee could objectively analyze and decide whether a receivership or a bankruptcy proceeding would be the best option for the insolvent entity and defrauded claimants—both creditors and security holders—under any set of circumstances. The upshot would be employing the best parts of the receivership and the Code. Such a system would inject a confidence in SEC receivers for creditors, and likewise provide a similar sense of security for defrauded security holders in bankruptcy.

CONCLUSION

This Note is intended to educate stakeholders about how equitable receiverships are being utilized. Furthermore, it hopes to advance the conversation on integrating securities fraud enforcement with bankruptcy law. To meaningfully continue such a conversation, any solution to harmonize the SEC's civil enforcement strategy with the Bankruptcy Code must start with § 510(b). Effectively reprioritizing securities fraud claims to provide a remuneration path for security holders in bankruptcy will eliminate the SEC's incentive to use mechanisms like the equitable receivership and take the first step in bringing those claims back into bankruptcy proceedings. Without that incentive, the increased, coordinative efforts between a newly-empowered U.S. Trustee and the SEC can provide the framework for a more efficient system to equitably compensate all defrauded claimants in and out of bankruptcy. In sum, the race between the SEC and creditors will end.

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[135] *See* SEC v. Byers, 609 F.3d 87, 91 (2d Cir. 2010). *See also* Eberhard v. Marcu, 530 F.3d 122, 132 (2d Cir. 2008) (noting that "receivership should not be used as an alternative to bankruptcy"); SEC v. Am. Bd. of Trade, Inc., 830 F.2d 431, 436–38 (2d Cir. 1987) (instructing the SEC to inform district courts of the Second Circuit's reservations that equity receiverships should not be used to effect the liquidation of defendants in actions brought under the securities laws).