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BANKRUPTCY'S PROTECTION FOR NON-DEBTORS FROM SECURITIES FRAUD LITIGATION

John M. Wunderlich[*]

ABSTRACT

Given the recent economic climate, the judiciary faces an all too familiar challenge: navigate through the web that is bankruptcy and securities fraud. So far, bankruptcy has evolved into a tool to resolve mass tort litigation, like securities fraud. However, this Article explores bankruptcy as a tool to resolve securities litigation against non-debtors, those that never file for bankruptcy protection. The protection the Bankruptcy Code provides to non-debtors, like officers and directors, goes largely unnoticed, much to the detriment of securities fraud victims. Mindful that we now are in the midst of another financial crisis and that attention will slowly turn to the courts to pick up the pieces, this Article explores the significant protection non-debtors obtain from their debtor-company's bankruptcy filing and the adverse consequences it has for securities fraud litigants seeking recovery from these non-debtors.

I. INTRODUCTION

Bankruptcy has evolved into a tool to resolve mass tort litigation, like securities fraud. However, this Article explores bankruptcy's effect on securities litigation against non-debtors, those that never file for

[*] Staff Law Clerk for the United States Court of Appeals for the Seventh Circuit; J.D. Loyola University Chicago School of Law, 2009. Special thanks to Susan N.K. Gummow, of Butler Pappas, L.L.P.; Professor Michael J. Kaufman, Academic Dean of Loyola University Chicago School of Law; Kevin LaCroix, author of the D&O Diary, (www.dandodiary.com); and Professor Chunlin Leonhard, of Loyola University of New Orleans College of Law.

bankruptcy protection. The protection the Bankruptcy Code ("the Code") provides non-debtors, like officers and directors, goes largely unnoticed, much to the detriment of securities fraud victims. Mindful that the recent economic climate will force the judiciary to navigate the web that is bankruptcy and securities fraud,[1] this Article explores the significant protection non-debtors obtain from their debtor-company's bankruptcy filing and the adverse consequences it has for securities fraud litigants seeking recovery from these non-debtors.

This Article first discusses the general concept of investor recovery under the securities laws and the Code.[2] Next, it explores bankruptcy's implications for securities fraud suits against non-debtors.[3] The Article discusses how the automatic stay is used to protect directors and officers from securities litigation and affect a *de facto* release from liability.[4] It shows that a company's bankruptcy can impose duplicative discovery costs on plaintiff-investors and even influence the certification of a class action outside of bankruptcy against non-debtors.[5] Furthermore, the Article demonstrates that in a company's bankruptcy, the bankruptcy court can release non-debtors from liability outright.[6] It then argues that the Code's proposed remedy for investor-fraud, the bankruptcy trustee, is inadequate.[7] The trustee likely lacks standing to sue on behalf of plaintiff-investors, and may be barred from recovering applicable insurance proceeds. The Article concludes that bankruptcy's unnoticed protection for non-debtors from securities fraud impedes investor recovery for fraud.

II. THE BANKRUPTCY CODE AND THE SECURITIES LAWS

Both bankruptcy and private securities fraud class actions are collective devices that pool the congruent interests of multiple claimants

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1. Richard D. Cudahy, *What Use is the Judiciary in a Financial Crisis?* 41 LOY. U. CHI. L.J. iii, x (2010).

2. *See infra* Part II (discussing investor-recovery under the Code, private rights of action for securities fraud, and bankruptcy's protection for corporate defendants from securities litigation).

3. *See infra* Part III.A.-D.

4. *See infra* Part III.B. (showing that directors and officers often seek to extend the automatic stay under the Code with arguments resting on faulty premises).

5. *See infra* Part III.C.

6. *See infra* Part III.D.

7. *See infra* Part IV.A-B.

to a single fund.[8] Apart from this common design, bankruptcy petitions and securities fraud allegations often go hand-in-hand as economic downturn causes corporations to miss earnings expectations or default on debt, fueling both securities litigation and bankruptcy.[9] Filing rates for business bankruptcies and securities lawsuits between 2007 and 2009 evidence this correlation. Business bankruptcies increased dramatically as a result of the financial market turmoil caused by the subprime mortgage crisis in 2008 and 2009.[10] According to the Administrative Office of the United States Courts, at the end of September 2009, business bankruptcies increased by fifty-two percent from a year earlier.[11] Securities litigation likewise spiked.[12] Interestingly, many of

8. *See In re* Computer Learning Ctrs. Inc., 344 B.R. 79, 92 n.19 (Bankr. E.D. Va. 2006) (observing that the advantage of proceeding by a class action—aggregating claims and determining liability for an entire class in a single trial—can be achieved in bankruptcy as well).

9. Kevin LaCroix, *Corporate Defaults, Bankruptcies, and D&O Claims*, IV INSIGHTS, 4 (Mar. 2009), *available at* http://www.oakbridgeins.com/newsletter.htm; Cudahy, *supra* note 1, at x ("[B]ankruptcy is frequently followed by corporate fraud charges and it is an old story how this can be triggered by public indignation driven by widespread financial losses."). History bares out this correlation as well, as agitation for bankruptcy legislation arose during the depression in 1793, the financial crisis and controversy over the Bank of the United States in the 1820s, the Panic of 1837, and the Panic of 1857. DAVID A. SKEEL, JR., DEBT'S DOMINION, A HISTORY OF BANKRUPTCY LAW IN AMERICA, 25 (2001). Professor Roberta Romano similarly observes that "the Enron scandal was followed by revelations of accounting fraud and insider self-dealing at several large corporations, nearly all of which were thereafter pushed into bankruptcy: Adelphia Communications, Global Crossing, Tyco International, and WorldCom." Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L. J. 1521, 1545 (2005).

10. John Hartgen, *Total Bankruptcy Filings Up 34 Percent, Business Filings Up 61 Percent in Third Quarter*, American Bankruptcy Institute, (Dec. 15, 2008), http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=55930 (last visited on Feb. 5, 2009)

11. Press Release, Admin. Office of the Courts, *Bankruptcy Filings Up 34 Percent over Last Fiscal Year* (Nov. 25, 2009), http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsSep2009.cfm. Similarly, between 2007 and 2008, the number of bankruptcy filings increased by twenty-eight percent. Press Release, U. S. Bankr. Courts, *Bankruptcy Cases Commenced and Terminated During the Twelve Month Periods ended June 30, 2007 and 2008*, http://www.uscourts.gov/Press_Releases/2008/bankrupt_newstat_ftable_jun2008.xlswww.uscourts.gov/bnkrptcystats/bankruptcystats.htm. As of February 2009, bankruptcy filings were up thirty-seven percent from a year earlier. Bill Rochelle & Bob Willis, *U.S. Bankruptcy Filings Surged 37% in February Over Prior Year* (Mar. 19, 2009), http://www.bankruptcy-statistics.com. "All

the companies that file bankruptcy are named in securities fraud suits (seventy-seven percent of the large public companies that filed for bankruptcy between 2007 and 2008).[13] This Part explores the Code's effect on investor recovery, private rights of action for securities fraud, and how a company is protected in bankruptcy from securities litigation.

A. INVESTOR RECOVERY UNDER THE BANKRUPTCY CODE

The Code governs how persons and companies go out of business or recover from debt. The Code gives the honest, but unfortunate, debtor a "financial fresh start."[14] The bankruptcy discharge accomplishes this goal by releasing debtors from personal liability from specific debts and prohibiting creditors from taking action against the debtor to collect those debts.[15] Upon discharge, the debtor is no longer liable for any debt incurred before the bankruptcy petition.[16] The nature and scope of a debtor's discharge depends on the chapter of the Code under which the debtor files. The Code affords two types of relief: liquidation under Chapter 7 and reorganization under either Chapter 11 or 13.

1. Chapter 7 Bankruptcy Liquidation

Chapter 7 is used to liquidate the debtor's assets and distribute the property to the debtor's creditors.[17] In Chapter 7, a bankruptcy court

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but twelve states had double-digit increases in filings in February from the prior month." *Id.*

12. Cornerstone Research, *Securities Class Action Filings: 2009: A Year in Review*, at 3 (2009), *available at*, http://www.cornerstone.com/files/News/02dc60a4-d89f-4e99-82cf-cb19742db676/Presentation/NewsAttachment/364f486f-9f92-4354-8002-d2c9912cdab8/Cornerstone_Research_Filings_2009_YIR.pdf (finding 177 filings in 2007, and 223 filings in 2008); Stephanie Plancich & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2009 Year-End Update*, at 2 (2009), *available at*, http://www.nera.com/publication.asp?p_ID=4015 (finding 195 filings in 2007, and 253 in 2008).

13. LaCroix, *supra* note 9, at 3 (citing the Advisen Report analyzing securities fraud lawsuits and bankruptcies). Both the largest bankruptcies and biggest corporate scandals in the past ten years occurred simultaneously, including WorldCom, Enron, and Adelphia Communications. Bankruptcydata.com.

14. *E.g.*, Local Loan v. Hunt, 292 U.S. 234, 244 (1934).

15. *E.g.*, Cent. Virginia Cmty. Coll. v. Katz, 546 U.S. 356, 363-64 (2006).

16. 11 U.S.C. §§ 727(c)(1), 1141, 1328.

17. *E.g.*, Boston & Maine Corp. v. Mass. Bay Transp. Auth., 587 F.3d 89, 99-100

grants a discharge after the termination of the period for filing objections to the discharge by the trustee and the debtor's creditors.[18] Typically, Chapter 7 cases are "no asset" cases and are used by persons.[19] In Chapter 7, debts as a result of securities fraud, i.e., judgments or settlements, cannot be discharged.[20]

A company may also file under Chapter 7, although this is rare; when it does so, it stops all operations, liquidates any assets, and goes out of business.[21] The recovery of such a company's investors depends on the ordering system (or "rules of priority") in the Code.[22] Investors who take the least risk—by extending credit backed by collateral, such as a mortgage—are paid first.[23] Bondholders likely recover more than shareholders; bonds represent the debt of the company, and the company has agreed to pay bondholders interest and return their principal.[24] Shareholders take the greatest risk owning the company's profits and losses,[25] so they are last in line for repayment if the company fails.[26]

2. Chapter 11 and Chapter 13 Reorganization

Chapters 11 and 13 "reorganize" the debtor and provide for a payment plan for creditors. Chapter 13, the reorganization process used by persons, grants a discharge to a debtor upon the completion of the

(1st Cir. 2009); *In re* M & S Grading, Inc., 526 F.3d 363, 367 (8th Cir. 2008).

18. 11 U.S.C. § 727(c)(1); FED. R. BANKR. P. 4004.

19. Ed Flynn, et al., *Chapter 7 Asset Cases,* 21 AM. BANKR. INST. L.J. 22 (2003) ("During the year ended June 30, 2002, there were 1,026,901 chapter 7 cases closed nationwide. About 96 percent of chapter 7 cases are closed without any funds collected and distributed to creditors by the assigned trustee.").

20. 11 U.S.C. § 523(a)(19).

21. *See, e.g.,* Carpenters Health & Welfare Trust Funds for Cal. v. Roberston (*In re* Rufener Constr., Inc.), 53 F.3d 1064, 1066 (9th Cir. 1995).

22. 11 U.S.C. § 727.

23. Leonidas Ralph Mecham, Bankruptcy Basics: What Happens When Public Companies Go Bankrupt? What Every Investor Should Know 69 (2004).

24. U.S Securities and Exchange Commission, What Every Investor Should Know . . . Corporate Bankruptcy, http://www.sec.gov/investor/pubs/bankrupt.htm (last visited Oct. 3, 2009) [hereinafter *What Every Investor Should Know*].

25. "Securities are specialized contracts. Investors agree to contribute capital and bear the risk of the enterprise; in exchange they get promises of a role in running the business and a share of the returns." Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611, 614 (1985).

26. *See* 11 U.S.C. § 510(b) (subordinating investors to all other claimants).

debtor's plan of reorganization.[27] Conversely, a debtor who files under Chapter 11 receives a discharge when the plan is merely confirmed, rather than completed.[28] A corporation often uses Chapter 11 to "reorganize" its business to try to become profitable again and continue for the sake of its employees and other interested parties.[29] In a Chapter 11 bankruptcy, management continues to run the daily operations, while the bankruptcy court must approve all significant decisions.[30] The debtor files a plan of reorganization (an exclusive right for the first 120 days[31]) that provides for the discharge of nonexempt, pre-petition debt.[32] Chapter 11 reorganization departs from the traditional liquidating function of bankruptcy.[33] In general, under the plan, old shares and interests may be exchanged for new shares and interests in the reorganized company, which may be fewer in number and worth less.[34] Also under the plan, bondholders may stop receiving interest and principal payments, and shareholders may stop receiving dividends.[35] Bondholders may receive new stock in exchange for their bonds, new

27. 11 U.S.C. § 1328.

28. 11 U.S.C. § 1141.

29. *E.g.*, Boston & Maine Corp. v. Mass. Bay Transp. Auth., 587 F.3d 89, 99-100 (1st Cir. 2009); NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (*In re* Integrated Telecom Express, Inc.), 384 F.3d 108, 119 (3d Cir. 2004); Cedar Shore Resort, Inc. v. Mueller (*In re* Cedar Shore Resort, Inc.), 235 F.3d 375, 379 (8th Cir. 2000); Canadian Pac. Forest Prods., Ltd. v. J.D. Irving, Ltd. (*In re* Gibson Group, Inc.), 66 F.3d 1436, 1442 (6th Cir. 1995). This was the case with many airlines throughout the 1980s and 1990s. *See* Robert M. Hardaway, *Of Cabbages and Cabotage: The Case for Opening Up the U.S. Airline Industry to International Competition*, 34 TRANSP. L.J. 1, 25 (2007); Mark Mathiesen, Comment, *Bankruptcy of Airlines: Causes, Complaints, and Changes*, 61 J. AIR L. & COM. 1017, 1024-25 (1996).

30. 11 U.S.C. §§ 1107(a), 1108; *see also* 11 U.S.C. § 363(b)-(c).

31. *Id.* at § 1121.

32. *See id.* at § 1141(d); *see also* United States v. White, 466 F.3d 1241, 1246 (11th Cir. 2006); U.S. Commodity Futures Trading Comm'n. v. NRG Energy, Inc., 457 F.3d 776, 779-80 (8th Cir. 2006); Sequa Corp. v. Christopher (*In re* Christopher), 28 F.3d 512, 515 (5th Cir. 1994). "[E]xempt property is property that a debtor does not have to turn over to his creditors if he files for bankruptcy. Permitting a debtor a few of his things, the reasoning goes, will help him make a 'fresh start' once his debts have been discharged in bankruptcy." SKEEL, JR., *supra* note 9, at 41.

33. Richard E. Mendales, *Intensive Care for the Public Corporation: Securities Law, Corporate Governance, and the Reorganization Process*, 91 MARQ. L. REV. 979, 982 (2008).

34. *What Every Investor Should Know*, *supra* note 24.

35. *Id.*

bonds, or some combination, and shareholders may receive nothing.[36]

B. Private Rights of Action Under the Securities Laws

While the Code deals with liquidating and reorganizing a business, the securities laws deal with issuing securities when starting a company (such as initial public offerings or "IPOs") and the secondary trading of securities in the market. To ensure the integrity of the American marketplace, the securities laws afford private rights of action to victims of securities fraud.[37] The Supreme Court has repeatedly recognized the need for private enforcement as a supplement to enforcement by the Securities and Exchange Commission ("SEC") and the Department of Justice ("DOJ").[38] Several significant securities laws have shaped private securities fraud litigation.

1. The New Deal and the 1933 and 1934 Acts

As part of the "New Deal" in response to the Great Depression, President Roosevelt promulgated two statutes that changed the landscape of securities offerings and trading: the Securities Act of 1933[39] and the Securities Exchange Act of 1934.[40] The Securities Act

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36. *Id.*

37. *E.g.*, H.R. Rep. No. 105-803, at 2 (1998) (Conf. Rep.) (finding that securities regulation protects investors and promotes growth of financial markets); *see also* H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), *reprinted in* 1995 U.S.C.C.A.N. 730, 731 (stating that the purpose of securities laws is to protect investors and maintain confidence in the market so national savings and investments may grow for the benefit of all).

38. *E.g.*, Tellabs, Inc. v. Makor Issues & Rights Ltd., 551 U.S. 308, 313 (2007); Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 345 (2005); Basic Inc. v. Levinson, 485 U.S. 224, 231 (1988); Randall v. Loftsgaarden, 478 U.S. 647, 664 (1986); J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964). Indeed, "[f]ederal prosecutions for serious financial crime plummeted as the nation headed toward one of the worst economic meltdowns in U.S. history," and from 2003 to 2009, the number of federal corporate fraud cases dropped by 55%, securities fraud charges dropped 17% and bankruptcy fraud cases fell by 44%. Brad Heath, *Fraud Prosecutions Fell As Crisis Loomed*, USA Today (Dec. 16, 2009), http://www.usatoday.com/news/washington/2009-12-15-prosecute-fraud_N.htm.

39. 15 U.S.C. § 77(a) *et. seq*.

40. 15 U.S.C. § 78 *et. seq*. The Great Depression not only spurred securities reform, but Bankruptcy reform as well. The large number of corporate insolvencies created pressure to modify the reorganization process. *See* Mendales, *supra* note 33, at

of 1933 (the "1933 Act") sought to provide investors with sufficient, material information regarding securities that were offered for sale, and to prohibit deceit by the offerees.[41] The 1933 Act, which regulates the primary offering of securities, contains two anti-fraud measures enforceable by private rights of action that threaten issuers and related parties into accurate disclosure.[42]

First, Section 11 allows those that buy securities in an IPO to sue IPO "participants" who have made a material misrepresentation (either a misstatement or omission) in the stock's registration statement.[43] A "participant" includes the issuer of the securities, its officers and directors, the signers of the registration statement, underwriters, and other professionals such as accountants, engineers, appraisers, and attorneys.[44] Under Section 11, plaintiffs may establish liability by showing that the registration statement contained a material misrepresentation or omission.[45] However, defendants (except for the issuer) are protected from this draconian form of liability if they proved that they exercised due diligence in the offering.[46]

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41. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

42. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288-89 (2d Cir. 1969). A fundamental purpose of the Securities Act of 1933 "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

43. 15 U.S.C. § 77k.

44. Michael J. Kaufman, *Section 11 of Securities Act of 1933—Material Misstatement or Omission in Registration Statements, in* § 1:7 EXPERT WITNESSES: SECURITIES CASES (2010); *In re* Worlds of Wonder Sec. Litig., 35 F.3d 1407, 1421 (9th Cir. 1994) (auditor liability); Monroe v. Hughes, 31 F.3d 772, 774 (9th Cir. 1994) (accountant liability); *In re* Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424, 1458 (D. Ariz. 1992) (attorney liability).

45. *E.g., In re* Constar Int'l Inc. Sec. Litig., 585 F.3d 774, 782-83 (3d Cir. 2009); APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261, 1271 (11th Cir. 2007); *In re* Daou Sys., Inc., 411 F.3d 1006, 1027 (9th Cir. 2005). Scienter is not required for a Section 11 claim. *In re* Charles Schwab Corp. Sec. Litig., 257 F.R.D. 534, 544 (N.D. Cal. 2009).

46. *See* 15 U.S.C. § 77k(a)-(b). "Due diligence" requires the defendants to conduct a reasonable investigation which leaves them with no grounds to believe that the parts of the registration statement attributed to them contained material misstatements or omissions. 15 U.S.C. 77k(b)(3); *see also* Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 697-703 (S.D.N.Y. 1968).

Second, Section 12 allows the purchasers of securities to sue anyone who offers or sells the securities through a prospectus or oral communication that contains a material misstatement or omission.[47] A plaintiff need only prove that the offeror or seller made a material misstatement or omission.[48] The difference between Section 11 and Section 12 is that the former pertains to misrepresentations made in a registration statement, while the latter pertains to misrepresentations made in a prospectus.[49]

Also as part of the "New Deal," Congress passed the Securities Exchange Act of 1934 (the "1934 Act") to regulate the secondary trading of securities.[50] The 1934 Act sought to protect investors against the manipulation of stock prices by giving investors the right to sue for securities fraud.[51] The majority of securities fraud claims are brought under § 10(b) and SEC Rule 10b-5,[52] which allows plaintiffs to recover damages caused by an act or omission resulting in fraud or deceit in connection with the purchase or sale of any security.[53] A plaintiff must allege and prove: (1) that the defendant made a material misrepresentation or omission (materiality); (2) that the defendant acted with a wrongful state of mind (scienter); (3) that the material misrepresentation or omission was made in connection with the

47. 15 U.S.C. § 71(a)(2). A prospectus is a printed document that describes a corporation's business and is distributed to prospective buyers or investors. BLACK'S LAW DICTIONARY 1259 (8th ed. 2004).

48. An offeror or seller is someone who successfully solicits the purchase of securities motivated at least in part by a desire to serve his own financial interests or those of the securities owner. Pinter v. Dahl, 486 U.S. 622, 642-43 (1988).

49. *See, e.g.*, Miller v. Thane Int'l, Inc., 519 F.3d 879, 885 (9th Cir. 2008); Benzon v. Morgan Stanley Distrib., Inc., 420 F.3d 598, 608 (6th Cir. 2005); *In re* Adams Golf, Inc. Sec. Litig., 381 F.3d 267, 277 (3d Cir. 2004); Oxford Asset Mgmt., Ltd. v. Jaharis, 297 F.3d 1182, 1189 (11th Cir. 2002); Gasner v. Bd. of Superintendents of the County of Dinwiddie, Va., 103 F.3d 351, 356 (4th Cir. 1996).

50. 15 U.S.C. § 78(a).

51. 15 U.S.C. § 78j(b); *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); Alan R. Bromberg & Lewis D. Lowenfels, *Origin of 10b-5 and its Place Among the Fraud Provisions, in* 1 BROMBERG & LOWENFELS ON SECURITIES FRAUD § 2:11 (2d ed. 2009).

52. Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 BUS. LAW. 309, 310 (1996).

53. 17 C.F.R. § 240.10b-5. Although neither § 10(b) nor Rule 10b-5 explicitly provides for a private cause of action, the availability of a 10b-5 action is now beyond doubt because of legislative acquiescence, judicial consensus, and the test of time. *See* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983).

purchase or sale of a security (in connection with); (4) that the plaintiff relied on the material misrepresentation (reliance); (5) that the plaintiff suffered an economic loss as a result (damages); and (6) that the material misrepresentation actually caused the loss (loss causation).[54]

2. The Contract with America and the Private Securities Litigation Reform Act

After the enactment of these laws, "America's financial markets became the envy of the world" and foreign capital flowed into the United States from investors assured that American markets were not being manipulated.[55] These investors received assurance because defrauded investors could bring private actions to recover damages upon a violation of the securities laws.[56]

Yet in the 1990s, Congress perceived a threat to the stability of American financial markets from frivolous investor suits.[57] In response, Congress passed the Private Securities Litigation Reform Act of 1995 ("PSLRA") to encourage plaintiffs' lawyers to pursue only merited claims.[58] To do this, Congress imposed a heightened pleading requirement that: mandated that plaintiffs plead facts with particularity and a strong inference of scienter;[59] revised the ways lead plaintiffs and counsel were selected in securities class actions;[60] enhanced Rule 11's application in the securities context;[61] and stayed discovery pending a motion to dismiss.[62] However, the PSLRA simply shifted securities litigation to state courts.[63] Thus, in 1998, as a supplement to the PSLRA, Congress enacted the Securities Litigation Uniform Standards Act ("SLUSA") that made federal courts the exclusive venue for class

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54. Dura Pharm. Inc. v. Broudo, 544 U.S. 336, 341-42 (2005).

55. Michael J. Kaufman, *The PSLRA, Enron and Laxity*, in SECURITIES LITIGATION: DAMAGES § 4:4 (2010) (Judge Abner J. Mikva discussing the history of the securities laws).

56. S. REP. NO. 104-98, at 8 (1995) *reprinted in* 1995 U.S.C.C.A.N. 679, 687.

57. *Id*. at 4-5.

58. *Id.* at 4, 6.

59. 15 U.S.C. § 78u-4(b); Tellabs, Inc. v. Makor Issues & Rights, Ltd., 551 U.S. 308, 313 (2007).

60. 15 U.S.C. § 78u-4(a).

61. 15 U.S.C. § 78u-4(c)(1)-(2).

62. 15 U.S.C. § 78u-4(b)(3)(B) (stay of discovery provision).

63. JOHN C. COFFEE, JR., ET. AL, SECURITIES REGULATION: CASES AND MATERIALS,1047 (10th ed. 2007).

actions alleging fraud in the sale of certain securities.[64]

3. Enron and Sarbanes-Oxley

However, "[i]n 2001, a corporate scandal of unprecedented magnitude struck the American economy. It began with the collapse of Enron in late 2001. Within eight months, three other corrupt corporate giants had followed Enron into bankruptcy: Worldcom, Global Crossing, and Adelphia. Each had the same problem: fraudulent managers who had cooked the books and looted the companies."[65] In response, in 2003, Congress enacted the Sarbanes-Oxley Act ("SOX"), which had several effects on corporate governance. It required principal executive officers to certify that each annual and quarterly report filed with the SEC contained no false or misleading information and that the financial statements fairly represented the financial condition of the company.[66] SOX also provided criminal penalties if the CEO or CFO knowingly certified false information.[67] Additionally, SOX required that each annual report filed by the company discuss the internal controls established to guard against fraud and assess their effectiveness.[68]

SOX was the only legislation to recognize the link between bankruptcy and securities fraud actions. Before SOX, the bankruptcy laws permitted wrongdoers to discharge judgments or settlements for securities fraud in bankruptcy.[69] Congress sought "to help defrauded investors recoup their losses and to hold accountable those who violate securities laws"[70] by amending the Code to render nondischargeable debts arising from the violation of laws and regulations dealing with securities.[71] However, Congress has never elaborated on bankruptcy's

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64. The Securities Litigation Uniform Standards Act (SLUSA), 15 U.S.C. §§ 77z-1, 78u; *see* Cal. Pub. Emps' Ret. Sys. v. Worldcom, Inc., 368 F.3d 86, 98 (2d Cir. 2004). According to a joint House-Senate Committee Report, the decline in federal securities class action suits that occurred after the passage of PSLRA was accompanied by a nearly identical increase in state court filings. *See* H.R. REP. NO. 105-803, at 14-15 (1998) (Conf. Rep.).

65. LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 145 (2005).

66. 15 U.S.C. § 7241(a).

67. 15 U.S.C. § 1350(c).

68. 15 U.S.C. § 7262(a)-(b).

69. 15 U.S.C. § 7202.

70. 15 U.S.C. § 7202.

71. 18 U.S.C. § 1514A(b)(2).

effects on securities fraud litigation. Nor has Congress ever addressed bankruptcy's implications for securities fraud litigation actions against non-debtors.

C. BANKRUPTCY'S PROTECTION FOR THE DEBTOR-COMPANY

Apart from the practical reason securities fraud plaintiffs do not pursue insolvent companies (the company is broke), the Code also serves to deter recovery for securities fraud. Without providing an extensive overview of a securities fraud claimant's path through the debtor-company's bankruptcy, this Part highlights three key points that deter vigorous pursuit of securities fraud claims against a debtor: (1) the automatic stay; (2) the partial disapproval of the class action in bankruptcy; and (3) the absolute priority rule that subordinates shareholders' claims.

First, the automatic stay under Section 362 of the Code stops securities fraud litigation.[72] The automatic stay is a fundamental aspect of the Code because it provides the debtor a "breathing spell" from creditors and collection actions.[73] Although securities fraud plaintiffs

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72. 11 U.S.C. § 362(a)(1). *See, e.g.*, Caprin v. Simon Transp. Servs., Inc., 99 F. App'x 150, 153 n.1 (10th Cir. 2004) (non-precedential disposition)*; In re* Spring Corp. Sec. Litig., 232 F. Supp. 2d 1193, 1199-12000 (D. Kan. 2002); *In re* ComDisco Sec. Litig., 166 F. Supp. 2d 1260, 1261, n.1 (N.D. Ill. 2001); Brick v. Dominion Mortg. & Realty Trust, 442 F. Supp. 283, 309-10 (W.D.N.Y. 1977).

73. S. REP. NO. 95-989, at 52 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840. Depending on the federal circuit, actions taken in violation of the automatic stay are void or voidable. *Compare* Mann v. Chase Manhattan Mortg. Co., 316 F.3d 1, *3 (1st Cir. 2003) (stating that actions taken in violation of the stay are void) *and* E. Refractories, Co., Inc. v. Forty-Eight Insulations, Inc., 157 F.3d 169, 172 (2d Cir. 1998) (same), *and In re* Myers, 491 F.3d 120, 127 (3d Cir. 2007) (same), *and* Chao v. Hosp. Staffing Servs., Inc. 270 F.3d 374, 384 (6th Cir. 2001) (same), *and* Middle Tenn. News Co., Inc. v. Charnel of Cinn., Inc., 250 F.3d 1077, 1082 (7th Cir. 2001) (same), *and* Griffin v. Wardrobe (*In re* Wardrobe), 559 F.3d 932, 935 (9th Cir. 2009) (same), *and* Franklin Sav. Ass'n v. Office of Thrift Supervision, 31 F.3d 1020, 1022 (10th Cir. 1994) (same), *and* United States v. White, 466 F.3d 1241, 1244 (11th Cir. 2006) (same), *with* Sikes v. Global Marine, Inc., 881 F.2d 176, 178 (5th Cir. 1989) (stating that actions taken in violation of the stay are only voidable), *and* Bronson v. United States, 46 F.3d 1573, 1576-77 (Fed. Cir. 1995) (same). The automatic stay is so important, that if one violates it, the bankruptcy court may award punitive damages, including costs and attorneys fees, to the debtor. 11 U.S.C. § 362(k)(1); *see also* Kassover v. Computer Depot, Inc., 691 F. Supp. 1205, 1213-14 (D. Minn. 1987) (awarding attorneys' fees to defendants who moved to dismiss securities class action filed in violation of the

can—and often do—move to lift the automatic stay "for cause,"[74] this proves difficult. The bankruptcy courts have relied on aspects inherent in all securities litigation to justify the refusal to lift the automatic stay. For example, the bankruptcy courts refuse to lift the automatic stay because shareholders' claims are subordinated under the Code, so they will likely recover nothing.[75] Further, bankruptcy courts conclude that the extensive discovery likely to result from securities litigation will impair the debtor's fresh start, and thus refuse to lift the stay.[76]

Second, some federal circuits do not permit a proof of claim to be filed in bankruptcy on behalf of a class.[77] All creditors, including

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automatic stay).

74. 11 U.S.C. § 362(d)(1) ("On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—(1) for cause, including the lack of adequate protection of an interest in property of such party in interest . . . ."). Whether cause exists is determined case by case. *See In re* ComDisco, Inc., 271 B.R. 273, 276 (Bankr. N.D. Ill. 2002).

75. *In re* Chan, 355 B.R. 494, 498 (Bankr. E.D. Pa. 2006) (stating that if the claim is going to be discharged in a no-asset case, there is no purpose to further litigation to determine the extent and existence of liability); *In re* ComDisco, Inc., 271 B.R. at 280-81; *In re* Towner Petroleum Co., 48 B.R. 182, 184-85 (Bankr. W.D. Okla. 1985); *see also* 11 U.S.C. § 510(b) (1984) ("[A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock."); 11 U.S.C. § 1129(b).

76. *See* ProvinceTown Boston Airline, Inc. v. Miller (*In re* ProvinceTown Boston Airline, Inc.), 52 B.R. 620, 624 (Bankr. M.D. Fla. 1985).;*see also* Adelphia Commc'ns Corp. v. Rigas (*In re* Adelphia Commc'ns, Corp.), 293 B.R. 337, 357-58 (Bankr. S.D.N.Y. 2003) (extending automatic stay to preserve the "level playing field" the bankruptcy court had effected with securities fraud claimants and non-debtors); *In re* Rickel Home Ctrs. Inc., 199 B.R. 498, 501 (Bankr. D. Del. 1996) (issuing automatic stay because of discovery concerns); *In re* Circle K Corp., 121 B.R. 257, 261 (Bankr. D. Ariz. 1990) (extending automatic stay to directors and officers because of discovery concerns); Stoller v. Baldwin-United Corp., 41 B.R. 884, 890-92 (D.C. Ohio 1984) (extending the automatic stay to non-debtors because plaintiffs could benefit from bankruptcy discovery and thus, refrain from engaging in civil discovery). *But cf. In re* LJM2 Co-Inv., L.P., 327 B.R. 786, 795 (Bankr. N.D. Tex. 2005) (lifting the stay to allow for limited discovery).

77. Sheftelman v. Standard Metals Corp. (*In re* Standard Metals Corp.), 817 F.2d 625, 631-32 (10th Cir. 1987); *see also In re* W.R. Grace & Co., 316 F. App'x 134, 136 (3d Cir. 2009) (nonprecedential decision).

securities fraud plaintiffs, must file a proof of claim during the bankruptcy proceedings to preserve their claim against the debtor.[78] However, individual suits for securities fraud are often uneconomical, so the claims are aggregated in the form of a class action.[79] Although persons who have already filed a proof of claim in bankruptcy can later request the bankruptcy court to certify them as a class,[80] the courts disagree on whether a person can file a class proof of claim on behalf of others *who have yet to file* a proof of claim.[81] This disagreement stems from Bankruptcy Rule 3001, which requires that a proof of claim be executed by the "creditor or the creditor's authorized agent."[82] Courts that do not allow class proofs of claims on behalf of persons yet to file reason that lead plaintiffs are not "authorized agents" per the text and that class actions have limited utility in bankruptcy since a bankruptcy proceeding is already a collective proceeding similar to a class action.[83]

Third, the bankruptcy priority rules act as a barrier to securities fraud claims because they diminish the prospects of any significant recovery. Section 1129(b) and Section 510(b) of the Code (collectively,

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78. FED. R. BANKR. P. 3003. The bankruptcy court sets a bar date before which all creditors must file their proofs of claim. *Id.* A court may extend this time for cause or excusable neglect. *See In re* Pettibone Corp., 123 B.R. 304, 308 (Bankr. N.D. Ill. 1990).

79. *E.g.,* David S. Evans, *Class Certification, the Merits, and Expert Evidence*, 11 GEO. MASON L. REV. 1, 4–5 (2002); James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 497 (1997); Eisen v. Carlisle & Jacqueline, 417 U.S. 156, 185–86 (1974) (Douglas, J., concurring in part, dissenting in part).

80. *See, e.g., In re* Standard Metals Corp., 817 F.2d at 631-32*; In re* FirstPlus Fin., Inc., 248 B.R. 60, 69 (Bankr. N.D. Tex. 2000).

81. *Compare* Reid v. White Motor Corp., 886 F.2d 1462, 1470 (6th Cir. 1989) (permitting class proof of claim), *and In re* Charter Co., 876 F.2d 866, 873 (11th Cir. 1989) (same), *and* Birting Fisheries, Inc. v. Lane (*In re* Birting Fisheries, Inc.), 92 F.3d 939, 939-40 (9th Cir. 1990) (same), *and In re* Am. Reserve Corp., 840 F.2d 487, 493 (7th Cir. 1988) (same), *with In re Standard Metals Corp*., 817 F.2d at 632 (denying class proof of claim), *and In re* Amdura Corp., 130 B.R. 575 (Bankr. D. Colo. 1991) (same), *and In re* Texaco Inc., 81 B.R. 820 (Bankr. S.D.N.Y. 1988) (same).

82. FED. R. BANKR. P. 3001(b).

83. *In re* Computer Learning Ctrs., Inc., 344 B.R. 79, 91-93 (Bankr. E.D. Va. 2006). For a full discussion of this approach, see Luisa Kaye, Note, *The Case Against Class Proofs of Claim in Bankruptcy,* 66 N.Y.U.L. REV. 897 (1991). *But see In re Charter Co.,* 876 F.2d at 873 (arguing that although class members do not consent to original filing beforehand, it is inherent in the nature of a class action and that class filing cannot prejudice the class members in any way because class action procedures, such as notice, representatives of the named class members, and opt-out provisions, protect their interests).

the "absolute priority rule") make any victory private securities fraud plaintiffs might obtain in the bankruptcy court a hollow one by subordinating a securities fraud claim to all other claims in bankruptcy.[84] This rule of absolute priority requires that creditors take before shareholders.[85] Plans of reorganization must classify claims, with different classes receiving different orders of priority for payment, and, under the priority rules, unless creditors are paid in full (or unless each class of creditors consents otherwise) the debtor's shareholders are not entitled to recover any property through the bankruptcy process.[86] In the normal course of Chapter 11, creditors (secured and unsecured) take before the shareholders, the plaintiffs in a securities fraud suit.[87] These

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84. Gen. Holdings, LLC v. S&J Diving, Inc. (*In re* Seaquest Diving, LP), 579 F.3d 411 (5th Cir. 2009).

85. The absolute priority rule has its roots in *Northern Pacific v. Boyd,* 228 U.S. 482 (1913). At the time of *Boyd*, it was standard practice in receiverships (the predecessors to modern bankruptcy proceedings) to give old bondholders a stake in the new company and ask shareholders to contribute new cash in return for continuing their interest, but to exclude general unsecured creditors. SKEEL, JR., *supra* note 9, at 67. After Northern Pacific Railway was reorganized, one of the general unsecured creditors argued to the Supreme Court that reorganizers should not be allowed to give an ongoing interest to shareholders without giving anything to unsecured creditors. *Id.* The Supreme Court agreed and the 'absolute priority rule' was born. *Id.* Congress enacted Section 510(b) in response to a line of decisions in which some courts allowed shareholders equal priority with unsecured creditors when bringing securities fraud claims. Int'l Wireless Commc'ns, Inc. v. Int'l Wireless Commc'ns Holdings, Inc. (*In re* Int'l Wireless Commc'ns Holdings, Inc.), 68 F. App'x 275, 278 (3d Cir. 2003) (non-precedential disposition). In a seminal law review article, this approach was criticized by John J. Slain and Homer Kripke. Slain and Kripke argued that shareholders assumed two risks: (1) the risk of business insolvency from whatever cause; and (2) the risk of illegality in securities issuance. John J. Slain & Homer Kripke, *The Interface Between Securities Regulation and Bankruptcy – Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors*, 48 N.Y.U. L. REV. 261, 286 (1973). The absolute priority rule is also used to subordinate directors' and officers' claims for indemnification of costs associated with defending against securities fraud litigation. *See, e.g.*, *In re* Mid-Am. Waste Sys., Inc., 228 B.R. 816, 829 (Bankr. D. Del. 1999).

86. *See* 11 U.S.C. § 1129(b)(2)(B)(ii). The entire "plan" process may be short-circuited by the sale of the business under § 363, which often results in inadequate recovery by small creditors. Mendales, *supra* note 33, at 992.

87. Any class (including the class of unsecured creditors) may reject the plan and then the plan cannot be confirmed. 11 U.S.C. § 1129(a). But the debtor may confirm the plan by cramming it down the throat of the rejecting class under Section 1129(b) if: (1) the plan does not discriminate unfairly between the classes; and (2) it is fair and

shareholders take last, because, just as they gladly accept the upside potential increases in their shares' value, whatever the reason, they also assume the risk of decline in value for whatever the reason, including fraud.[88] If shareholders are permitted to rescind their stock purchase, the risk of securities fraud then would be impermissibly shifted to the general, unsecured creditors, who purchased no stock.[89] The absolute priority rule makes it unlikely that securities fraud plaintiffs will receive any distribution,[90] and so has the practical effect of prohibiting securities

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equitable. ELIZABETH WARREN & JAY L. WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 655-56 (5th ed. 2006). "In the bankruptcy reorganizations of large, publicly held companies, plans are rarely crammed down against resisting classes of creditors or shareholders. There is a widespread belief among practitioners that cram down is expensive and impractical." Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 141 U. PA. L. REV. 669, 682 (1993).

88. *In re* Int'l Wireless Commc'ns Holdings, Inc., 68 F. App'x at 278; *In re* Worldcom, Inc., 329 B.R. 10, 14 (Bankr. S.D.N.Y. 2005) ("Obviously, the sophisticated and intelligent persons and firms who invested in Worldcom, Enron, Global Crossing, and the whole litany of corporate fiascos of recent years never imagined that their investments would be subjected to the kinds of risks that brought these and many other companies into bankruptcy in recent years. But the plain fact is that all of these debacles happened, and when [the investors] purchased their stock, that is exactly what they 'subscribed' to, just like all the other disappointed investors in this or any other era of capitalism."); John J. Rapisardi, *Subordination of Claims Relating to Stock-Based Compensation*, 239 N.Y.L.J. 3 (May 14, 2008).

89. Melanie J. Schmid, Note, *A Congressional Montage of Two Systems of Law - Mandatory Subordination Under the Code,* 13 AM. BANKR. INST. L. REV. 361, 364 (2005). Section 510(b) subordinates all securities claims, regardless of nature, scope, or extent of risk. *E.g.,* SeaQuest Diving, LP v. S&J Diving, Inc. (*In re* SeaQuest Diving, LP), 579 F.3d 411 (5th Cir. 2009); *In re* Am. Wagering, Inc., 493 F.3d 1067, 1071 (9th Cir. 2007); *In re* Worldcom, Inc., 329 B.R. 10, 14 (Bankr. S.D.N.Y. 2005). So long as the nature of the harm complained of by a shareholder results from the purchase or sale of securities, the claim falls within Section 510(b)—even absent an allegation of fraud. Baroda Hill Invs., Ltd. v. Telegroup, Inc. (*In re* Telegroup, Inc.), 281 F.3d 133, 140-42 (3d Cir. 2002); *In re* Worldcom, Inc., 329 B.R. at 14; *see also In re* SeaQuest Diving, LP, 579 F.3d 411 (subordinating claim under 510(b) because it arose from purchase of securities and transaction was rescinded and no fraud took place); Laurence May, *Claimants Fight Subordination: The Expansion of Section 510(b) Continues,* 242 N.Y.L.J. 9 (Sept. 28, 2009) (discussing recent circuit decisions that interpret Section 510(b) broadly).

90. *In re* ComDisco, Inc., 271 B.R. 273, 278 (Bankr. N.D. Ill. 2002) ("[U]nder § 510(b) the securities fraud claims are likely to be subordinated to creditor claims, and dealt with on the same priority as the shareholder interests. . . . The effect of that subordination is not possible to predict with certainty. But one very real possibility is

fraud class actions against the debtor-company by reducing the economic incentive for litigation.[91] Even Section 523(a)(19), which specifically excepts from discharge any judgment or settlement on account of securities fraud,[92] does not ensure recovery for securities fraud victims as it applies only to Chapter 7 cases,[93] which are usually no-asset cases.[94]

III. CORPORATE BANKRUPTCY'S IMPLICATIONS FOR PRIVATE SECURITIES FRAUD SUITS AGAINST NON-DEBTORS

Corporate bankruptcy spawns securities litigation that endures for years, almost decades, after the corporation originally files for bankruptcy.[95] The extensive liability scheme under the securities laws reaches all those involved in a stock offering marred with misrepresentations[96] and those who manipulate stock prices by fraud.[97] A company's bankruptcy may, however, shield non-debtors—like the company's officers and directors, underwriters, accountants, attorneys, or stock analysts—from liability even though the securities laws would

that the plaintiff class claims will be discharged by the plan without any payment. That will happen if the confirmed plan makes no distribution at the equity level. In other words, if the reorganization value of the Debtor is insufficient to pay all of the $4 billion in claims (and if the creditors do not agree to a distribution at the equity level), then by operation of law the plaintiff's claims against the Debtor will be discharged without any possibility of a recovery.").

91. 2 HOWARD J. STEINBERG, BANKRUPTCY LITIGATION § 10:83 (2008).

92. 11 U.S.C. § 523(a)(19).

93. *In re* WorldCom, Inc., 329 B.R. at 13.

94. Ed Flynn, et al., *Chapter 7 Asset Cases*, 21 AM. BANKR. INST. L.J. 22 (2003).

95. *See* Newby v. Enron Corp., 542 F.3d 463, 466 (5th Cir. 2008) ("In December 2001, Enron Corporation filed for bankruptcy. Seven years later, litigation involving the Enron collapse endures."); John Gibeaut, *As WorldCom Turns, Cases Pile Up*, 90 A.B.A. J. 40, 42 (Sept. 2004) ("[P]arallel proceedings have multiplied with the wave of corporate scandals. They are especially common in securities fraud, where the sheer volume of money and countless number of victims ensure an almost endless . . . plaintiff procession. . .").

96. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288-89 (2d Cir. 1969). A fundamental purpose of the Securities Act of 1933 "was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963).

97. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

hold them accountable. This non-debtor protection inhibits investor recovery for fraud and subverts the aims of the securities laws.

This Part shows that a company's bankruptcy can deter investor suits for fraud against non-debtors. First, there is some suggestion that bankruptcy courts can void pre-petition settlements with non-debtors, thereby undoing any recovery investors achieved.[98] Second, bankruptcy courts can prevent any adjudication of non-debtors' liability by extending the automatic stay, which turns into a *de facto* release from liability.[99] Further still, securities fraud actions against non-debtors may be uneconomical after a company files for bankruptcy because of duplicative discovery costs; one appellate court has even concluded that certification of a class action against a non-debtor is an abuse of discretion when the claim may be resolved as part of the company's bankruptcy.[100] Last, non-debtors may be released from liability for securities fraud through the debtor's reorganization plan.[101]

A. VOIDING PRE-PETITION SETTLEMENTS WITH NON-DEBTORS

A corporation's bankruptcy can affect securities fraud settlements entered into with non-debtors before the bankruptcy filing. For example, the debtor-company's bankruptcy trustee may attempt to void a pre-petition settlement between plaintiff-investors and the debtor-company's directors and officers if that settlement utilized certain insurance proceeds.[102] The trustee may argue that the settlement constituted a voidable preference or fraudulent conveyance under the Code.[103] In *In re Imperial*, plaintiff-investors brought a securities fraud

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98. *See supra* Part III.A.

99. *See supra* Part III.B.

100. *See supra* Part III.C.

101. *See supra* Part III.D.

102. *See* Imperial Corp. of Am. v. Milberg, Weiss, Bershad, Specthrie & Lerach (*In re* Imperial Corp. of Am.), 144 B.R. 115, 116 (Bankr. S.D. Cal. 1992); Durkin v. Shields (*In re* Imperial Corp. of Am.), No. 92-1003-IEG (LSP), 1997 WL 808631, at *1 (S.D. Cal. Aug. 14, 1997); Durkin v. Shields (*In re* Imperial Corp. of Am.), No. 92-1003-IEG (LSP), 1997 WL 808628, at *1 (S.D. Cal. Aug. 20, 1997).

103. 11 U.S.C. § 547(b) (stating that the trustee may avoid any transfer made for the benefit of a creditor on the account of antecedent debt made while the debtor was insolvent if it is made within 90 days before the date of the filing of the debtor's petition); 11 U.S.C. § 548(a) (enabling a trustee to avoid a transfer if it was made by the debtor with actual intent to hinder, delay, or defraud creditors).

class action against Imperial's officers and directors.[104] The parties settled and the settlement was funded mostly by Imperial's insurer.[105] Imperial filed for bankruptcy a few days after the court approved the class's attorney's fees.[106] Imperial's bankruptcy trustee sought to avoid the settlement and claimed that the insurance proceeds were estate property, thereby making the settlement a preferential transfer.[107] Although the court refused the trustee's avoidance action, it only did so because it found that the insurance proceeds were not property of the estate: the policy provided direct coverage to the officers and directors, as opposed to entity or indirect coverage.[108] *Imperial* makes clear that the outcome of such an avoidance action depends on the type of coverage. It suggests that indirect or entity coverage—property of the estate[109]—may justify voiding a pre-petition, non-debtor settlement if the other elements for a voidable transfer are met.[110]

B. DE FACTO RELEASES: THE AUTOMATIC STAY AND DIRECTORS AND OFFICERS

"It is commonplace for securities fraud actions to be pending against officers and directors of a debtor that is concurrently in a case under the Bankruptcy Code."[111] When a company with public debt or equity gets into financial difficulty, directors and officers are often targeted by securities fraud plaintiffs who complain that the directors and officers failed to adequately disclose the pre-bankruptcy condition

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104. *In re Imperial Corp. of Am.*, 144 B.R. at 117.

105. *Id.* Under the settlement agreement, a settlement fund was created, which included $13 million in cash and 1.5 million warrants for the purchase of stock at $2.50 per share. *Durkin*, 1997 WL 808631, at *1. Imperial's D&O insurer provided $12.5 million to the settlement fund. *Id.*

106. *In re Imperial Corp. of Am.*, 144 B.R. at 117.

107. *Id.*

108. *Id.* at 117-18.

109. *See supra* Part III.B (discussing when insurance is considered property of the estate).

110. John Collen, *Bankruptcy and D&O Insurance*, 11 J. BANKR. L. & PRAC. 121, 142-43 (2002).

111. *In re* Recoton, Corp., 307 B.R. 751, 759 (Bankr. S.D.N.Y. 2004); *see also In re* DVI Inc. Sec. Litig., 249 F.R.D. 196, 198 (E.D. Pa. 2008); *In re* First Cent. Fin. Corp., 238 B.R. 9, 15 (Bankr. E.D.N.Y. 1999); *In re* Mortg. & Realty Trust, 125 B.R. 575, 578 (Bankr. C.D. Cal. 1991).

of the company.[112] A company's bankruptcy can prevent the adjudication of a non-debtor's liability for securities fraud. This is quite remarkable given that Congress explicitly relegated securities claims to the federal courts—and *not* the bankruptcy courts—when it enacted the "reference" provisions of the Code.[113] Contrary to Congress's intent to leave securities litigation to federal district court, bankruptcy courts

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112. THOMAS J. SALERNO, ET AL., THE EXECUTIVE GUIDE TO CORPORATE BANKRUPTCY,104 (2001). "[W]hether a company can continue as a going concern can become an allegation in a shareholders' class action complaint. For example, the complaint in a recent securities suit against NextWave Wireless alleges that the company had concealed questions surrounding its ability to continue as a going concern." Kevin LaCroix, *Corporate Defaults, Bankruptcies, and D&O Claims*, IV INSIGHTS,2-3 (Mar. 2009), *available at* http://www.oakbridgeins.com/newsletter.htm. Corporations are in a precarious position disclosing bankruptcy prospects. Whether the company will plunge into bankruptcy is a material fact that any reasonable investor would want to know. But if the company is on the verge of bankruptcy, disclosing that information will likely result in a significant drop in the company's stock price, pushing them into bankruptcy and impairing the company's ability to finalize any deals. If the company does not disclose the situation, the company risks investor suits, but may be able to keep the company from slipping into insolvency. *See* Miller v. Champion Enters., Inc., 346 F.3d 660, 682 (6th Cir. 2003) (stating that because of this double-effect, the defendant-corporation's refusal to disclose bankruptcy information was not an extreme departure from the standards of ordinary care and thus did not amount to a strong inference of recklessness).

113. Under the mandatory withdrawal provisions of the Code, a district court must withdraw the bankruptcy court's reference if the proceedings require consideration of both the Code and other federal laws. 28 U.S.C. § 157(d). Congress specifically contemplated securities cases when it enacted the mandatory withdrawal portion of Section 157(d) of the Code. In the floor debate, a House Representative stated that the mandatory withdrawal provision would apply to "related causes which may require consideration of both title 11 issues and other federal laws including cases involving the National Labor Relations Act, civil rights law, *Securities and Exchange Act of 1934*, and other similar laws." 1 COLLIER ON BANKRUPTCY 3-53 n.114 (quoting 130 Cong. Rec. H1850 (Mar. 21, 1984)) (emphasis added). But courts disagree as to the meaning of "other federal law" with some courts concluding that mandatory withdrawal is required whenever consideration of the federal law is involved, *see, e.g.,* Burger King Corp. v. B-K of Kansas, Inc., 64 B.R. 728, 730 (D. Kan. 1986), and others concluding that mandatory withdrawal is required when only the federal law is necessary for the resolution of the case, *see, e.g.,* Adelphia Commc'ns Corp. v. Rigas (*In re* Adelphia Commc'ns Corp.), No. 02 Civ. 8495 GBD, 2003 WL 21297258, at *3 (S.D.N.Y. June 4, 2003); Randall v. Am. Solar King Corp. (*In re* Am. Solar King Corp.), 92 B.R. 207, 210 (W.D. Tex. 1988); Price v. Craddock, 85 B.R. 570, 572 (D. Colo. 1988); *In re* White Motor Corp., 42 B.R. 693 (N.D. Ohio 1984); *In re* Chan, 355 B.R. 494, 506 (Bankr. E.D. Pa. 2006).

impede this litigation by extending the automatic stay.

Under the Code, directors and officers cannot avail themselves of the corporation's automatic stay because it is for the benefit of the debtor.[114] In theory, while the corporation is in bankruptcy, securities fraud plaintiffs should be able to pursue their claims against corporate officers and other liable parties.[115] However, directors and officers attempt to extend the automatic stay to these securities fraud suits. Even though this protection is not permanent (and thus distinct from an actual discharge or release, as discussed in Part III.D.),[116] for practical purposes, if the directors and officers can extend automatic stay protection, the plaintiff-investors will settle their claims against the directors and officers as part of the company's plan of reorganization.[117]

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114. 11 U.S.C. § 362(a)(1)-(3); *see also* McCartney v. Integra Nat'l Bank N., 106 F.3d 506, 509-10 (3d Cir. 1997).

115. One of the reviewers of this Article notes that generally a securities fraud case against non-debtors goes forward without the debtor-company named in the suit. So, in practice, whether the court should extend the automatic stay usually is not an issue. Nevertheless, in the cases in which it does arise, it presents a considerable problem worthy of attention. *See, e.g.*, *In re* Phil. Newspapers, LLC, 407 B.R. 606, 615 (E.D. Pa. 2009); *In re* Cont'l Airlines, 177 B.R. 475, 479-81 (D. Del. 1993); *In re* Shearin Family Invs., LLC, No. 08-07082-8-JRL, 2009 WL 4042670, at *1-*2 (Bankr. E.D.N.C. Nov. 19, 2009); *In re* SN Liquidation, Inc., 388 B.R. 579, 585 (Bankr. D. Del. 2008). Further, the existence of the possibility of a procedural bar such as the automatic stay will likely influence settlement values. As cases abound in which directors and officers have moved to extend automatic stay protection, *see, e.g.*, *In re* MCSi, Inc., 371 B.R. 270 (S.D. Ohio 2007); *In re* Sunbeam Sec. Litig., 261 B.R. 534, 535 (S.D. Fla. 2001); *In re* Uni-Marts, LLC, 404 B.R. 767, 780-82 (Bankr. D. Del. 2009); *In re* Trans-Service Logistics, Inc., 304 B.R. 805, 807 (Bankr. S.D. Ohio 2004); *In re* marchFIRST, Inc., 288 B.R. 526, 527-28 (Bankr. N.D. Ill. 2002); and the possibility of extending the stay rises, costs increase and the plaintiff's probability assessment of the chance of a successful verdict must account for this adverse possibility, thus lowering settlement values. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 568 (6th ed. 2003) (discussing how settlement is a product of the probability of success on the merits less litigation costs).

116. After a debtor receives a discharge in bankruptcy, the automatic stay is replaced with a section 524 post discharge injunction. 11 U.S.C. § 524(a)(2). This post-discharge injunction, however, does not affect the enforceability of any non-debtor liability for pre-petition debt. Patronite v. Beeney (*In re* Beeney), 142 B.R. 360, 362 (B.A.P. 9th Cir. 1992); *In re* W. Real Estate Fund, Inc., 922 F.2d 592, 600 (10th Cir. 1990).

117. SALERNO, ET AL., *supra* note 112, at 105. A bankruptcy court can extend the automatic stay under both Section 362 and its general injunctive power under Section 105. *In re* Sunbeam Sec. Litig., 261 B.R. 534, 536 (S.D. Fla. 2001). One of the central

Thus, extension of the automatic stay allows these claims to be resolved in the company's bankruptcy.

Bankruptcy courts have extended automatic stay protection to corporate directors and officers under the guise of "unusual circumstances."[118] Unusual circumstances exist if there is sufficient identity between the debtor and the third party such that the debtor may be considered the real party defendant and a judgment against the third party will act as a judgment against the debtor.[119] Directors and officers advance four "unusual circumstances" to extend automatic stay protection: (1) that a securities fraud suit will involve extensive discovery; (2) that the directors and officers are indemnified by the corporation's insurance, which constitutes property of the estate; (3) that the directors and officers are integral to the debtor's reorganization efforts; and (4) that findings in the suit against the directors and officers may bind the debtor through collateral estoppel or res judicata.[120] These

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issues in surviving to plan confirmation is protecting the directors and officers from securities fraud lawsuits. SALERNO, ET AL., *supra* note 112, at 104.

118. *In re* Sunbeam Sec. Litig., 261 B.R. at 536. Section 105(a) provides that a bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the Code. 11 U.S.C. § 105(a). Relief under Section 105 includes an injunction. ProvinceTown Boston Airline Inc. v. Miller (*In re* ProvinceTown Boston Airline, Inc.), 52 B.R. 620, 624 (Bankr. M.D. Fla. 1985). An injunction under Section 105(a) is an extraordinary remedy and more than perceived necessity is required to demonstrate its appropriateness. *E.g.*, *In re* First Cent. Fin. Corp., 238 B.R. 9, 20 (Bankr. E.D.N.Y. 1999). The party seeking the injunction must show: (1) a strong probability on the merits; (2) irreparable injury if the relief sought is not granted; (3) the injunction will not cause substantial harm; and (4) the injunction will best serve the public interest. *In re* ProvinceTown Boston Airline, Inc., 52 B.R. at 624-25 (collecting cases). Another source of equitable power is Section 1123(b)(6), which allows a Chapter 11 plan to include any appropriate provision so long as it is consistent with the Code. 11 U.S.C. § 1123(b)(6).

119. A.H. Robins Co., Inc. v. Piccinin, 788 F.2d 994, 999-1002 (4th Cir. 1986); *In re* Family Health Servs., Inc., 105 B.R. 937,942 (Bankr. C.D. Cal. 1989); Rickel Home Ctrs., Inc. v. Baffa (*In re* Rickel Home Ctrs., Inc.), 199 B.R. 498, 500 (Bankr. D. Del. 1996). This is an exception to the plain text of Section 362(a) which provides stay protection to the debtor alone, and thus, it is interpreted narrowly. *See In re* First Cent. Fin. Corp., 238 B.R. at 19.

120. *See, e.g.*, *In re* Sunbeam Sec. Litig., 261 B.R. at 536; *In re* Reliance Acceptance Grp., Inc., 235 B.R. 548, 556 (D. Del. 1999); JNA-1 Corp. v. Uni-Marts, LLC (*In re* Uni-Marts, LLC), 404 B.R. 767, 780-81 (Bankr. D. Del. 2009). Not all courts though have extended the automatic stay to directors and officers. *See, e.g.*, *In re* MCSi, Inc., Sec. Litig., 371 B.R. 270, 274 (S.D. Ohio 2007) (refusing to extend stay because directors and officers were not entitled to insurance proceeds); Catholic Order

"unusual circumstances" are not so unusual at all, however; in fact, they exist in every securities fraud suit. Further, the arguments are usually flawed in that they rely on faulty or untested premises. This Part explores each of these arguments.

1. Discovery Concerns

In a related context where the debtor-company seeks to keep the stay in place to deny its directors and officers access to insurance funds, these companies argue that the stay should not be lifted because securities fraud actions involve extensive and intensive discovery.[121] This reasoning is equally applicable to a non-debtor's effort to extend the stay. Excessive and intensive discovery is a common criticism of securities fraud class actions.[122] The courts have been receptive to this discovery concern and have refused to lift the stay (or be persuaded to extend its protection) even if the action is already filed in federal court and discovery already has begun.[123] They want to protect the debtor

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of Foresters v. U.S. Bancorp Piper Jaffray, Inc., 337 F. Supp. 2d 1148, 1162-63 (N.D. Iowa 2004) (refusing to extend the stay because the non-debtor did not demonstrate unusual circumstances); *In re* Trans-Serv. Logistics, Inc., 304 B.R. 805, 808 (Bankr. S.D. Ohio 2004) (refusing to extend the stay because the case involved only a single and straight-forward lawsuit); Maxwell v. Megliola (*In re* marchFIRST, Inc.), 288 B.R. 526, 529-30 (Bankr. N.D. Ill. 2002) (refusing to extend the stay because the insurance proceeds were not property of the estate); *In re* Sunbeam Sec. Litig., 261 B.R. at 536-37 (refusing to extend the stay because insurance proceeds were not property of the estate); Gray v. Hirsch, 230 B.R. 239, 243-44 (Bankr. S.D.N.Y. 1999) (refusing to extend stay because suit would have no effect on debtor); *In re* Rickel Home Ctrs., Inc., 199 B.R. at 500-01 (refusing to extend stay because non-debtors could not demonstrate unusual circumstances); *In re* Crazy Eddie Sec. Litig., 104 B.R. 582, 584 (Bankr. E.D.N.Y. 1989) (refusing to extend stay where the non-debtor's liability rests on his own breach of duty).

121. *See, e.g.*, Scott B. Schreiber & Andrew T. Karron, *Back to the Future: The New Focus on Predictions as a Basis for Securities Fraud Claims*, 1 STAN. J.L. BUS. & FIN. 73 (1994); Shannon Rose Seldon, *(Self-)Policing the Market: Congress's Flawed Approach to Securities Law Reform*, 33 J. LEGIS. 57, 75 (2006).

122. *E.g.*, Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741, (1974) (stating that the potential for abuse of the discovery provisions of the Federal Rules of Civil Procedure may exist in securities litigation more than any other litigation, that extensive depositions of directors and officers takes up the time of a number of people, and in sum, forces defendants *in terrorem* into settlement).

123. *See In re* ProvinceTown Boston Airline, Inc., 52 B.R. 620, 623 (Bankr. M.D. Fla. 1985). ProvinceTown Boston Airline, Inc. (PBA) was one of the largest operators

from the bombardment of discovery that would impede reorganization efforts.[124]

But the argument rests on the faulty premise that discovery in securities fraud litigation is abusive and wrongly forces defendants to settle. This widespread sentiment has not been empirically verified.[125] Furthermore, imposing high discovery costs is inconsistent with rational behavior for plaintiff-investors: plaintiff-investors front the cost of litigation (when victory is uncertain) and high discovery costs for defendants decrease available insurance proceeds—a vital source of funding for settlement or judgment if the company is in bankruptcy.[126]

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of a commuter airline. *Id.* at 622. The plaintiffs, shareholders of PBA's, filed suits against PBA and its directors, officers, and underwriter alleging that PBA failed to disclose in its prospectus accompanying its IPO certain charges and administrative actions by the Federal Aviation Authority against PBA which resulted in the revocation of PBA's operating certificate. *Id.*, *see also* The Securities Act of 1933 § 12(2). After PBA filed for bankruptcy, the plaintiffs sought to lift the automatic stay to proceed against PBA, and PBA, in response sought an extension of the automatic stay to its related non-debtors. *In re* ProvinceTown Boston Airline, Inc., 52 B.R. at 622. The district court ultimately refused to extend the automatic stay because several of the non-debtors were no longer officers or directors, were never officers or directors, or had no connection with the debtor. *Id.* at 626.

124. *In re* ProvinceTown Boston Airline, Inc., 52 B.R. at 624; *see also In re* Towner Petroleum Co., 48 B.R. 182, 185, 191 (Bankr. W.D. Okla. 1985) (refusing to lift automatic stay where debtor and non-debtors would be subject to extensive discovery from fraud case involving oil and gas leases); *cf.* Hoenig v. Hoffman (*In re* Hoffman), 33 B.R. 937, 941 (Bankr. W.D. Okla. 1983) (allowing limited discovery).

125. *See* Linda S. Mullenix, *Discovery in Disarray: The Pervasive Myth of Pervasive Discovery Abuse and the Consequences for Unfounded Rulemaking*, 46 STAN. L. REV. 1393 (1994) (documenting, "Faludi-style," the myth of pervasive discovery abuse); Judith A. McKenna & Elizabeth C. Wiggins, *Empirical Research on Civil Discovery*, 39 B.C. L. REV. 785, 787 (1998) (stating that the debate over discovery reform was based on salient personal experiences, and not with the benefit of empirical evidence). But there is still no working definition of what constitutes "appropriate" discovery. Linda S. Mullenix, *The Pervasive Myth of Pervasive Discovery Abuse: The Sequel*, 39 B.C. L. REV. 683, 688 (1998).

126. *See* Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors' and Officers' Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 777-78 (2009). D&O policies are "wasting" policies. Thomas A. Dubbs, *A Scotch Verdict on "Circularity" and Other Issues*, 2009 WIS. L. REV. 455, 462 n.28 (2009). A "wasting" policy is an insurance policy whereby the costs of defense are taken off the top and "waste" away at the policy; as litigation progresses, the available insurance funds reduces. Judge Nicholas H. Politan, *Mediating Securities Class Actions: A View from the Captain's Quarters*, 800 PLI/Lit 133, 137 (2009).

2. Directors' and Officers' Liability Insurance

Nearly all public companies have some form of directors' and officers' ("D&O") liability insurance to protect them from securities litigation.[127] A D&O liability insurance policy, generally an indemnity policy,[128] offers three types of coverage: (1) direct (or "Side-A") coverage;[129] (2) indirect (or "Side B") coverage; and (3) entity (or "Side C") coverage.[130] Direct coverage provides insurance coverage for any actual or alleged wrongful acts by the directors or officers while acting in their official capacities (unless the company has already indemnified them).[131] Direct coverage is the only kind of coverage that actually

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127. Seth Van Aalten, Note, *D&O Insurance in the Age of Enron: Protecting Officers and Directors in Corporate Bankruptcies*, 22 ANN. REV. BANKING & FIN. L. 457 460 (2003). The deductibles tend to be substantial. DICTIONARY OF INSURANCE TERMS 134 (4th ed. 2000). D&O policies provide an incentive for directors and officers to make risky decisions necessary to corporate growth. Eric W. Collins, Note, *Level 3 v. Federal Insurance: Do You Know What is in Your Directors and Officers Liability Insurance Policy*, 73 UMKC L. REV. 199, 208 (2004).
D&O insurance was first introduced after the enactment of the 1933 and 1934 Acts, but it was not widely purchased until after the Supreme Court decided *Basic v. Levinson*, where the Supreme Court created a presumption of reliance for lawsuits involving securities traded in the secondary public markets, now known as the fraud-on-the-market theory. Van Aalten, *supra* note 127, at 460; Basic Inc. v. Levinson, 485 U.S. 224, 246-47 (1988). The result of the *Basic* decision was an upsurge in securities class actions and expanded liability as it allowed for widely dispersed investors to aggregate small claims and threaten a company with daunting damages. A.C. Pritchard, *Stoneridge Investment Partners v. Scientific-Atlanta: The Political Economy of Securities Class Action Reform*, 2008 CATO SUP. CT. REV. 217 (2008).

128. SUSAN N.K. GUMMOW, BANKRUPTCY AND INSURANCE LAW MANUAL 133 (3d ed. 2009). These D&O policies differ from traditional professional liability policies in that the D&O policies do not obligate the insurer to provide a defense, but only to reimburse expenses incurred in defense of the claims against the insured. Lee R. Russ & Thomas F. Segalla, *Directors and Officers: General Coverage Terms*, *in* 9A COUCH ON INSURANCE, § 131:31 (2009).

129. Direct insurance coverage generally comes into play when the company is insolvent. Bonnie Brewer Cavanaugh, *Looking for Trouble: With Litigation Rising, Insurers Advise Companies to Shore Up Their Liability Defenses*, 109 BEST'S REV. 49 (Mar. 2009).

130. GUMMOW, *supra* note 128, at 133-34.

131. GUMMOW, *supra* note 128, at 133. Covered losses include compensatory damages, settlements, and legal fees incurred by the person in connection with service as a director/officer of the corporation. Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers'*

covers the individual directors and officers.[132] Conversely, indirect coverage provides the company with insurance coverage when the company has indemnified its directors or officers for a loss.[133] Last, entity coverage insures the company for any claims brought against it.[134]

If the company has D&O insurance (and well-over ninety percent of public companies do[135]), the bankruptcy court may extend automatic stay protection so long as the insurance policy and its proceeds are considered property of the company's bankruptcy estate.[136] Officers and directors argue that allowing a shareholder's claim to go forward will harm the debtor-company by diminishing funds available under the D&O policies through defense costs and judgment awards, thereby adversely affecting property of the estate.[137] The majority of the federal circuits state that insurance policies are property of the estate and protected by the automatic stay,[138] but whether the proceeds from a D&O policy are property of the estate is assessed case by case.[139]

Liability Insurance Policies, 154 U. PA. L. REV. 1147, 1164 (2006). According to most policies, a director or officer usually includes any past, present, or future director or officer of the company. Russ & Segalla, *supra* note 128.

132. Griffith, *supra* note 131, at 1164.

133. GUMMOW, *supra* note 128, at 133.

134. GUMMOW, *supra* note 128 at 134.

135. Griffith, *supra* note 131, at 1168.

136. *See, e.g.*, Bidermann Indus. USA Inc. v. Zelnik (*In re* Bidermann Indus. USA, Inc.), 200 B.R. 779 (Bankr. S.D.N.Y. 1996) (recognizing that Section 362 stays actions that interfere with property of the estate, and that if insurance policies are used to satisfy judgments against non-debtors and debtor has an interest in those proceeds, the insurance policies may be property of the estate); Maxicare Health Plans v. Centinela Mammoth Hosp. (*In re* Family Health Servs., Inc.), 105 B.R. 937, 942-43 (Bankr. C.D. Cal. 1989). The automatic stay precludes any act to obtain possession of property of the estate. 11 U.S.C. § 362(a)(3); *see also* Circle K Corp. v. Marks (*In re* Circle K Corp.), 121 B.R. 257, 258, 261 (Bankr. N.D. Ariz. 1990).

137. *In re* Reliance Acceptance Grp., Inc., 235 B.R. 548, 556-57 (D. Del. 1999).

138. *See, e.g.*, MacArthur Co. v. Johns-Manville, Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89, 92 (2d Cir. 1988); A.H. Robins Co., Inc. v. Piccinin (*In re* A.H. Robins, Co., Inc.), 788 F.2d 994, 1001 (4th Cir. 1986); *In re* Davis, 730 F.2d 176, 184 (5th Cir. 1984); *In re* First Cent. Fin. Corp., 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).

139. *See* Houston v. Edgeworth, (*In re* Edgeworth), 993 F.2d 51, 56 (5th Cir. 1993); *In re* Metro. Mortg. & Sec. Co., Inc., 325 B.R. 851, 857-58 (Bankr. E.D. Wash. 2005) (stating that an insurance policy is not property of the estate where the debtor has no legal interest in the proceeds); *In re* Sfuzzi, Inc., 191 B.R. 664, 668 (Bankr. N.D. Tex. 1996). The distinction between the insurance policy and its proceeds is necessary as a practical matter: the bankruptcy courts want to allow directors and officers to obtain insurance proceeds, but also prohibit the debtor's insurer from cancelling the policy.

Generally, if the D&O policy provides direct coverage, then the proceeds are not property of the estate and the bankruptcy court will not extend the automatic stay.[140] Similarly, if the debtor's plan of reorganization extinguishes directors' and officers' claims under D&O policies, the automatic stay should not be extended.[141] For indirect and entity coverage situations, however, if the debtor-company is exposed in any way to claims covered under the D&O policy, the proceeds are property of the estate.[142]

If both the directors, officers, and the company have an interest in the insurance proceeds, the bankruptcy court will extend the automatic stay to prevent competition for policy proceeds.[143] This competition

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Cf. In re Minoco, Grp. of Cos., Ltd., 799 F.2d 517, 519 (9th Cir. 1986).

140. *See* La. World Exposition, Inc. v. Fed. Ins. Co. (*In re* La. World Exposition, Inc.), 832 F.2d 1391, 1400-01 (5th Cir. 1987).

141. *See In re* Sunbeam Sec. Litig., 261 B.R. 534, 537 (S.D. Fla. 2001). In *In re Sunbeam*, Sunbeam filed for Chapter 11 bankruptcy and its directors and officers sought to extend the automatic stay to securities litigation against them. *Id.* at 535. The court refused to extend the stay because: (1) Sunbeam did not also seek extension of the stay, indicating that these managers were not necessary to reorganization; (2) Sunbeam was not required to indemnify the non-debtors for any costs or judgments; and (3) the recovery from the managers' insurance would not effect the debtor's recovery because the debtor had no right to those proceeds. *Id.* at 536-37.

142. *In re* CHS Elec., Inc., 261 B.R. 538 (Bankr. S.D. Fla. 2001) (stating that entity coverage itself does not mean that the proceeds are property of the estate because "in actuality," there was no entity coverage); *see also In re* First Cent. Fin. Corp., 238 B.R. 9, 17 (Bankr. E.D.N.Y. 1999) (same); *but see In re* Vitek, 51 F.3d 530, 534 (5th Cir. 1995) (stating that where a D&O policy provides coverage for judgments or losses against the bankrupt corporation itself, the proceeds belong to the estate regardless of the presence of personal liability coverage for officers and directors).

143. *E.g.*, *In re* Metro. Mortg. & Sec. Co., Inc., 325 B.R. 851, 857 (Bankr. E.D. Wash. 2005); *In re* First Central Fin. Corp., 238 B.R. at 17. A securities fraud claim must have been filed against the debtor that implicates insurance coverage; if no party expresses any interest in making these claims, a bankruptcy court should not extend automatic stay protection to directors and officers based on mere speculation. *See, e.g.*, *In re* Adelphia Commc'ns, Corp., 298 B.R. 49, 53-54 (S.D.N.Y. 2003); *In re* Reliance Acceptance Grp., Inc., 235 B.R. 548, 561 (D. Del. 1999); Official Unsecured Creditors' Comm. v. Bowen (*In re* Phar-Mor, Inc., Sec. Litig.), 164 B.R. 903, 905 (W.D. Pa. 1994). In this situation, the available insurance provides no tangible benefit to the estate. *In re First Central Fin. Corp*., 238 B.R. at 18. "Claiming the [debtor-company] now h[as] a property interest in those proceeds makes no sense at this juncture. Such argument would be akin to a car owner with collision coverage claiming he has the right to proceeds from his policy simply because there is a prospective possibility that his car will collide with another tomorrow, or a living person having a death benefit policy, and

may descend into a free-for-all, causing a race to judgment or settlement.[144] This problem is exacerbated if the cost of determining each claimant's interest in the policy proceeds depletes the available moneys, as in the case of a "wasting" policy.[145] Under a "wasting" policy, for every dollar paid to the officers and directors, one less dollar of coverage is available to the debtor-company's estate.[146]

Extending the stay because of the presence of insurance, however, conflates issues of insurance coverage with the presence of a securities fraud claim. Rather, the insured and insurer should resolve the question of coverage without enjoining the securities fraud claim. The plaintiff-investors pursue an action against the directors and officers, not against the insurer.[147] Insurers may contest coverage, making the insurer's involvement uncertain. For example, insurers may invoke a policy provision for fraud exclusion,[148] which excludes coverage for any loss resulting from any profit or advantage that the director or officer obtained by violating the securities laws.[149] Similarly, insurers may dispute whether there is a covered "loss" as defined in the policy. Policies often define "loss" to mean damages, judgments, settlements, and defense costs.[150] If plaintiff-investors seek restitution or disgorgement, however, it is an open question whether the claim is a

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claiming his beneficiaries have a property interest in the proceeds even though he remains alive." *In re Adelphia Commc'ns, Corp*., 298 B.R. at 53-54.

144. *In re Metro. Mortg. & Sec. Co., Inc*., 325 B.R. at 857.

145. *Id.*

146. *In re First Cent. Fin. Corp*., 238 B.R. at 17.

147. *See In re* Reliance Acceptance Grp., Inc., 235 B.R. at 557; *see also* Boles v. Turner (*In re* Envid, Inc.), 364 B.R. 139, 157 (Bankr. D. Mass. 2007) ("The existence of D & O Policies, which are subject to the unliquidated, contingent claims of the Plan Trustees and the settled claims of the Shareholder Plaintiffs who have suffered a loss within the meaning of those policies, does not form the basis for extraordinary injunctive relief favoring the Plan Trustees over the Shareholder Plaintiffs and the D & O Defendants simply because the Plan Trustees happen to have obtain their status through confirmation of liquidating plans. While the amount of insurance proceeds available to the Plan Trustees will be reduced, that is not so extraordinary a circumstance as to warrant exercise of the Court's limited, "related to" jurisdiction to enter an injunction under § 105(a) . . . The right of the parties to pursue the same assets and individuals is not, in and of itself, a cognizable theory in support of an injunction.").

148. GUMMOW, *supra* note 128, at 139.

149. GUMMOW, *supra* note 128, at 140. This includes gains from insider trading as well. *See* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 400 (D. Del. 2002).

150. Michael J. Kaufman, *Insurance, in* 26A SECURITIES LITIGATION: DAMAGES § 20:28 (2010).

covered "loss."[151] Additionally, insurers may threaten to rescind coverage on the basis of misrepresentation in the insurance application.[152] A securities fraud suit's effect on insurance is relevant only between the debtor-company, the officers and directors, and the insurers.[153] The nature and amount of coverage is a matter to be resolved between the insurers and insured, without enjoining securities fraud plaintiffs from proceeding with their claim.[154]

Similarly, the policy does not provide defense funds as a matter of right because a securities fraud claim has been filed. Defense funds are not property of the debtor until either agreement or a finding by a court.[155] Even when an insurer pays for defense, it reserves its right to contest coverage.[156] Thus, not only has the debtor-corporation's interest

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151. Kaufman, *supra* note 150. Professor Kaufman goes on to note that this argument is plain wrong because Section 11 and Section 12 of the 1933 Act make clear that any recovery of damages is measured by and limited to the plaintiff's losses, not the disgorgement of any profit to the defendants. *Id.*

152. As scholars Tom Baker and Sean J. Griffith explain:

> Corporations typically submit a copy of their financial statements with their application for D&O insurance, and D&O insurance underwriters commonly use financial measures derived from the financial statements to price that insurance. Thus, fraud in the financial statements [often the basis for 10b-5 liability] can become fraud in the application for insurance, provided that the underwriter had insisted that the corporation provide an application that incorporated the financial statements and that the insurer can prove that the underwriter relied on the fraudulent information in the statements.

Baker & Griffith, *supra* note 126, at 800.

153. *In re* Reliance Acceptance Grp., Inc., 235 B.R. 548, 557 (D. Del. 1999) ("If the Shareholders are successful and obtain a judgment or judgments, coverage may be relevant as a practical matter, as certain of the defendants may not have the ability to pay any judgment. The defendants may have claims against the Company and the insurers for indemnification. It is at that time and in that context, an action among the Debtors, the officers and directors and the insurers, that this issue of the nature and extent of coverage would be resolved.").

154. *Id.*

155. Maxwell v. Megliola (*In re* Marchfirst, Inc.), 288 B.R. 526, 530 (Bankr. N.D. Ill. 2002).

156. ALLAN D. WINDT, *Consent By Insured to Defense Offered Subject to a Reservation of Rights*, *in* 1 INSURANCE CLAIMS AND DISPUTES § 2:17 (5th ed. 2009); *see also In re* Marchfirst, Inc., 288 B.R. 526, 530 (Bankr. N.D. Ill. 2002). Many courts that have considered whether an insured can reject an insurer's tendered defense with a reservation of rights have held that the insured has an absolute right to reject any defense offered subject to a reservation of rights. *E.g.*, City of Carter Lake v. Aetna Cas. & Sur. Co., 604 F.2d 1052, 1060 n.7 (8th Cir. 1979) (Iowa law); State ex rel. Rimco, Inc. v. Dowd, 858 S.W.2d 307, 309 (Mo. Ct. App. E.D. 1993);. The insurer

in the insurance proceeds not matured, but it may never do so.[157] Therefore, the presence of D&O insurance is insufficient to extend automatic stay protection to directors and officers.

3. The Debtor-Company's Reorganization Efforts

A key feature of Chapter 11 reorganization proceedings is that the debtor's management retains control of the company while in bankruptcy.[158] Based on this feature, management argues that the stay should be extended to bar securities fraud suits against them because their undivided attention is necessary to facilitate the debtor's reorganization.[159] Some courts have agreed, extending the automatic stay (or issuing an injunction) to protect non-debtors whose time and energy should not be diverted.[160]

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must either (1) affirm the policy, defend the suit, and pay any resulting adverse judgment, regardless of the existence of any policy defenses; or (2) to refuse to defend and take its chances that its denial of coverage will stand up in a later suit on the policy, Cont'l Ins. Co. v. Bayless & Roberts, Inc., 608 P.2d 281, 288 (Alaska 1980).

157. *In re* Marchfirst, Inc., 288 B.R. at 530.

158. Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 128 (1990). When the debtor's management retains exclusivity over presenting the plan of confirmation, this management wields considerable power:

> When exclusivity is maintained, the debtor corporation's management drafts and proposes a plan of reorganization after consulting and negotiating with the key representatives of the creditors and sometimes the shareholders. Those representatives may include "official" committees appointed by the United States Trustee, unofficial committees organized by members of the affected group, or other representatives, such as indenture trustees or the attorneys for the plaintiffs in a class action. Whether or not the representatives agree to a proposed plan, management can force a vote of the affected creditors and shareholders.

Id. at 128-29.

159. *See* Gray v. Hirsch, 230 B.R. 239, 243 (S.D.N.Y. 1999). The central purpose of extending the automatic stay is to suspend actions that pose a serious threat to the debtor-company's reorganization efforts. Gerard v. W.R. Grace & Co. (*In re* W.R. Grace & Co.), 115 F. App'x 565, 570 (3d Cir. 2004) (non-precedential disposition); JNA-1 Corp. v. Uni-Marts, LLC (*In re* Uni-Marts, LLC), 404 B.R. 767, 780-81 (Bankr. D. Del. 2009).

160. *E.g.*, SALERNO, ET AL., *supra* note 112, at 105; *see also* Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 979 (1st Cir. 1995); *In re Uni-Marts*, LLC 404 B.R. at 782; *In re* K-Mart Corp., 285 B.R. 679, 689 (Bankr. N.D. Ill. 2002); E. Airlines, Inc. v. Rolleston (*In re* Ionosphere Clubs, Inc.), 111 B.R. 423, 435 (Bankr. S.D.N.Y. 1990); Supermercado Gamboa, Inc. v. Camara de Commerciantes Mayoristas De P.R., Inc. (*In re* Supermercado Gamboa), 68 B.R. 230, 233 (D. P.R. 1986); ProvinceTown Boston

Three problems with this argument exist, however. First, whether a director or officer's continued service is crucial to the debtor-company's reorganization is a highly factual inquiry.[161] If the direction of the debtor's bankruptcy case is already established, extending the stay is inappropriate because the directors or officers are no longer needed to guide the company through the bankruptcy.[162] Administration connotes planning, executive decision-making, and supervision of the bankruptcy estate,[163] and if no more planning, decision-making, or supervision is necessary, these officers and directors no longer need the protection of the automatic stay.

Second, the premise of the argument—that management *should* guide the company through bankruptcy—is flawed. Behavioral analysis teaches that entrenched management may impede reorganization efforts. In the sphere of individual decision-making, people systematically overrate their abilities and contributions, resulting in excessive optimism and an inflated sense of ability to control events and risk.[164] This bias

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Airline, Inc. v. Miller (*In re* ProvinceTown Boston Airline, Inc.), 52 B.R. 620, 625-26 (Bankr. M.D. Fla. 1985) (recognizing that courts consider officers and directors vital to reorganization if they own assets that are used to fund the debtor's reorganization or if they play a significant and meaningful role in preserving the debtor's credit); Johns-Manville Corp. v. Asbestos Litig. Grp. (*In re* Johns-Manville Corp.), 26 B.R. 420, 426 (Bankr. S.D.N.Y. 1983).

Certain factors, though, may counsel against extending the stay. For example, bankruptcy courts are reluctant to extend the stay if the management is exposed to one or a few suits that will not likely consume significant portions of management's time. *In re Uni-Marts, LLC*, 404 B.R. at 782. Bankruptcy courts are also hesitant to extend automatic stay protection if the securities fraud allegations focus on the personal misconduct of the officers and directors. Morgan v. Korbin Sec. Inc., 649 F. Supp. 1023, 1032 (N.D. Ill. 1986). It is also significant if the debtor-company does not seek to extend the stay, or otherwise concedes that the parallel proceeding will not impair its reorganization efforts. *See, e.g.*, *In re* Sunbeam Sec. Litig., 261 B.R. 534, 537 (S.D. Fla. 2001).

161. *See In re* Baldwin-United Corp., 43 B.R. 443, 461-62 (S.D. Ohio. 1984). In that hearing, the bankruptcy court should focus on the benefits that the debtor can demonstrate that it would obtain from the directors' continued services, as opposed to the potential detriment the directors will experience. *Id.* at 462.

162. *See In re* Envid, Inc., 364 B.R. 139, 149-50 (Bankr. D. Mass. 2007).

163. *Id.* at 149.

164. Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, *in* BEHAVIORAL LAW & ECONOMICS149 (Cass R. Sunstein ed., 2000); *see also* Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing*

may distort judgment regarding the cause of the company's bankruptcy: attributing the bankruptcy to an external circumstance outside of management's control, rather than mismanagement. Moreover, once a person voluntarily commits to an idea or course of action, this person is beset with a strong motivation to resist evidence that the course was ill-chosen.[165] Thus, management already set on a way of doing things—possibly things that led to the company's perilous financial situation to begin with—may disregard objective evidence that undermines their original course of action.

Third, in reality, current management of public companies is often ousted when the company files for bankruptcy.[166] Bankruptcy expert Lynn M. LoPucki debunks the idea that current officers and directors of bankrupt companies should shepherd a corporation through bankruptcy.[167] Examining cases from 1990 through 2004, LoPucki concluded that when a member of pre-petition management remained as CEO through the crucial stages of the bankruptcy case, the company was more likely to fail in the five years after it emerged from bankruptcy.[168] Conversely, a company that hired a new CEO from outside the company was more likely to succeed in the five years after it emerged from bankruptcy.[169] Retaining management premised on the idea that they

the Rationality Assumption from Law and Economics, 88 CAL . L. REV. 1051, 1091-93 (2000).

165. Langevoort, *supra* note 164, at 149, 151 ("Self-confidence and external image are threatened both by introducing a troubling awareness of the possibility of mistake, and by raising the need to consider a reversal of one's position, which, in turn, calls into question one's reputation for consistency, a highly valued asset in our economic culture. Cognitive-dissonance theory predicts that once a commitment is made, attitudes and beliefs will shift to preserve consistency."); *see also* A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 5-6 (2003). The tendency to remain at the status quo is called the status quo bias. Daniel Kahneman, et. al, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, *in* CHOICE, VALUES, & FRAMES 159, 163 (Kahneman & Tversky eds., 2000).

166. WARREN & WESTBROOK, *supra* note87, at 445; *see also* LoPucki & Whitford, *supra* note 87, at 726 (finding that in large public company reorganizations, management changed in seventy percent of the cases).

167. LOPUCKI, *supra* note 65, at 143-45.

168. LOPUCKI, *supra* note 65, at 145.

169. LOPUCKI, *supra* note 65, at 145. Because of these behavioral biases and the evidence that supports their validity, at least one scholar has suggested that directors should be under a duty to file a timely bankruptcy petition to encourage directors to consider the interests of all the company's constituents, including workers, creditors, the community, and shareholders. *See generally* Dickerson, *supra* 165. But most of

are "vital" to the reorganization may impede reorganization efforts, and it sacrifices the claims of securities fraud victims.

4. Res Judicata Concerns

One of the most potent arguments directors and officers advance is that the stay should be extended because the securities fraud litigation may produce findings that would bind the debtor-company through res judicata or collateral estoppel.[170] Collateral estoppel bars a party from re-litigating an issue determined against that party in an earlier action.[171] Some bankruptcy courts have been receptive to this argument and have recognized that this concern may warrant extending the automatic stay.[172] Indeed, it does weigh in favor of extending the automatic stay. However, this is an "unusual" circumstance that is not present in *every* securities fraud case. Moreover, it assumes the plaintiffs will sue the debtor-company. Even still, allowing securities fraud claims to be determined by the federal district court is consistent with Congress's intent that the federal district courts, not the bankruptcy courts, resolve

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the efforts aimed at eradicating the overconfidence bias have failed and no clear solution has yet presented itself that would counteract this bias. Baruch Fischhoff, *Debiasing, in* DANIEL KAHNEMAN, ET AL, JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 432 (1982).

170. *See, e.g.*, *In re* Uni-Marts, LLC, 404 B.R. 767, 780-81 (Bankr. D. Del. 2009); *In re* SN Liquidation, Inc., 388 B.R. 579, 585 (Bankr. D. Del. 2008); *In re* Am. Film Tech., Inc., 175 B.R. 847, 850-54 (Bankr. D. Del. 1994).

171. BLACK'S LAW DICTIONARY 279 (8th ed. 2004). The consequences of collateral estoppel can be dire for both defendants and plaintiffs: "[i]t can be invoked offensively . . . to preclude litigation of an issue that was decided favorably . . . in a prior action. Or, it can be used defensively . . . to preclude relitigation of an issue that was decided in his favor in a prior suit." JACK H. FRIEDENTHAL, ET AL., CIVIL PROCEDURE: CASES & MATERIALS 1273 (10th ed. 2009).

172. *In re* Ionosphere Clubs, Inc., 111 B.R. 423, 435 (Bankr. S.D.N.Y. 1990); *In re Am. Film Techs., Inc.*, 175 B.R. at 848; *In re* Johns Manville Corp., 40 B.R. 219, 225 (S.D.N.Y. 1984) ("[O]nce a witness has testified to a fact, or what sounds like a fact, that witness may be confronted with his prior testimony under oath in a future proceeding directly involving [the debtor], whether or not [the debtor] was a party to the record on which the initial testimony was taken. Once an admission against interest is made, under oath or otherwise, by the agent of a party, that admission stands for all time. No matter what [the plaintiffs] may stipulate, the thousands of other claimants and cross claimants who [may be] after [the debtor's] assets, would be entitled to use the product of such discovery.").

these claims.[173]

C. MAKING NON-DEBTOR SECURITIES FRAUD ACTIONS UNECONOMICAL

Securities fraud actions against non-debtors face another barrier as a result of the company's bankruptcy: increased costs. As this Part shows, a company's bankruptcy may make securities fraud actions against non-debtors uneconomical by imposing unnecessary and duplicative discovery costs on investor plaintiffs.[174] Also, it may result in the denial of class certification outside of the bankruptcy court.[175]

1. Bankruptcy Materials and Heightened Pleading for Securities Fraud

First, bankruptcy can duplicate discovery efforts for plaintiff-investors. Securities fraud actions already face considerable procedural barriers on a motion to dismiss,[176] for class certification,[177] and for summary judgment.[178] Specifically, under the PSLRA, Congress

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173. *See infra* note 113 and accompanying text (explaining that Congress relegated securities fraud claims to the federal district court, not bankruptcy courts); *see also supra* note 246 and accompanying text (explaining that bankruptcy courts may not have jurisdiction to determine securities fraud liability in the first instance).

174. *See supra* Part III.C.1.

175. *See supra* Part III.C.2.

176. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, interpreted the PSLRA's scienter requirement and has required a "mini-trial on the merits" at the 12(b)(6) stage absent any benefit of discovery. *In re* ProQuest Sec. Litig., 527 F. Supp. 2d 728, 747 (E.D. Mich. 2007). John M. Wunderlich, *Amending Pleadings in Securities Fraud Litigation After* Tellabs, 37 No. 4 SEC. REG. L.J. 360 (2009) (discussing the varied approaches to whether Rule 15's liberal amendment policy perseveres in light of the PSLRA and *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*)

177. *E.g.,* Fener v. Operating Eng'rs. Constr. Indus. & Misc. Pension Fund, 579 F.3d 401, 407-410 (5th Cir. 2009) (holding that absent an event study that rules out other causes of a stock price decline, a court will deny class certification to the plaintiff class); *In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 486 (2d Cir. 2008) (mandating that defendants be given an opportunity to rebut the fraud-on-the-market presumption at class certification); Oscar Private Equity Invs. v. Allegiance Telecom, Inc., 487 F.3d 261, 270 (5th Cir. 2007) (requiring plaintiffs to establish loss causation by a preponderance of the evidence to use the fraud-on-the-market presumption of reliance at the class certification stage).

178. *In re* Williams Sec. Litig., 496, F. Supp. 2d 1195 (N.D. Okla. 2007) (requiring a reliable event study to connect post-transaction stock movement to the defendant's fraud and holding that absent an event study, a court will grant summary judgment for the defendant); *see also* Michael J. Kaufman & John M. Wunderlich, *Regressing: The*

enhanced the pleading standard, requiring that plaintiffs allege facts (including the defendant's state of mind) with particularity.[179] Congress also stayed discovery pending a motion to dismiss.[180] This stay of discovery has forced plaintiffs to resort to other, less conventional means to meet the heightened requirement.[181] Materials prepared in the context of a company's bankruptcy—such as the bankruptcy petition, the bankruptcy docket and pleadings, transcripts from bankruptcy proceedings, a trustee's complaint, or a bankruptcy examiner's report—may provide a wealth of information for plaintiffs' attorneys.[182] Recognizing this, defendants in related securities fraud actions often object vigorously to a plaintiffs' use of this information.[183] This Part

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Troubling Dispositive Role of Event Studies in Securities Fraud Litigation, 15 STAN. J.L. BUS. & FIN. 183, 208-09 (2009) (arguing that an event study is now an essential element of 10b-5 liability).

179. 15 U.S.C. § 78u-4(b) ; *see also* Novak v. Kasaks, 216 F.3d 300, 306 (2d Cir. 2000).

180. 15 U.S.C. § 78u-4(b)(3)(B) . Even mandatory disclosures are put on hold until after the court rules on a motion to dismiss. Medhekar v. U.S. Dist. Court, 99 F.3d 325, 328-29 (9th Cir. 1996); 15 U.S.C. § 78u-4(b)(3)(C) . The discovery stay has two exceptions: (1) to preserve evidence; and (2) to prevent undue prejudice. Med. Imaging Ctrs. of Am., Inc. v. Lichtenstein, 917 F. Supp. 717, 720 (S.D. Cal.1996). An additional purpose of the discovery stay is that it slows the race to the courthouse door by forcing plaintiffs to conduct more extensive prefiling investigations. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. ILL. L. REV. 913, 929 (2003).

181. *See, e.g.*, Michael J. Kaufman & John M. Wunderlich, *Resolving the Continuing Controversy Regarding Confidential Informants in Private Securities Litigation*, 19 CORNELL J.L. & PUB. POL'Y 637 (2010) (discussing how securities plaintiffs often rely on confidential informants to satisfy the heightened pleading burden); Michael J. Kaufman & John M. Wunderlich, *Congress, the Supreme Court and the Proper Role of Confidential Informants in Securities Fraud Litigation*, 36 No. 2 SEC. REG. L.J. 345, 345-46 (2008) (same); Ethan D. Wohl, *Confidential Informants in Private Litigation: Balancing Interests in Anonymity and Disclosure*, XII FORDHAM J. CORP. & FIN. L. 551, 555 (2007) (same).

182. *In re* Stratosphere, Corp., Sec. Litig., 1 F. Supp. 2d 1096, 1106 n.8 (D. Nev. 1998); *see also In re* Rockefeller Ctr. Props., Inc., Sec. Litig., 311 F.3d 198, 221-22 (3d Cir. 2002) (transcript from bankruptcy proceedings); Cohen v. Nw. Growth Corp., 385 F. Supp. 2d 935, 965-66 (D.S.D. 2005) (bankruptcy petition); Catholic Order of Foresters v. U.S. Bancorp Piper Jaffray, Inc., 337 F. Supp. 2d 1148, 1160 (N.D. Iowa 2004) (bankruptcy docket and pleadings). The scope of examination in bankruptcy is much broader than discovery under the Federal Rules of Civil Procedure. *In re* Recoton, Corp., 307 B.R. 751, 755 (Bankr. S.D.N.Y. 2004).

183. *See, e.g.*, *In re* New Century Trs. Holdings, Inc., 407 B.R. 558, 562-63 (Bankr.

shows that bankruptcy materials help plaintiff-investors meet their pleading and evidentiary burdens, but the courts may impede the use of these materials.

Certain records in the debtor's bankruptcy case—like statements made at bankruptcy hearings or a trustee's complaint alleging fraud—prove useful to securities fraud plaintiffs.[184] Any party in interest in the debtor's bankruptcy may request the appointment of a trustee,[185] with power to avoid transfers, assume executory contracts, retain professionals, and even operate the debtor's business.[186] The trustee can also bring claims on behalf of the debtor's estate.[187] In *In re Huffy*, the plaintiff-investors brought a securities class action against Huffy Corporation and its executives for violating the securities laws by misrepresenting its acquisition of Gen-X, a rival manufacturer of sporting goods.[188] On a motion to dismiss, the plaintiffs asked the court to take judicial notice of the trustee's complaint filed in Huffy's bankruptcy, which alleged that the Huffy executives breached their fiduciary duty by paying nearly $2.7 million out of Huffy's retirement plan to another executive without determining whether Huffy was solvent.[189] This allegation, the plaintiffs maintained, demonstrated the

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D. Del. 2009); *In re Recoton Corp.*, 307 B.R. at 754.

184. *Cf.* Jacobson v. AEG Capital Corp., 50 F.3d 1493, 1496 (9th Cir. 1995); *see* Charal Inv. Co., Inc. v. Rockefeller (*In re* Rockefeller Ctr. Props., Inc., Sec. Litig.), 311 F.3d 198, 221-22 (3d Cir. 2002) (counsel's statements made at bankruptcy hearing); SEC. v. Antar, 120 F. Supp. 2d 431 (D.N.J. 2000) (deposition testimony).

185. 11 U.S.C. § 1104(a) ("At any time after the commencement of the case but before confirmation of a plan, *on request of a party in interest* or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee . . .").

186. 11 U.S.C. §§ 544-550; 365; 327; 1108.

187. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) ("The Trustee stands in shoes of bankrupt corporation and has standing to bring any suit that corporation could have instituted had it not petitioned for bankruptcy."); *see also* Smith v. Arthur Anderson, LLP, 421 F.3d 989 (9th Cir. 2005) (holding that the trustee could assert claims against Chapter 11 debtor's former officers and directors, attorneys, auditors, and investment bankers for breach of fiduciary duty, breach of contract, and professional malpractice).

188. *In re* Huffy Corp. Sec. Litig., 577 F. Supp. 2d 968, 974 (S.D. Ohio 2008). (plaintiffs claimed that the Gen-X acquisition was a "disaster," because Gen X's costs were not controlled, its inventory was in a state of disarray, its invoices had not been collected and its bills were unpaid).

189. *Id.* at 979-80.

executive's scienter (or motive) to misrepresent.[190] The court took judicial notice of the trustee's complaint for two reasons.[191] First, the plaintiffs were only asking the court to take judicial notice of the allegations, not the truth of it, and on a motion to dismiss, as opposed to a motion for summary judgment, the court had to address only whether the allegations in the complaint stated a claim for relief, not whether sufficient evidence made the case.[192] Second, the request for judicial notice was comparable to asking for leave to amend.[193] Further, the court noted that taking judicial notice of the trustee's complaint, rather than dismissing without prejudice and forcing the plaintiffs to file an amended complaint, would conserve judicial resources.[194] Once the district court considered the trustee's complaint, the plaintiffs were able to adequately allege scienter for one of the executives.[195]

Bankruptcy examiners have played major roles in investigating pre-petition misconduct that led to the filing of some of the most notorious cases of corporate fraud, including Enron and WorldCom.[196] Under the

190. *Id.* at 981 (explaining that defendants argued the Court could not take judicial notice of the Trustee's complaint, because it contained only allegations and not facts).

191. *Id.* at 978-79. ("In determining whether to grant a Federal Rule 12(b)(6) motion, district courts primarily consider the allegations in the complaint. The court is not limited to the four corners of the complaint, however. Numerous cases . . . have allowed consideration of matters incorporated by reference or integral to the claim, items subject to judicial notice, matters of public record, orders, items appearing in the record of the case, and exhibits attached to the complaint whose authenticity is unquestioned; these items may be considered by the district judge without converting the motion into one for summary judgment." (citing 5B WRIGHT & MILLER, FEDERAL PRACTICE & PROCEDURE § 1357 at 375-76)).

192. *In re* Huffy Corp. Sec. Litig., 577 F. Supp. 2d at 978 (stating that on a motion to dismiss under Rule 12(b)(6), a court ordinarily cannot consider matters outside of the pleading unless the court converts the Rule 12(b)(6) motion into a motion for summary judgment under Rule 56.); *See, e.g.*, Buck v. F.D.I.C., 75 F.3d 1285,1288 n.3 (8th Cir. 1996).

193. *In re Huffy Corp. Sec. Litig.*, 577 F. Supp. 2d at 981 (stating that leave to amend is freely given and that the PSLRA does not limit this.). But the circuits are divided over whether Rule 15's liberal amendment policy remains in tact in light of the PSLRA and Tellabs. *See* Wunderlich, *Amending Pleadings in Securities Fraud*, *supra* note 176. If the court takes a stringent view of Rule 15, judicial notice may not have been appropriate because amendment may not have been proper.

194. *In re Huffy Corp. Sec. Litig.*, 577 F. Supp. 2d at 981-82.

195. *Id.* at 995.

196. Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners After BAPCPA*, 80 AM. BANKR. L.J. 289, 321 (2006); *see also* Colin

Code, the bankruptcy court can (although rarely does[197]) appoint a bankruptcy examiner to investigate conduct and then file a report regarding that investigation.[198] An examiner is usually appointed when the movant alleges securities fraud by the debtor and its management team.[199] If a bankruptcy examiner is charged with investigating any fact pertaining to fraud or misconduct, his report is highly relevant to securities law violations.[200] The examiner's report can roadmap future litigation, but also put the brakes on meritless causes of action.[201] If a

Barr, *$642 Million To clean up Lehman—and Counting*, CNNMONEY.COM, (Mar. 12, 2010), *available at*, http://money.cnn.com/2010/03/12/news/companies/lehman.fees.fortune/index.htm.

197. David J. Baldwin & R. Stephen McNeill, *Considerations of Examiner Appointments in Bankruptcy Actions*, 26 BANKR. STRATEGIST 1 (June 2009).

198. *See* 11 U.S.C. §§ 1104(c); 1106(a)-(b); *In re* Big Rivers Elec. Corp. v. Schilling, 355 F.3d 415, 422, 429 (6th Cir. 2004). The examiner's report, once filed, is a public record. 11 U.S.C § 107(a) (". . . a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge . . ."). A bankruptcy court can, however, order the information sealed for commercial, confidential, or defamatory reasons. *In re* Ionosphere Clubs, Inc., 156 B.R. 414, 433 (S.D.N.Y. 1993). An examiner may obtain documents and materials from the debtor-company, its directors, officers, and even its auditors, to name a few. *See, e.g.*, *In re* New Century Trs Holdings, Inc., 407 B.R. 558, 562-63 (Bankr. D. Del. 2009). An examiner performs his duties at the request of the bankruptcy court, for the benefit of the debtor, its creditors, and shareholders. *See, e.g.*, *id*.

199. Baldwin & McNeill, *supra* note 197, at 1.

200. *See* Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), No. MDL-1446, 2005 WL 3504860, at *10 n.19 (S.D. Tex. Dec. 22, 2005); In re SemGroup Energy Partners, L.P., Sec. Litig., No. 08-MD-1989-GKF-FJM, 2009 WL 3713524, at *1 (N.D. Okla. Nov. 4, 2009). In Lehman Brothers' bankruptcy, the bankruptcy examiner reported that Lehman Brothers' use of an accounting device, the "Repo105," was used only for the purposes of balance sheet manipulation and that there would likely be a colorable claim against the senior officers that certified and oversaw the transactions involving this accounting device. *Introduction, Executive Summary, and Procedural Background*, Report of Examiner in *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (JMP), at 5-8, 18-21 (Mar. 11, 2010), *available at,* http://lehmanreport.jenner.com/VOLUME%201.pdf; *see also Final Report of Bankruptcy Examiner*, Final Report of Examiner in *In re New Century Trs Holdings, Inc.*, No. 07-10416 (KJC) (Feb. 29, 2008), *available at* http://graphics8.nytimes.com/packages/pdf/business/Final_Report_New_Century.pdf (concluding that the debtor company engaged in a number of significant improper and imprudent practices related to its loan originations).

201. White III & Theus, *supra* note 196, at 323. This point should not be glossed over. Securities fraud opponents are often concerned that much of securities litigation is frivolous. This was a driving belief behind enactment of the PSLRA. S. REP. NO.

securities fraud plaintiff may rely on a bankruptcy examiner's report, the plaintiff can save significant time and money otherwise spent in duplicative discovery.[202]

Bankruptcy courts are mindful, however, that an examiner's report should not "fuel the litigation fires of third party litigants."[203] This concern existed in the massive bankruptcy of Baldwin-United, which was alleged to have artificially inflated the value of its stock through misleading financial reports, statements, and press releases.[204] Baldwin-United eventually filed bankruptcy in 1983,[205] which was, at the time, the largest bankruptcy in American history.[206] Three days after filing

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104-98, at 5 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 679, 683 ("The Committee heard substantial testimony that today certain lawyers file frivolous "strike" suits alleging violations of the Federal Securities Laws in the hope that defendants will quickly settle to avoid the expense of litigation."); H.R. REP. NO. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730 (discussing the "abusive practices" employed in securities litigation). Thus, allowing a bankruptcy examiner to screen out frivolous claims would best serve Congress's intent behind the PSLRA and inhibit the filing of frivolous suits.

202. *In re* Baldwin United Corp., 46 B.R. 314,316 (Bankr. S.D. Ohio 1985) ("[T]he Examiner's file drawers offer a most enticing alternative to the long and bloody battles which plaintiffs's counsel often face in the discovery phase of securities litigation."); *see also* Colin Barr, *$642 Million To clean up Lehman—and Counting*, CNNMONEY.COM, (Mar. 12, 2010), *available at*,http://money.cnn.com/2010/03/12/news/companies/lehman.fees.fortune/index.htm(". . . the Lehman report cost less than half as much as the examiner reports for Enron—another large, complicated, high profile case—and was issued much sooner after Lehman's bankruptcy filing. That could help plaintiffs seeking to recover Lehman losses.").

203. *In re Baldwin United Corp*., 46 B.R. at 316; *In re New Century Trs Holdings, Inc.*, 407 B.R. at 566 (citing *In Re Baldwin United Corp.);* JOHN C. COFFEE, JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 39 (2006). (stating that a bankruptcy examiner is in fact an advocate who seeks to frame the case for liability against those who might be induced to contribute to the bankrupt estate.)

204. Stoller v. Baldwin United, No. C 1 82 1438, 1984 WL 884, at 885 (S.D. Ohio Sep. 19, 1984).

205. Lynn M. LoPucki, *Bankruptcy Research Database*, *available at*, http://lopucki.law.ucla.edu/companyinfo.asp?name=Baldwin-United+Corporation (last visited, Sep. 16, 2009).

206. Stoller v. Baldwin-United Corp., 41 B.R. 884, 886 (S.D. Ohio 1984). ("The balance sheets contemplated nearly ten billion dollars, and the case involved more than 200 subsidiaries of the debtor corporations."); Baldwin-United Corp. v. Paine Webber Group, Inc. (In re Baldwin-United Corp.), 57 B.R. 759, 769 (S.D. Ohio. 1985) ("There were over 8,000 claims filed representing well over 1000,000 peoples and entities.").

for bankruptcy, multiple securities fraud suits were brought in various federal district courts[207] but were stayed by Section 362 of the Code.[208] The bankruptcy court appointed an examiner to identify any fraud, dishonesty, or mismanagement in the affairs of the debtor-company.[209] The securities fraud plaintiffs moved to lift the stay to pursue their securities litigation, arguing that if they could not continue, they would lose valuable evidence.[210] The district court denied the request even though the plaintiffs would have benefitted from the examiner's report.[211] In the bankruptcy court, the securities fraud plaintiffs then moved for an order requiring the court-appointed examiner to preserve documents and other investigative materials.[212] The bankruptcy court, however, was wary that if examiners become "civil grand juries" (thereby losing their nonadversarial role), the subjects of their investigation would be hampered by the threat of litigation.[213]

Similarly, in the Enron debacle, the securities fraud plaintiffs incorporated the entire bankruptcy examiner's report in their complaint.[214] The district court found that the plaintiffs' incorporation

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207. *See In re Baldwin-United Corp. Litig.*, 765 F.2d at 344; *In re Baldwin-United Corp.*, 57 B.R. at 762.

208. 11 U.S.C. § 362.

209. *In re* Baldwin United Corp., 46 B.R. 314 (Bankr. S.D. Ohio 1985).

210. *Stoller*, 41 B.R. at 884, 890. The bankruptcy court is not the only forum that determines third party discovery issues relating to the examiner. *See In re* Baldwin United Corp., 46 B.R. at 317.

211. *Stoller*, 41 B.R. at 891 ("As to the potential for fading memory or misplaced records, the impact of that concern is blunted by the fact that the bankruptcy examiner will be conducting an investigation into whether fraud occurred in the recent corporate past of the debtors. As already noted, the bankruptcy court, in denying these plaintiffs' motion for relief from the § 362 stay, concluded that '[w]hile the scope of [the examiner's] investigation may not precisely coincide with the thrust of the . . . plaintiffs' discovery, it would appear totally senseless for the plaintiffs to proceed with their monumental task until they have the benefit of [the examiner's] efforts.'").

212. *In re Baldwin United Corp*., 46 B.R. at 314. The Bankruptcy court was concerned that the prospect of litigation surrounding the examiner's investigation would chill compliance with the examiner's efforts. *Id.* at 316. To assuage these concerns, the plaintiffs cleverly argued that they sought only the preservation of the evidence and not the use of it. *Id.* The bankruptcy court was unimpressed and stated that there was "little doubt that they will at some point seek to require the Examiner to turn over some or all of the documents and other information which he has obtained through his investigation." *Id.*

213. *Id.* at 317.

214. Newby v. Enron Corp. (*In re* Enron Corp. Sec., Derivative & ERISA Litig.), No. MDL-1446, 2005 WL 3504860, at *11 n.20 (S.D. Tex. Dec. 22, 2005).

of the report was proper and as a result, the plaintiffs were able to overcome a motion to dismiss.[215] Relying on an examiner's report to muster a securities fraud claim does present some risk, however. LoPucki aptly describes this danger within the context of Enron, where the plaintiffs incorporated the entire examiner's report in their complaint[216]:

> Enron and the other parties who wished to sue on Enron's behalf had only two years in which to file their cases or be barred by the statute of limitations. Because the case was handled so awkwardly, nearly six months passed before the examiner was even appointed. The effect was to rush the investigation. The examiner worked quickly but was still completing his report when the deadline expired. That left parties who discovered their causes of action through the examiner's work little or no time in which to digest the 4,500-page report, retain counsel, and prepare their lawsuits for filing.[217]

If the bankruptcy case is handled poorly, securities fraud plaintiffs may not be able to wait for the examiner's report. Additionally, LoPucki warns that the bankruptcy examiner may—as in the case of Enron—work against class action plaintiffs and destroy documents that these investors seek because, for one reason or another, the examiner promised confidentiality to the sources.[218]

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215. *Id.* at *11, 13-14. The court supported its conclusion by referring to Rule 10(c) which allows a party to incorporate any instrument as an exhibit to a pleading. *Id.*; *see also* FED. R. CIV. P. 10(c) ("A statement in a pleading may be adopted by reference elsewhere in the same pleading or in any other pleading or motion. A copy of a written instrument that is an exhibit to a pleading is a part of the pleading for all purposes.").

216. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 2005 WL 3504860, at *11 n.20.

217. LOPUCKI, *supra* note 65, at 151.

218. *Id.* at 148; *cf.* Colin Barr, $642 Million To Clean Up Lehman—and Counting, CNNMONEY.COM, (Mar. 12, 2010), *available at*, http://money.cnn.com/2010/03/12/news/companies/lehman.fees.fortune/index.htm ("At the same time, the Lehman report cost less than half as much as the examiner reports for Enron—another large, complicated, high profile case—and was issued much sooner after Lehman's bankruptcy filing. That could help plaintiffs seeking to recover Lehman losses. 'The Lehman case is much like the Enron case. . . People were waiting for the examiner report in the Enron case, and it ended up serving as the basis for lots of civil suits.' The promptness of the [examiner's report in Lehman's bankruptcy] will give the many aggrieved parties in the Lehman case ample time to pursue claims against the company's officers, business partners and others . . . The statute of limitations for

Moreover, the bankruptcy courts may place limits on the use of bankruptcy materials in securities fraud litigation.[219] For example, in *In re Recoton,* the committee of unsecured creditors moved the bankruptcy court to authorize subpoenas for the production of documents and to examine witnesses.[220] The directors of the debtor-company (the persons from whom discovery was sought) objected because securities fraud suits were pending against them in federal district court.[221] The directors argued that an examination in bankruptcy would deny them the benefit of the PSLRA's stay of discovery provision.[222] The district court rejected the defendants' PSLRA argument, however because the PSLRA only applies to suits that have in fact begun and provides for a mandatory stay of discovery in actions brought only under the federal securities laws.[223] Thus, the district court ordered the examination under Bankruptcy Rule 2004,[224] stating:

> The investigation that a debtor or creditors committee may . . . be an essential element in the formulation of a Chapter 11 plan or in a Chapter 7 trustee's ability to make any distribution to creditors. It would seriously delay and disrupt the administration of bankruptcy cases if the happenstance of a pending securities action gave the defendants in that suit the ability to impede investigations that the

claims filed by a bankruptcy trustee is two years, which means many Lehman cases will have to be filed in the next six months.").

219. *See In re* Recoton, Corp., 307 B.R. 751, 759 (Bankr. S.D.N.Y. 2004).

220. *Id.* at 754. The committee is expressly authorized to investigate the acts, conduct, assets, liabilities and financial condition of the debtor under § 1103 of the Bankruptcy Code. 11 U.S.C. § 1103(c)(2) (stating that a committee appointed under Section 1102 may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan.").

221. *In re Recoton, Corp.*, 307 B.R. at 755.

222. *Id.*

223. *Id.* at 757-58.

224. The relevant portions of Bankruptcy Rule 2004 states:

> (a) Examination on motion.
> On motion of any party in interest, the court may order the examination of any entity.
> (b) Scope of examination.
> The examination of an entity . . . may relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge. . . .

FED. R. BANKR. P. 2004(a)-(b).

debtor or committee may appropriately conduct . . .[225]

Yet, the court only permitted the examination because the court received assurances from the committee that any discovery would be subject to a protective order "prohibiting its use for any purpose whatsoever other than in connection with this bankruptcy proceeding and prohibiting its disclosure . . . to the plaintiffs in the [securities class action]."[226]

Prohibiting the use of discovered material relevant to fraud unjustifiably duplicates discovery costs for plaintiffs. Allowing plaintiffs access to materials can simplify suits, decrease costs for both parties, and most important, expose corporate fraud.

2. Denying Class Certification in Non-Debtor Actions in Non-Debtor Forums

A company's bankruptcy may even influence a district court's decision to certify a securities class action against a non-debtor. In *Gregory v. Finova Capital*, the high-water mark for bankruptcy's protection of non-debtors from securities fraud, the Fourth Circuit held that the district court abused its discretion when it certified a class action against a non-debtor.

In *Gregory*, noteholders of the Thaxton Group, Inc. ("TGI") filed a class action against TGI's lender, Finova Capital Corporation ("Finova").[227] TGI sold the notes in a series of person-to-person transactions and under eight separate registration statements filed with the SEC.[228] According to the plaintiffs, Finova worked with TGI to put together a group of companies that were insolvent by about $40 million and that TGI was doomed to fail from its inception.[229] TGI, which was started by Finova, had no net profits, and could only stay in business by raising money from a larger and larger group of investors, similar to a Ponzi scheme.[230] The day after the plaintiffs filed suit against Finova,

225. *In re Recoton, Corp*., 307 B.R. at 759.

226. *Id.* at 756; *see also In re* Mittco, Inc., 44 B.R. 35, 35 (Bankr. E.D. Wis. 1984) (limiting Rule 2004 discovery when it is designed to abuse or harass).

227. Gregory v. Finova Capital Corp., 442 F.3d 188, 189 (4th Cir. 2006).

228. *Id.*

229. Brief of Plaintiffs-Appellees at 4, Gregory v. Finova Capital Corp., 442 F.3d 188 (4th Cir. 2006) (No. 05-2118).

230. Brief of Plaintiffs-Appellees at 6, Gregory v. Finova Capital Corp., 442 F.3d

TGI filed for Chapter 11 bankruptcy.[231] The noteholders alleged that TGI misrepresented financial data in the notes' registration statements.[232] They also alleged that Finova was jointly and severally liable for the misrepresentations as a controlling person under Section 15 of the 1933 Act,[233] which provides for joint and several liability on behalf of controlling persons.[234] The noteholders sought to certify a class action against Finova in federal district court.[235]

Meanwhile, after the noteholders filed their class action, the committee of TGI's unsecured creditors brought an adversary proceeding against Finova, in TGI's bankruptcy, to either disallow or subordinate Finova's claims to the noteholders' claims because Finova violated the securities laws.[236] After these events in the bankruptcy court, the district court certified the noteholders as a class.[237]

The Fourth Circuit reversed the district court's class certification decision, finding that the district court abused its discretion by certifying

188 (4th Cir. 2006) (No. 05-2118). A "Ponzi scheme," or "pyramid scheme," is a fraudulent investment scheme in which money contributed by investors is used directly to repay or pay interest to earlier investors. BLACK'S LAW DICTIONARY (8th ed. 2004).

231. *Gregory*, 442 F.3d at 189.

232. The Securities Act of 1933 § 11, 15 U.S.C. § 77k(a) ("In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may ...sue... every person who signed the registration statement...").

233. *Gregory*, 442 F.3d at 189. Section 15 of the 1933 Act and Section 20(a) of the 1934 Act both impose liability on controlling persons, but they differ slightly in language. Section 15 appears to provide a complete defense for ignorance while Section 20(a) requires a showing of good faith. COFFEE, JR., SECURITIES REGULATION, *supra* note 63, at 1078-79. Courts are still wrestling with what this difference in language means though.

234. The Securities Act of 1933 § 15, 15 U.S.C. § 77o. According to the plaintiffs, Finova was an active partner and counselor to TGI, took a leading role in most of TGI's major business decisions, and was fully aware of the note-sale program designed to transfer the risky portion of Finova debt to the unsuspecting noteholders. *Gregory*, 442 F.3d at 189.

235. *Gregory*, 442 F.3d at 189.

236. *Id.; see also* 11 U.S.C. § 510(c).

237. *Gregory*, 442 F.3d at 190. To certify a class, a plaintiff must satisfy the numerosity, commonality, adequacy, and typicality requirements of Rule 23(a). FED. R. CIV. P. 23(a). In addition, for actions certified under Rule 23(b)(3) seeking monetary damages, the class issues must predominate over individual issues and the class action device must be a superior method of adjudication. Fed. R. Civ. P. 23(b)(3)(B).

the class. It reasoned that the district court failed to analyze whether the class action was superior to the adversary proceeding pending in the bankruptcy court to adjudicate the noteholders' claims.[238] The court reasoned that it would be "inefficient and needlessly duplicative" and that the adversary proceeding would make the same findings regarding Finova's conduct.[239] Additionally, the court observed that if the noteholders were made more or less whole by success in the adversary proceeding—success would result in payment from TGI's assets ahead of Finova — Finova's direct liability to the noteholders would be more or less extinguished.[240]

Gregory wrongly reversed the district court, however. First, the Fourth Circuit ignored the highly deferential standard governing the review of a district court's decision to certify a class action.[241] Here, there was no abuse of the district court's discretion when it certified a securities class action consisting of *noteholders* of the debtor proceeding against a *lender* of the debtor (non-debtor vs. non-debtor) over the objection of—not the debtor—but *creditors* of the debtor (non-debtor vs. non-debtor, with non-debtors objecting). Second, the adversary bankruptcy proceeding concerned only whether Finova must wait behind the noteholders in line for TGI's assets, and it would not resolve whether

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238. *Gregory*, 442 F.3d at 190-91. A district court's decision to certify a class is reviewed for an abuse of discretion. Lienhart v. Dryvit Sys., Inc., 255 F.3d 138 (4th Cir. 2001); McClain v. S.C. Nat'l Bank, 105 F.3d 898, 902 (4th Cir. 1997).

239. *Gregory*, 442 F.3d at 191 n.5.

240. *Id.*; *see* the Securities Act of 1933 § 15, 15 U.S.C. § 77o (providing for joint and several liability for violations of Section 11 of the 1933 Act).

241. The abuse of discretion standard requires a reviewing court to show enough deference to a decision maker's judgment that the court does not reverse merely because it would have come to a different result in the first instance. *See* Henry J. Friendly, *Indiscretion About Discretion*, 31 EMORY L.J.747, 754 (1982) ("[T]he trial judge has discretion in those cases where his ruling will not be reversed simply because an appellate court disagrees."); *see also* Monroe v. City of Charlotesville, Va., 579 F.3d 380, 384 (4th Cir. 2009) (stating that a decision to deny or grant class certification is accorded "great" deference); Brown v. Nucor Corp., 576 F.3d 149, 161 (4th Cir. 2009) (noting that an appellate court reviews a decision to certify a class under the "highly deferential" abuse of discretion standard); *In re* PolyMedica Corp. Sec. Litig., 432 F.3d 1, 4 (1st Cir. 2005) (same). What's more, when reviewing a grant of class certification, as in Gregory, appellate courts accord the district court noticeably more deference than when reviewing a denial of class certification. *E.g.*, *In re* Flag Telecom Holdings, Ltd. Sec. Litig., 574 F.3d 29, 34 (2d Cir. 2009); *In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 480 (2d Cir. 2008); Marisol A. v. Giuliani, 126 F.3d 372, 375 (2d Cir. 1997).

Finova was directly liable to the noteholders.[242] Whether the noteholders' direct claims against Finova will be extinguished by the adversary bankruptcy proceeding was speculative because: (1) it was uncertain whether the creditors committee would prevail; and (2) even if they did prevail, the Code provides only that the bankruptcy court "may," and not "must," equitably subordinate the claims.[243] Further, the plaintiffs were not even parties to the adversary proceeding in bankruptcy.[244]

Third, a bankruptcy court may lack authority to determine securities fraud liability in the first instance.[245] The bankruptcy courts disagree over whether they have the authority to determine liability between the debtor-company and the securities fraud claimant.[246] If this authority is questionable (debtor vs. non-debtor), then a bankruptcy court's authority to determine liability for securities fraud between a securities fraud claimant and a non-debtor *(*non-debtor vs. non-debtor), is even less

242. *Gregory*, 442 F.3d at 194-95 (King, J., dissenting).

243. *Id.* at 194 n.3.

244 Brief of Plaintiffs-Appellees at 60, Gregory v. Finova Capital Corp., 442 F.3d 188 (4th Cir. 2006) (No. 05-2118).

245. In this case, it would also be questionable whether the bankruptcy court had subject matter jurisdiction as well. Bankruptcy courts are courts of limited jurisdiction. *E.g*., *In re* Querner, 7 F.3d 1199, 1201 (5th Cir. 1993); *In re* Granger Garage, Inc., 921 F.2d 74, 77 (6th Cir. 1990). Bankruptcy courts have only derivative jurisdiction; "They do not operate under an exclusive grant of jurisdiction as in § 1471(c) but rather derive their jurisdiction from the district courts." White Motor Corp. v. Citibank, N.A., 704 F.2d 254, 263 (6th Cir.1983). Under 28 U.S.C. § 1334, a district court has exclusive jurisdiction of all bankruptcy cases under title 11 and "original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11." 28 U.S.C. § 1334(b); *see also id.* § 157(b) (authorizing district courts to refer "core" and "related to" proceedings to bankruptcy courts for adjudication). Jurisdiction over proceedings between third parties which have an effect on the bankruptcy estate flow from the court's "related to" jurisdiction. *Id.* § 1334(b). It is a considerable stretch that this non-debtor action against other non-debtors, to which only non-debtors are objecting, is related to the bankruptcy estate, particularly when recovery would not involve any of the debtor's interests.

246. *Compare In re* Jafari, 401 B.R. 494, 495 (Bankr. D. Colo. 2009) (stating a bankruptcy court lacks authority under Section 523(a)(19) to adjudicate liability as opposed to dischargeability); *cf In re* Zimmerman, 341 B.R. 77, 80 (Bankr. N.D. Ga. 2006); *In re* Demers, No. 08 00616 FLK7, 2009 WL 3681675, at *1 (Bankr. E.D. Wash. Oct. 30, 2009) (concluding that bankruptcy court lacked jurisdiction to determine liability under Section 523(a)(19)); *with In re* Chan, 355 B.R. 494, 501 (Bankr. E.D. Pa. 2006) (concluding a bankruptcy court has authority to determine both liability and dischargeability); *see also In re* Litchman, 388 B.R. 396, 409 (Bankr. M.D. Fla. 2008).

clear.[247] As discussed, not all courts are receptive to class proofs of claim.[248] Judge King observed the practical problem this would present in *Gregory*: each TGI noteholder—approximately 4,000 of them—would have to file a separate lawsuit to preserve his claim against Finova.[249] The burden of bringing multiple, individual adversary proceedings or a single proceeding with multiple parties would be enormous.[250] Last, *Gregory* encourages gamesmanship and increases litigation costs. In the district court, Finova argued that the bankruptcy court was the proper forum, but in the bankruptcy court, Finova argued that the district court should resolve the case.[251] Finova—the party that engineered TGI's bankruptcy to begin with—argued it both ways and won.

247. *See In re* Refco Inc., 505 F.3d 109, 118 (2d Cir. 2007) ("Bankruptcy court is a forum where creditors and debtors can settle their disputes with each other. Any internal dispute between a creditor and that creditor's investors belongs elsewhere.").

248. *In re Standard Metals Corp*., 817 F.2d at 632 (denying class proof of claim); *In re* Amdura Corp., 130 B.R. 575 (Bankr. D. Colo. 1991) (same); *In re* Texaco Inc., 81 B.R. 820 (Bankr. S.D.N.Y. 1988) (same).

249. *Gregory*, 442 F.3d at 194. For example, in Drexel Burnham's bankruptcy, "the magnitude and complexity of 850 securities-related proofs of claim, which totaled more than $20 billion, was viewed as an almost impossible bar to achieving a reorganization. The barrier was overcome by the creation of a no-opt-out class, whose representatives negotiated a settlement with the Drexel debtors." Leonard H. Gerson, *Another Look at Treatment and Use of Class Proofs of Claim and Class Actions in Bankruptcy*, 27 AM. BANKR. INST. L.J. 16 (2008).

250. Consider Drexel Burnham's case—the debtor would have to bring 850 individual adversary proceedings or file one adversary proceeding with 850 parties. This places considerable strain on the debtor-company, the other parties, and the judicial system. This burden can be reduced by bringing a single adversary proceeding and a single class proof of claim. Gerson, *supra* note 249, at 16.

251. Brief of Plaintiffs-Appellees at 58-59, Gregory v. Finova Capital Corp., 442 F.3d 188 (4th Cir. 2006) (No. 05-2118).

D. THE PLAN OF REORGANIZATION: JURISDICTION AND POWER TO RELEASE NON-DEBTOR'S FROM SECURITIES FRAUD LIABILITY[252]

The courts have not been nearly as subtle as the previous Parts suggest in releasing non-debtors from liability in bankruptcy. Courts outright release non-debtors in the debtor's plan of reorganization. In exchange for surrendering all assets over to the bankruptcy court's jurisdiction, the debtor receives a discharge from pre-petition debt, quid pro quo.[253] This discharge benefits only the debtor; it does not apply to guarantors, co-defendants, employees, or related companies—and therefore, creditors are free to collect from these co-liable parties.[254]

Nevertheless, bankruptcy courts have used their general, equitable powers under the Code to extinguish claims against non-debtors.[255] Recently, in *Travelers Indemnity v. Bailey*, the Supreme Court held that bankruptcy courts have subject matter jurisdiction to discharge claims against non-debtors in the debtor's plan of reorganization if the claims[256]

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252. David A. Skeel, Jr., suggests that trial lawyers have been supportive, rather than critical, of bankruptcy's role in mass tort resolution and that this support reflects the comparative attractions of bankruptcy as opposed to bringing class action litigation outside of bankruptcy. SKEEL, JR., *supra* note 9, at 220. This may be especially true for securities litigation, where, in recent years, the federal courts have made the standards for class certification more rigorous. *See generally* Michael J. Kaufman & John M. Wunderlich, *The Unjustified Judicial Creation of Class Certification Merits Trials in Securities Fraud Actions*, 43 U. MICH. J. L. REFORM 323 (2010).

253. E.g., *In re* Mosby, 244 B.R. 79, 85 (Bankr. E.D. Va. 2000) (quoting *In re Jeffrey*, 176 B.R. 4, 6 (Bankr. D. Mass. 1994)) ("A chapter 7 case involves a quid pro quo: debtors receive a discharge and, in exchange, make full disclosure about their financial affairs, especially their assets, and surrender their nonexempt assets to the trustee for liquidation and distribution among creditors. . . . Having received a discharge, they cannot now ignore their obligation to surrender their assets for the benefit of creditors."); *In re* O'Shaughnessy, 252 B.R. 722, 735 (Bankr. N.D. Ill. 2000) ("Complete and full disclosure is the quid pro quo for the substantial benefits obtained by the automatic stay of 11 U.S.C. § 362(a) which is subsumed by the discharge provisions of 11 U.S.C. § 1141 in a Chapter 11 case.").

254. 11 U.S.C. § 524(a) (applying only to the *debtor*).

255. Joshua M. Silverstein, *Hiding in Plain View: A Neglected Supreme Court Decision Resolves the Debate Over Non-Debtor Releases in Chapter 11 Reorganizations*, 23 EMORY BANKR. DEV. J. 13, 16-17 (2006). "For at least eighteen years, the federal courts have been divided over whether such releases are permissible." *Id.* at 17.

256. "[T]he expanded definition of *claim* (together with the Code's elimination of any requirement that a debtor be insolvent when it files for bankruptcy) has played a crucial role in some of the most visible bankruptcy cases of the past two decades, the

relate to the property of the bankruptcy estate.[257] *Travelers*, though, leaves much to be desired, as it does not address whether bankruptcy courts have the power—as opposed to jurisdiction[258]—to release these non-debtors. To determine whether a bankruptcy court has the power to discharge non-debtor liabilities in a plan of reorganization, the majority of the circuits adopt a flexible approach, assessing the propriety of the injunction and release of a non-debtor on a case by case basis.[259]

'mass tort cases—bankruptcies filed by Johns Manville, A.H. Robins, Dow Corning, and other firms after they were sued by thousands of actual and potential tort victims." SKEEL, JR., *supra* note 9, at 217.

257. Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195 (2009). Professor Joshua M. Silverstein argues that a much earlier decision, *United States v. Energy Resources, Co.*, 495 U.S. 545 (1990), resolved the debate and concludes that bankruptcy courts have the power to issue non-debtor releases, but only in narrow circumstances. Silverstein, *supra* note 255, at 19-20. This decision was not relied on in *Travelers*. *See* 129 S. Ct. 2195.

258. "Subject matter jurisdiction and power are separate prerequisites to the court's capacity to act. Subject matter jurisdiction is the court's authority to entertain an action between the parties before it. Power under section 105 is the scope and forms of relief the court may order in an action in which it has jurisdiction." Am. Hardwoods, Inc. v. Deutsche Credit Corp. (*In re* Am. Hardwoods, Inc.), 885 F.2d 621, 624 (9th Cir. 1989). Jurisdiction over proceedings between third parties which have an effect on the bankruptcy estate flow from the court's "related to" jurisdiction. 28 U.S.C. § 1334(b) ("Except as provided in subsection (e)(2), and notwithstanding any Act of Congress that confers exclusive jurisdiction on a court or courts other than the district courts, the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11.").

259. *See, e.g.*, SEC v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 960 F.2d 285, 293 (2d Cir. 1992); Menard-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694, 702 (4th Cir. 1989); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760-61 (5th Cir. 1995); *In re* Munford Inc., 97 F.3d 449, 455 (11th Cir. 1996); *In re* AOV Indus., Inc., 792 F.2d 1140, 1154 (D.C. Cir. 1986). "[N]on-debtor releases are receiving 'growing judicial acceptance' and becoming increasingly common in Chapter 11 plans of reorganization. Indeed, one commentator has suggested that 'the practice of approving non-debtor releases is more widespread than the number of published judicial opinions would suggest[,]'because appellate challenges to plan reorganization are often mooted by consummation of the plan." Silverstein, *supra* note 255, at 18 (citing Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959, 964 n.15 (1997)). Professor Silverstein notes that the debate is split four ways, rather than two: one group of pro-release courts that assert the equitable powers of the Code allow for non-debtor releases; a group of anti-release courts that assert that non-debtor releases violate Section 524; a second group of anti-release courts that contend that Section 524 does not prohibit non-debtor

Considerations analyzed by these courts include: (1) whether the case involves a mass tort claim;[260] (2) whether the claim is direct rather than derivative;[261] (3) whether there was a consensual release;[262] (4) whether the claimants were in some way compensated for the release under the plan;[263] (5) whether the release is integral for the debtor to settle with other creditors;[264] and (6) whether the plan contains a channeling injunction.[265] The courts that have adopted this flexible approach—the infamous mass tort bankruptcies: *In re A.H. Robins* (intrauterine Dalkon Shield device), *In re Johns-Manville* (asbestos), *In re Drexel Burnham* (securities fraud), *In re Dow Corning* (silicone breast implants)—were all bankruptcies that involved thousands of actual and potential tort victims[266] similar to securities class actions.

Even still, a few circuits are reluctant to extend the release to non-

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releases, but the bankruptcy policies underlying it do; and another group of anti-release courts that argue that Section 524 does not constitute a bar, but the equitable provisions in the Code simply do not grant enough power to release non-debtors. *Id.* at 17. Because non-debtor releases are not the main focus of this article, I will generalize and discuss two approaches: the pro-release courts, and the anti-release courts.

260. *In r*e Digital Impact, Inc., 223 B.R. 1, 9 (N.D. Okla. 1998); *see also In re* A.H. Robins Co., 88 B.R. 742, 743-45 (E.D. Va. 1988) (observing that thousands of tort actions forced A.H. Robins into bankruptcy); Kane v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 843 F.2d 636, 640, 649 (2d Cir. 1988) (noting that thousands of asbestos actions pushed Johns Manville into bankruptcy); *In re* Drexel Burnham Lambert Group, Inc., 130 B.R. 910, 918-19 (S.D.N.Y. 1991) (noting that the bankruptcy involved tens of thousands of securities fraud claimants).

261. *In re* Zenith Elec. Corp., 241 B.R. 92, 111 (Bankr. D. Del. 1999); *In re* Arrowmill Dev. Corp., 211 B.R. 497, 506 (Bankr. D.N.J. 1997).

262. *See In re* Specialty Equip. Co., 3 F.3d 1043, 1049 (7th Cir. 1993) (noting that consensual agreement is relevant). Consensual non-debtor releases are generally permissible under the Code because they do not primarily involve the bankruptcy court's power. *See In re Arrowmill Dev. Corp.*, 211 B.R. at 506. Rather, the validity of a consensual release is a question of contract law and courts recognize that they are no different from any other settlement or contract. *See id.*.

263. *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d at 293; *In re AOV Indus.*, Inc., 792 F.2d at 1154.

264. *In re* Munford Inc., 97 F.3d 449, 455 (11th Cir. 1996).

265. Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760 (5th Cir. 1995). A channeling injunction is a provision in the debtor's plan of reorganization that enables a court to enjoin all future suits against the debtor or its insurer. Susan N.K. Gummow & John M. Wunderlich, *Suing the Debtor: Examining Post-Discharge Suits Against the Debtor*, 83 AM. BANKR. L.J. 495, 525-26 (2009). Instead, these suits are "channeled" to certain proceeds already set aside. *Id.*

266. SKEEL, JR., *supra* note 9, at 217.

debtors.[267] This minority concludes that the debtor-company cannot, as part of its plan of reorganization, release non-debtors, such as the directors or officers, from shareholders' claims.[268] These courts strike these provisions on their own, even if the plaintiffs do not object.[269] Consider *In re Continental Airlines*, in which the plaintiffs brought securities fraud class actions against Continental's directors and officers, alleging that they violated the securities laws.[270] After these suits were filed, Continental filed for bankruptcy under Chapter 11.[271] The bankruptcy court stayed the plaintiffs' class action against the directors and officers and Continental later filed its plan of reorganization, which released and enjoined the plaintiff-investors' class action against Continental's directors and officers, who themselves were not in bankruptcy. The bankruptcy court approved the plan over the plaintiffs' objections.[272]

On appeal, the Third Circuit reversed, stating that the Code explicitly authorizes the release and permanent injunction of claims against non-debtors in only one instance: resolving asbestos claims.[273] Other than that, the court stated, the Code clarifies that a discharge does not relieve non-debtors of their liabilities.[274] Even though Section 105(a) grants the bankruptcy courts power to issue any necessary order to carry out the Code, the court continued, Section 105 is limited in

267. *See, e.g.*, *In re* Chateaugay Corp., 167 B.R. 776, 780 (S.D.N.Y. 1994); *In re* Mkt. Square Inn, Inc., 163 B.R. 64, 66-67 (Bankr. W.D. Pa. 1994).

268. *See* Gillman v. Cont'l Airlines *(In re* Cont'l Airlines), 203 F.3d 203, 205 (3d Cir. 2000); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) ("The bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan."); Landsing Diversified Properties-II v. First Nat'l Bank & Trust Co. of Tulsa (*In re* W. Real Estate Fund, Inc.), 922 F.2d 592, 601 (10th Cir. 1990); *see also In re* Original IFPC S'holders, Inc., 317 B.R. 738, 746-48 (Bankr. N.D. Ill. 2004); *In re Arrowmill Dev. Corp.*, 211 B.R. at 500, 504-06; *In re* Future Energy Corp., 83 B.R. 470, 485-86 (Bankr. S.D. Ohio 1988).

269. *See In re* Davis Broad., Inc., 176 B.R. 290, 292 (M.D. Ga. 1994).

270. *In re Cont'l Airlines*, 203 F.3d at 205.

271. *Id.* The plaintiffs did not name the debtor-company in their securities fraud class action suits, but they did file a class proof of claim in the debtor's bankruptcy. *Id.* at 205 n.1.

272. *Id.* at 206-07. The district court affirmed the bankruptcy court's approval of the plan. *Id.* at 208.

273. *Id.* at 211; 11 U.S.C. § 524(g).

274. *In re Cont'l Airlines*, 203 F.3d at 211.

scope and cannot create rights that are otherwise unavailable.[275] The Third Circuit then held that the blanket release and injunction was not permissible, even under the most liberal read of Section 105.[276]

Whether a bankruptcy court can enjoin future actions against non-debtors in a plan of reorganization presents a recurring question of jurisdiction and bankruptcy court power. The Supreme Court's recent decision in *Travelers Indemnity Company v. Bailey* involved a state law claim for fraud against the debtor's insurer. The case sheds some light on when a bankruptcy court has jurisdiction (though not power) to enjoin other actions (such as securities actions) against non-debtors (like an officer or director).[277] In *Travelers,* the bankruptcy court approved settlement agreements that provided that when the settling (non-debtor) insurer paid funds to a designated trust, all persons would be permanently enjoined from bringing or continuing any suit against the (non-debtor) insurer.[278] Ten years later, the plaintiffs brought suit against the insurer for fraud, and the bankruptcy court enjoined the action.[279]

The Supreme Court concluded that the bankruptcy court had subject-matter jurisdiction to interpret and enforce its own prior order so long as it dealt with the property of the estate.[280] Thus, *Travelers*

275. *Id.* "One of the most commonly employed canons is *expressio unius est exclusio alterius*, which dictates that the express inclusion of one thing signals the exclusion of all other things. This rule is one individuals use all of the time in everyday life, just without such formal articulation. In the 'no dogs in the park' example, the commonsense logic of the expressio unius canon is what leads the average person to the conclusion that 'no dogs' does not apply to cats." Note, *Textualism as Fair Notice*, 123 HARV. L. REV. 542, 559 (2009).

276. *In re Cont'l Airlines*, 203 F.3d at 214; *see also* Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) (overturning bankruptcy court's approval of plan of reorganization that released directors and officers from liability for securities law violations).

277. Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195 (2009).

278. *Id.* at 2199-2200.

279. *Id.* at 2200.

280. *Id.* at 2205; *see also* Ophir v. City of Boston, 647 F. Supp. 2d 86, 91 (D. Mass. Aug. 14, 2009) ("[I]n the context of the enforceability of a Bankruptcy Court order releasing an insurer from any claims "based upon, arising out of or relating to" certain insurance policies, the Supreme Court broadly interpreted the phrase 'relating to.'"); Cano v. GMAC Mortg Corp. (*In re* Cano), 410 B.R. 506, 546 (Bankr. S.D. Tex. 2009) ("In *Travelers Indemnity,* the Supreme Court held that, post-discharge, a bankruptcy court has jurisdiction to interpret and enforce its own orders even though the bankruptcy case was closed and the claims would not affect the bankruptcy estate."). However the

suggests that a bankruptcy court may entertain the prospect of enjoining suits against non-debtor directors and officers on the presence of D&O insurance alone. The connection between directors and officers, the bankruptcy estate, and D&O insurance is much closer than the attenuated relationship in *Travelers*, which involved state law claims for fraud against the insurer that happened to insure the debtor.

Much of *Travelers*, however, was devoted to cabining the decision. The Court stated that the holding was narrow and did not resolve whether a bankruptcy court has the *power* to enjoin claims against non-debtors that are not derivative of the debtor's wrongdoing.[281] The Court's suggestion that the bankruptcy court could enjoin these claims had explicit textual support in the Code, as Section 524(g)(4)(A) deals specifically with asbestos claims.[282] Moreover, the dissenting justices argued that bankruptcy courts have the power to enjoin claims against non-debtors only if the non-debtors seek recovery from the bankruptcy estate.[283]

What is most troubling about a non-debtor release—in effect, a non-debtor discharge—is that it is broader than the discharge these non-debtors would be afforded under the Code. Certain liabilities under the Code are non-dischargeable.[284] Debts obtained by false pretenses, false representation, or actual fraud (other than a statement respecting the

Supreme Court did note that at some point the term "relate to" loses any meaning because "everything is related to everything else." *Travelers Indem. Co.*, 129 S. Ct. at 2203-04 (quoting Cal. Div. of Labor Enforcement v. Dillingham Constr., 519 U.S. 316, 335 (1997)).

281. *Travelers Indem. Co.* 129 S. Ct. at 2207.

282. *Id.* at 2207; *see also* 11 U.S.C. § 524(g).

283. *Travelers Indem. Co.*, 129 S. Ct. at 2207-08, 2210 (Stevens, J., dissenting) ("A bankruptcy court has no authority . . . to adjudicate, settle, or enjoin claims against nondebtors that do not affect the debtor's estate.").

284. 11 U.S.C. § 523(a). To except a debt from discharge, the claimant must file a discharge complaint in the debtor's bankruptcy proceeding. FED. R. BANKR. P. 4007. Bankruptcy Rule 4007(c) provides as a general rule that a complaint to determine the dischargeability of a debt under section 523(c) must be filed no later than 60 days after the first date set for the meeting of creditors. FED. R. BANKR. P. 4007(c). Section 523(a)(19) however is governed by Rule 4007(b). FED. R. BANKR. P. 4007(b). Rule 4007(b) contains no limit for complaints filed under Section 523(a)(19). FED. R. BANKR. P. 4007(b). The heightened pleading provisions applicable to securities fraud claims also apply to motions to except a debt from discharge if it is based on securities fraud. Guerriero v. Kilroy (*In re* Kilroy), 354 B.R. 476, 488-89 (S.D. Tex. 2006).

debtor's or an insider's financial condition) are nondischargeable.[285] Section 523(a)(19) of the Code also states that any debt for the violation of any federal or state securities law, or common-law fraud in connection with the purchase or sale of a security is nondischargeable.[286] Granting non-debtors releases for claims that they themselves could not obtain by filing for bankruptcy is inconsistent with the Code.[287]

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285. 11 U.S.C. § 523(a)(2)(A). To except from discharge a debt under Section 523(a)(2)(A), the creditor must show justifiable reliance. Field v. Mans, 516 U.S. 59, 68, 74-75 (1995). Securities fraud plaintiffs can either present direct evidence of their actual reliance or they can invoke a presumption of reliance. In *Stoneridge Investment Partners v. Scientific-Atlanta*, the Supreme Court noted that a rebuttable presumption of reliance exists in two instances: (1) if there is an omission of a material fact by one with a duty to disclose; and (2) if the statement at issue becomes public, thereby falling under the fraud-on-the-market presumption. Stoneridge Inv. Partners v. Scientific-Atlanta, Inc. 128 S. Ct. 761, 769 (2008) (*citing* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (presuming fraud where there is an omission and a duty to disclose) *and* Basic, Inc. v. Levinson, 485 U.S. 224 (1988) (presuming fraud under the fraud-on-the-market presumption)). The bankruptcy courts have not yet addressed whether a securities fraud plaintiff can invoke one of the reliance presumptions in a Section 523(a)(2)(A) discharge complaint, but if the basis of securities fraud liability is "controlling person" liability, then the Code's discharge exception under Section 523(a)(2)(A) does not apply. Hoffend v. Villa (*In re* Villa), 261 F.3d 1148, 1153 (11th Cir. 2001); Owen v. Miller (*In re* Miller), 276 F.3d 424, 429 (8th Cir. 2002).

286. 11 U.S.C. § 523(a)(19). For a debt to be nondischargeable under Section 523(a)(19): (1) the debt must be for a violation of federal or state securities laws, or common-law fraud, in connection with the purchase or sale of a security; and (2) the debt results from a judgment, order, decree, or settlement. Frost v. Civiello (*In re* Civiello), 348 B.R. 459, 464 (Bankr. N.D. Ohio 2006). Section 523(a)(19) applies to corporate executives and even individual brokers. Kelli A. Alces, *Moving Toward a Federal Law of Corporate Governance in Bankruptcy*, 31 S. ILL. U. L.J. 621, 630 (2007). It encompasses statutory securities violations and common-law fraud in securities transactions. Smith v. Gibbons (In re Gibbons), 289 B.R. 588, 592 (Bankr. S.D.N.Y. 2003). Section 523(a)(19) was enacted to amend the Code to make nondischargeable judgments and settlements arising from state and federal securities law violations challenged by state or federal regulators, as well as by private parties. S. REP. NO. 107-146, at 11 (2002); *see also In re* Weilein, 319 B.R. 175, 179 (Bankr. N.D. Iowa 2004); *In re* McClung, 304 B.R. 419, 424 (Bankr. D. Idaho 2004).

287. This principle is well-settled. *E.g.*, Scrivner v. Mashburn (*In re* Scrivner), 535 F.3d 1258, 1263 (10th Cir. 2008) ("We have repeatedly emphasized . . that a bankruptcy court may not exercise its broad equitable powers under § 105(a) in a manner that is inconsistent with the other, more specific provisions of the Code.") (internal quotations omitted); *In re* Nat'l Energy & Gas Transmission, Inc., 492 F.3d 297, 302 n.4 (4th Cir. 2007) ("The Bankruptcy Code, of course, provides parameters within which courts must exercise their equitable powers in administering an estate.");

IV. BANKRUPTCY'S PROBLEMATIC REMEDY FOR SECURITIES FRAUD

Thus far, this Article has shown that bankruptcy can impede investor recovery for fraud, even outside of the bankruptcy context, from non-debtors. This Part now turns to the Code's proposed remedy—the trustee—and shows why the trustee is not always adequate. First, trustees encounter problems of standing when pursuing claims for securities fraud. Even if the trustee circumvents standing by using securities fraud as a basis for voiding a transaction, rather than proceeding directly on an action for securities fraud, the trustee cannot pursue damages.[288] Even still, a trustee would likely encounter considerable trouble recovering insurance proceeds, the principal funding for securities fraud violations.[289]

A. STANDING PROBLEMS AND INADEQUATE RESCISSORY REMEDIES

A trustee is an independent person that takes control of the bankrupt company.[290] The trustee employs investigators that work from inside—demanding discovery without resorting to the court, accessing the company's files without restrictions, and requiring disclosure from the company's attorneys without the protection of the attorney-client privilege.[291] The Code mandates the appointment of a trustee in cases of fraud.[292]

Sherman v. Harbin (*In re* Harbin), 486 F.3d 510, 521 (9th Cir. 2007) ("[T]he bankruptcy court may exercise its equitable discretion to develop an appropriate remedy, provided, of course, that the chosen remedy is consistent with the provisions of the Bankruptcy Code."); Vill. of Rosemont v. Jaffe, 482 F.3d 926, 935 (7th Cir. 2007) ("Instead, the equitable discretion conferred upon the bankruptcy court by section 105(a) is limited and cannot be used in a manner inconsistent with the commands of the Bankruptcy Code."); Noonan v. Sec'y of Health & Human Servs. (*In re* Ludlow Hosp. Soc., Inc.), 124 F.3d 22, 28 (1st Cir. 1997) ("The bankruptcy court may not utilize section 105(a) if another, more particularized Code provision ... impedes the requested exercise of equitable power."); Smith v. Omni Mfg., Inc. (*In re* Smith), 21 F.3d 660, 666 (5th Cir. 1994) ("Bankruptcy courts cannot use their equity power under Section 105(a) ... to negate substantive rights or remedies that are available" under the Code.").

288. *See supra* Part IV.A.

289. *See supra* Part IV.B.

290. LOPUCKI, *supra* note 65, at 11.

291. LOPUCKI, *supra* note 65, at 11-12.

292. 11 U.S.C. § 1104(a)(1) ("At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States

Under the Code, the trustee can pursue claims on behalf of the debtor's estate, including claims the debtor-company may have against its officers and directors or other entities for securities fraud.[293] However, standing under the securities laws still presents a problem. Only a purchaser or seller of stock can sue for securities fraud under § 10(b) and Rule 10b-5.[294] The trustee is neither a purchaser nor a seller of securities. Although a trustee can bring suit as the issuer (or seller) of the stock,[295] this recovery inures for the benefit of the corporation and its

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trustee, and after notice and a hearing, the court shall order the appointment of a trustee—(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor . . . "). Surprisingly in Enron, the bankruptcy court did not appoint a trustee even though the Code gave the court discretionary authority to appoint a trustee in Chapter 11 proceedings in cases of fraud, dishonesty, incompetence, or gross management at the time. LOPUCKI, *supra* note 65, at 12; *see also* 11 U.S.C. § 1104(a)(1). Section 1104 of This mandate was Congress's response to Enron's bankruptcy in which the bankruptcy judge delayed a hearing on motions for the appointment of a trustee until a deal was brokered that left most of Enron's management in place and "[a]s a result, the investigators remained on the outside for the duration of the Enron case." LOPUCKI, *supra* note 65, at 14. To remedy the failure to appoint a trustee in Enron, Congress ordered that the United States Trustee must move for the appointment of a trustee if there are reasonable grounds to suspect that those currently in control of the business participated in actual fraud, dishonesty, or criminal conduct as they managed the debtor. WARREN & WESTBROOK, *supra* note 87, at 443. There is a quid pro quo here too though: while the appointment of a trustee removes those suspected of fraud from the reins of the corporation, it puts the trustee at the helm, who, no doubt, is less capable of running the business. *Id*. at 444.

293. 11 U.S.C. § 323(b).

294. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731 (1975).

295. *In re* Enron Corp. Sec., Derivative & ""ERISA'' Litig., 511 F. Supp. 2d 742, 797 (S.D. Tex. 2005); Profilet v. Cambridge Fin. Corp., 231 B.R. 373, 378 (S.D. Fla. 1999); Estate of Soler v. Rodriguez, 63 F.3d 45, 54 (1st Cir.1995) ("It is now well-established that a corporation has a claim under § 10(b) if the corporation was defrauded in respect to the sale of its own securities by some or even all of its directors."); *In re* Stat-Tech Sec. Litig., 905 F. Supp. 1416, 1423 (D. Colo. 1995) (holding that corporation emerging from bankruptcy has standing under 10b-5 because "it is 'well established' that § 10(b) and Rule 10b-5 protect corporations as well as persons. Thus a corporation that issues its own stock in reliance on another's deceptive or manipulative practice may be deemed a 'seller' with standing to sue under § 10(b) and Rule 10b-5.") (citing Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971)); Hooper v. Mountain States Sec. Corp., 282 F.2d 195, 200-03 (5th Cir. 1960),.

creditors. The individual purchasers do not benefit—their claims are subordinated in bankruptcy.[296] The trustee has no standing to assert claims for damages on behalf of the defrauded purchasers of securities.[297]

Standing can be avoided for purchasers of securities, though, if the trustee uses the violation of the securities laws, not as an action for securities fraud, but as a basis for setting aside certain transactions. Specifically, the Code gives a trustee the power to avoid fraudulent transfers.[298] If a transaction violates the federal securities laws, it may be basis for avoiding the transaction.[299] In *In re Fink*, the Chapter 7 debtor's trustee filed an adversary complaint against a securities brokerage firm to recover certain payments.[300] The debtor, a securities salesman with a brokerage firm, arranged for bridge financing for Renaissance Golf Products' initial public offering.[301] The National Association of Securities Dealers ("NASD"), however, objected to the IPO, finding the compensation for participants, including the brokerage firm, excessive.[302] To accommodate the NASD and keep its compensation deal intact, the debtor had a third party assign a portion of the stock it would receive to the debtor for the benefit of the brokerage firm.[303] Renaissance made no mention of this deal in its revised

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296. 11 U.S.C. §§ 510(b), 1141(d).

297. *E.g.*, *In re* Parmalat Sec. Litig., 377 F. Supp. 2d 390, 420 (S.D.N.Y. 2005); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir.1995); Bloor v. Carro, Spanbock, Londin, Rodman & Fass, 754 F.2d 57, 62 n.4 (2d Cir. 1985); *In re* Fuzion Tech. Group, Inc., 332 B.R. 225, 237 (Bankr. S.D. Fla. 2005); Wolkowitz v. Soll, Rowe, Price, Raffel & Browne, Inc. (*In re* Fink), 217 B.R. 614, 622 (Bankr. C.D. Cal. 1997).

298. 11 U.S.C. § 548. The Code gives a trustee the power to avoid a variety of kinds of pre-petition transactions. Such transactions include preferential payments to creditors (§ 547), fraudulent transfers (§ 548), the fixing of statutory liens (§ 545), and setoffs (§ 553). In addition, the Code gives a trustee the same avoiding powers that a creditor has under state law (§ 544(b)).

299. *See In re* Fink, 217 B.R. at 618.

300. *Id.* at 617-18.

301. *Id.* at 617.

302. *Id*. ("The NASD is authorized . . . to act as a self regulatory organization for all brokers and dealers of securities that are traded over the counter. [The Securities Exchange Act of 1934 § 15A, 15 U.S.C. § 78s.] Because the Renaissance securities were to be traded over the counter, rather than upon a national securities exchange, the NASD had the authority, subject to the regulation and oversight of the SEC, to ensure that the IPO was in compliance with NASD and SEC rules.").

303. *In re Fink*, 217 B.R. at 617.

prospectus.[304] After the IPO was completed, the third party transferred the stock to the debtor, and the debtor in turn transferred the stock to the brokerage firm.[305] Ten months later, the debtor filed for Chapter 7 bankruptcy and the trustee sought to void the sale and intercept the debtor's payment to the brokerage firm.[306] After concluding that the transfer violated the securities laws, and thus was illegal, the court avoided the transfer.[307] The bankruptcy court emphasized that only a purchaser or seller of securities could sue for violating § 10(b) and Rule 10b-5. Further, here, the trustee's claim was not brought under these securities laws, but only premised on them to argue that the transaction was illegal, and therefore could not impose a valid, legal obligation.[308] This provides less than full recovery for plaintiff-investors. The trustee's avoidance power is equivalent to rescission or rescissory damages.[309] Yet, securities fraud victims can also obtain consequential or actual damages in addition to rescissory damages.[310] The trustee cannot seek these consequential damages.

B. EXCLUSIONS FROM INSURANCE COVERAGE

The trustee remains an imperfect remedy for securities fraud for an additional reason: A securities fraud judgment or settlement is usually funded by insurance.[311] Insurance, an untapped source of funding, is

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304. *Id.* at 618.

305. *Id.*

306. *Id.*

307. *Id.* at 623.

308. *Id.* at 622 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

309. Rescission and rescissory damages are available for claims under both Section 11 and Section 12 of the 1933 Act and under both § 10(b) of the 1934 Act and Rule 10b-5. COFFEE, JR., SECURITIES REGULATION, *supra* note 63, at 1117-18. Rescissory damages measure the difference between the plaintiff's purchase price and the plaintiff's resale price, plus interest, and less any dividends or other corporate distributions with interest that the plaintiff received. *Id.* at 1117.

310. *Id.* at 1130-32; *see also* Ambassador Hotel Co. v. Wei Chuan Inv., 189 F.3d 1017, 1030 (9th Cir. 1999); Grubb v. Fed. Deposit Ins., Corp., 868 F.2d 1151, 1165 (10th Cir. 1989); Zeller v. Bogue Elec. Mfg., Corp., 476 F.2d 795, 803 (2d Cir. 1973); James v. Meinke, 778 F.2d 200, 205-06 (5th Cir. 1985).

311. Baker & Griffith, *supra* note 126, at 761 ("[T]he vast majority of securities claims settle within or just above the limits of the defendant corporation's D&O coverage."). *But see*, Bernard Black, et al., *Outside Director Liability*, 58 STAN. L. REV. 1055, 1057 (2006) (in both Enron and Worldcom—both mega-frauds and mega-

even more important as the company is in bankruptcy and its managers' personal wealth is often tied to the performance of the company.[312] However, a trustee, suing on behalf of the company, may be prohibited from recovering under these insurance policies because of the "insured vs. insured" exclusion, which provides that the insurer shall not be liable to pay for loss in connection with a claim made against an insured that is brought by any insured or by the company.[313] This exclusion protects the insurer from collusive suits between insureds, i.e., the company and its officers and directors.[314] This is a real concern as insurance fraud is the second most common white collar crime in the United States (the first is tax evasion).[315] Some securities litigation scholars have found evidence that plaintiffs and defendants collude to pressure the insurer to settle on terms that may not reflect the merits of the claim.[316]

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bankruptcies—the companies' directors personally paid millions as part of settlement).

312. Kenneth B. Davis, Jr., *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 DUKE L.J. 1, 45 (1983). Coverage under a D&O policy includes a claim brought by the corporation against one of its officers. Lee R. Russ & Thomas F. Segalla, *Directors and Officers: Application to Actions Involving Corporation, or Other Officers and Directors, in* 9A COUCH ON INSURANCE, § 131:32 (2009).

313. GUMMOW, *supra* note 128 at 142; Susan N.K. Gummow & David P. Bart, *Director and Officer Liability Insurance: How Bankruptcy Transforms the Rights of the Various Parties*, 14 J. BANKR. L. & PRAC. 101, 113 (2005). Traditionally, the "insured vs. insured" exclusion was employed to deny coverage for actions by a director, officer, or the named company against other directors or officers. Coverage is not limited to third-party claims; it includes a claim brought by the corporation against one of its officers. Russ & Segalla, *supra* note 128. Some policies contain an exception to the "insured vs. insured" exclusion for persons appointed by a bankruptcy court to act on behalf of the bankrupt insured. *See* Kelley v. Fed. Ins. Co. (*In re* HA 2003, Inc.), 310 B.R. 710, 716-17 (Bankr. N.D. Ill. 2004).

314. *In re* Buckeye Countrymark, Inc., 251 B.R. 835, 840-41 (Bankr. N.D. Ohio 2000).

315. Diane L. Polscer & Brett W. Sommermeyer, *Fraud, Concealment, and Misrepresentation, in* LAW & PRACTICE OF INSURANCE COVERAGE LITIGATION § 2:15 (2009).

316. Baker & Griffith, *supra* note 126, at 756; John C. Coffee Jr., *Reforming The Securities Class Action: An Essay on Deterrence and its Implementation*, 106 COLUM. L. REV. 1534, 1585 ("To the extent that contemporary securities litigation imposes its costs almost exclusively on the corporation and its insurers, this system benefits three sets of actors corporate insiders, plaintiffs' attorneys, and insurance companies—but not shareholders. Viewed in this way, the plaintiff's attorney is less a champion of shareholders and more a participant in a process by which the parties shift liabilities created by corporate managers onto shareholders through the medium of costly insurance paid for by shareholders. Because the repeat players managers, attorneys,

Thus, whether claims asserted by a trustee against the debtor-company's directors and officers are excluded from coverage under the "insured vs. insured" exclusion is a recurring question. Although a trustee is treated the same as any other plaintiff with no greater or lesser rights to insurance proceeds,[317] the "insured vs. insured" question arises because the trustee stands in the shoes of the insured, the company itself.[318] Some courts have recognized this tension and have held that the "insured vs. insured" exclusion does not apply because a claim by the trustee is made on behalf of the creditors, and not the debtor.[319] In this case, the trustee is adverse to the directors and officers.[320] A trustee's ability to recover insurance proceeds for securities fraud is nevertheless premised on a trustee's ability to sue for fraud to begin with, and, as the preceding section showed, the trustee lacks standing on behalf of plaintiff-investors.

V. CONCLUSION

The aftermath of the financial crisis will focus attention on the judiciary as it addresses the overlapping bankruptcies and allegations of securities fraud. This Article illustrates that bankruptcy can provide significant protection from securities fraud litigation. However, investors—the victims of fraud—are further victimized when the company's fraud forces it to file bankruptcy and they are denied recovery against those that do not file for bankruptcy. The securities laws provide for expansive liability to deter fraud on the market and promote recovery from liable parties. A company's bankruptcy though, for reasons unsupported by the Code or the securities laws, deters investors from even adjudicating the liability of non-debtors (those that never consent to the quid pro quo of bankruptcy). In the coming wave of regulatory reform, Congress must consider this overlap and set the

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and insurers all benefit from this system, it remains stable, and the outcome is usually the same: settlement. . . Often, the result is litigation that is, to a degree, feigned.").

317. *In re* Jones, 179 B.R. 450, 455 (Bankr. E.D. Pa. 1995).

318. LaCroix, *supra* note 9, at 4.

319. GUMMOW, *supra* note 128, at 143; *see also* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 404 (D. Del. 2002); Rigby v. Underwriters at Lloyd's London, 907 So.2d 1187, 1189 (Fla. App. Ct. 2005) (applying Florida law); *In re* County Seat Stores, Inc., 280 B.R. 319, 326 (Bankr. S.D.N.Y. 2002).

320. GUMMOW, *supra* note 128, at 143.

course to promote investor recovery.