

The Securities Claim Exemption in Bankruptcy: The Good, the Bad, and the Ugly

By Nelson S. Ebaugh

In 2002, Congress amended the Bankruptcy Code to make it much more difficult for a debtor to avoid paying a judgment arising from a securities claim. Congress did so by adding a “securities claim exemption” to the list of other debts that a debtor cannot avoid just by filing for bankruptcy protection.¹ Subsequently, in 2005, Congress amended the securities claim exemption to provide that it applied to all debts recoverable under a securities claim—even if the claim had not been reduced to a judgment prior to the date that the debtor filed for bankruptcy.²

Almost all securities litigators are aware of the securities claim exemption in bankruptcy, but most do not know which securities claims are covered by the exemption and in which bankruptcies the exemption applies. The answers to these questions may surprise you. In addition, as with any new law, the courts will have their own take on how to apply the securities claim exemption.

The Good News

Because scienter is often difficult to prove, Congress created statutory causes of action that did not require the aggrieved investor to prove scienter to recover. For instance, Section 11(a) of the Securities Act of 1933 provides investors with a strict liability claim against an issuer in the event that the registration statement contains a material misrepresentation or omission.³ Section 12(a)(2) of the Securities Act of 1933 imposes strict liability upon a person who makes a misrepresentation or omission in, or orally about, a prospectus.⁴ In addition, many states have adopted Section 410(a) of the Uniform Securities Act of 1956 in one fashion or another. Section 410(a) provides that a seller of securities is strictly liable to the investor if the seller is not registered as a broker, sells an unregistered security, or makes a misrepresentation or an omission in the sale of a security. These are powerful claims. They remove what is usually the most difficult element to prove in a common law fraud claim—scienter.

Before Congress amended the Bankruptcy Code to add the securities claim exemption, a debtor could obtain a discharge of all debts arising from these strict liability claims under the securities laws. Apparently recognizing the injustice of this, Congress added debts recoverable under these securities claims to the list of nondischargeable debts in a bankruptcy.

At least one commentator claimed that Congress did not intend to include such claims within the scope of the securities claim exemption.⁵ He argued that, in general, only debts stemming from culpable conduct could be nondischargeable.⁶ At least one court has made a note of this argument.⁷ But, the court did not agree with or reject the argument because the case did not hinge on the construction of the securities claim exemption.⁸ Since then, courts have routinely found strict liability claims under the securities laws to be nondischargeable under the securities laws.⁹ As a consequence, it is safe to say that strict liability claims under the securities laws are nondischargeable under the securities claim exemption.

By adopting the securities claim exemption, Congress also insured that all securities fraud claims—those that require proof of scienter—would also be nondischargeable. For years, debts resulting from a debtor’s actual fraud have been exempt from discharge.¹⁰ Consequently, before the adoption of the securities claim exemption, a debt arising under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder was nondischargeable in certain instances.¹¹ But, if investors intended to prove their Rule 10b-5 claim by employing the fraud-on-the-market theory, courts had held that this constituted inadequate proof of reliance to qualify for the fraud exemption to discharge. The securities claim exemption solved this problem.¹² The securities claim exemption preserves all debts incurred under a Rule 10b-5 claim, even if the investors employ the fraud-on-the-market theory in lieu of actual reliance.

Because there is some overlap between the securities claim exemption and the fraud exemption, if an investor pursuing a Rule 10b-5 claim can prove actual reliance, he may be able to assert that his claim is nondischargeable under both the securities claim exemption and the fraud exemption. But even when these two exemptions overlap, it may still be better to seek a finding of nondischargeability under the securities claim exemption.

To preserve his rights under the fraud exemption, ordinarily an investor must file an adversary proceeding asserting his entitlement to the fraud exemption within 60 days after the debtor files for bankruptcy protection.¹³ If an investor fails to file an adversary proceeding within this period, he may forever waive his right to obtain an

order of nondischargeability on his Rule 10b-5 claim. In fact, in some federal circuits, the investor waives this right even if the court is negligent in failing to give the required notice of the deadline.¹⁴ Fortunately, however, the same deadline does not apply to the securities claim exemption.¹⁵ In fact, under the securities claim exemption, there is no deadline for an investor to obtain a determination on whether the debt due under a Rule 10b-5 claim is dischargeable.¹⁶ The investor could even wait until after the bankruptcy proceeding has been closed before obtaining a determination under the securities claim exemption.

Finally, a discussion about the securities claim exemption would be incomplete without mentioning its counterpart, the “Enron rule.” In Texas, a debtor filing for bankruptcy may elect to exempt his property under state or federal law. If a debtor elects to exempt his property under Texas law, he obtains an unlimited homestead exemption. For obvious reasons, most, if not all, of the Enron executives that filed for bankruptcy protection elected to exempt their property under Texas law. By doing so, their multimillion dollar mansions were placed out of the reach of aggrieved investors.

Due to public outrage, Congress amended the Bankruptcy Code in 2005 to place a limit on the amount of the homestead exemption available under state law.¹⁷ If a debtor owes a debt arising from “any violation of the Federal securities laws . . . any State securities laws, or any regulation or order issued under Federal securities laws or State securities laws” and elects to exempt his property under state law, the homestead exemption is capped at \$125,000.¹⁸ The amount of this cap periodically increases.¹⁹ At the moment, the cap is \$136,875. Because it curbs conduct typified by Enron executives, commentators dubbed this homestead cap the “Enron rule.”²⁰ Used in conjunction with the securities claim exemption, the Enron rule provides aggrieved investors with a powerful tool to recover their losses from corporate managers and stockbrokers that file for bankruptcy protection.

Despite the attributes of the securities claim exemption and the Enron rule, securities litigators must be aware of their limitations—the most significant limitation being that the securities exemption does not apply in all bankruptcies.

The Bad News

To the shock of many securities litigators, the securities claim exemption does not apply in a corporate bankruptcy.²¹ All securities claims brought by an investor are dischargeable in a corporate bankruptcy or in the bankruptcy of any business entity for that matter.

When a corporation files for bankruptcy, an investor with a securities claim against the corporation generally assumes the same position as the other unsecured creditors.

The securities claim exemption only applies to individual debtors; that is, living, breathing human beings. Consequently, it has absolutely no applicability against business entities. Likewise, private plaintiffs are barred from asserting the fraud exemption to obtain a nondischargeability finding against a corporation.

Prior to 2005, all debts of a corporation owed to the government, even those fraudulently incurred, where dischargeable in a corporate bankruptcy. In 2005, Congress amended the Bankruptcy Code to provide that the government could use the fraud exemption against a corporation to find a debt owed to the government nondischargeable.²² Consequently, the SEC can now enforce a Rule 10b-5 claim against a bankrupt corporation through the fraud exemption.²³ Private plaintiffs, however, do not have an equivalent right against a bankrupt corporation.

There is more bad news. The securities claim exemption does not always apply against individual debtors. If a person files for bankruptcy protection under Chapter 13 of the Bankruptcy Code, the securities claim exemption ordinarily does not apply.²⁴ In a Chapter 13 bankruptcy, the debtor is required to make payments to his creditors over a period of three to five years. If the Chapter 13 debtor fails to make all of these payments, only then would the securities claim exemption apply.²⁵

Because the securities claim exemption is ordinarily inapplicable in Chapter 13 bankruptcies, the securities claim exemption is typically useful only against corporate managers or securities brokers that file for bankruptcy under Chapter 7 or Chapter 11. There may be a way for some investors, however, to make an end run around the inapplicability of the securities claim exemption in Chapter 13 cases. As mentioned above, an alternative objection to the discharge of some debts due to securities fraud can be made under the fraud exemption to discharge.

Until 2005, debts arising from fraud were automatically discharged in a Chapter 13 bankruptcy. But in

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2005, Congress amended the Bankruptcy Code to provide that debts arising from fraud are not automatically discharged in a Chapter 13 bankruptcy.²⁶ Consequently, if an investor can prove the debtor's scienter, his securities claim may be nondischargeable under the fraud exemption.²⁷

The Surprising Development

As mentioned at the beginning of this article, Congress amended the securities claim exemption to apply to all debts recoverable under a securities claim even if the claim had not been reduced to a judgment prior to the date that the debtor filed for bankruptcy. Congress made this change because some courts had been interpreting the securities claim exemption to only apply if the investor had obtained a judgment before the bankruptcy case had been filed.²⁸

In an unusual and unexpected decision, the Bankruptcy Court for the Northern District of Georgia held that this change to the securities claim exemption also gave an investor the right to proceed with his securities claim in a nonbankruptcy forum. In *Holland v. Zimmerman*,²⁹ the aggrieved investors filed a motion to lift the automatic stay to allow them to proceed with their securities claims against

the debtor in arbitration.³⁰ After examining the securities claim exemption, particularly the phrase added to it in 2005, in conjunction with the portion of the Bankruptcy Code that provides that bankruptcy courts have exclusive jurisdiction to determine nondischargeability under some exemptions, but not the securities claims exemption, the court held that Congress intended for investors to have the "right to pursue their [securities] claims under nonbankruptcy law in other courts, notwithstanding the bankruptcy filing."³¹ This is a significant holding because it essentially allows an investor to immediately continue with the prosecution of his securities claim despite the filing of the bankruptcy.

Subsequently, the Bankruptcy Court for the Eastern District of Pennsylvania handled a case with facts similar to those in *Zimmerman*. In *In re Chan*,³² the

aggrieved investor filed a motion to lift the automatic stay.³³ The bankruptcy court, however, was not persuaded by the reasoning in the *Zimmerman* decision.³⁴ Instead, the court decided whether or not to lift the automatic stay under traditional factors. The court did, however, remark at the beginning of its decision that "I conclude that the existence of a [securities claim exemption] may be considered in the [motion to lift stay] analysis, but it is not outcome determinative."³⁵ Strangely enough, in *Chan*, the court ultimately declined to consider the securities claim exemption as a factor when deciding whether or not to lift the automatic stay.³⁶ But, it appears that the court might consider the securities claim exemption as a factor when deciding whether or not to lift the stay in other cases.

Other than the *Zimmerman* court and the *Chan* court, no other courts have weighed in on whether the securities claim exemption manifests Congress's intent that all securities claims must be litigated in a nonbankruptcy forum. It will be interesting to see how other courts approach this issue.

Conclusion

Since the securities claim exemption became effective on July 30, 2002, there have been only a handful of decisions construing the exemption. But, as demonstrated above, there have been enough cases to give litigators a better understanding of when the exemption applies and when it does not. In addition, at least a couple of cases have construed the securities claim exemption in a way that most securities litigators would not have imagined. Perhaps the *Zimmerman* and the *Chan* decisions will lead to precedent that the securities claim exemption may be considered as a factor in lifting the automatic stay. Alternatively, the *Zimmerman* case may even lead to precedent that the securities claim exemption requires bankruptcy courts to always lift the stay to allow the investor to proceed with his securities claim in a nonbankruptcy forum. ✱

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1. Section 803 of the Sarbanes-Oxley Act of 2002 (amending 11 U.S.C. § 523(a) to add 11 U.S.C. § 523(a)(19)).

2. Section 1404(a) of the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (amending 11 U.S.C. § 523(a)(19)).

3. 15 U.S.C. § 77k(a).

4. 15 U.S.C. § 77l(a)(2).

5. Keith N. Sambur, *The Sarbanes-Oxley Act's Effect on Section 523 of the Bankruptcy Code: Are All Securities Laws Debts Really Nondischargeable?*, 11 AM. BANKR. INST. L. REV. 561 (Winter 2003).

6. *Id.* at 564–66.

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7. *In re Weilein*, 319 B.R. 175, 177–78 (Bankr. N.D. Iowa 2004).
8. *Id.* at 180.
9. *Trucks v. Williams*, 370 B.R. 397, 400–02 (Bankr. M.D. Fla. 2007); *Bricker v. Martin*, 348 B.R. 28, 31 (W.D. Pa. 2006).
10. 11 U.S.C. § 523(a)(2).
11. *SEC v. Bilzerian*, 1453 F.3d 1278, 1282–83 (11th Cir. 1998); *Wilbert Life Ins. Co. v. Beckemeyer*, 222 B.R. 318, 322 (Bankr. W.D. Tenn 1998).
12. *See Sambur, supra* note 5, at 576; Lucian Murley, *Closing a Bankruptcy Loop-Hole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 KY. L. J. 317, 330–31 (2005).
13. FED. R. BANKR. P. 4007(c).
14. *In re Alton*, 837 F.2d 457, 459 (11th Cir. 1998); *Neeley v. Murchison*, 815 F.2d 345, 346–47 (5th Cir. 1987).
15. *Nibbi v. Kilroy*, 354 B.R. 476, 486 (Bankr. S.D. Tex. 2006).
16. FED. R. BANKR. P. 4007(b).
17. Section 322 of the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (amending 11 U.S.C. § 522 to add 11 U.S.C. § 522(q)).
18. 11 U.S.C. § 522(q)(1)(B).
19. 11 U.S.C. § 104(b).
20. Alan Eisler, *The BAPCA's Chilling Effect on Debtor's Counsel*, 55 AM. U. L. REV. 1333, 1343 n.63 (2006).
21. *In re WorldCom, Inc.*, 329 B.R. 10, 13 (Bankr. S.D.N.Y. 2005).
22. Section 708 of the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005.
23. 11 U.S.C. § 1141(d)(6).
24. 11 U.S.C. § 1328(a).
25. 11 U.S.C. § 1328(b).
26. Section 314(b) of the Bankruptcy Abuse Prevention & Consumer Protection Act of 2005 (amending 11 U.S.C. 1328(a)).
27. 11 U.S.C. § 1328(a)(2).
28. *Prime Equity Fund, L.P. v. Lichtman*, 388 B.R. 396, 408 n. 22 (Bankr. M.D. Fla. 2008); *Nibbi v. Kilroy*, 354 B.R. 476, 495 (Bankr. S.D. Tex. 2006).
29. *Holland v. Zimmerman*, 341 B.R. 77, 80 (Bankr. N.D. Ga. 2006).
30. *Id.* at 78.
31. *Id.* at 80.
32. *In re Chan*, 355 B.R. 494 (Bankr. E.D. Pa. 2006).
33. *Id.* at 496.
34. *Id.* at 503–05.
35. *Id.* at 496.
36. *Id.* at 505.