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High Court Bankruptcy Ruling Is Unintended Gift To The SEC

By **Thad Wilson, Aaron Lipson and Matt Warren**
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On Feb. 22, the U.S. Supreme Court held in Bartenwerfer v. Buckley that the fraud exception to dischargeability in Section 523(a)(2)(A) of the Bankruptcy Code applies to all debts for money obtained by fraud, regardless of the debtor's own culpability.

Thad Wilson

The undefined breadth of the court's holding, however, may have indirectly resolved another, separate circuit split in favor of the U.S. Securities and Exchange Commission and boosted the agency's authority to collect monetary judgments arising out of its enforcement actions.

Case Background

In 2005, Kate and David Bartenwerfer purchased an investment home to remodel and flip. David handled most aspects of the project — Kate did not actively participate — and in later selling the remodeled home, David concealed property defects from the buyer.

Aaron Lipson

After discovering those defects, the buyer sued, and ultimately obtained a judgment in excess of $200,000 against the Bartenwerfers jointly and severally in California state court on claims of negligence, breach of contract and nondisclosure of material facts.

Unable to pay the judgment, the Bartenwerfers each filed for relief under Chapter 7 of the Bankruptcy Code, seeking to discharge the state-court judgment.

Matt Warren

The buyer challenged the Bartenwerfers' ability to discharge the judgment under Section 523(a)(2)(A) of the Code, which precludes an individual debtor from obtaining discharge of "any debt ... for money ... to the extent obtained by ... false pretenses, a false representation, or actual fraud," according to the justices' decision.

The bankruptcy court found that Kate's liability was nondischargeable because David's fraudulent intent was imputed to her since she and David had formed a legal partnership.

The U.S. Bankruptcy Appellate Panel for the Ninth Circuit, however, determined that David's fraudulent

intent could be imputed to Kate only if she knew or should have known about David's fraud.

The U.S. Court of Appeals for the Ninth Circuit, in turn, reversed the BAP and held that culpability under Section 523(a)(2)(A) — which applies to individual debtors in Chapter 7, Chapter 11 and Chapter 13 cases — is irrelevant, and thus Kate's debt was nondischargeable without regard to her knowledge or participation.

The Supreme Court's Opinion

Resolving a circuit split on the issue, the Supreme Court, in a unanimous opinion authored by Justice Amy Coney Barrett, affirmed the Ninth Circuit's view.

The high court first looked to the statute's text, which, the justices found, Congress had written in the passive voice to focus on a fraudulently obtained debt — without regard to who committed the fraud.

The justices then noted that its plain-text interpretation is consistent with Supreme Court case law dating to the 19th century construing bankruptcy dischargeability statutes, which Congress chose not to disturb in subsequently amending those statutes.

Finally, in rejecting policy arguments for a contrary result, the court explained that Congress balanced the Bankruptcy Code's "fresh start" principles with competing interests, including Congress' determination that not all debts are dischargeable.

Notably, in a concurrence joined by Justice Ketanji Brown Jackson, Justice Sonia Sotomayor expressed the view that the court's decision extends only to frauds committed by debtors' agents and partners because Kate and David Bartenwerfer acted as partners in their house-flipping project.

That limitation, the concurrence states, is consistent with common-law fraud principles.

The court's opinion, though, as authored by Justice Barrett, does not appear to limit itself to this "agents and partners" distinction and uses simply the "money obtained by fraud" language.

Intersection of Bartenwerfer and Securities Law

Notwithstanding the concurrence's attempted limitation, the unanimous decision paints in a broad brush.

As the high court noted, "innocent people are sometimes held liable for fraud they did not personally commit, and, if they declare bankruptcy, § 523(a)(2)(A) bars discharge of that debt."

This can certainly be the case in the context of violations of securities laws.

Indeed, the court held that "§ 523(a)(2)(A) does not define the scope of one person's liability for another's fraud. That is the function of the underlying law. ... Section 523(a)(2)(A) takes the debt as it finds it."

Substituting the federal securities laws for California law will likely create new challenges for certain defendants and respondents in enforcement proceedings brought by the SEC, particularly if those

persons cannot discharge potential monetary damages in their individual Chapter 7, 11 or 13 bankruptcy cases.

For example, the SEC regularly asserts monetary claims directly against relief defendants for being unjustly enriched as a result of their unknowing receipt of the proceeds of a fraud.

While relief defendants are not themselves accused of wrongdoing, the SEC in these cases brings an action in federal district court against them to relinquish those funds when the SEC believes that they are wrongfully in possession of the proceeds. This remedy is not directly provided for under the federal securities laws, but rather is an equitable theory of recovery permitted in the courts.[1]

In the same vein, receivers are often appointed by federal courts in SEC actions alleging a fraudulent securities offering. Receivers are generally tasked by courts to assist investors that were victims of a securities fraud scheme with tracing, recovering and distributing funds.

Most commonly in the Ponzi scheme context though, receivers and trustees will consider potential clawback actions against net winners — those individual investors who may have withdrawn their Ponzi investments before the scheme collapsed and may have recouped not just their initial investment, but their paper profits as well. Those profits, however, are generally just money that was redistributed through the scheme from other victim investors.

In such cases, it is not uncommon for the receiver or trustee to pursue litigation against these net winners to put all victims on a similar footing, which often results in judgments against the net winners.

But what if a net winner has spent its profits and no longer has the means to repay any judgment?

Under the reasoning in Bartenwerfer, the net winners may not be able to discharge their net winner liability through bankruptcy, even though to date, the law in certain circuits might permit it.

For context, prior to the Sarbanes-Oxley Act, debtors who had been convicted of securities fraud or other securities violations could often discharge the debt owed to their victims. Congress then enacted Section 523(a)(19) in 2002 to close that loophole.

Similarly, relief defendants and net winners could discharge their debt prior to 2002, but Section 523(a)(19) is less clear regarding whether relief defendants and net winners can still discharge debt connected to a violation of the securities laws.

Specifically, under Section 523(a)(19), an individual debtor cannot discharge any debt that is for "the violation of any of the Federal securities laws, ... any of the State securities laws, or any regulation or order issued under such Federal or State securities laws."

The interpretation of this provision has thus resulted in a circuit split regarding whether debtors who were not personally liable for a securities law violation can still discharge their debts as a relief defendant or net winner.

With investor protection being a key part of the SEC's mission, it is reasonable to expect that the SEC would prefer to prevent net winners of a Ponzi scheme or relief defendants who had no equitable right to the proceeds of a fraud from declaring bankruptcy so that other investors who lost money still had a chance of recovery.

The Bartenwerfer holding may potentially resolve this ongoing circuit split regarding Section 523(a)(19).

The Ninth Circuit's 2011 opinion in Sherman v. SEC and the U.S. Court of Appeals for the Tenth Circuit's 2012 decision in Oklahoma Department of Securities v. Wilcox held that Section 523(a)(19) requires conduct by the debtor in violation of securities laws,[2] whereas in 2017, the U.S. Court of Appeals for the Eleventh Circuit held in In re: Lunsford that 532(a)(19) applies regardless of whether the debtor was personally liable for the violation.[3]

This issue is currently pending appeal in In re: Simons before the U.S. Court of Appeals for the Eighth Circuit as well, although the district court found that the debtor was not liable for a securities violation and therefore could discharge his debt for the same reasoning used by the Ninth and Tenth Circuits.[4]

In this context, Bartenwerfer would prevent the debtor from discharging their debt regardless of whether they had committed a federal securities law violation and, thus, may have indirectly resolved this circuit split.

Notably, however, this result may contradict Congress' intent because the Ninth and Tenth Circuits based their holdings on Congress' rejection of language in Section 532(a)(19) that excepted debts "relating to" securities violations in favor of language excepting a debt that "is for" a securities violation.[5]

Further, in going back to Justice Sotomayor's concurrence, this result may only hold true for agents and partners, which would exempt a large number of relief defendants from the scope of Section 523(a)(19) and allow them to discharge their debts.

Thus, we are left with the impression that the Supreme Court may have given a significant, albeit potentially temporary, end-around to the SEC and receivers.[6]

SOX 304 Clawback Analogies

Notwithstanding arguments that may limit the scope of Bartenwerfer, the Supreme Court's holding may go so far as to effect other types of clawbacks as well.

For example, Section 304 of the Sarbanes-Oxley Act permits the SEC to claw back bonuses or other incentive-based compensation of public company CEOs and chief financial officers when an issuer is required to make a restatement as a result of misconduct.

Section 304 clawbacks are based on the concept that if misconduct occurred at a public company that was sufficiently material to require a restatement, the CEO or CFO should repay certain compensation, even if they knew of or were involved in the misconduct.

Section 304 clawbacks are a key focus of the SEC, as was most recently seen in the SEC's adoption of Section 10D-1 of the Securities Exchange Act of 1934 on Oct. 26, which became effective on Jan. 27 and requires issuers to have a policy on the recovery of erroneously awarded incentive-based compensation received by current or former executive officers.[7]

The SEC's rulemaking thus comports with Bartenwerfer in requiring those who potentially do nothing wrong to relinquish funds connected to wrongdoing by others. In both cases, we can assess whether the

spouse or the CEO or CFO should have known that their partner or company was committing any misconduct, but at the end of the day, for purposes of discharging erroneously received payments, under Bartenwerfer neither could arguably discharge their debts.

This conclusion is supported by the language of Section 10D-1 in that the recovery of erroneously awarded compensation is limited only to impracticability exceptions based on (1) expenses paid to third parties to assist with enforcement being larger than the amount to be recovered; (2) recovery violating the home country law that existed at the time of adoption of the rule; or (3) recovery causing an otherwise tax-qualified retirement plan to fail to meet IRS requirements.

The rule therefore does not support the idea that debtors who have not been convicted of a securities violation should be allowed to have their debt discharged, and Bartenwerfer bolsters the SEC's position regarding its authority to collect compensation indirectly obtained through fraud.

In sum, while Bartenwerfer applies to bankruptcy, its holding may have reinforced what many government enforcement agencies like the SEC, with the support of the courts, believe is within their authority — the ability to collect debts connected to misconduct in order to allow victims to recover.

And when such agencies go after individuals for alleged ill-gotten gains related to securities law violations, those individuals, who may themselves be victims, may not be able to use bankruptcy to discharge any such liabilities.

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[1] See, e.g., SEC v. Egan, 856 F.Supp. 401 (N.D. Ill. 1993).

[2] See Okla. Dep't of Sec. v. Wilcox, 691 F.3d 1171 (10th Cir. 2012); Sherman v. SEC, 658 F.3d 1009 (9th Cir. 2011), abrogated on other grounds by Bullock v. BankChampaign, 569 U.S. 267 (2013).

[3] See Lunsford v. Process Techs. Servs., 848 F.3d 963 (11th Cir. 2017).

[4] In re: Simons, 2021 WL 5229540, at *9 (Bankr. D. Minn. Nov. 9, 2021).

[5] Wilcox, 691 F.3d at 1175; Sherman, 658 F.3d at 1016–17.

[6] Importantly, a judgment by the SEC against a relief defendant, or by a receiver in a clawback action against a net winner, would not seem to be a "fine, penalty, or forfeiture payable to and for the benefit of a governmental unit." As a result, the exceptions to discharge under Section 523(a)(7) would seem equally inapplicable.

[7] Sec. & Exch. Comm'n, Listing Standards for Recovery of Erroneously Awarded Compensation, File No.

S7-12-15 (Oct. 26, 2022). Notably, both Sarbanes-Oxley Act Section 304 and Exchange Act Section 10D-1 are drafted in terms of reimbursement or recovery by the "issuer," not the SEC itself. As a result, Section 523(a)(7) again seems inapplicable as the potential clawback debt will likely be owed to the issuer and not to the government.