It Isn't What It Used To Be, But the SEC Still Protects Shareholder Interests

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For cases administered under the Bankruptcy Act ("Act"), the United States Securities and Exchange Commission ("SEC") often had important responsibilities to assist and advise the bankruptcy courts relating to the reorganization of companies. For example, if the indebtedness of a chapter X debtor were $3 million or more, the Act required a proposed plan of reorganization to be submitted to the SEC for its review. Further, a court could not approve a plan of reorganization until the SEC had an opportunity to file a report expressing its opinion of the fairness and feasibility of the plan.

Although the Act was intended to assist the debtor in reaching a fast and effective reorganization, Congress observed that, for the period between 1967 and 1977, only about 20% of chapter X plans were consummated. *See* H.R. Rep. No. 95-958, statement by Senator DeConcini at S17,419 (Oct. 6, 1978). Adding to this problem was that prolonged litigation arose in some bankruptcy cases regarding whether a case should be administered under chapter XI or chapter X of the Act. *See* Aaron Levy, *The Role of the Securities and Exchange Commission and the Judicial Functions Under the Bankruptcy Reform Act of 1978*, 54 Am. Bankr. L.J. 29 (1979). In an attempt to improve the chances for successful reorganizations, the Act was completely overhauled by the Bankruptcy Reform Act of 1978 ("Reform Act") and a new system for reorganizations emerged – chapter 11.

The Reform Act and the resulting Bankruptcy Code ("Code") evidenced an intent by Congress to eliminate the litigation (which was often initiated by the SEC) at the beginning of a case relating to which chapter of reorganization was appropriate. However, the Code did much more than minimize the SEC's role relating to the appropriate chapter for the reorganization. In enacting chapter 11, Congress also chose not to include the provisions of the Act that required the mandatory submission of plans of reorganization to the SEC. Thus, based on the changes in the Reform Act, it appears Congress contemplated that the SEC should have a less prominent role in the reorganization process.

It is unclear whether Congress was aware of the full impact the Reform Act changes would have on the participation of the SEC in bankruptcy cases, but the reality has been that the SEC's participation in bankruptcy cases and role as a court advisor has been substantially diminished. The SEC still may appear on any issue in a case under chapter 11 (although it rarely does) but it cannot file an appeal.[1] Under the Code, the right of the SEC to appear in a case is not dependent on the amount of the assets or liabilities and is not limited to companies having any particular number of shareholders. With respect to the prohibition against the SEC filing an appeal, it does not preclude the SEC from joining in an appeal brought by another party.[2]

One surprising aspect of the Code is that the language of the legislative history suggests that the SEC might lack the authority to move for the appointment of a trustee or examiner because it does not have "party in interest" status.[3] Although the SEC is one of the parties that is most likely to have knowledge about a debtor's improper conduct that might support removal of current management, the SEC may have to leave it to other parties to seek the appropriate relief. In that case, it would be relegated only to raising the relevant facts after another party initiates the action.

Although the SEC's involvement in bankruptcy cases has been limited since the enactment of the Code, that has changed to some extent since the enactment of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), Publ. L. No. 107-204. One of the actions the SEC can take under Sarbanes-Oxley is to distribute penalties and disgorged funds obtained as a result of claims against a bankruptcy debtor based on a violation of securities laws.[4] Such authority allows the SEC to once again gain a significant participatory role in the chapter 11 reorganization process. The material extent to which the SEC acquires the ability to shape the distribution of assets of a debtor under Sarbanes-Oxley is demonstrated by *Official Committee of Unsecured Creditors of WorldCom, Inc. v. Securities and Exchange Commission,* 467 F.3d 73 (2nd Cir. 2006) ("*Committee v. SEC*").

At issue in *Committee v. SEC* was the propriety of the proposed distribution plan of the SEC for $750 million in civil penalties to which it was entitled as an unsecured creditor as a result of the settlement during the *WorldCom* chapter 11 case of a civil fraud action against WorldCom brought by the SEC.[5] Pursuant to 15 U.S.C. § 7246(a), the fair fund provision of Sarbanes-Oxley ("Fair Fund Provision"), the SEC proposed to distribute the settlement funds only to certain groups of interest holders of WorldCom. Specifically, the SEC's proposed plan of distribution with respect to the $750 million excluded a number of interest holders, including those who recovered thirty-six cents or more on the dollar under the chapter 11 reorganization plan.

Prior to Sarbanes-Oxley, civil penalties obtained by the SEC based on actions under the securities laws were paid to the United States Treasury and were not available for distribution by the SEC to investors who were injured by the securities fraud. The Fair Fund Provision provided the SEC with flexibility to distribute, at its discretion, civil penalties to defrauded investors. *See WorldCom,* 467 F.3d at 82; *see also* 15 U.S.C. § 7246(a).

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1 11 U.S.C. § 1109(a); See *In re Johns-Manville Corp*. 68 B.R. 155 (S.D.N.Y. 1986).

2 H.R. Rep. No. 95-595, 95th Cong. 1st Session 116 (1977).

3 124 Cong.Rec. H11,102 (Sept. 28, 1978), S17,419 (Oct. 6, 1978).

4 15 U.S.C. § 7246(a).

5 The actual settlement was for $2.25 billion in civil penalties, but because the settlement gave rise to a general unsecured claim, the anticipated distribution from the WorldCom estate was expected to be approximately $750 million.

Although the Official Committee of Unsecured Creditors of WorldCom ("Committee") supported the amount of the settlement between the SEC and WorldCom of the SEC's securities law claim, the Committee (and others) objected to the SEC's distribution plan ("SEC's Plan") that was submitted to the District Court for the Southern District of New York ("District Court") for approval. The Committee objected to the SEC's Plan based on a contention that it unfairly excluded several categories of interest holders from the class of proposed distribution beneficiaries. The District Court rejected the Committee's arguments and issued a Memorandum Order Approving Distribution Plan holding that the Plan was "fair and reasonable."[6] The Committee appealed to the Second Circuit Court of Appeals raising numerous issues.[7]

The Committee argued that in approving the SEC's Plan the District Court (a) gave "inappropriate deference" to the SEC, (b) applied an incorrect standard of review with respect to the Plan and (c) approved the SEC's Plan although it proposed a distribution of assets in a manner that was contrary to the priority scheme of the Code. The Second Circuit refused to adopt any of the Committee's arguments and sustained the SEC's position that the SEC's Plan was "fair and reasonable," and that such standard was applicable for consideration of the SEC's Plan under the Fair Fund Provision even though the distribution dealt with penalties rather than just disgorgement funds. The Court also held that the District Court did not abuse its discretion in approving the SEC's Plan, and that when the SEC prepares a plan to distribute civil penalties and disgorged profits, it is acting within the scope of its expertise and, therefore, is entitled to deference with respect to the SEC's conclusions regarding a plan's distribution scheme.

Possibly the greatest significance of the opinion to bankruptcy attorneys is that the Second Circuit expressly refused to resolve what it recognized as the "tension" between (a) the SEC's Plan that selected certain types of interest holders as beneficiaries and (b) the priority scheme under the Code. The Committee contended that the SEC's Plan violated public policy because it would result in certain shareholders receiving (through the SEC's Plan) assets of WorldCom while bondholders, who had a higher distribution priority under the Code, would not receive equivalent assets. The Second Circuit concluded that there was nothing in Sarbanes-Oxley that compelled the SEC to follow the Code's priority scheme. The Court noted that the SEC's Plan provided for the distribution of assets outside of the administration of the bankruptcy case. The Second Circuit concluded that so long as the SEC's Plan was "fair and reasonable," the court could allow the SEC to prefer certain interest holders over certain creditors of the bankruptcy debtor.

The holding in *Committee v. SEC* would seem to open the door for the SEC to have a considerable impact on the distribution of estate assets in those cases in which the debtor is the subject of securities law claims brought by the SEC. Although not an issue in the WorldCom bankruptcy case because the Committee agreed with the settlement amount, the SEC appears to have significant leverage in negotiating a substantial claim for penalties. There is no predetermined formula to which the SEC

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6 *SEC v. WorldCom, Inc.*, 2004 WL 1621185 (S.D.N.Y. July 20, 2004).

7 As a preliminary matter, the Second Circuit found that the Committee had "non-party" standing to appeal because the Committee had asserted an interest that appeared to be affected by the District Court's order. *Committee v. SEC*, 467 F.3d at 79.

must adhere with respect to such penalties. The SEC's main source of constraint with respect to the amount of the penalties it seeks appears to be that the penalty should not exceed the total amount of the ill-gotten gains resulting from the securities fraud and that the size of the penalty should not be determined *primarily* on the basis of how much shareholder loss will be compensated. *See* 15 U.S.C. § 78u(d)(3)(B); *see also Securities and Exchange Commission v. WorldCom*, 273 F.Supp.2d 431, 434 (S.D.N.Y. 2003).[8] As noted by the District Court in approving the settlement, the SEC could have sought penalties that would have "killed" WorldCom and caused a liquidation but instead, in the Court's opinion, acted wisely in the formulation of the settlement amount.[9] As long as the amount of the claim settlement "fairly and reasonably reflects the realities" of the situation[10] and the SEC's Plan is "fair and reasonable,"[11] the SEC can support a claim against a bankruptcy debtor that will result in the distribution of a debtor's assets to interest holders who otherwise would not have been entitled to the estate's assets under the Code's priority scheme.

Although the Reform Act moved the SEC out of direct participation in the plan of reorganization approval process, it again becomes a significant player in the distribution of assets in those bankruptcy cases in which penalty and disgorgement claims arising from securities law violations are asserted by the SEC. The Second Circuit in *Committee v. SEC* has thoroughly analyzed the SEC's rights with respect to distributions made pursuant to the Fair Fund Provision when the SEC obtains a distribution from a bankruptcy debtor. It is clear that, at least in the Second Circuit, significant deference will be given to the distribution scheme created by the SEC. Equally clear is that the "fair and reasonable" standard established by *SEC v Wang*, 944 F.2d 80 (2d Cir. 1991) for disgorgement plans will be applied to a distribution scheme created pursuant to the Fair Fund Provision.

Subject only to the "fair and reasonable" standard, the SEC can establish a plan based on considerations that are not recognized under the Code by which it distributes to interest holders injured by the debtor assets of such debtor. The Second Circuit in *Committee v. SEC* expressly refused to "mitigate the tension" between the SEC's power to establish, in its discretion, a distribution plan for the funds it receives as an unsecured creditor and the Code's priority scheme. Thus, the SEC will once again have a significant role in reorganization cases in which it has asserted securities law violations for the recovery of penalties and disgorgement funds that can be distributed under the Fair Funds Provision of Sarbanes-Oxley.

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8 The SEC can, however, take *some* account of shareholder loss in formulating the size of the penalty. *WorldCom,* 273 F.Supp.2d at 434.

9 *WorldCom*, 273 F.Supp 2d at 433.

10 *Id.* at 436.

11 *Committee v. SEC*, 467 F.3d at 84.