By Sean Kelly[1]

SEC vs. Creditors

Why SEC Civil Enforcement Practice Demonstrates the Need for a Reprioritization of Securities Fraud Claims

Editor's Note: *ABI conducted its Tenth Annual Bankruptcy Law Student Writing Competition during the first semester of 2018. Law students from around the nation submitted papers, which focused on topics such as trademarks, the* Spanish Peaks *case and international procedures. All papers were judged by a panel of bankruptcy experts on style, substance and relevance.* ***Sean Kelly****, a second-year student at St. John's University School of Law, won first place in the competition. As the winner, he received a $2,000 cash prize (sponsored by Blank Rome LLP), a one-year ABI membership and publication of the paper in the* ABI Journal.

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For nearly 40 years, there has been a growing tension between the Securities and Exchange Commission's (SEC) civil-enforcement mission to protect defrauded securities-holders and bankruptcy law's treatment of those claimants. Section 510(b) of the Bankruptcy Code 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.

This article examines how this tension has motivated the SEC to use receiverships as a preferred vehicle to maximize recovery for defrauded securities-holders and, in the process, create what amounts to an SEC-run bankruptcy proceeding. The use of these receiverships has triggered an ongoing race to the courthouse between 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 article proposes a solution that starts with revisiting § 510(b) to reprioritize securities fraud claims in bankruptcy.

Section 510(b): Mandatory Subordination

Section 510 is an integral part of Bankruptcy Code §§ 501-511, which establishes an allocation of estate assets among claimants in liquidation or reorganization cases.[2] Within that section, Congress asked the "difficult policy question" concerning the status of the defrauded security-holding claimant: "Should he be treated as a general unsecured creditor based on his tort claim ... or should his claim be subordinated?"[3] The answer was mandatory subordination, embodied in § 510(b).[4]

Section 510(b) mandates that security-based claimants are unable to elevate their interests from the level of equity to general claims.[5] Instead, such claims are subordinated to all claims senior or equal to the claim represented by the security.[6] 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.[7]

In codifying § 510(b), Congress generally adopted a theory of risk allocation proposed in 1973 by Profs. John Slain and Homer Kripke as its foundation.[8] In doing so, Congress necessarily rejected opposing arguments — the most vocal of which was the SEC,[9] which posed the following 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?"[10] 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.[11]

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2 *Collier on Bankruptcy*, ¶ 510.01, 510-3 (16th ed. 2009).
3 H.R. Rep. No. 595, 95th Cong., 1st Sess. 194 (1977).
4 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 section 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's decision to favor subordination via § 510(b), *see* Kenneth B. Davis, Jr., "The Status of Defrauded Security Holders in Corporate Bankruptcy," 1983 *Duke L.J.* 1 (February 1983).
5 *Collier*, *supra* n.2, ¶ 510.04[2] at 510-13.
6 *Id.*
7 *Collier*, *supra* n.2, ¶¶ 510.04[2][7] at 510-13, 510-17. 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." *In re Geneva Steel Co.*, 281 F.3d 1173, 1179 (10th Cir. 2002).
8 *See* H.R. 595 at 194, 196. John J. Slain and 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). Profs. Slain and Kripke presented a problem rooted in two risks. Both the creditor and security-holder shared the first risk of insolvency, but only security-holders assumed the risk of illegality. Allowing a person to assert a claim in bankruptcy as an unsecured creditor based on the purchase of an equity interest impermissibly shifted the risk of illegality onto creditors, allowing the buyer of a risky security to bootstrap himself into a less-risk class. *See* Thomas Jackson, *Logic and Limits of Bankruptcy*, 63 (1986); *Collier*, *supra* n.2, ¶ 510.04[2] at 510-14.
9 *See* H.R. 595 at 195-196.
10 *Davis*, *supra* n.4, at 1-2 (citing Securities and Exchange Comm., Report on S.235 and S.236, *reprinted in* The Bankruptcy Reform Act, Hearings on S.235 and S.236 Before the Subcomm. on Improvements in Judicial Mach. of the Senate Comm. on the Judiciary, 94th Cong., 1st Sess. 738-79 (1975)).
11 H.R. 595 at 196.

SEC, the Code and Sarbanes-Oxley

When Congress overhauled the nation's bankruptcy laws in 1978, it also rejected the SEC's position that its oversight was essential to protecting investors, and almost entirely excluded the agency from the bankruptcy process.[12] Its function under chapter 11 reorganization was circumscribed so that in practice, the SEC would not play a significant role in the vast majority of cases.[13] Instead, Congress "adopted the 'view that ... equityholders 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."[14] Further, to complete the abatement, Congress created the Office of the U.S. Trustee to subsume much of the SEC's prior function.[15] However, the agency's demotion would not be permanent.[16]

The SEC's bankruptcy revival began with Congress's passage of the Sarbanes-Oxley Act of 2002.[17] In § 308(a), the "Fair Fund Provision" (a response to the discrepancy in dollars lost and the amount that the SEC could collect by disgorgement alone), the SEC could now combine penalty and disgorgement amounts to compensate injured investors at its discretion.[18] Accordingly, the SEC began to use § 308(a) to compensate securities fraud claimants who were otherwise subordinated in bankruptcy.[19] However, implementing a distribution plan for amounts deposited in a fair fund in large and complex cases proved to be cumbersome.[20] As a result, equitable receiverships resurged as an alternative to bankruptcy in SEC civil-enforcement proceedings.[21]

Inequitable Receiverships

When the question arises as to whether bankruptcy or liquidation through an equity receivership is appropriate, the SEC knows the receivership's advantage: "no absolute priority rule."[22] Thus, receiverships have evolved to become an often-preferred SEC vehicle to compensate securities fraud victims of insolvent entities: "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."[23]

SEC Influence over SEC Receivers

A receiver is procedurally and nominally an independent officer of, and appointed by, the court.[24] That being said, it is the SEC that nominates the receiver and continues to exert significant influence over the subsequent proceedings. 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.[25] A recent example illustrates its influence over a receiver's decision-making.

Only six months after the appointment, the SEC-nominated receiver for Platinum Management resigned due to differing views with agency staff on how the receivership should progress.[26] 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.[27] In the "Managing Assets" section of the order, the SEC proposed an entirely new paragraph that mandated the following, in part: "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."[28] This rejected language would have allowed the SEC to hijack the receivership proceeding, transforming a supposed equitable receivership into a functional arm of the SEC.[29]

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

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.[30] The creditors' committee of Wextrust (the insolvent entity at issue in *Byers*) argued that § 303 of the Bankruptcy Code

12 David A. Skeel, Jr., "The Rise and Fall of the SEC in Bankruptcy," Univ. of Penn. Law Sch. Inst. for Law and Econ., Working Paper No. 267 (August 1999), *available at* https://ssrn.com/abstract=172030 (unless otherwise specified, all links in this article were last visited on May 8, 2018).

13 *Collier*, *supra* n.2, ¶ 1109.03[4].

14 *Id.* at ¶ 1109.LH[1][d] at 1109-65 (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)). *Collier*, *supra* n.2, ¶1109.LH[1][d] at 1109-65 (modified "advisory role of the SEC will enable the court to balance the needs relating to the economy"). Congress expressly recognized the SEC's role in bankruptcy by including it in the "Right to be Heard" section of the Bankruptcy Code. That being said, the legislative history of § 1109 confirms that Congress intended a substantially modified role for the SEC. *Id.*

15 28 U.S.C. § 586 (2010); H.R. 595 at 109 (U.S. Trustee will "operate much as the [SEC] operates under current Chapter X of the Bankruptcy Act, protecting the public interest and ensuring that bankruptcy cases are conducted according to the law").

16 David A. Skeel, Jr., "Welcome Back, SEC?," 18 *ABI L. Rev.* 573, 573-74 (2010), *available at* abi.org/member-resources/law-review.

17 *See id.*; Alistaire Bambach and Samuel R. Maizel, "The SEC's Role in Public Company Bankruptcy Cases Where There Is a Significant Enforcement Interest," 2005 *Ann. Surv. Bank. L.* 3 (2006). Bambach is the assistant regional director and chief bankruptcy counsel to the Division of Enforcement of the SEC. The views expressed by her do not necessarily reflect the views of the SEC, but as the SEC's top bankruptcy lawyer since 2001, her views are highly influential in its enforcement strategy in bankruptcy.

18 Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 (2003), U.S. Sec. & Exch. Comm'n, *available at* sec.gov/news/studies/sox308creport.pdf.

19 This end-run on § 510(b) came to a head in the *WorldCom* bankruptcy case, wherein the court recognized this tension between the Fair Fund provision and § 510(b). *Official Committee of Unsecured Creditors of WorldCom Inc. v. SEC*, 467 F.3d 73, 83 (2d Cir. 2006). 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." Bambach and Maizel, *supra* n.17. For a full analysis of the interaction and competition between the competing principles and purposes of the Fair Fund provision and § 510(b) through an in-depth analysis of the *WorldCom* case, *see* Zack Christensen, "The Fair Funds for Investors Provision of Sarbanes-Oxley: Is It Unfair to the Creditors of a Bankrupt Debtor?," *U. Ill. L. Rev.* 339, 340-41 (2005).

20 Nicole A. Baker, *et al.*, *Securities Enforcement Manual: Tactics and Strategies* at 208 (Kirkpatrick & Lockhart Nicholson Graham, American Bar Association 2d ed. 2007).

21 *See* Alistaire Bambach, "The SEC in Bankruptcy: Past and Present," *ABI L. Rev.* 607, 611 (2010), *available at* abi.org/member-resources/law-review.

22 *See* Alistaire Bambach, "Issues That the SEC Confronts in the Liquidation of Hedge Funds," 22 *ABI L. Rev.* 125, 127 (2014), *available at* abi.org/member-resources/law-review. The SEC also recognizes bankruptcy benefits like established case law, experienced judges and the participation of the U.S. Trustee. *Id.*

23 Bambach, "Past and Present," *supra* n.21 at 612-13.

24 Keith Miller, "Regulatory Litigation with the SEC," 7 *Bus. & Com. Litig. Fed. Cts.* § 79:47 (4th ed.) (Westlaw) (November 2017).

25 *See* Bambach, "Hedge Funds," *supra* n.22 at 127.

26 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 for Approval of Resignation of Receiver by Bart Schwartz, *SEC v. Platinum Mgmt. (NY) LLC, et al.*, No. 16-cv-06848-BMC (2016) ECF No. 170. Lawrence Delevingne, "Platinum Receiver Asks to Resign Over Disagreements with SEC," Reuters (June 26, 2017), *available at* reuters.com/article/us-hedgefunds-platinum/platinum-receiver-asks-to-resign-over-disagreements-with-sec-idUSKBN19H216.

27 Blacklined Proposed Second Amended Order Appointing Receiver, *Platinum Mgmt. (NY) LLC, et al.*, No. 16-cv-06848-BMC ECF No. 174-2.

28 *Id.* at 13 (emphasis added).

29 The 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." Next, in the section that authorized the receiver to develop a "liquidation plan," the amended order stipulated authorization "upon consultation with the SEC staff." *Id.* at 15-17.

30 *SEC v. Byers*, 609 F.3d 87 (2d Cir. 2010).

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granted creditors an absolute right to commence an involuntary bankruptcy proceeding against the debtor.[31] However, 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.[32] This holding entrenched the receivership to the detriment of creditors' reliance on the Code, providing receivers relief from involuntary bankruptcy petitions and acting like an automatic stay in a bankruptcy proceeding.[33] While the court stressed that these anti-bankruptcy provisions should be "exercised cautiously" and "sparsely," these provisions are also a staple in SEC receiver requests.[34]

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 its active receiver-distribution plans.[35] For example, in *Byers*, the Wextrust receiver set forth a *pro rata* (proportionate) distribution of funds to each security-holder and unsecured creditor, explaining the similar treatment in a footnote: "In this regard, defrauded investors may be viewed as tort creditors with contingent, unliquidated, and potentially disputed claims."[36] The Wextrust receiver's reprioritization of claims to treat defrauded security-holders on a *pro rata* basis with unsecured creditors is not uncommon, as it is also a widespread practice.[37] In fact, every active receivership listed on the SEC's website treats the claims of defrauded security-holders on an equal-to[38] or preferred basis to creditors.[39] Thus, the SEC — through its receivers — has perfected an end-run around to the Code's mandatory subordination and § 510(b).[40]

Had the *Byers* court overturned the validity of an anti-bankruptcy injunction that foreclosed the invocation of § 303, creditors would have the right to force an insolvent entity into bankruptcy. Many, if not most, of these distribution plans would be vastly different where, now under the Code, defrauded security-holders would be subordinated pursuant to § 510(b).[41] Such is the critical importance of the anti-bankruptcy injunction to the SEC receiver.

The Race Resumed: SEC vs. Creditors

The Second Circuit's decision in *Byers* reinvigorated the collective-action problem that the Bankruptcy Code sought to end: the race to the courthouse.[42] However, as the Wextrust creditors recognized in its briefing, the race is no longer among self-interested creditors; it now pits creditors versus the SEC.[43] The high stakes of this renewed race, as evidenced in receiver distribution plans, was exemplified in

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31 *Id.* 11 U.S.C. § 303(a) and (b)(1) (2016) (involuntary case could be commenced by at least three claim-holding entities (*i.e.*, creditors) under chapter 7 or 11 and only against a person that might be a debtor under the chapter under which such case is commenced).

32 *Byers*, 609 F.3d at 92 ("[T]here is no unwaivable right to file an involuntary bankruptcy petition, and, even if there were, the receivership accomplishes what a bankruptcy would.").

33 The automatic stay is a fundamental aspect of the Bankruptcy Code because it provides the debtor with a "breathing spell" from creditors and collection actions. John M. Wunderlich, "Bankruptcy's Protection for Nondebtors from Securities Fraud Litigation," 16 *Fordham J. Corp. & Fin. L.* 375, 386-87.

34 *Byers*, 609 F.3d at 89, 91.

35 These findings are based on the listed links that were either active or included a receiver's specific website that was active. *See* "Receiverships," SEC, *available at* sec.gov/divisions/enforce/receiverships.htm.

36 Receiver's Proposed Plan of Distribution at 7, 27 fn. 30, *SEC v. Byers, et al.*, No. 08 Civ. 7104 (DC) (S.D.N.Y. 2009), *available at* wextrustreceiver.com/documents/court_papers/Receivers%20Proposed%20Plan%20of%20Distribution.pdf.

37 *See, e.g.*, Receiver's Motion (I) to Set Amount of Disputed Claims and (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. 2013), *available at* febginfo.com/images/PLE_%20Receiver_s%20Motion%20to%20Set%20Amount%20of%20Disputed%20Claims.PDF (distributing claims to defrauded securities-holders and creditors on a *pro rata* basis); Receiver's Final Report and Proposed Distribution at 9-10, *SEC v. Secure Investment Servs. Inc., et al.*, No. 2:07-Cv-01724 Geb Cmk (E.D. Cal. 2015), *available at* secreceiver.com/sis/documents/2015.01.29.D0982-1.Receivers.Final.Report.and.Proposed.Distribution.pdf (same); Motion to Approve Plan of Distribution at ¶ 17, *SEC v. Brian A. Bjork*, No. 4:11-Cv-2830 (S.D. Tex. 2013), *available at* selectassetreceiver.com/docs/motion-to-approve-plan.pdf (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. 2013), *available at* stanfordfinancialreceivership.com/documents/3-09-cv-0298-N_1877_Order_Granting_Interim_Distribution_Plan.pdf (same); Report of the Receiver Dated November 29, 2012, and Request for Interim Distribution at 11, *SEC v. Millennium Bank, et al.*, No. 7:09-CV-050-O (N.D. Tex. 2012), *available at* tklaw.com/files/uploads/Receiverships//Dkt%20No.%20196.pdf (same); Plan for Claims Administration and Distribution of Proceeds at 10, *SEC v. Travis E. Correll, et al.*, No. 4:05-Cv-472 Ras (E.D. Tex. 2008), *available at* haysconsulting.net/wp-content/uploads/2012/10/Dkt.-387-2-Ex.-A-Receivers-Plan-for-Claims-Administration-and-Distribution-of-Proceeds.pdf (same); Receiver's Motion for Authorization to Make an Initial Distribution to Creditors with Undisputed Claims and Request to Set a Hearing to Resolve Disputed Claims, *SEC v. John P. Utsick, et al.*, No. 06-20975-CIV-HUCK/O'Sullivan (S.D. Fla. 2008), *available at* entertainmentgroupinfo.com/images/PLE.%20Motion%20for%20Initial%20Distribution%20(PDF)%20(FT543554).PDF (same); Receiver's Motion for Approval of Interim Distribution Plan and Entry of Claims Bar Date, *SEC v. James G. Temme*, No. 4:11-Cv-655 (same).

38 *See, e.g.*, Receiver's Motion to Approve Plan of Distribution and Memorandum of Law in Support at 18, *SEC v. Angelo A. Alleca, et al.*, No. 1:12-CV-3261-WSD (N.D. Ga. 2017), *available at* swmreceivership.com/uploads/Summit_Motion_for_Plan_of_Distribution_with_Exhibits.pdf ("Allowed Claims of investors and of trade creditors are proposed to stand on equal footing, and therefore the Receiver proposes no classes of Claims."); Receivers Motion to Establish Claims Procedure Plan and Approve Claim Forms and Brief in Support at 13, *SEC v. Edward T. Stein*, No. 1:09-cv-03125-RJS (S.D.N.Y. 2010), *available at* asg-thg.com/estein/wp-content/uploads/2010/10/doc163.pdf ("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 Administration and Distribution of Proceeds at 10, *SEC vs. Travis E. Correll, et al.*, No. 4:05-Cv-472 Ras (E.D. Tex. 2008), *available at* haysconsulting.net/wp-content/uploads/2012/10/Dkt.-387-2-Ex.-A-Receivers-Plan-for-Claims-Administration-and-Distribution-of-Proceeds.pdf (investors and unsecured creditors are general unsecured claims against the receiver estate and shall be paid with equal priority).

39 *See, e.g.*, Amended Joint Plan of Distribution for Atlantic Asset Management LLC Filed by Securities and Exchange Commission and Marti P. Murray, as Receiver at 12-14, *SEC v. Atlantic Asset Mgmt. LLC*, No. 15 Civ. 9764 (Whp) (S.D.N.Y. 2016), *available at* sec.gov/divisions/enforce/claims/docs/amended-plan-atlantic-asset-management.pdf (plan established general distribution that included investor claims, and only allowed unsecured creditors to participate on *pro rata* basis with investors in any supplemental distribution thereafter); Receiver's Motion for Court Approval of Proposed Claims Process at 6-7, *SEC v. Commodities Online LLC, et al.*, No. 11-60702-Civ-Cooke/Torres (S.D. Fla. 2015) (receiver based priority on available money for distribution; since available money was insufficient to fully compensate defrauded investors, receiver subordinated all non-investor claims); Receiver's Motion to Authorize First Interim Distribution, Establish Record Dates and Set First Interim Distribution Date at 4-5, *SEC v. Rex Venture Grp. 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 make up "claims secured by collateral, claims asserted by taxing authorities, and claims asserted by general unsecured creditors"); Receiver's Unopposed Motion to (1) Approve First Interim Distribution, (2) Establish Reserves, and (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. 2012), *available at* nadelreceivership.com/docs/DKT_825_Receiver_Motion_Approve_First_Interim_Distribution.pdf (defrauded investors stood first in line before secured creditor claims (limited to sale of its security), and unsecured creditor claims received third priority — 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), *available at* mbcreceiver.com/html/images/02-22-09_MtnDisbursementFunds.pdf (receiver determined that no trade creditors will receive distributions "[b]ecause there will be insufficient funds to satisfy the investor claims"); Plaintiff Securities and Exchange Commission's Plan for Distribution of Receivership Assets at 4-5, *SEC v. Cobalt Multifamily Investors I LLC, et al.*, No. 06 Civ. 2360 (KMW) (MHD) (S.D.N.Y. 2008), *available at* sec.gov/divisions/enforce/claims/cobaltmultiplanofdistribution.pdf (SEC submitted distribution plan on *pro rata* basis giving 50 percent to investors; and 25 percent to unsecured creditors; and future recoveries would be distributed as follows: 33.3 percent to investors and 33.3 percent to unsecured creditors).

40 In so doing, the SEC has answered its own question from 40 years earlier: Securities fraud victims should not "receive different treatment from that accorded ... a pedestrian hit by the bankrupt's delivery truck." See the first part of this article discussing the SEC's argument against § 510(b).

41 11 U.S.C. § 510(b).

42 *See* Douglas G. Baird, "Priority Matters Absolute Priority, Relative Priority, and the Costs of Bankruptcy," 165 *U. Penn. L. Rev.* 785, 789 fn.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 recover what she is owed without paying attention to the consequences for everyone else." 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.* at 789.

43 Reply Brief for Interested Party-Appellants International Ad-Hoc Committee of Wextrust Creditors and International Consortium of Wextrust Creditors at 4, *SEC v. Byers*, 609 F.3d 87 (2d Cir. May 20, 2009) (Nos. 09-0234-cv(L), 09-0284-cv(CON)). ("[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.").

Spongetech Delivery Systems Inc., a case where the SEC lost the courthouse race by mere hours.[44] In that case, the SEC charged Spongetech with orchestrating a massive pump-and-dump scheme that deceived investors into believing that they were buying stock in a highly successful company.[45] On June 18, 2010, the SEC took its first step to appoint a receiver — equipped with an anti-bankruptcy injunction[46] — over Spongetech, its subsidiaries and affiliates, including wholly owned subsidiary Dicon Technologies LLC.[47] The SEC took what appeared to be an early lead.

However, while the agency hurried to appoint its receiver in Brooklyn, just three hours earlier in a bankruptcy court in Savannah, three Dicon Technologies creditors sprinted to file an involuntary bankruptcy petition under § 303,[48] simultaneously moving for the immediate appointment of a chapter 11 trustee.[49] Those creditors succeeded, and a trustee was appointed over Dicon on July 9.[50] Unlike in *Byers*, the Dicon creditors won the race to the courthouse, and its parent, Spongetech, eventually entered its own chapter 11 bankruptcy with a trustee appointment.[51] The SEC withdrew its receiver request[52] because, as the agency points out, "the bankruptcy trustee would undertake many of the same functions as a receiver."[53]

Spongetech's chapter 11 trustee's interim report illustrated 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."[54] 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 appointed, security-holders likely would have been on equal footing with — or greater footing than — creditors.[55] 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 as is required under § 510(b).

The importance of just a few hours in this race is embodied in the *Spongetech* court's decision to maintain the Code's priority for a secured creditor's claim over an SEC disgorgement claim.[56] The *Spongetech* bankruptcy case resulted in the disbursement of the entire $1.46 million estate to Solution Funding, a secured creditor, because the creditors won the race to the courthouse.[57] Had those creditors acted a few hours later and the SEC — holding a $5.69 million disgorgement claim — installed its receiver, it is likely, as the SEC argued, that no creditor (secured or not) would have seen any compensation.[58]

Reintegration of Securities Fraud Claims

Revisiting § 510(b)

The Bankruptcy Code's treatment of defrauded securities-holders under § 510(b) gives the SEC few alternatives short of a receivership to avoid or ameliorate the Code's broad subordination of defrauded security-holder claims. This part proposes a solution that might realign SEC civil-enforcement strategy with the Bankruptcy Code while furthering the interests of securities-holders and creditors alike. Ironically, in order to better protect creditors, Congress should revisit the Code's section purposed to protect them: 510(b).[59] In doing so, Congress should consider three objectives: (1) Permit securities fraud victims to be fairly represented in bankruptcy cases; (2) incentivize creditors to act as more effective fraud monitors; and (3) remove the SEC's primary motivation to use receiverships that conflict with the Code's priority scheme.[60]

First, providing defrauded securities-holders with 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.[61] Any change should 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."[62] Permitting defrauded securities-holders to act as private attorneys generals would free up valuable SEC resources, supplement the SEC's enforcement objectives and allow the SEC to bring more selective actions against individuals, effectively achieving greater overall deterrence.[63]

Next, also in the spirit of deterrence, improving defrauded securities-holders' ability to recover in bankruptcy should incentivize creditors to better monitor entities to which they decide to extend credit. This would particularly be the case 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 in this context, will promote the early detection of serious securities law violations.

44 *SEC. v. Spongetech Delivery Sys. Inc.*, 98 F. Supp. 3d 530 (E.D.N.Y. 2014).
45 *Id.* at 543; *see also* "SEC Charges Spongetech and Senior Executives in Pump-and-Dump Scheme," SEC (2010), *available at* sec.gov/news/press/2010/2010-70.htm.
46 [Proposed] Order Granting Appointing a Receiver Over Defendant Spongetech Delivery Systems Inc. at 9-10, *Spongetech*, 98 F. Supp. 3d, 530 (E.D.N.Y. June 18, 2010) (No. 10-CV-02031 (DLI)), ECF No. 44-3.
47 Appointment of Receiver Brief June 18, 2010; Motion to Support p. 1.
48 *See supra* n.31. *See also* 11 U.S.C. § 303(a) and (b)(1) (2016) (involuntary case might be commenced by at least three claim-holding entities (*i.e.*, creditors) under chapter 7 or 11, and only against a person who might be a debtor under the chapter under which such case is commenced).
49 Letter Informing Court of Involuntary Bankruptcy Petition and Motion for Trustee for Dicon by U.S. Securities & Exchange Commission, *Spongetech*, 98 F. Supp. 3d, 530 (E.D.N.Y. June 21, 2010) (No. 10-CV-02031 (DLI)), ECF No. 49.
50 Letter Informing Court of Involuntary Bankruptcy Petition and Motion for Trustee for Dicon by U.S. Securities & Exchange Commission, *Spongetech*, 98 F. Supp. 3d, 530 (E.D.N.Y. June 21, 2010) (No. 10-CV-02031 (DLI)).
51 Following the Dicon petition, Spongetech filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York. In addition, the U.S. Trustee filed an expedited motion supporting the immediate appointment of a chapter 11 trustee over Spongetech. Motion of the United States 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, *In re Spongetech Delivery Sys. Inc.*, No. 10-13647 (SMB) (Bankr. S.D.N.Y. July 16, 2010), ECF No. 91-4.
52 Letter Informing the Court that a Bankruptcy Trustee Has Been Appointed as to Spongetech by U.S. Securities & Exchange Commission, *Spongetech*, 98 F. Supp. 3d, 530 (E.D.N.Y. July 20, 2010) (No. 10-CV-02031 (DLI)), ECF No. 93.
53 Plaintiff Securities and Exchange Commission's Reply Memorandum in Support of Motion for Appointment of a Receiver at 2, *Spongetech*, 98 F. Supp. 3d, 530 (E.D.N.Y. July 16, 2010) (No. 10-CV-02031 (DLI)), ECF No. 91.
54 Trustee's First Interim Report at 11, *In re Spongetech Delivery Sys. Inc.*, No. 10-13647 (SMB) (Bankr. S.D.N.Y. July 29, 2010), ECF No. 69. *See also* 11 U.S.C. §§ 510(b), 1129(a).
55 *See supra* n.36-41 and accompanying text.

56 *Spongetech*, 98 F. Supp. 3d at 540.
57 *Id.*
58 *Id.* at 535.
59 *See Collier*, *supra* n.2, ¶ 510.04[1] at 510-13.
60 *See* Bambach, *supra* n.22 at 127.
61 *See* James J. Park, "Securities Class Actions and Bankrupt Companies," Research Paper No. 241 (2013), *available at* ssrn.com/abstract=1892229 (finding that significant percentage of securities class actions involve failed companies, and there are many cases in which company has not formally filed for bankruptcy but is in financial distress).
62 H.R. Conf. Rep. No. 104-369, 104th Cong., 1st. Sess. 31 (1995).
63 *See* Park, *supra* n.61. Focusing securities fraud liability on these individuals could better deter securities fraud, so bankruptcy cases are a setting where individuals (rather than the company) should be the focus of liability. Wunderlich, *supra* n.33 at 376-77.

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Finally, Congress must revisit § 510(b) in order to reduce the SEC's incentive to use receiverships to avoid the Code's priority, which 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.[64] With defrauded securities-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.

In Bankruptcy: Empowering the U.S. Trustee

In a second step to integrate securities fraud enforcement in bankruptcy, the U.S. 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.[65]

However, 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 act as the "watchdog over the bankruptcy process."[66] The U.S. Trustee lacks the proper influence to work in coordination with — or to challenge — a powerful agency when necessary to protect the Bankruptcy Code. As a case in point, 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, and for the SEC to have faith in an equitable distribution in bankruptcy. Thus, the U.S. Trustee should be re-equipped with the tools needed to realize its congressionally intended mission: to "serve as bankruptcy watchdogs to prevent fraud, dishonesty, and overreaching in the bankruptcy arena"[67] 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."[68]

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 bankruptcy over a receivership in which it exerts significant influence that directly benefits the security-holders that the SEC seeks to protect. However, this continued race to the courthouse will only end in diminished SEC enforcement resources, whether it wins or loses.

The creation of an SEC position focused on promoting fairness in receiverships, equipped with the necessary oversight capabilities to establish certainty within the process, could result in a more effective distribution process that benefits defrauded securities-holders and creditors. In addition, a position like this could ensure satisfaction with the Second Circuit's past instructions.[69] This position could also act to coordinate with the U.S. Trustee, allowing each agency to objectively analyze and decide whether receivership or bankruptcy would be the best option for the insolvent entity and defrauded claimants — both creditors and securities-holders — under any set of circumstances. The upshot would be employing the best parts of the receivership and the Bankruptcy Code, injecting a confidence in SEC receivers for creditors, and likewise providing a sense of security for defrauded securities-holders in bankruptcy.

Conclusion

This article is intended to educate stakeholders about how equitable receiverships are being utilized. In addition, it hopes to forward 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 securities-holders in bankruptcy will eliminate the SEC's incentive to use mechanisms like the equitable receivership and will effectively take the first step toward bringing those claims back into bankruptcy proceedings.

Without that perverse incentive, the increased and 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 would end. abi

64 *See* Bambach, *supra* n.22 at 127 (recognizing bankruptcy benefits like established case law, experienced judges and participation of U.S. Trustee).

65 28 U.S.C. § 586 (2010); *see also* "About the U.S. Trustee Program," *available at* justice.gov/ust.

66 *See* "About the U.S. Trustee Program": "The U.S. Trustee's powers are strictly circumscribed, and the program has been embattled from its inception." *See also* Skeel, *supra* n.12 at 45.

67 H.R. 595 at 88. *See* Skeel, *supra* n.12 at 45 (citing Peter C. Alexander, "A Proposal to Abolish the Office of United States Trustee," 30 *U. Mich. L.L. Ref.* 1, 8 fn. 45 (1996), for a critical assessment of the U.S. Trustee's performance).

68 H.R. 595 at 109. *See* Skeel, *supra* n.12 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.").

69 *Id. 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*, 830 F.2d 431, 436-38 (2d Cir. 1987) (instructing SEC to inform district courts of Second Circuit's reservations that equity receiverships should not be used to effect liquidation of defendants in actions brought under securities laws).