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Securities Law Claims in Insolvency Proceedings

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Securities Law Claims in Insolvency Proceedings

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Acknowledgement

We are pleased to introduce the second paper under our technical papers series titled "Securities Law Claims in Insolvency Proceedings" written by one of INSOL's scholars, Professor Janis Sarra, Associate Dean, University of British Columbia Faculty of Law, Vancouver, Canada.

The paper explores the contours of the intersection between securities law and insolvency regimes at a time when a corporate entity is in financial difficulty. In particular, the paper deals with the subordination of equity claims during insolvency, special provisions for bankruptcy of securities law firms, and concluding policy options. Within this context, the paper also discusses a number of leading case law developments in jurisdictions like Australia, USA, Canada and the UK.

We would like to express our sincere thanks to Professor Sarra for writing this well researched and excellent paper that will no doubt provide interesting and useful information to all our members.

Securities Law Claims in Insolvency Proceedings

I. Introduction

Securities law and insolvency law both perform important public policy functions in modern capital markets. Securities law is aimed generally at the protection of investors and the creation of efficient capital markets. Insolvency law is aimed at providing a fair and efficient mechanism for creditors to realize on their claims and at providing a framework for the rehabilitation of a company where there is a viable going forward business plan that is acceptable to creditors. In most jurisdictions, both legal regimes are enabling, in that they generally regulate only to the extent necessary to advance public policy goals, but leave considerable room for equity investors, creditors and corporate officers to make their own business decisions about debt or equity investments in the firm. Both regulate different aspects of the provision of capital to business enterprises and their proper functioning is important to the economy.

Securities law and insolvency law regimes intersect at the point that a firm is in financial distress. Public policy in many jurisdictions has chosen to subordinate the ordinary claims of equity investors to those of creditors on the basis that equity investors have assumed the risks of the firm's financial status when they chose equity investment in return for receipt of any upside rewards in excess of the financial claims of creditors. Increasingly, however, the intersection of these regimes and the interests that they protect has created new tensions, in part because many jurisdictions have shifted from liquidation to restructuring regimes and in part because investors have been harmed by the misconduct of corporate officers to an extent and manner not historically considered part of ordinary business risk. This paper begins to explore the contours of this intersection.

There have been an increasing number of cases in which insolvencies are either precipitated by securities law claims, or the claims of securities holders arise during the course of insolvency proceedings. In large measure, these claims are a function of relatively new statutory remedies granted to securities holders in the post-*Sarbanes Oxley* era of enhanced disclosure and governance requirements and of increased enforcement by securities authorities based on fraud and other misconduct.[1] In a number of jurisdictions, investors have been granted additional rights to bring civil actions against directors and officers for alleged failure to meet statutory disclosure requirements and/or fraudulent conduct. Given the nature of securities, which can be debt or equity, or some combination, the treatment of these claims in insolvency proceedings has been somewhat uncertain, particularly when there have been complex class action suits filed prior to or concurrently with insolvency proceedings.

There have also been failures of securities firms, such as brokerage companies, and the insolvency of such firms pose their own challenges, given the myriad ways that such firms hold assets for investors. A number of jurisdictions have enacted special statutory regimes to address the insolvency of securities firms, some within existing insolvency legislation and some creating a separate, complementary, legislative scheme.

Just as healthy insolvency laws help to foster robust capital markets through certainty in credit decisions and realization, effective securities legislation is a key to enhancing global capital markets by fostering fair and efficient capital raising processes and confidence in the market through the protection of investors. Yet the regimes may be in conflict in certain circumstances. For example, litigation alleging securities law violations can be complex, time-consuming and expensive for a debtor company, and can create a risk to timely realization of creditors' claims at the point of firm financial distress. For jurisdictions with federal legislative structures, there also may be paramountcy questions in respect of insolvency and securities laws.

At the heart of these issues is how to distribute losses during firm insolvency. The tension between securities law and insolvency law has generated a number of questions. How does domestic law treat securities law claims in the context of restructuring or liquidation proceedings? How can one protect, if possible, the reasonable expectations of both debt and equity investors in reconciling these legal regimes? How does the insolvency of a brokerage firm create challenges for understanding the nature of the assets and what may be distributable to creditors? The paper begins to explore these questions by examining the policy choices made by several jurisdictions

[1] *Sarbanes-Oxley Act of* 2002, Pub. L. No. 107-204, 116 Stat. 745, codified in Titles 11, 15, 18, 28 and 29 U.S.C. (2002).

in terms of subordination of claims, redressing of harms through securities law remedies and the protection of equity investors when their securities firm become bankrupt.[2]

While securities law in many jurisdictions regulates debt and equity instruments together, in insolvency, debt is treated differently than equity investments, both in terms of priority of claims for payment, but also in the special treatment accorded to some forms of securities, such as eligible financial contracts.[3]

II. Subordination of Equity Claims During Insolvency

While there is broad policy agreement that equity claims arising out of ordinary business risk should be subordinated to creditors, there is a tension between remedies under securities law and insolvency law in respect of the treatment of claims for alleged misrepresentation, failure to disclose, fraud and other violations under securities law. In some jurisdictions, this tension has been resolved by clear statutory language. In other jurisdictions, the statutory language and recent judicial pronouncements have raised new policy issues in respect of trying to reconcile both the objectives and substantive provisions of the two regimes.

Most jurisdictions subordinate the ordinary claims of equity holders during insolvency. Greece, France, Germany, Brazil, Australia, the U.K. and the U.S. are just a few examples. The policy rationale is that shareholders reap the benefits of any upside value created by the wealth generating activities of a company and also take the risks associated with failure of the company. In contrast, creditors agree only to repayment of their investment with interest, and while not entitled to any profits generated, they do not assume the risk of loss of their investment in the same way, although arguably, at least for senior creditors, insolvency risk is factored into the pricing and availability of credit. Insolvency law is aimed generally at maximizing the value of the estate in order to meet creditors' claims and equity claimants generally rank behind creditors. Typically, there is express statutory language that shareholders' or members' claims to equity rank after unsecured creditors.[4] There is also statutory language or common law specifying that

[2] For purposes of this paper, "security" means any document, instrument or written or electronic record that is commonly known as a security, and includes a document, instrument or written or electronic record evidencing a share, participation right or other right or interest in property or in an enterprise, including an equity share or stock, or a mutual fund share or unit, a document, instrument or written or electronic record evidencing indebtedness, including a note, bond, debenture, mortgage, hypothec, certificate of deposit, commercial paper or mortgage-backed instrument, a document, instrument or a written or electronic record evidencing a right or interest in respect of an option, warrant or subscription, or under a commodity future, financial future, or exchange or other forward contract, or other derivative instrument, including an eligible financial contract. Adopted from section 253 of the Canadian *Bankruptcy and Insolvency Act,* R.S.C. 1985, c. B-3, as amended *(BIA).*

[3] Insolvency law treatment of securities' claims must also deal with the issue of beneficial securities holders.

[4] See for example, Germany's *Insolvenzordnung,* InsO, as amended; Thailand's *Public Companies Act,* B.E. 2535, s. 172.

shareholders are liable to pay into the insolvency estate money that they committed to subscribe for shares, which had not yet been paid at the time of the insolvency, as it increases the pool of capital available to creditors on liquidation.

The extensive amendments to securities laws in many jurisdictions over the last few decades have raised new issues, however, in respect of the subordination of shareholder claims. Many jurisdictions have adopted extensive continuous disclosure regimes for publicly traded companies, and have provided investors with access to remedies based either on a reasonable investor test or a market impact test. Although these tests vary slightly in their approach, generally, jurisdictions require a company to disclose material facts, material change or material information that might impact the value of the investment or that might influence the decisions of investors to buy, sell or hold their securities. A failure to comply with these provisions gives rise to new remedies for fraud and misrepresentation, in particular, civil remedies for a company's failure to meet statutory disclosure requirements. Given that these remedies are not the usual claims by shareholders to a residual share of the value of the assets, but rather, are claims for compensation for the injury to the value of their investments, the issue is whether they are to be subordinated in the same manner as equity claims when the company becomes insolvent.[5]

In some jurisdictions, such as the U.S., claims arising out of breach of statutory disclosure obligations are clearly subordinated to creditors under bankruptcy legislation. In other jurisdictions, such as the U.K. and Australia, the statutory language subordinating claims differs and recent judgments indicate that the courts have adopted a purposive and integrative approach in trying to reconcile the securities law and insolvency law regimes. Both of these approaches are discussed below. The public policy concern is that on the one hand, creditors are entitled to some certainty in respect of where their claims lay on the hierarchy of credit, and hence subordinating shareholders' claims creates greater certainty. On the other hand, subordinating all claims of shareholders fails to recognize that shareholders, while investing in ordinary business risk and risk of insolvency, do not assume risk of massive corporate fraud or violations of securities legislation or criminal codes. Such subordination may create inappropriate incentive effects on corporations that may utilize insolvency proceedings to bypass claims arising out of their officers' misconduct or misrepresentation, creating a lack of confidence for investors in terms of equity investments in capital markets. The incentive effects may be increased if the restructuring proceeding allows these officers to remain in control of the enterprise after equity investors' remedies are subordinated and extinguished without payment. Moreover, it treats

[5] For ease of reference, I shall refer to both insolvency and bankruptcy as insolvency, appreciating that some jurisdictions treat these as distinct phases in the debtor's financial life cycle.

shareholders' rights to statutory remedies differently in and outside of insolvency, whereas creditors do not face this differential treatment.

At first impression, the U.S. has a strict subordination regime, where shareholder claims of all types are subordinated to those of creditors. However, in the past five years the "shareholder claims last" policy has been tempered by the fair funds provisions of the *Sarbanes-Oxley Act*.[6] The result overall is that while equity claims continue to be subordinated in bankruptcy proceedings, shareholders can receive remedies for securities law harms in particular circumstances on a basis equal to unsecured creditors, as discussed below.

In the U.S., the absolute priority rule under the U.S. *Bankruptcy Code* clearly specifies that shareholder claims are subordinated until all non-shareholder claims are satisfied, a rule that is largely uncontested in respect of the ordinary business risk that shareholders assume in their investment decisions.[7] However, § 510(b) of the *Bankruptcy Code* also expressly subordinates claims arising from shareholder rights to rescission and claims for damages arising from the purchase or sale of a security. The underlying policy rationale for enacting the provision was that unsecured creditors rely generally on the equity provided by shareholder investment to assist in ensuring trade credit is repaid; shareholders invest understanding that they are undertaking a higher degree of risk and they should justifiably bear the risk of misleading or fraudulent conduct; and it is unfair to allow shareholders to make rescission claims in respect of securities fraud by the debtor such that they are competing with creditors for a limited pool of capital.[8] Shareholders enjoy the potential of substantial returns on their investment whereas creditors can realize only on the amount of their claim and the interest agreed to under the debt instrument. Hence, U.S. bankruptcy law allocates securities law risks in insolvency proceedings to the equity investors.

The U.S. courts have interpreted the statutory language broadly to subordinate the claims of shareholders to those of unsecured creditors, finding that claims that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged illegality in sale or purchase or from corporate misconduct, are to be subordinated.[9] U.S. courts have held that the provision was enacted as a risk allocation device "to prevent disappointed shareholders from recovering their investment losses by using fraud and other securities claims to bootstrap

[6] *Sarbanes-Oxley Act of 2002*, *supra*, note 1.

[7] 11 U.S.C. §741 *et seq.;* §§ 501-511.

[8] John J. Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy" (1973) 48 NYU Law Review 261-300.

[9] *Re Telegroup Inc.* 281 F 3d 133 (3rd Cir. US Court of Appeals 2002); *Re WorldCom* 329 BR 10 (Bankr. S.D.N.Y. 2005); *Re Granite Partners LP,* 208 BR 332 (Bankr. S.D.N.Y. 1997); *Allen v. Geneva Steel Co.* 281 F 3d 1173 (10th Cir. US Court of Appeals 2002); *Re Pre-Press Graphics Inc.* 307 BR 65 (N.D. Ill. 2004).

their way to parity with general unsecured creditors in a bankruptcy proceeding".[10] The rationale for the subordination of shareholder claims are the dissimilar risk and return expectations of shareholders and creditors, and the reliance of creditors on the equity cushion provided by shareholder investment.[11] The Court in *WorldCom* held that the statute does not distinguish between massive frauds and petty swindles, rather, it applies even-handedly to both; and the degree of risk accepted by investors is irrelevant because when investors purchase stock, they agree to accept a total loss, even if they do not consciously expect it, and hence equity claims are subordinated.[12]

However, the U.S. courts are not entirely settled on the scope of § 510(b). For example, one U.S. court found that a shareholding stake arising from a sale contract did not include conditions consistent with the purchase of equity and the transaction was structured so that the shareholder would not bear the risk of illiquidity or insolvency; hence while there was equity in name, it possessed few characteristics associated with that status and the purpose of § 510(b) was not served by imposing the risk of business failure on a party that unequivocally did not contract for it.[13]

U.S. scholars have been critical of the public policy reasons underlying mandatory subordination, distinguishing between risk assumed by investors for business investment and the non-assumption of risk in respect of fraudulent conduct on the part of the debtor corporation.[14] Davis observes that in bankruptcy, the equity cushion previously relied on by creditors is already depleted, and that mandatory subordination leads to inconsistencies as a corporation's creditor asserting securities law claims is required to recover the full amount of its fraud claim before shareholders can access the corporate asset pool, whereas outside of bankruptcy, shareholders who discover securities fraud and receive a judgment in respect of their claims are entitled to full payment from the assets of the company, including the equity cushion.[15]

[10] *Re Telegroup Inc.* 281 F 3d 133 (3rd Cir. US Court of Appeals 2002) at 142.

[11] *American Broadcasting Systems Inc. v. Nugent,* U.S. Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) at 1097; *Re PT-1 Communications, Inc.,* 304 BR 601 (Bankr. E.D.N.Y. 2004); *In re Enron Corp. et al v. International Finance Corp,* interlocutory judgment by Judge Gonzalez, Case No. 01B16034 (Bankr. S.D.N.Y., 2005) at 9; *Allen v. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. US Court of Appeals) at 1180.

[12] *In re WorldCom, Inc.,* 329 B.R. 10 (Bankr. S.D.N.Y. 2005) at 13-14.

[13] *Raven Media Investments LLC. v. DirecTV Latin America, LLC.* (2004) No. Civ. 03-981-SLR, 2004 WL 302303 (D. Del.).

[14] Kevin Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy", (1983) Duke L.J. 1; Robert Stark, "Reexamining the Subordination of Investor fraud Claims in Bankruptcy: A Critical Study of *In re Granite Partners*", (1998) 72 Am. Bankr. L.J. 497; David Henry, "Subordinating Subordination: WorldCom and the Effect of *Sarbanes-Oxley's* Fair Funds Provision on Distributions in Bankruptcy", (2004) 21 Emory Bankruptcy Developments Journal 259.

[15] Davis, *ibid.* at 21.

In the U.S., the subordination of equity claims has been tempered in the case of securities fraud by the ability of investors to receive compensation under powers granted to the Securities Exchange Commission (SEC) under the *Sarbanes-Oxley Act*. The SEC is given express power to distribute payments to investors as part of the "fair funds for investors" civil penalty and disgorgement powers.[16] Section 308(a) of the *Sarbanes-Oxley Act* allows civil penalties to be added to disgorgement funds for the relief of victims of securities fraud, allowing the SEC to distribute both the civil penalties and disgorgement funds from the assets of the bankruptcy estate to investors. Previously, civil penalties could only be paid to the U.S. Treasury. Hence, while a shareholder's claim is subordinated pursuant to § 510(b) of the U.S. *Bankruptcy Code*, the investor may be eligible for a distribution pursuant to the fair funds for investors provision under the *Sarbanes-Oxley Act* from the bankrupt's assets indirectly through the SEC.[17] Arguably, this eligibility creates a tension in reconciling the public policy objectives of these two statutes.

The SEC already had the ability under the U.S. *Bankruptcy Code* to enforce securities law even if the debtor was in bankruptcy proceedings, although it cannot attempt to enforce a money judgment outside of the bankruptcy proceedings and recovery of the penalty amounts may only occur through the final bankruptcy distribution.[18] This exemption from the usual stay provisions recognizes the public policy underpinning enforcement activities by the commission and other governmental authorities.

The fair funds provision allows the SEC to enhance its enforcement of securities law and to seek remedies that will serve as a deterrent to fraudulent conduct by issuing corporations. The amount of civil liability that the SEC will seek to impose depends on the egregiousness of the issuer's conduct, the degree of its scienter, whether the conduct created substantial losses or risk of losses to others, whether the conduct was of a recurring nature, and the debtor's current and anticipated financial condition.[19] While the SEC bears the burden of proving that the amount sought is appropriate, the amount of disgorgement need only be "a reasonable approximation of profits causally connected to the violation".[20]

[16] *Sarbanes-Oxley Act, supra,* note 1, s. 308. For a discussion, see Zack Christensen, "The Fair Funds for Investors Provisions of *Sarbanes-Oxley:* Is it Unfair to the Creditors of a Bankrupt Debtor?", (2005) University of Illinois L. Rev 339 at 374; Marvin Sprouse and Jackson Walker, "A Collision of Fairness: *Sarbanes-Oxley* and § 510(b) of the *Bankruptcy Code*", (2005) 24 American Bankruptcy Institute Journal 8.

[17] *S.E.C. v. Lybrand,* 281 F. Supp. 2d 726 (S.D.N.Y. 2003) at 727; *S.E.C. v. Giesecke*, Accounting and Auditing Enforcement Release No. 1636 (25 September 2002), http://www.sec.gov/litigation/litreleases/lr17745.htm .

[18] Section 362(b), *Bankruptcy Code*.

[19] *S.E.C. v. Kane*, 2003 U.S. Dist. LEXIS 5043 (S.D.N.Y. 2002) at 11; *S.E.C. v. Credit Bancorp, Ltd.,* 2002 U.S. Dist. LEXIS 20597 (S.D.N.Y. 2002) at 9; SEC, *2006 Performance and Accountability Report* http://www.sec.gov/about/secpar/secpar2006.pdf at 56.

[20] *S.E.C. v. Patel,* 61 F. 3d 137, 139 (2d Cir. 1995).

In a bankruptcy proceeding, the SEC's civil action is frequently settled and in such cases, the court must approve the settlement on the basis of whether it is fair and equitable and in the best interests of the estate, and does not fall below a range of reasonableness. Where the SEC has received a judgment for civil penalties and disgorgement, either on a settlement basis or after litigation, the amount ordered by the court is the SEC's claim against the estate of the debtor corporation and it ranks with ordinary creditors, above equity claimants. Under Chapter 11 *Bankruptcy Code* proceedings, the debtor is discharged from the SEC's monetary penalty on confirmation of a plan of reorganization; however, the debtor must pay the SEC a percentage of the penalty equal to the percentage received by unsecured creditors under the reorganization plan.

In *SEC v. WorldCom*, involving a massive accounting fraud, the Court approved a settlement in which the SEC imposed a US $2.25 billion monetary penalty, to be satisfied by a US $750 million payment from the bankruptcy estate, comprised of US $500 million cash payment and US $250 million in the reorganized company's common stock.[21] The settlement expressly provided that the settlement assets would be directed to defrauded shareholders pursuant to the fair funds for investors provision of *Sarbanes-Oxley.* In approving the settlement, Judge Rakoff observed that the SEC had authority to seek a civil penalty for the full value derived from WorldCom's fraud, an estimated US $10-17 billion and that a penalty of that magnitude would necessarily destroy the company to the detriment of some 50,000 innocent employees.[22] The Court held that compensation is a secondary goal to deterrence, but that the SEC could rationally take account of shareholder loss as a relevant factor in formulating the size of the penalty and it could distribute the settlement amount to investors.[23] In the bankruptcy proceedings of WorldCom, Judge Gonzalez approved the settlement with the SEC pursuant to Federal Rule of Bankruptcy Procedure 9019, based on the committee support for the settlement and the risk of an even greater penalty if the amount were litigated to judgment. While noting the apparent conflict between the two statutes, the Judge held that the settlement did not "fall below the lowest point in the range of reasonableness" and that the SEC had taken adequate account of the magnitude of the fraud and the need for deterrence, while fairly and reasonably reflecting the realities of a complex situation.[24]

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[21] *SEC v. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003) at 435. The settlement amount was 75 times greater than any prior penalty for accounting fraud.

[22] *Ibid.*

[23] *Ibid.*

[24] *S.E.C. v. WorldCom Inc.,* 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 435; *In re WorldCom Inc.,* Ch. 11 Case No. 02-13533, Docket # 8125 (Bankr. S.D.N.Y. Aug. 6, 2003).

S.E.C. v. WorldCom Inc., Litigation Release No. 17588 (Civil Action 02 CV 4963 (S.D.N.Y.) (June 27, 2002)), www.sec.gov/litigation/litreleases/lr17588.htm; *S.E.C. v. WorldCom Inc.,* 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 436.

In *Adelphia,* the bankruptcy court was asked to endorse a comprehensive settlement of fraud and accounting irregularities that would require Adelphia to contribute US $715 million to a restitution fund. [25] The Court held that § 510(b) did not prohibit the settlement since shareholders would not be sharing in the assets of the estate under a plan, but rather sharing in a fund created and owned by the government, and that the subordination provision does not apply to assets belonging to the government.

Scholars have observed that while the court's application of the fair funds provision may be contrary to the theory underlying the absolute priority rule and subordination of shareholder claims, it is a proper application of securities law and treatment of funds arising from securities law fraud claims.[26] While shareholders may agree to ordinary risk of business loss from their investment, they are not agreeing to assume the extraordinary risk of business fraud loss.[27]

In sum, subordination of shareholder claims under the U.S. *Bankruptcy Code* has been tempered by the *Sarbanes-Oxley* fair funds provision. While shareholders continue to have their claims subordinated under ordinary business risk principles, the fair funds process creates a public policy mechanism aimed at deterring corporate misconduct and at allocating proceeds recovered from such harms to those harmed through distribution of disgorgement and civil penalties funds. This mechanism of indirect redress for harms is distinguishable from granting shareholders direct remedies for harms arising out of statutory violations during insolvency proceedings, which is not a public policy choice that the U.S. has made. The fact that investors realize only through the enforcement activities of the SEC means that the SEC acts in a gatekeeping role in respect of these claims, addressing the argument that shareholders would somehow use securities claims to bootstrap their position on liquidation. The SEC's primary function in seeking disgorgement and civil penalties is the deterrence objective. While secondary, compensation to investors does appear to have assisted in meeting the public policy goals of securities laws, while continuing to observe the public policy goals of insolvency law.

In Canada, there is not yet express statutory language regarding shareholder claims; and equity claims have been subordinated to creditor claims under corporate law and common law principles.[28] The courts will consider the true nature of a transaction and the surrounding circumstances to determine whether a claim is a claim provable in bankruptcy or restructuring

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[25] *In re Adelphia Communications Corp.,* 327 B.R. 143, 149 (Bankr. S.D.N.Y. 2005).

[26] Henry, *supra*, note 14 at 297; see also Christensen, *supra*, note 16 at 374.

[27] Henry, *ibid.* at 299.

[28] *Re Central Capital Corporation* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at 245; *Canada Deposit Insurance Corp.* v. *Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402-408.

proceedings, specifically, whether the true nature of the relationship is that of an equity investor or a creditor owed a debt.[29] In the context of restructuring proceedings, Canadian courts have held that where there is no equity value left in the debtor corporation, shareholders will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding.[30] The underlying policy rationale is that shareholders are at the bottom of the hierarchy of claims during an insolvency or bankruptcy proceeding and where there is not sufficient value to meet the claims of unsecured creditors, there is clearly no residual value for equity claims and hence they should not be given a vote in the proceedings. While courts will consider the interests of shareholders along with other stakeholders such as employees, trade suppliers and local communities, this is a public interest consideration as opposed to recognizing equity claims as having a determinative status.[31]

Re Blue Range Resource Corp. was the first Canadian case that dealt directly with the issue of whether an equity investor in a takeover bid, allegedly induced by fraud to purchase shares of a debtor corporation, was able to assert its claim in such a way as to achieve parity with other unsecured creditors in a *Companies' Creditors Arrangement Act (CCAA)* proceeding.[32] The Court held that the claim for misrepresentation was hybrid in nature, combining elements of both a claim in tort and a claim as shareholder, but that the nature of the claim was in substance a claim by a shareholder for a return of what it invested as shareholder and that fairness dictated that its claims should be subordinated. The Court held under corporate law and common law principles that shareholders are not entitled to share in the assets of the debtor corporation until ordinary creditors have been paid in full, as creditors assess risk and price their loans on the basis of that priority and shareholders invest with the knowledge that they are taking the risk of business failure.[33]

The Canadian judgments have used equitable principles and corporate law principles to subordinate shareholder claims in insolvency proceedings without detailed consideration of the impact or intersection of securities laws and insolvency law and their respective public policy goals. It is not evident on the face of the first judgments regarding subordination of claims arising from the alleged misconduct of the debtor or its officers that the courts were provided with

[29] See also *National Bank of Canada* v. *Merit Energy Ltd.,* 2001 CarswellAlta 913 (Alta. Q.B.).

[30] *Re Canadian Airlines Inc.* (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

[31] See Janis Sarra, *Creditor Rights and the Public Interest* (Toronto: University of Toronto, 2002).

[32] *Re Blue Range Resource Corp.,* 2000 CarswellAlta 12, 15 C.B.R. (4th) 169 (Alta Q.B.). *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, as amended (*CCAA*).

[33] *Re Blue Range Resource Corp., ibid.* at 17. The reasoning in *Blue Range* was subsequently endorsed in *National Bank of Canada* v. *Merit Energy Ltd.* 2001 CarswellAlta 913 (Alta. Q.B.).

fulsome argument on why treatment of claims for statutory violations may be deserving of different consideration. One Canadian judgment suggests, without deciding the issue, that claims for damages arising out of securities law violations may be creditor claims.[34] In the context of deciding whether to endorse a proposed settlement to U.S. proceedings, the Ontario Court held that while the fact that treatment of claims under U.S. bankruptcy law would be considerably less favourable than their treatment under Canadian law was not determinative, but was a factor for consideration when taken in conjunction with the loss of voting rights in the Canadian plan. The judgment indicates that the court viewed the claims for damages arising out of securities law violations as unsecured claims and it expressed concern that a proposed settlement that compromised the right of those claimants to vote on a Canadian CCAA plan, although the court did not have to make a definitive determination of the ranking of the claims.

In Canada, there is proposed statutory language that will codify subordination of equity claims, without the accompanying fair funds provision that exists in the U.S.[35] If enacted, the *BIA* will specify that a party is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied.[36] Provisions of the *BIA* that currently specify that debts not discharged in bankruptcy for public policy reasons include fraudulent misrepresentation, will now be amended to specify that "any debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim" is not discharged.[37] The policy rationale is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into investing in a business, when a firm is financially distressed, shareholders should be placed at the bottom of the priority of claims.[38]

Under the proposed Canadian statutory reform, no proposal or plan of arrangement that provides for the payment of an equity claim is to be approved by the court unless the proposal provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.

[34] Menegon v. Philip Services Corp. [1999]

[35] *An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts,* S.C. 2005, Chapter 47, Royal Assent November 25, 2005, not yet proclaimed in force as of June 15, 2007 (Chapter 47). Further amendments have been introduced under Bill C-52 *An Act to implement certain provisions of the budget tabled in Parliament on March 19, 2007*, Royal Assent June 22, 2007, Chapter 29 Statutes of Canada; and Bill C-62, *An Act to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005,* third reading June 14, 2007 and are pending before the Canadian Senate as of June 15, 2007.

[36] Bill C-62, *ibid.,* proposed s. 140.1, *BIA.*

[37] Bill C-62, *ibid.,* proposed s. 178(1)(e), *BIA.*

[38] Government Briefing Book, Chapter 47 amendments at bill clause no. 37.

This language may be to rigid in that there can be cases in which creditors decide it is helpful to place some value on the table in order to reach agreement on a restructuring plan or because there is goodwill or other reputational reasons to recongnize and value claims arising out of securities law violations. Those with equity claims are to be in the same class of creditors in relation to those claims but may not vote at any meeting, unless the court orders otherwise.[39] This authority codifies current practice where courts have allowed shareholders to vote where there is still equity remaining in the debtor corporation. The statute will define equity interest and equity claims for the first time.[40] The amendments also specify that the stay order in a restructuring proceeding will not affect the rights of a regulatory body with respect to any investigation in respect of the company or any action, suit or proceeding to be taken by it against the company, except when it is seeking to enforce any of its rights as a secured creditor or an unsecured creditor.[41] There is an exception where the court determines that a viable compromise or arrangement could not be made in respect of the company if that subsection were to apply and where it is not contrary to the public interest that the regulatory body be affected by the stay order.[42]

The proposed changes were passed by the House of Commons and sent to the Canadian Senate in June 2007 and may come into force later this year, depending upon whether or not Canada faces a federal election. During the legislative process, there was very little policy debate as to whether adopting the U.S. approach was preferable to one that has distinguished between ordinary shareholder claims and those arising out of corporate officers' violating corporate or securities statutes. In part this may be a function of the highly integrated nature of Canadian and U.S. capital markets and the pressure to align both securities and insolvency systems to a certain extent. However, there has not been public debate in respect of whether there are different policy implications given that debtors can enter Chapter 11 proceedings in the U.S. where they are not insolvent, whereas in Canada, it is a prerequisite to access to proceedings. Arguably, the lack of policy debate is also a function of there not being an active plaintiff's bar in Canada yet, given the very recent nature of civil remedies, which might have at least raised the public policy issue of whether claims arising out of egregious corporate conduct ought to be treated differently than ordinary business risk. A positive aspect of the proposed statutory language is that it focuses on the nature of the claim and not the claimant, in keeping with jurisprudential treatment of claims generally and the rationale for distinguishing equity claims from debt claims. However, Canada

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[39] Bill C-62, *supra*, note 35, proposed s. 54.1, *BIA* and s. 22.1, *CCAA*.

[40] Proposed s. 2, *BIA.*

[41] Proposed s. 11.1(1), *CCAA*.

[42] Bill C-62, *supra*, note 35, proposed s. 11.1, *CCAA* and s. 69.6, *BIA*.

does not have the mechanisms afforded to U.S. securities regulators to serve a gatekeeping function while providing remedies to harmed equity investors.

In the U.K., member (shareholder) claims are generally subordinated in insolvency proceedings, based on the same principles as articulated above.[43] Section 74(2)(f) of the U.K. *Insolvency Act 1986* specifies that a "sum due to any member of the company, in his [her] character of a member, by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself [herself] and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves". The specific language has given rise to the question of whether claims by investors arising out of misconduct by the debtor corporation or its officers should be treated differently than ordinary shareholder claims to the residual value of assets. While the caselaw was initially unsettled, the House of Lords has clarified the scope of remedies.

In *Soden v. British & Commonwealth Holdings Plc.,* in the context of a takeover, the House of Lords held that s. 74(2)(f) requires a distinction to be drawn between sums due to a member in his or her character as a member and sums due to a member otherwise than in his or her character as a member, and that sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company pursuant to provisions of the U.K. *Corporations Act*, i.e. arise out of a cause of action on the statutory contract.[44] The House of Lords held that the relevant principle is not that "members come last", but rather, that the "rights of members as members come last", i.e. rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors. The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors; however, a member having a cause of action independent of the statutory contract is claiming as a creditor and is in no worse position than any other creditor.[45] The House of Lords held that the subordination provision did not apply to a takeover bidder because it had purchased shares in the market and not directly from an offering of the debtor company, and that the misrepresentation claims of transferee shareholders should not be subordinated and should rank *pari passu* with unsecured creditors.[46]

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[43] Section 74(2)(f), U.K. *Insolvency Act 1986.*

[44] *Soden* v. *British & Commonwealth Holdings plc* [1998] AC 298 (H.L.).

[45] *Ibid.*

[46] *Ibid.*

Essentially, the U.K. court has distinguished the nature of the claim based on the statutory contract of shareholding; it is not a distinction based on fraud versus ordinary business risk associated with equity investments. However, since remedies that arise out of secondary market purchases are remedies for fraud and misrepresentation, the courts are effectively distinguishing on that basis, although only for secondary market purchasers.

In Australia, the statutory language is similar to the U.K. and while claims made in relation to subscription of shares from companies are subordinated to unsecured creditors, for shareholders with claims in the secondary market, the courts had more recently adopted a different approach, similar to the reasoning of the U.K. House of Lords in *Soden, supra*.[47] However, the most significant recent case, *Sons of Gwalia Ltd. v. Margaretic*, decided in January 2007 by the High Court of Australia, took a different analytical approach.[48]

Sons of Gwalia Ltd. v. Margaretic marks a departure from the U.K. reasoning and reflects further development of the Australian court's balancing of different public policy objectives.[49] A shareholder that purchased shares in Sons of Gwalia Ltd. in the secondary market a few days before the company became insolvent claimed damages pursuant to trade practice and securities legislation on the basis that the company had engaged in misleading and deceptive disclosure in that it failed to disclose material adverse information.[50] The High Court of Australia held that a shareholder with a claim under a statute against a company for misleading or deceptive conduct, or for failure to comply with its continuous disclosure obligations could prove in the administration or liquidation of that company in respect of the damages for which the company was liable, and that this applied whether the shareholder acquired the shares by subscription or purchase. This ability to claim applied even though the investor's loss did not crystallize before the insolvency administration. The High Court held that s. 563A of the *Corporations Act, 2001* did not operate to postpone the debts owed to shareholders with claims against a company for misleading or deceptive conduct. Shareholders with such claims were not owed debts in their capacity as members of the company; rather, they were seeking to enforce remedies to which they were entitled under various statutes providing protection to investors.

Shortly after the High Court's judgment was rendered, the Australian government ordered the Corporations and Markets Advisory Committee to study whether shareholders who acquire

[47] *Cadence Asset Management* v. *Concept Sports Ltd.* (2005) 147 FCR 434.

[48] Section 563A of the Australian *Corporations Act, 2001*. See *Houldsworth* v. *City of Glasgow Bank* (1880) 5 App Cas 317; *Re Addlestone Linoleum Co.* (1887) 37 Ch D 191; *Webb Distributors (Aust) Pty Ltd.* v. *The State of Victoria* (1993) 179 CLR 15; [1993] HCA 61.

[49] *Sons of Gwalia Ltd* v. *Margaretic* [2007] HCA 1.

[50] *Ibid.* at para. 8.

shares as a result of misleading conduct by a company prior to its insolvency should be able to participate in an insolvency proceeding as an unsecured creditor; and if so, whether there are any statutory reforms that would facilitate the efficient administration of insolvency proceedings in the presence of such claims; or if not, whether there are any reforms that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information.[51]

The recent cases in the U.K. and Australia raise some interesting issues in respect of securities claims in insolvency. First, those with claims against the debtor corporation for its misconduct are found to resemble unsecured creditors more closely than equity claimants. Arguably, the recognition of these types of claims as creditor claims by the U.K. and Australian courts is based in part on the express statutory language, and in part on the recognition by the courts that it is important to give public policy recognition to the objectives of both securities law and insolvency law in order to support fair and efficient capital markets. One issue is whether recognition of such claims will create particular incentive effects, such as creating incentives to make such claims as a means of being recognized as a creditor in the negotiations for a workout or other outcome of a firm's insolvency. Moreover, there can be considerable uncertainty in respect of the scope of continuous disclosure requirements, both in terms of content of the disclosure and in the timing of such disclosure such that ephemeral information is not unnecessarily disclosed to the market.[52] Thus, another question is just how timely a publicly traded corporation must be in disclosing its financial distress such that shareholders can decide to buy, sell or hold based on that expectation of decline, and such that their future claims rank equally with unsecured creditors.

From an administrative perspective, the ability of shareholders to assert claims under insolvency proceedings raises the question of whether there will be higher administration costs as administrators assess whether to admit shareholder claims, and in dealing with challenges to their decisions. Another issue is how insolvency professionals are going to assess the quantum of the loss and damage, particularly where there are many investors seeking a remedy for the misconduct of the debtor company. Given that these claims are contingent and that there are time pressures in insolvency proceedings, a concern is that such claims may delay or prevent a viable going forward business plan, particularly where shareholders do not see any upside in compromising their claims in order to facilitate a restructuring. This additional process may affect the timeliness of meeting creditors' claims.

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[51] Chris Pearce, MP, Parliamentary Secretary to the Treasurer, http://parlsec.treasurer.gov.au/cjp/content/pressreleases/2007/002.asp, (7 February 2007). The Committee's deliberations are continuing as this paper goes to press.

[52] For a discussion of this issue, see Janis Sarra, "Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions", in *Canada Steps Up, Final Report of the Task Force to Modernize Securities Legislation in Canada* (Toronto: IDA, 2006).

However, it merits note that the reasoning of the U.K. and Australian courts is unlikely to result in substantial losses for creditors in the amount of assets available to satisfy their claims in insolvency proceedings. Most debtor companies have not engaged in misrepresentation or fraudulent conduct, such that their insolvency will give rise to securities law claims. Even where such conduct has occurred, there are hurdles to shareholders proving that the company engaged in the prohibited conduct and that it led to his or her loss. From a public policy perspective, one of the most helpful aspects of the *Sons of Gwalia* judgment is that it has assisted in sparking a broader public policy discussion regarding subordination of claims that arise from statutory violations. Such claims are clearly distinguishable from equity claims arising in the course of firm insolvency, for which there is broad global consensus regarding their placement on the hierarchy of satisfaction of claims. Given that securities law and insolvency law regulate different aspects of the provision of capital to business, it is important that there be a balance in how their policy goals and substantive remedies are realized when the two schemes intersect.

III. Special Provisions for Bankruptcy of Securities Law Firms

Given the exponential growth in capital markets in the past fifty years and the number of companies servicing the market, it was inevitable that there would be a greater number of securities firm failures. The insolvency of securities firms has unique challenges. Such firms often actively trade in large volume, and at any given point, a securities firm holds: securities for customers in the form of securities in the name of the securities firm with the customer as beneficial owner only; securities in the customer's name but endorsed such that the securities firm can trade at its discretion or at the customer's discretion; securities in the customer's name that are segregated; and/or customers' cash arising at any given moment from the sale of securities or dividends received but not yet paid to the customer. Each of these types of holding raises issues in respect of whether they are held in trust for the specific investor.

Previously, insolvency administrators were left to try to sort out which securities properly belonged to the bankruptcy estate and which were clearly those of the securities firm's customers. At common law, there were complex constructive trust and tracing rules, which in turn often had serious consequences for the size of the pool of assets available for satisfaction of creditors' claims. Such tracing of investors' funds in the hands of the securities firm was difficult, expensive and time consuming, as often the funds were commingled or absent such that tracing ownership was futile. In jurisdictions that attempted to utilize these common law doctrines, insolvency administrators would frequently be left holding securities whose value was uncertain or highly fluctuating, preventing timely disposition of the shares in order to maximize estate value.

In Canada, the United States and other jurisdictions, special statutory regimes for administering securities firm insolvency attempt to create an expeditious and timely means of dealing with such insolvencies.[53] In Canada, Part XII of the *BIA* was enacted to simplify and streamline the administration of a bankrupt securities firm's estate.[54] Under the statutory scheme, securities registered in a customer's name are returned to the customer, and all other cash and securities held by an insolvent securities firm are placed in a general customer pool, and then subsequently distributed on a *pro rata* basis to the firm's customers. The customer pool fund is paid out before any creditors are paid out of the general fund of assets. The operation of Part XII is subject to the rights of secured creditors and the rights of a party to a contract, including an eligible financial contract with respect to termination, set-off or compensation. Where a securities firm purchases blocks of securities; is registered as the holder of the securities in its own name; and subsequently allocates the securities to its clients, such securities do not constitute "customer name securities" within the meaning of the *BIA*.[55] The trustee in bankruptcy is given broad powers in respect of the securities, other than customer name securities, to purchase, sell or transfer any security vested in the trustee, meet margin calls, distribute cash and securities to customers; or transfer securities accounts to another securities firm.[56]

The statutory provisions have streamlined and clarified how the assets of a bankrupt securities firm are to be dealt with. The first cases have been primarily disputes with respect to the composition of the customer pool, because making assets available to securities holders means they are not available to meet creditors' claims; as well as cases that clarify that Parliament's objective was to eliminate the myriad of competing trust claims and the associated legal costs and time delays.[57] However, the courts have distinguished trust claims arising out of bankruptcy legislation and true trusts under common law, the latter not subordinated to the legislative

[53] Part XII, Section 253, *BIA* (Canada).

[54] *Ashley* v. *Marlow Group Private Portfolio Management Inc.,* [2006] O.J. No. 1195 (Ont. S.C.) at para. 30.

[55] For a detailed discussion of the provisions, see J. Sarra, "From Subordination to Parity: An International Comparison of Securities Law Claims in Insolvency Proceedings", *the longer version of this paper (forthcoming, August 2007)*.

[56] Section 259, *BIA*.

[57] *Re Vantage Securities Inc.* (1998), 64 B.C.L.R. (3d) 148, 9 C.B.R. (4th) 169 (B.C. S.C. [In Chambers]); *Ashley* v. *Marlow Group Private Portfolio Management Inc.*, 2006 CarswellOnt 3449, [2006] O.J. No. 1195, 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]); *Ontario (Securities Commission)* v. *Portus Alternative Asset Management Inc.* (2006), 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]) at para. 3; *Re Marchment & Mackay Ltd.,* (2000), 16 C.B.R. (4th) 247 (Ont. S.C.J. [Commercial List]); *Re White,* 2006 WL 3004129, 2006 CarswellOnt 6424 (Ont. S.C.J.) (Registrar). For a discussion of these cases, see Sarra*, supra*, note 1.

scheme as the provisions were not intended to operate to defeat claims arising from a specific trust where those assets have been improperly commingled and can be traced.[58]

Canada also established the Canadian Investor Protection Fund (CIPF) as a mechanism to address losses to investors on insolvency of brokerage firms. Since its inception, CIPF has paid claims totalling $37 million to eligible customers of 17 insolvent member firms.[59] Funded by industry members, CIPF covers customers who have suffered or may suffer financial loss solely as a result of the insolvency of a member. The trustee is required to consult CIPF during administration of a securities firm bankruptcy, and CIPF has the right to be consulted and involved in negotiations for any settlement.[60]

In the United States, the *Securities Investor Protection Act of 1970* (*SIPA)* was enacted to protect investors against financial losses arising from the insolvency of their brokers.[61] Although the U.S. *Bankruptcy Code* provides for a stockbroker liquidation proceeding, it is more common that a failed securities firm is addressed in a *SIPA* proceeding than a *Bankruptcy Code* liquidation proceeding.[62] Both schemes allow for the return of customer name securities. The difference between liquidation under the U.S. *Bankruptcy Code* and the *SIPA* is that under the *Code*, the trustee is charged with delivering customer name securities, but then converting all other securities to cash expeditiously and making cash distributions to customers to meet their claims. In contrast, a *SIPA* trustee is to distribute securities to customers to the greatest extent practicable, and to this end, there is a statutory grant of authority to the trustee to purchase securities to satisfy customers' net equity claims to specified securities.[63] Hence, *SIPA* is aimed at placing customers in as close a position as possible that they would have been had the firm not become insolvent by seeking to preserve the investor's portfolio as it stood on the filing date.[64] Trustees appointed under the *Bankruptcy Code* do not have the resources to try to meet fully the claims, and hence their role is to protect the filing date value of the customers' securities by liquidating all non-customer name securities and distributing the cash.

The *SIPA* advances its statutory purpose by according those claimants in a *SIPA* liquidation proceeding who qualify as "customers" of the debtor company priority over the distribution of

[58] *Ontario (Securities Commission)* v. *Portus Alternative Asset Management Inc.*, *ibid.* at para. 102.

[59] Canadian Investor Protection Fund, http://www.cipf.ca/c_home.htm.

[60] Section 264, *BIA. Re Thomson Kernaghan & Co.* (2003), 50 C.B.R. (4th) 287 [Ont. S.C.J. [Commercial List]).

[61] *Securities Investor Protection Act of 1970,* 15 U.S.C. § 78 aaa *et seq. (SIPA)*; *SEC v. S.J. Salmon & Co.,* 375 F. Supp. 867, 871 (S.D.N.Y. 1974).

[62] *Bankruptcy Basics,* Administrative Office of the United States Courts Public Information Series, April 2004 at 53.

[63] *SIPA,* 15 U.S.C. §§ 78fff-2(d), *ibid.* at 55.

[64] *Bankruptcy Basics, supra*, note 62 at 55.

customer property.[65] The trustee must promptly deliver customer name securities to the debtor's customers, distribute the fund of "customer property" to customers, and pay, with money advanced by Securities Investor Protection Corporation (SIPC) fund, remaining net equity claims to the limits provided for.[66] As under the Canadian legislation, each customer shares ratably in the customer property fund of assets to the extent of the customer's net equity at the time of filing. If the fund of customer property is insufficient to make the customers whole, the fund created by the *SIPA* funds the difference up to a specified limit. The SIPC fund is capitalized by the general brokerage community.[67] The current limits of protection are set at US $500,000 claim per customer for securities, and US $100,000 per customer for cash.[68]

Where customer names securities and SIPC advances are not sufficient to satisfy the full net equity claims of customers, the customers are entitled to participate in the estate as unsecured creditors.[69] Since the *SIPA* was enacted, cash and securities distributed for customers of broker-dealers in financial difficulty have totalled US$14.1 billion, of which US$13.8 billion came from debtors' estates; and while not all proceedings were bankruptcy proceedings, all did involve firms in financial difficulty.[70]

The U.S. litigation arising out of securities' firm insolvencies has focused on whether claimants are customers within the meaning of the *SIPA*;[71] the validity of claims and the enforceability of guarantees post liquidation;[72] issues of controlling persons in connection with related companies;[73] potential liability of compliance principals;[74] potential liability of general partners in a bankruptcy;[75]

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[65] *SIPA*, 15 U.S.C. §§ 78fff-2(b) & (c)(1), 78111(4).

[66] *SIPA*, 15 U.S.C. §§ 78fff-2(a)-(c).

[67] *SIPA*, 15 U.S.C. §§ 78fff-3, 78ddd; *SEC v. Packer, Wilbur & Co.,* 498 F.2d 978, 980 (2d Cir. 1974).

[68] *SIPA,* 15 U.S.C. §§ 78fff-3. See also the Securities Investor Protection Corporation, *2005 Annual Report*, www.sipc.org.

[69] 15 U.S.C. §§ 78fff-2(c)(1).

[70] *Ibid.*

[71] *Stafford v. Giddens (In re New Times Securities Services, Inc.*), Case No. CV-05-0008 (JS) (E.D.N.Y. August 16, 2005), reversed U.S. Court of Appeals for the second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. Dec. 13 2006; *Edward G. Murphy, Inc. Profit Sharing Plan, et al* v. *Selheimer & Co. Inc. and SIPC* No. 02-6847 (E.D. Pa. Feb. 23, 2003); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003); *Arford v. Miller (In re Stratton Oakmount, Inc.)* 210 F.3d 420 (2d Cir. 2000); *In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1786 (Bankr. S.D.N.Y.); *In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1784 (Bankr. S.D.N.Y.); *Stephenson v. Deutsche Bank AG, Deutsche Bank Securities Inc., Deutsche Bank Securities Limited, Wayne Breedon et al,* Case No. CV02-4845 RHK/AJB (D. Minn.); *SIPC v. MJK Clearing Inc.,* Adv. Proc. No. 01-4257 RJK (Bankr. D. Minn. Jan. 18, 2006).

[72] *Stephenson* v. *Greenblatt et al. (In re MJK Clearing, Inc.),* 408 F.3d 512 (8th Cir. 2005).

[73] *Mishkin v. Gurian (In re Adler, Colman Clearing Corp.),* 399 F.Supp.2d 486 (S.D.N.Y. 2005).

[74] *Lutz v. Chitwood (In re Donahue Securities, Inc.*), Case No. C-1-05-010 (S. D. Ohio, Sept. 6, 2005).

[75] *SIPC v. Murphy (In re Selheimer & Co.),* 319 B.R. 395 (Bankr. E.D. Pa. 2005); *Murphy v. Selheimer (In re Selheimer & Co.) ,*319 B.R. 384 (Bankr. E.D. Pa. 2005); *SIPC v. Murphy (In re Selheimer & Co.),* Adv. Prc. No. 04-0669 (Bankr. E.D. Pa. April 12, 2005), appeal allowed, *Murphy v. SIPC*, Civ. Action No. 05-2311 (E.D. Pa. Oct. 14, 2005).

and alleged fraudulent transfers.[76] *SIPA* requires the claimant to establish customer status by requiring that a debtor's obligations to its customers be "ascertainable from the books and records of the debtor" or otherwise established to the satisfaction of the trustee.[77] The courts have generally given a narrow interpretation to the term "customer" and require evidence of a timely written complaint in respect of the securities where the claimant believes that the trades were unauthorized.[78] Where plaintiffs had decided to swap their *SIPA*-protected securities investments for non-protected loan instruments, the Court held that their only legitimate expectation must have been that they were lenders; and that while they were defrauded, *SIPA* does not protect against all cases of alleged dishonesty and fraud.[79] However, the fact that the property is missing, for unauthorized trading or otherwise, does not affect customer status.[80]

IV. Conclusion: Policy Options

At the heart of all the issues canvassed here is the allocation of risk and remedies at the point of firm insolvency. It is uncontested that in the ordinary course of business, equity claims come last in the hierarchy of claims. What is less clear is whether claims arising from the violation of public statutes designed to protect equity investors ought to be treated differently. Since these claims resemble tort more than contract, the issue is whether they are to receive the same treatment. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals.

The challenge is to advance the protection of investors as much as possible while recognizing the importance of the priority scheme of credit claims under insolvency legislation. The critical question is the nature of the claim advanced by the securities holder. Is it more properly characterized as a claim in equity arising out of ordinary business risk, or is it more akin to a claim of an unsecured creditor where the claim arises from a statutory violation under securities or corporate law? It would seem that an absolute subordination is overreach by insolvency legislation that may give rise to inappropriate incentives for corporate officers within the insolvency law regime where restructuring is an option.

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[76] *Picard v. Taylor (In re Park South Securities, LLC)*, 326 B.R. 505 (Bankr. S.D.N.Y. 2005).

[77] 15 U.S.C. § 78fff-2(b); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 22.

[78] *Ibid.*, see also *In re Adler Coleman Clearing Corp.,* 204 B.R. 111, 115 (Bankr. S.D.N.Y. 1996); *In re A.R. Baron Co., Inc.,* 226 B.R. 790, 795 (Bankr. S.D.N.Y. 1998); *In re MV Securities, Inc.* 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985); *Schultz v. Omni Mut., Inc.,* [1993] Fed. Sec. L. Rep at 98 (S.D.N.Y. 1993)

[79] *Stafford v. Giddens (In re New Times Securities Services, Inc.*), U.S. Court of Appeals for the Second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. Dec. 13 2006, at 14.

[80] *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 28; *In re Adler Coleman Clearing Corp.,* 198 B.R. 75 (Bankr. S.D.N.Y. 1996) at 75.

The U.S. has provided a limited statutory exception to complete subordination through the fair funds provision of the *Sarbanes-Oxley Act*. Courts have permitted the SEC claims for penalties and disgorgement to rank equally with unsecured creditor claims even though the funds are to be distributed to shareholders. The U.K. and now Australian schemes permit shareholders to claim directly as unsecured creditors for fraudulent acts and misrepresentation by the issuer in specified circumstances. Canada alone of the countries discussed in this paper has not come to grips with the distinction between ordinary equity claims and those based on wrongdoing. What are the options and policy grounds for adopting a particular approach?

One possibility is that only new purchasers of securities would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that existing shareholders arguably have access to information such that they can be monitoring their risk. The difficulty with this policy option is that, for the most part, today's shareholders are not insiders; they are a widely dispersed group that does not have the time, resources or capacity to monitor corporate officers. To treat them differentially where there is a violation of securities law is difficult to justify on public policy grounds, not withstanding the temptation to try to scope the availability of such remedies during insolvency. Moreover, it is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk.

Another option is to grant securities regulators enhanced powers such that disgorgement of funds and penalties paid for misconduct can be directed towards investors harmed by the misconduct of the debtor corporation or its officers, as has occurred in the U.S. While this does not allow equity investors to realize directly on their claims, it does offer some financial relief from the harms caused. In such a model, the securities regulator serves a gatekeeping function that ensures that only meritorious claims are advanced and that securities claims are not inappropriately used by shareholders to leverage their position or their voice and control rights during insolvency proceedings. The difficulty is that securities regulators may determine that the harms caused in a particular case do not merit resources being directed towards enforcement, leaving those shareholders without a remedy. Moreover, few, if any, jurisdictions have committed the resources and energy to securities enforcement as the U.S. has, and hence such an option in other jurisdictions may be less meaningful or effective.

The third option would be to treat shareholder claims arising out of securities law violations as unsecured creditor claims. It seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. While such claims may initially be contingent, they would have to be provable and quantifiable. There are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims. In some jurisdictions, for example, there is the issue of causation, which is time-consuming and expensive to determine and which would slow the resolution of securities law claims in insolvency proceedings considerably. Yet the challenges for designing a system for the expeditious determination of claims arising out of securities law violations should not be a bar to recognizing these claims, just as product liability or other tort claims are treated as unsecured claims. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

Numerous jurisdictions have not hesitated to adopt a codified response to the time and resources consumed in trying to deal with the various common law tracing claims by customers in a securities firm insolvency. Of course, an important difference is that the customers' claims originate as property claims whereas the fraud and misrepresentation claims of shareholders are not founded on property rights. However, there may be elements of such models that could be applied generally in fashioning a framework to deal with securities law claims in insolvency proceedings.

If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. In this respect, however, it is important to note that recognizing claims arising from securities law violations would not affect the realization of claims by secured creditors, who would continue to rank in priority and who generally set the thresholds for pricing of credit. Further study and public policy debate about the intersection of these important areas of law is required.