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Closing a Bankruptcy Loop-Hole
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Sarbanes-Oxley Creates a New
Exception to Discharge

BY LUCIAN MURLEY*

INTRODUCTION

The Corporate and Criminal Fraud Accountability Act of 2002 ("the Act"), part of the Sarbanes-Oxley Act, includes changes to many different areas of the law: accounting and auditing procedures, financial disclosures, corporate tax law, securities law, and bankruptcy law. The impetus behind the Sarbanes-Oxley Act is the recent high-profile financial scandals involving Enron, WorldCom, and Global Crossing, among others. The Act’s goal is to guarantee “trust in the financial markets by ensuring that the corporate fraud and greed may be better detected, prevented and prosecuted” and to “ensure that such greed does not succeed.”

Although scandals involving other Fortune 500 companies have come to light since 2001, Enron seems to have garnered most of the attention from the public and Congress. A Texas pipeline company incorporated in 1985, Enron expanded to become an energy broker upon the deregulation of major power markets. Enron misled investors and regulators by using a variety of complicated transactions with putatively separate business entities designed to bolster purported profits, conceal actual losses, and

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2 See S. REP. NO. 107-146 (2002), 2002 WL 863249, at *2 (statement of Senator Leahy) [hereinafter Leahy Statement] (stating that the Act is intended to restore trust in the financial markets after the Enron “debacle”).

3 Id.

4 See id.

5 Id.
ultimately boost Enron’s share price.\textsuperscript{6} These practices eventually caught up with the company and Enron announced a $618 million loss for the third quarter of 2001, reduced shareholder equity by $1.2 billion, and later filed the largest bankruptcy in United States history.\textsuperscript{7} As a result, Enron shareholders were left with virtually worthless stock.\textsuperscript{8} The market fallout from this and other accounting scandals has affected virtually every American; the Securities and Exchange Commission ("SEC") reported that the average household lost $60,000.\textsuperscript{9}

In reaction to these events, the Sarbanes-Oxley Act created a new bankruptcy provision, section 523(a)(19), that renders debt from judgments for violations of federal or state securities laws and debts incurred through common law fraud, deceit, or manipulation in connection with the purchase or sale of a security nondischargeable in bankruptcy.\textsuperscript{10} This new section was added because Congress perceived that there was a "loophole" in the existing law governing personal bankruptcy that allowed securities laws violators to unfairly discharge their debts to defrauded investors.\textsuperscript{11}

Part I of this Note provides a general overview of bankruptcy law and securities regulation. Part II examines the substantive changes section 523(a)(19) makes to the requirements of creditor reliance and debtor fraudulent intent for a finding of nondischargeability based on fraud. Part III offers opinions as to whether section 523(a)(19) is an appropriate closing of this bankruptcy "loophole."

I. OVERVIEW OF LEGAL CONCEPTS

\textbf{A. Bankruptcy Law}

Every individual bankruptcy case has two goals: resolving creditors' claims against the debtor and giving the debtor a "fresh start."\textsuperscript{12} By far the

\textsuperscript{6} Id.

\textsuperscript{7} Id. WorldCom now holds the record for largest bankruptcy when it filed in July of 2002. See Shawn Young et al., \textit{Leading the News: WorldCom Files for Bankruptcy}, WALL ST. J., July 22, 2002, 2002 WL-WSJ 3401243.

\textsuperscript{8} S. REP. NO. 107-146, at *3.

\textsuperscript{9} Jeanne Cummings & Michael Schroeder, \textit{Leading the News: Lesser-Known Candidates Head List for SEC Chief}, WALL ST. J., Nov. 15, 2002, 2002 WL-WSJ 103126320 (noting also that the national exchanges as a whole lost $5 trillion in market value during the same time period).

\textsuperscript{10} Leahy Statement, \textit{supra} note 2, at *10.

\textsuperscript{11} See id.

\textsuperscript{12} See BFP v. Resolution Trust Corp., 511 U.S. 531, 563 (1994) (stating that the "policies of obtaining a maximum and equitable distribution for creditors and
most common form of bankruptcy is Chapter 7, also known as a straight liquidation bankruptcy. Any person that "has a domicile, a place of business, or property in the United States" may file a Chapter 7 petition. After bankruptcy is filed, an independent third party—the bankruptcy trustee—collects and manages the debtor's bankruptcy estate, liquidates the assets, and distributes the proceeds to the debtor's creditors.

In exchange for giving up all of his assets, the bankruptcy court discharges the debtor's obligation to pay old debts. In the context of bankruptcy law, "discharge is a release of the debtor from any further personal liability for his or her pre-bankruptcy debts." Consequently, if the debtor owes an unsecured creditor a debt and that debt is discharged in bankruptcy, the unsecured creditor will only receive a pro rata share of the assets from the bankruptcy estate. Often, the creditor will receive only cents on the dollar.

In other situations, a creditor would be better off if the debtor has positive earning capacity. In these instances, the debtor retains his property and pays his creditors with future earnings. This approach is often used for insolvent corporations, where Chapter 11 acts to rehabilitate an insolvent business through reorganization. Similarly, Chapter 13 allows a debtor ensuring a 'fresh start' for individual debtors...
meeting certain requirements to enter into a plan to repay creditors gradually over a period of years.\(^2\) The philosophy behind both Chapters 11 and 13 is to encourage debtors to restructure rather than simply liquidate their assets.\(^3\) Since the concept of discharge is only relevant in Chapter 7 bankruptcies, this Note will not further discuss the other chapters of bankruptcy.\(^4\) Likewise, since discharge and the exceptions to discharge in section 523 apply only to individual debtors,\(^5\) corporate and business entity bankruptcies will not be discussed.

Section 523 of the Bankruptcy Code contains the exceptions to discharge.\(^6\) If a debt is excepted from discharge, the creditor can not only share in the bankruptcy distribution, but also collect on the debt after bankruptcy.\(^7\) Note that discharge (and exceptions to discharge) is not about dividing up the bankruptcy estate; the bankruptcy court’s determination of debt dischargeability is independent of questions such as the secured status of debt,\(^8\) exempt property,\(^9\) or the priority of different claims.\(^10\)

\(^{22}\) See generally Epstein et al., supra note 18, §§ 1-8 to 1-9.

\(^{23}\) See Tabb, supra note 13, § 1.2.

\(^{24}\) For a concise discussion of bankruptcy chapters other than Chapter 7, see Epstein et al., supra note 18, §§ 1-8 to 1-10.


\(^{26}\) See id. § 523.

\(^{27}\) Tabb, supra note 13, at 693. Expanding upon the example in footnote 20, assume now that Debtor and Creditor used to be married and the $1,000 debt is alimony owed to Creditor. Because alimony is one of the exceptions to discharge under the Bankruptcy Code, see 11 U.S.C. § 523(a)(5), Creditor can share in the bankruptcy estate just as in the previous example (receiving $250) and now, by virtue of alimony payments being nondischargeable, Creditor can collect the remainder of the debt after bankruptcy.

\(^{28}\) See 11 U.S.C. § 506(a). “An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property . . . .” Id.

\(^{29}\) “Exempt property” means property that will not be lost in a Chapter 7 liquidation. Some common examples of exempt property are the debtor’s home, id. § 522(d)(1), car, id. § 522(d)(2), household goods, id. § 522(d)(3), and retirement benefits, id. § 522(d)(10). Note that these exemptions are not wholesale exemptions and are circumscribed by dollar amounts or other limitations. See, e.g., id. § 522(d)(2) (setting $17,425 as the ceiling for protection under the homestead exemption); In re Fisher, 63 B.R. 649 (Bankr. W.D. Ky. 1986) (determining a debtor’s need and ability to provide for himself upon retirement before granting an exemption for retirement savings).

\(^{30}\) See id. § 507 (providing the rank of priorities).
B. Securities Law

1. General Legal Concepts

Section 523(a)(19) makes debts from any violation of state or federal securities laws nondischargeable. The two main sources of federal securities law are the Securities Act of 1933 ("the 1933 Act") and the Securities Exchange Act of 1934 ("the 1934 Act"). "The fundamental purpose undergirding the [1933 Act and 1934 Act] is 'to eliminate serious abuses in a largely unregulated securities market.'"\(^{34}\) The enactment of the 1933 and 1934 Acts was a reaction to the "outrageous conduct of securities promoters" that contributed to the stock market crash of 1929.\(^{35}\) The 1933 Act primarily regulates securities when they are initially offered to the public,\(^{36}\) while the 1934 Act is much broader in scope and deals with a variety of transactions involving stocks and other securities when they are in the market.\(^{37}\)

A company's stock is subject to the reporting provisions of the 1934 Act if that particular class of stock trades on a national exchange\(^{38}\) or if the class of stock has more than five hundred shareholders and is worth more than ten million dollars.\(^{39}\) Additionally, each state has legislation—generically termed "blue sky laws"—in place to regulate securities. While these state blue sky laws can "vary widely in their terms and scope," most states have adopted some form of the Uniform Securities Act.\(^{40}\) The 1933 Act, the 1934 Act, and the state blue sky laws are not mutually exclusive—an issuer could conceivably be subject to all three in a single transaction.

2. Statutory Definition of "Security"

Both the 1933 Act and the 1934 Act define "security." While the two Acts' definitions vary slightly, they are treated as the same.\(^{41}\)

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\(^{31}\) Id. § 523(a)(19)(A)(i).


\(^{34}\) Id. (quoting United Hous. Found., Inc. v. Forman, 421 U.S. 837, 849 (1975)).


\(^{36}\) Id. at 7.

\(^{37}\) Id. at 8.


\(^{39}\) See id. § 78l(g)(1); 17 C.F.R. § 240.12g-1 (2002).

\(^{40}\) HAZEN, supra note 35, at 388-89.

\(^{41}\) See Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (holding that the respective definitions of "security" in the 1934 and 1933 Acts are "virtually identical").
The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing.\textsuperscript{42}

In enacting such a long-winded definition, Congress aimed to paint with a "broad brush."\textsuperscript{43} Courts have often gone beyond a mechanical application of the statutory definition; in determining whether an instrument is a security, a court is not bound by "legal formalisms" but is to look to the "economics of the transaction" in question.\textsuperscript{44}

3. Judicial Interpretation of "Security"

"Congress' purpose in enacting the securities laws was to regulate investments, in whatever form they are made and by whatever name they are called."\textsuperscript{45} For example, even though the 1934 Act includes "note" in its definition of the term "security," it is not axiomatic that a court will hold that any note is a security—the "family resemblance" test must be applied.\textsuperscript{46}

In evaluating whether the instrument is a security, a court begins with a rebuttable presumption that the instrument is a security due to the

\textsuperscript{42} 15 U.S.C. § 78c(a)(10).
\textsuperscript{43} Reves v. Ernst & Young, 494 U.S. 56, 60 (1990).
\textsuperscript{44} See id. at 61.
\textsuperscript{45} Id.
\textsuperscript{46} To illustrate, Issuer sells promissory notes to Investor to raise money. Subsequently, Issuer becomes insolvent, and Investor's promissory notes become virtually worthless. Investor alleges that Issuer violated antifraud provisions of the 1934 Act and seeks rescission of the sale of the promissory notes. Therefore, the question of whether the notes are "securities" under the 1934 Act becomes determinative of whether the antifraud provisions of the 1934 Act apply.
inclusion of "note" in the 1934 Act definition. Next, a court looks to the judicially crafted list of exceptions to finding a note as a security (for example, a note delivered in consumer financing or a note secured by a mortgage on a home). If the note is found to bear a "family resemblance" to one of the exceptions, the initial presumption that the instrument is a security is rebutted.

The Supreme Court's decision in SEC v. W.J. Howey Co. is the best example of the expansiveness of the statutory definition. Howey involved interpretation of the term "investment contract," which is included in the statutory definition of "security" in section 2(1). W.J. Howey Co., a large Florida orange grower, sold plots of its orchard to mostly out-of-state businesses and professionals. Howey offered both a land sales contract and a service contract to potential investors; the land sales contract conveyed a narrow strip of land consisting of a row of trees, and the service contract provided that Howey would cultivate the fruit. No registration statement was filed with the SEC when Howey sold these contracts nor were these interests evidenced by formal certificates. If the contracts and the deed were "separate transactions involving no more than an ordinary real estate sale and an agreement by the seller to manage the property for the buyer" as Howey argued, then there was no obligation to register; if these contracts were "securities" under the 1934 Act, then the failure to register would be a ground for rescission.

Emphasizing substance over form, the Court found the combination of the contracts and the deed was an "investment contract." All the elements

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48 See Reves, 494 U.S. at 67.
49 Id. at 66-67. In determining whether the instrument bears a "family resemblance," Reves provides a four-part test:

First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it . . . . Second, we examine the 'plan of distribution' of the instrument . . . . Third, we examine the reasonable expectations of the investing public . . . . Finally, we examine whether some factor such as the existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.

Id. (quoting SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943)).
52 Howey, 328 U.S. at 297-98.
54 See Howey, 328 U.S. at 300.
of a profit-seeking business venture were present: the investors were contributing money to share in the profits of an enterprise managed and operated by Howey; the investors had no desire to operate their orange groves themselves; and the "common enterprise" was essential for the investors to receive a return on their investment. This is the type of agreement that the Supreme Court has held to be an investment contract and thus a security. The Court held, "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promoter or a third party. . . ."

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The requirement in Howey that investors' profits result "solely" from the efforts of the promoter or third party has been softened in subsequent cases. "A literal application of the Howey test would frustrate the remedial purposes of the Act. . . . [I]t would be easy to evade [the Howey test] by adding a requirement that the buyer contribute a modicum of effort." Therefore, only if the investor's efforts are "undeniably significant" will the enterprise lose investment contract status.

To determine whether the investor is involved in a "common enterprise," the second element of the Howey test, courts have developed the concepts of "horizontal" and "vertical commonality." Horizontal commonality is defined as the relationship "between an individual investor and the pool of other investors." In Howey, horizontal commonality is present because each investor pooled his or her money with all the other investors' money.

55 Id. at 299-300.
56 See id. at 300.
58 Howey, 328 U.S. at 298-99.
59 SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 480 (5th Cir. 1974) (internal quotations omitted).
60 Id. at 483 n.14 (citing Securities Act Release No. 5211 [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,446 (Nov. 30, 1971), which provides liberal interpretation of this element and cites Howey as a mandate from the Supreme Court to focus on the "economic reality" of the transaction); accord SEC v. Glen W. Turner Enters., 474 F.2d 476, 482 (9th Cir. 1973). For deeper analysis of this element, see HAZEN, supra note 35, at 31-32.
62 See Howey, 328 U.S. at 296. The proceeds from the sale of fruit were distributed pro rata by shares, not by the discrete production of each investor's plot. Id. Note that the Supreme Court did not use the terms "vertical commonality" and
Vertical commonality occurs when the investors' fortunes are tied to the efforts and success of the promoter.63

This brief summary of securities law is intended not only to provide enough information to understand section 523(a)(19), but also to illustrate the broad scope of the term "security." A grasp of the volume and complexity of this area of the law is necessary to understand the gravity of section 523(a)(19), which incorporates the totality of securities law into a single exception to discharge.

II. SUBSTANTIVE CHANGES MADE BY SECTION 523(A)(19) TO THE REQUIREMENTS FOR NONDISCHARGEABILITY BASED ON FRAUD

The new bankruptcy provision, section 523(a)(19), reads:

(a) A discharge under . . . this title does not discharge an individual debtor from any debt—

    (19) that—
    (A) is for—
        (i) the violation of any of the Federal securities laws (as that
term is defined in § 3(a)(47) of the Securities Exchange Act
of 1934 (15 U.S.C. 78c(a)(47)), any State securities laws, or
any regulation or order issued under such Federal or State
securities laws; or
        (ii) common law fraud, deceit, or manipulation in
connection with the purchase or sale of any security; and
    (B) results from—
        (i) any judgment, order, consent order, or decree entered in
any Federal or State judicial or administrative proceeding;
        (ii) any settlement agreement entered into by the debtor; or

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"horizontal commonality" in Howey. See id. These terms were subsequently developed in the lower courts.

63 See, e.g., Turner, 474 F.2d at 483 (finding a pyramid scheme to be a security despite the absence of horizontal pooling among investors). For a skillful navigation through the concepts of horizontal and vertical commonality, see generally Maura K. Monaghan, An Uncommon State of Confusion: The Common Enterprise Element of Investment Contract Analysis, 63 FORDHAM L. REV. 2135 (1995) (identifying three different approaches to the commonality requirement among the circuits: horizontal commonality, strict vertical commonality, and the "broad vertical approach").
(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.  

The definition of "securities laws" for purposes of section 523(a)(19) includes both the 1933 Act and the 1934 Act. Not only must the debt involve a violation of these securities laws, it must also result from a judgment or settlement of a court or administrative proceeding.

The following sections examine the ways that section 523(a)(19) has altered the requirements of section 523(a)(2) when the debt involves a security.

A. The Merging of the Reliance Requirement: Subsections (A) and (B) When the Debt Involves Fraud in the Purchase or Sale of a Security

1. Reliance under Section 523(a)(2)

The most litigated exception to discharge is for debts incurred by fraud under section 523(a)(2). Section 523(a)(2)(B) ("Subsection (B)") applies to false representations of financial condition made in writing, while section 523(a)(2)(A) ("Subsection (A)") is a broad "catch all" and deals with all other representations not covered in Subsection (B). This Note will refer to Subsection (A) statements as "oral false financial statements" for the sake of simplicity. Subsection (B) statements will be referred to as "written false financial statements."

The elements of Subsection (B) are: (1) the statement must be written and "materially false;" (2) the statement must be "respecting the debtor's or an insider's financial condition;" (3) the creditor must reasonably rely

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66 TABB, supra note 13, at 715.
on the statement; and (4) the debtor must have intended to deceive the creditor. The elements of Subsection (A) are “false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor’s or an insider’s financial condition. . . .”

While Subsection (B) requires the creditor’s reliance on the written financial statement to be reasonable, there is no such express requirement in Subsection (A). However, the Supreme Court has read in a justified reliance standard. “Justifiable” is a more relaxed standard of reliance than “reasonable.” As this Note will show, the dual standard of reasonable reliance for written false financial statements and justified reliance for oral false financial statements no longer exists when the debt involves a judgment of common law fraud involving the purchase or sale of a security under subsection 523(a)(19).

To obtain a finding of nondischargeability under Subsection (A), the Supreme Court held that the creditor must manifest justified reliance. In analyzing Subsection (A), which has no express reliance requirement, the Court in Field v. Mans applied various rules of construction to hold that the reasonable reliance requirement in Subsection (B) was not intended to apply to Subsection (A). The Court, however, held that in drafting Subsection (A) and including the term “actual fraud,” Congress referred to common-law fraud. Therefore, a creditor must “justifiably,” rather than reasonably, rely on the debtor’s statement. On a continuum with reasonable reliance on one side and “mere reliance” (that is, subjective reliance) on the other, the Supreme Court would place justifiable reliance somewhere in the middle. The Court explained that “a person is justified in relying on a representation of fact ‘although he might have ascertained the falsity of the representation had he made an investigation.’” To manifest justifiable reliance, the creditor need not investigate, even if he could have done so “without any considerable trouble or expense.”

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69 Id. § 523(a)(2)(A).
71 See id. at 67-70, 74-75.
73 Field, 516 U.S. at 73-75.
74 See id. at 72-73 (referring to justified reliance as an “intermediate level” between reasonable reliance and mere reliance).
75 See id. at 70 (quoting RESTATEMENT (SECOND) OF TORTS § 540 (1976)).
76 RESTATEMENT (SECOND) OF TORTS § 540 cmt. a.
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have been disclosed by "a mere cursory glance" will the creditor be found to fail the requirement of justified reliance.77

2. Section 523(a)(2) after Section 523(a)(19)

Section 523(a)(19) includes judgments of "common law fraud . . . in connection with the purchase or sale of any security" as a basis for nondischargeability.78 This explicit reference to "common law fraud" hearkens back to the Supreme Court's application of justifiable reliance in Field. What was once two different standards of reliance for written fraud and oral fraud under section 523(a)(2) is now only one standard of reliance for fraud involving the purchase or sale of securities under section 523(a)(19).

To illustrate the significance of this change, consider the following example.79 Debtor, a shareholder of Corporation, sells some of his common shares of Corporation to Creditor. Debtor provides a written financial statement showing that Corporation's assets are substantially higher than its liabilities, that its orange groves and related real property are free from any mortgage or lien, and that its investors have enjoyed a substantial rate of return on their investment. Creditor gives the financial statement a cursory read-through, finds nothing that causes him concern, and buys Debtor's shares in the orange grove. Unbeknownst to Creditor, the financial statement is completely false. The orange grove is heavily leveraged, its real property is heavily mortgaged, and its investors have consistently lost money on their investment. Creditor files suit and receives a judgment against Debtor for common law fraud. Subsequently, Debtor files a petition for Chapter 7 bankruptcy. Before section 523(a)(19), Creditor would be relegated to section 523(a)(2)(B) and would have to show that he reasonably relied on Debtor's false financial statement. After section 523(a)(19), Creditor must only show that he justifiably relied on the statement.

Because the debt incurred involved common law fraud in the purchase or sale of a security, section 523(a)(19) is applicable.80 Creditor could have discovered that the financial statement was false if he had performed a reasonable investigation. Under this standard of justifiable reliance, an

77 See id.
79 This illustration is loosely based on the facts of Howey. Analysis of reasonableness has been simplified for illustrative purposes.
investigation is not required even though it could be done easily and inexpensively.\textsuperscript{81} Instead, the justifiable reliance standard was met by Creditor's "cursory glance" at the financial statement.\textsuperscript{82} Since this glance would not reveal the fraud, Creditor would have justifiably relied on the false financial statement. The result is that Debtor's debt to Creditor is nondischargeable in bankruptcy.

All that said, this point is largely academic: aggrieved shareholders will almost certainly use a private cause of action provided by one of the Securities Acts rather than sue on grounds of common law fraud because of the procedural and substantive advantages afforded to plaintiffs in the 1933 and 1934 Acts discussed below. Congress' inclusion of "common law fraud" in section 523(a)(19) is likely an effort to cover all of its bases by broad drafting, rather than the conscious establishment of a separate cause of action.

3. Reliance in Violations of Securities Laws

Section 5 of the 1933 Act requires an issuer\textsuperscript{83} to file a registration statement with the SEC before selling or offering its securities.\textsuperscript{84} Section 12(a)(1) of the 1933 Act provides that "any person who offers or sells a security in violation of section [5] . . . shall be liable . . . to the person purchasing such security from him. . . ."\textsuperscript{85} Therefore, if an issuer sells a security,\textsuperscript{86} or offers to sell or buy before the registration statement becomes effective,\textsuperscript{87} the issuer has violated section 12(a)(1) and any debt resulting from such a judgment would be nondischargeable.

Even if an issuer sells a security and has filed a registration statement, the issuer is far from in the clear. Section 11 of the 1933 Act grants a cause of action to "any person acquiring" a security if "the registration statement . . . contained an untrue statement of a material fact or omitted to state a

\textsuperscript{81} See RESTATEMENT (SECOND) OF TORTS § 540 cmt. a.
\textsuperscript{82} Id.
\textsuperscript{83} Section 2(4) of the 1933 Act provides the definition of "issuer." See 15 U.S.C. § 77b(a)(4).
\textsuperscript{84} See id. § 77e(a)(1), (c) (proscribing the sale of securities unless a registration statement is in effect and proscribing offers to sell or buy unless a registration statement has been filed). For purposes of this Note, the liability of all participants other than the issuer—while a significant focus of the 1933 Act—will be ignored.
\textsuperscript{85} Id. § 77l(a)(1).
\textsuperscript{86} Id. § 77e(a)(1).
\textsuperscript{87} Id. § 77e(c).
material fact required to be stated therein or necessary to make the statements therein not misleading. . . . \(^{88}\)

Sections 11 and 12(a)(2) have weight in bankruptcy court after section 523(a)(19). Recall that before Sarbanes-Oxley, an aggrieved creditor/shareholder would be relegated to fitting his claim under section 523(a)(2), proving either reasonable or justifiable reliance. \(^{89}\) Now, a section 12 plaintiff/creditor need not prove reliance to have his claim declared nondischargeable. The requirements of section 12 are (1) the offer or sale of a security must be through interstate commerce, (2) it must include an untrue statement of fact or an omission, and (3) the section 12 plaintiff/creditor must not know of its falsity. \(^{90}\) Some courts have gone so far as to hold that a plaintiff/creditor may recover under section 12 even if he did not read the prospectus provided by the issuer. \(^{91}\) Similarly, a plaintiff under section 11 does not have to prove reliance. A prima facie case is made upon a showing that the misstatement or omission was material. \(^{92}\)

Section 523(a)(19) also serves to include court-made securities laws as a basis for nondischargeability. “Fraud-on-the-market theory” is a judicially crafted doctrine within Rule 10b-5 of the 1934 Act. Rule 10b-5 prohibits any misleading statements involving the purchase or sale of any security. \(^{93}\) The elements necessary to sustain a 10b-5 action are the same as the

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\(^{88}\) Id. § 77k(a).

\(^{89}\) See discussion supra Part II.A.1.


\(^{92}\) See Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (holding that an issuer’s liability is “virtually absolute” upon a showing of materiality).

\(^{93}\) Section 11 is softened somewhat by the “due diligence” defenses in 1933 Act § 11(b). Note also that the 1933 Act provides a broad class of defendants for violations of sections 11 and 12. In addition to the laundry list of persons liable under [section 11(a)], section 15 imposes liability on “control persons”:

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections [11] or [12] of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.


\(^{93}\) See 17 C.F.R § 240.10b-5 (2003).
elements of common law fraud: materiality, reliance, causation, and damages.94

The idea behind fraud-on-the-market theory is that the plaintiff relies not on the actual false statement, but on the market price which reflects the false statement. In a face-to-face transaction, the question is whether the buyer relied on the seller’s statement. “With the presence of [an efficient market],”95 however, “the market is interposed between the seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.”96 “In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of stock, and purchasers generally rely on the price of stock as a reflection of its value.”97 Fraud-on-the-market theory allows the plaintiff to satisfy the reliance requirement under Rule 10b-5 without actually relying on the false statement.98 Once a material misrepresentation has been established, the only remaining requirement is the plaintiff must show that the market prices reacted to the misstatements.99 Under section 523(a)(2), prior to section 523(a)(19), a debtor had to prove that he either justifiably or reasonably relied on the false financial statement.100 Now the investors of publicly-traded bankrupt companies can avail themselves of fraud-on-the-market theory as a basis for non-dischargeability, even when they did not rely on or even know of the statement.

B. False Statements of Financial Condition under Section 523(a)(2); New Standards of Fraudulent Intent for Debtors When the Debt Involves a Security

1. Fraudulent Intent in Section 523(a)(2)

In addition to lowering the creditor’s standard of reliance from that in section 523(a)(2),101 section 523(a)(19) also changes the standard of the

94 HAZEN, supra note 35, at 770.
95 Basic Inc. v. Levinson, 485 U.S. 224, 248 n.27 (1988) (recognizing that one of the predicates for application of fraud-on-the-market theory is an “efficient market” on which the security trades).
96 Id. at 244 (citation and internal quotation marks omitted).
97 Id. (citation and internal quotation marks omitted).
98 See HAZEN, supra note 35, at 812.
100 See discussion supra Part II.A.1.
101 See supra Part II.A.2.
The element of fraudulent intent is more important in Subsection (B), false written statements, than it is in Subsection (A), false oral statements. In Subsection (A) actions, fraudulent intent can be inferred from a showing that the false statement was material. Therefore, this Note only examines the changes to the standard of intent as they relate to written false financial statements.

2. Fraudulent Intent for Violations of Securities Laws

There are numerous statutes and regulations requiring registration of securities in the 1933 Act, the 1934 Act, and state blue sky laws. Generally, a registration statement will include information about the company’s operations, financial history, accounts receivable, management structure, and other information relevant to an investor.

Some securities laws do not require the purchaser to show the fraudulent intent of the issuer. For example, section 11(a) of the 1933 Act grants securities purchasers a cause of action when a registration statement contains "an untrue statement of material fact or omit[s] to state a material fact." Liability under section 11 is not premised on fraudulent intent. Issuers are, in effect, strictly liable for misstatements; "the plaintiff need only show a material misstatement or omission to establish his prima facie case." The only defenses are the purchaser’s knowledge of the inaccuracies, lack of materiality, or expiration of the statute of limitations.

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103 Carini v. Matera, 592 F.2d 378, 380 (7th Cir. 1979).
104 See generally HAZEN, supra note 35, § 3.
106 See In re Ann Taylor Stores Sec. Litig., 807 F. Supp. 990, 997-98 (S.D.N.Y. 1992) ("An issuer has absolute liability for any misrepresentations or omissions. . . .").
108 HAZEN, supra note 35, at 338. To illustrate how such a violation of section 11 of the 1933 Act might occur yet remain dischargeable under the Code before section 523(a)(19), assume Debtor is the sole shareholder of Corporation. Creditor wishes to purchase Corporation. Debtor issues a written financial statement regarding the finances of Corporation that is materially false because the financial statement was negligently prepared. Debtor does not, however, publish the statement with an intent to deceive. Relying on the false financial statement, Creditor purchases Corporation by buying all of Debtor’s stock. Subsequently, Corporation turns out to be worthless and Debtor files for bankruptcy. Based on these facts, Creditor could not succeed in the Subsection (B) exception to discharge.
Similarly, section 14(a) of the 1934 Act does not require scienter to establish liability for a violation of the proxy rules. A negligence standard is applied to material omissions in proxy statements; the only requirement is that the drafters knew all of the facts behind the material omissions in the solicitation statement.\(^{109}\)

As a result of section 523(a)(19), a debtor can now use any of these violations of securities laws as a basis for nondischargeability because there is no intent requirement.\(^{110}\) Violation of securities laws as a basis for nondischargeability in the buying and selling of a business is especially important since the Supreme Court narrowed the “sale of business” exception. Although the 1933 Act expressly provides that stock is a security,\(^{111}\) the “sale of business” doctrine provides an exception: “‘[T]he sale of stock in a closely held corporation may not be a ‘security’ especially if it is, in essence, a transfer of ownership and management of the corporation’s assets.”\(^{112}\) After the Supreme Court’s decision in *Landreth Timber Co. v. Landreth*,\(^{113}\) the validity of this doctrine is in question.\(^{114}\)

In *Landreth Timber* the majority owner of a lumber mill sold his business.\(^{115}\) The sale of the stock was not registered as required in the Securities Exchange Act of 1933.\(^{116}\) The buyer sued for contract rescission based on the failure to register under the 1933 Act.\(^{117}\) As a defense, the seller asserted the “sale of business” exception to registration and argued that the transaction was not for the sale of a security as defined in the Act.\(^{118}\) The Court held that the buyer was a “passive investor” who did not contemplate running the business himself and, therefore, the statutory definition of security was satisfied.\(^{119}\)

After section 523(a)(19), it is plain to see the gravitas of the *Landreth Timber* decision in bankruptcy court when an exchange of stock is utilized to sell a business and there is a failure to register. With the “sale of

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\(^{112}\) HAZEN, supra note 35, § 1, at 40.


\(^{114}\) See generally HAZEN, supra note 35, § 3, at 40.

\(^{115}\) Landreth Timber, 471 U.S. at 684.


\(^{117}\) Landreth Timber, 471 U.S. at 684.

\(^{118}\) Id.

\(^{119}\) See id. at 695-96.
business" doctrine in question and a violation of securities laws as a basis for nondischargeability, a creditor is no longer confined to Subsection (B) where he has to prove the fraudulent intent of the debtor. Rather, the creditor can use the debtor’s violation of the registration requirement as a basis for nondischargeability and need not show that the debtor had fraudulent intent. Indeed, if the parties from Landreth Timber declared bankruptcy and section 523(a)(19) were in place, their debt to the buyer would not be dischargeable because of their failure to register.  

3. Incorporation of the Terms “Deceit” and “Manipulation”

The most cryptic provision in section 523(a)(19) is the exception to discharge for “deceit or manipulation in connection with the purchase or sale of a security.” Presumably, the terms “deceit” and “manipulation” reference the terms’ meanings in securities law, namely, section 10b of the 1934 Act titled “Employment of manipulative and deceptive devices.” However, the entire 1934 Act, including section 10b, was already incorporated in the preceding subsection of section 523(a)(19). Because violation of securities laws is included in the preceding subsection, an argument could be made that the terms “deceit” and “manipulation” must be given a different interpretation. The counter-argument is that inter-

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121 Id. § 523(a)(19)(A)(ii).

It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,  

(a) To employ any device, scheme, or artifice to defraud,  
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or  
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

125 See id.
126 Warner, supra note 122, at 44.
pretation of these terms as anything other than their meaning in section 10b and Rule 10b-5 is contrary to the Supreme Court's "plain meaning" interpretation of bankruptcy statutes. This part of section 523(a)(19) will require judicial interpretation.

Neither the 1933 and 1934 Acts nor academic commentary provide a clear, black-letter definition of "manipulation." The clearest definition of manipulation is a trade made with "bad" intent. Presumably, "bad" intent is at a slightly lower level than fraudulent intent. There are two alternative formulations suggested. The first is that manipulation means "concealment intended to induce people to trade a security or force its price to an artificial level." The second definition is "deliberate interference with the free play of supply and demand in the security markets." Applying the meaning of "manipulation" from securities law, a debtor manipulates a security if he "intended to raise the price of the stock to, or maintain the price of the stock at an artificial level...." This bodes well for stockholders looking to recover debts from personally liable corporate executives. Subject to further judicial interpretation of the terms "deceit" and "manipulation" found in section 523(a)(19), these losses might be nondischargeable in individual bankruptcies.

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128 See Warner, supra note 122, at 44 (stating that use of the terms "deceit" and "manipulation" require judicial interpretation).
129 See David J. Ross, Should the Law Prohibit "Manipulation" in Financial Markets?, 105 HARV. L. REV. 503, 506 (1991) ("[N]o satisfactory definition of ['manipulation'] exists. Indeed, neither the Securities Exchange Act nor the Commodity Exchange Act attempts to define the term, even though both have the prevention of manipulation as a primary goal. Academic commentary in this area also has been unhelpful.").
130 See id. at 510 (providing three conditions to "bad" intent on the part of a trade: (1) the trading is intended to move prices in a certain direction; (2) the trader has no belief that the prices would move in this direction but for the trade; and (3) the resulting profit comes solely from the trader's ability to move prices and not from his possession of valuable information").
131 Id. at 507 (quoting Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 STAN. L. REV. 385, 393 (1990)).
132 Id. (quoting TWENTIETH CENTURY FUND, INC., STOCK MARKET CONTROL 107 (Alfred L. Berheim et al., eds., 1934)).
133 United States v. Russo, 74 F.3d 1383, 1394 (2d Cir. 1996).
C. Abrogation of the Exception to Section 523(a)(2)(A) for Statements Regarding an Insider's Financial Condition Involving Securities

An exception to Subsection (A), oral false financial statements, is for those statements regarding an insider’s financial condition. The Code provides that when a debtor is an individual, an “insider” is the “corporation of which the debtor is a director, officer, or person in control.” This exception to discharge comes up when a debtor guarantees repayment of a loan to his or her business or otherwise becomes personally liable for the business’ debts.

To illustrate, Debtor is the president and sole shareholder of Corporation. Corporation is an “insider” of Debtor. Debtor makes a false oral statement to Creditor regarding the financial condition of Corporation and personally guarantees repayment of the loans. Creditor lends Debtor money relying on the false oral statement. Although the statements inducing the debt are false, and even though false oral statements are nondischargeable under Subsection (A), the debt is dischargeable in bankruptcy as an exception to Subsection (A) for statements regarding the financial condition of an insider. Section 523(a)(19), however, scales back much of this exception by making debts incurred through violation of state or federal securities laws nondischargeable.

In re Richey serves as a concrete example of a dischargeability issue that would have come out differently if section 523(a)(19) were applied. Richey, the debtor and sole shareholder of a trucking company, induced Harper to purchase shares of the company by claiming that there would be a high rate of return on his money. Harper purchased 1600 shares of common stock of the trucking company. Richey did not provide any

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135 Id. § 101(31)(A)(iv). Caution to those unfamiliar with bankruptcy law: this definition of “insider” is counterintuitive and difficult to digest.
138 See id. § 523(a)(2)(A).
141 Richey, 103 B.R. at 25.
142 Id. at 27. Richey claimed that the stock was a “good investment” and that Harper could hope to double his money. Id.
143 Id. at 28.
written financial statements to Harper before the stock was purchased.\textsuperscript{144} Richey declared bankruptcy and the court held that his debt to Harper was dischargeable because Richey’s statement was “respecting . . . an insider’s financial condition.”\textsuperscript{145} The court held that Richey may have violated Connecticut state securities laws,\textsuperscript{146} but “a violation of a state statute does not impute \textit{ipso facto} the necessary elements of a nondischargeability offense. . . .”\textsuperscript{147} After section 523(a)(19), however, a violation of Connecticut state securities laws would “impute \textit{ipso facto}” the elements of a nondischargeable debt,\textsuperscript{148} and Richey’s debt would not be dischargeable in bankruptcy.

CONCLUSION

In enacting section 523(a)(19), Congress was particularly concerned with the executives of large publicly-held corporations discharging their securities law debts in bankruptcy through “loopholes.”\textsuperscript{149} However, the Author questions the precision with which section 523(a)(19) addresses these concerns.

First, Senator Leahy claimed there were “loopholes” for debt from securities laws violations under the pre-Sarbanes-Oxley version of the Bankruptcy Code.\textsuperscript{150} Presumably, this means that such debts were not per se nondischargeable. Before section 523(a)(19), creditors with judgments of securities laws violations had to fit their claims under one of the exceptions to discharge, such as fraudulent oral or written statements,\textsuperscript{151}

\begin{itemize}
\item \textsuperscript{144} Id. at 27-28.
\item \textsuperscript{145} Id. at 29.
\item \textsuperscript{146} Id. at 30 (holding that Richey “may have” violated CONN. GEN. STAT. § 36-472 (West 1987 and Supp. 1989) (no person may sell a security by making “any untrue statement of material fact’’)).
\item \textsuperscript{147} Id. (quoting \textit{In re Allen}, 25 B.R. 566, 569-70 (Bankr. S.D. Ohio 1982)).
\item \textsuperscript{150} See S. REP. NO. 107-146, at 16.
\item \textsuperscript{151} See 11 U.S.C. § 523(a)(2).
\end{itemize}
breach of fiduciary duty,\textsuperscript{152} or intentional torts.\textsuperscript{153} Yet, in classifying every violation of securities laws as nondischargeable, Congress has subsumed much of the fine-tuning it had previously crafted with the exceptions to discharge.

Second, even though Congress was focusing on Enron when it promulgated the Sarbanes-Oxley Act, some parts of section 523(a)(19) will affect smaller issuers more than large, publicly-held issuers. For example, the rule for oral false financial statements regarding the financial condition of an insider was never available for executives of publicly held companies because, by definition, they would not be the sole shareholder. Ironically, small business owners/debtors, and not Fortune 500 executives, will feel the brunt of this particular aspect of the amendment to the Code. Perhaps Congress should have included only 1934 Act violations and not 1933 Act violations as a basis for non-dischargeability if it had wanted to focus section 523(a)(19) on large publicly-held companies.

Finally, how this amendment will affect the "fresh start" goal of bankruptcy remains to be seen. In the scale between the creditor's interests in fulfilling his claims and the debtor's interest of receiving a "fresh start," Congress may have dramatically tipped the balance in favor of creditors in enacting section 523(a)(19).

\textit{See also In re Britton, 950 F.2d 602, 604 (9th Cir. 1991)} (providing an elaborative five-part test to see if a debt is nondischargeable under 11 U.S.C. § 523(a)(2): "the creditor must show that: (1) the debtor made the representations; (2) that at the time he knew they were false; (3) that he made them with the intention and purpose of deceiving the creditor; (4) that the creditor relied on such representations; (5) that the creditor sustained the alleged loss and damage as the proximate result of the representations having been made").

\textsuperscript{152} \textit{See} 11 U.S.C. § 523(a)(4) ("(a) [T]his title does not discharge an individual debtor from any debt—(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. . . .")

\textsuperscript{153} \textit{Id.} § 523(a)(6) ("[T]his title does not discharge an individual debtor from any debt—(6) for willful or malicious injury by the debtor. . . .")