REOPENING THE LOOPHOLE: AVOIDING SECURITIES FRAUD DEBT THROUGH BANKRUPTCY

Andrew L. Van Houter[*]

I. INTRODUCTION

H.E. Pennypacker was a high-powered securities dealer whose clients were mostly small-time investors. Pennypacker routinely took advantage of his unsophisticated clients, many of them immigrants with little command of the English language. Pennypacker used his charm and savvy sales skills to induce investors to hand over their life savings for him to invest. Pennypacker, however, failed to explain the risks to his clients and omitted material information in the prospectus. After many complaints from investors who lost their savings, the Securities and Exchange Commission (SEC) investigated and ultimately brought charges against Pennypacker. Pennypacker settled the case for $250,000 without admitting liability. He then immediately filed for bankruptcy, never intending to pay the settlement he signed with the SEC. Since his bankruptcy, Pennypacker opened a new brokerage firm[1] and continues to defraud

[*] J.D., Seton Hall University School of Law; B.A. in Political Science, Lander College for Men, Touro College. Thank you to Professor Stephen J. Lubben, Professor Kristin N. Johnson, and Marissa Litwin for their comprehensive comments and guidance.

[1] Although the SEC may have prevented Pennypacker from opening a new brokerage firm by exercising its powers to revoke the registration of broker dealers, *see* Investment Advisers Act of 1940 § 209(d), 15 U.S.C. § 80b-1 (2010); Investment Company Act of 1940 § 42(d), 15 U.S.C. § 80a-1 (2006); The Securities Act of 1933 § 20(b), 15 U.S.C. § 77a (2006); The Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78a (2006), revocation of registration is not automatic. "The Commission generally focuses its limited resources in the broker-dealer examination program on firms with the greatest potential for significant financial risk and risk to material violations of the securities laws. The leading type of examination in recent years is the cause examination," which is based on a tip or complaint. SEC. EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT A-14 (2011). "In recent years, approximately 94% of examinations concluded with a deficiency letter which summarizes . . . findings and requests corrective action." *Id.* at A-15. While the Financial Industry Regulatory Authority (FINRA), as a self-regulatory organization, has the authority to sanction its members, Securities Exchange Act of 1934 §§ 15A(b), 19(g), 15 U.S.C. § 78a (2006), there were only 211 license

investors.[2] Given recent trends in the financial sector, these facts strike an emotional chord and highlight the sensibility of guaranteeing that all settlements for securities laws violations survive a bankruptcy petition. This would thereby ensure that dishonest debtors would be unable to hide behind the law to the detriment of their honest and unfortunate creditors.

A slight variation of the facts, however, reveals the harsh ramifications of implementing a blanket bankruptcy protection that automatically attaches to all settlements for securities violations. Consider Art Vandelay, the one-time owner of a small mattress retail store in Anytown, U.S.A. With dreams of moving into a bigger and better location on Main Street, Art Vandelay needed to raise capital. Vandelay mentioned his plans over Thanksgiving dinner and Janice, a friend of his mother's, agreed to invest. Vandelay, excited about the prospect of expanding his business, accepted $100,000 from Janice, and, in return, issued Janice thirty-five percent of the company's shares, which were not registered with the local Bureau of Securities.[3] When business slowed and Vandelay's mattress store no longer made a profit, Janice sued Vandelay for issuing unregistered securities. Vandelay casually mentioned the story to a friend who told Vandelay that not all securities need to be registered and his may be exempt. Vandelay calculated that it would be cheaper to just settle the case and did so for $25,000 without admitting liability. In reality, Vandelay's shares were exempt from the state's registration requirements. Vandelay paid the annuities on the settlement at first, but a few years later, his home was foreclosed on and Vandelay was

suspensions and 159 license revocations out of the 6,387 examinations it conducted into broker-dealers based on tips or complaints in 2010. SEC. EXCH. COMM'N, *supra*, at A-12. Thus, while it is possible that Pennypacker could have been prevented from opening another brokerage firm, it is by no means a given. Furthermore, even if Pennypacker's license were suspended or revoked, he may, as an unscrupulous fraudster, attempt to continue to do business until he is stopped. Therefore, this hypothetical is entirely possible.

[2] *See* Lydie Nadia Cabrera Pierre-Louis, *Nowhere to Run, Nowhere to Hide: The Impact of Sarbanes-Oxley on Securities Arbitration*, 81 ST. JOHN'S L. REV. 307, 308–09 (2007), on which this hypothetical is based.

[3] Each state has its own agency dedicated to regulating state securities laws. Mark J. Astarita, *Guide to State Securities Administrators*, SEC LAW.COM, http://www.seclaw.com/stcomm.htm (last updated Nov. 9, 2011). In New Jersey, for example, that agency is the Bureau of Securities. N. J. STAT. ANN. § 49:3-66 (West 1997); *see also Fact Sheet: New Jersey Bureau of Securities*, NEW JERSEY BUREAU OF SECURITIES, http://www.state.nj.us/lps/ca/bos/bosoverview.htm (last visited Feb. 1, 2012) ("The Bureau of Securities within the New Jersey office of the Attorney General is the state's securities regulatory agency.").

forced into bankruptcy before fully paying the settlement. Because all settlements resolving claims of securities laws violations survive bankruptcy, Vandelay must continue to pay the settlement payments to Janice and the substantial debt effectively bars Vandelay from receiving a financial fresh start.[4] Clearly, these facts curb the emotional reaction that the first story elicits, and cause one to reconsider issuing an all-inclusive bankruptcy immunity to all settlements for claims of securities laws violations.

We are thus presented with a dilemma: Do we utilize the bankruptcy code to protect investors at the risk of harming innocent debtors like Art Vandelay, the mattress store owner? Or do we allow innocent creditors, like the unsophisticated investors duped by Pennypacker, to be harmed for the sake of preserving debtors' rights to a fresh start? This Comment will explain how and why the current law treats both cases the same and suggests possible distinctions that should be implemented through amendment to the bankruptcy code based on public policy.

To fully appreciate the policy dilemma, it is important to have a basic understanding of fundamental bankruptcy principals and concepts. The main policy behind the federally created bankruptcy code is to grant debtors a means to achieve a financial fresh start.[5] As the Supreme Court stated, bankruptcy "gives to the honest but unfortunate debtor . . . a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt."[6] In other words, bankruptcy provides the much-needed compassion in a capitalistic society.[7] Employing the discharge accomplishes this goal.[8] Essentially, the discharge releases

[4] *See* Teresa H. Pearson, *What Bankruptcy Lawyers Need to Know About the Sarbanes-Oxley Act of 2002 and the Corporate and Criminal Fraud Accountability Act of 2002*, FINDLAW (Mar. 26, 2008), http://library.findlaw.com/2003/Mar/26/132662.html, on which this hypothetical is based.

[5] BANKR. JUDGES DIV., ADMIN. OFFICE OF THE U.S. COURTS, BANKRUPTCY BASICS 6 (rev. 3d ed. 2011), *available at* http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf.

[6] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

[7] The American "fresh start" concept is a uniquely liberal bankruptcy concept that is not completely duplicated in other developed countries. *See* Iain Ramsay, *Comparative Consumer Bankruptcy*, 2007 U. Ill. L. Rev. 241, 250–51 (2007); UDO REITNER ET AL., CONSUMER OVERINDEBTEDNESS AND CONSUMER LAW IN THE EUROPEAN UNION 165–66 (2003), *available at* http://www.ecri.eu/new/system/files/26+consumer_overindebtedness_consumer_law_eu.pdf. The American broad fresh start, however, is counterbalanced by the non-existence of a broader social safety net like those present in European countries. *See* Ramsay, *supra*, at 245–47.

[8] BANKR. JUDGES DIV., *supra* note 5, at 6; *see also* 11 U.S.C. § 524 (2006)

a debtor from all personal liability from certain debts.[9] Once a discharge occurs, creditors are forbidden from attempting to collect the debt.[10] Creditors are even barred from harassing the debtor about the debts through phone calls, letters, or any other means of communication.[11]

The discharge, however, does not apply to all debts.[12] The bankruptcy code lists certain types of debts that survive a discharge.[13] The statutory exceptions to discharge reflect Congress's conscious policy decision that preserving the ability to collect certain types of debts is of greater importance than granting debtors a fresh start.[14] Therefore, if an exception from discharge applies, the debt will survive bankruptcy and remain collectable. For that reason, debts resulting from wrongful or dishonest conduct are generally not dischargeable in bankruptcy.[15] The underpinning of the policy is obvious; Congress created the discharge to give the honest debtor a fresh start,[16] but the dishonest debtor deserves no such protection.[17] Thus, many dischargeability debates focus on the two goals of protecting honest debtors and preventing dishonest fraudsters from evading liability by hiding behind the bankruptcy code.[18]

One such exception from discharge based on debt incurred through wrongful conduct is the securities-claims exception of section 523(a)(19).[19] Congress added this exception to discharge as part of the Sarbanes-Oxley Act of 2002 (SOX), which, in turn, was a response to corporate fraud.[20] As the legislative history makes clear, Congress intended that the securities-claims exception prevent

(describing the effects of a discharge).

9 BANKR. JUDGES DIV., *supra* note 5, at 6.

10 *Id.*

11 *Id.* at 9.

12 *See* 11 U.S.C. § 523 (2006) (listing all the exceptions to discharge).

13 *Id.*

14 Honorable Bernice B. Donald & Kenneth J. Cooper, *Collateral Estoppel in Section 523(c) Dischargeability Proceedings: When is a Default Judgment Actually Litigated?*, 12 BANKR. DEV. J. 321, 323 (1995–96).

15 *Id.*; *see also* 11 U.S.C. § 523(a)(2) (2006) (excepting from discharge debt incurred by fraud); § 523(a)(4) (excepting from discharge debt incurred by fraud while acting in a fiduciary capacity); § 523(a)(6) (excepting from discharge debt incurred by willful and malicious injury); § 523(a)(11) (excepting from discharge debt incurred by fraud while acting in a fiduciary capacity to a bank).

16 *See supra* note 8 and accompanying text.

17 Donald & Cooper, *supra* note 14, at 323.

18 *Id.* at 323–24.

19 *See* § 523(a)(19).

20 *See infra* Part II.A.

fraudsters from using the bankruptcy code to evade debts for their wrongdoings.[21] Prior to the exception's enactment, many cases resulted in investors failing to collect their awards because fraudsters received bankruptcy protection after losing or settling securities claims.[22] Many small investors forfeited their entire life-savings and pursued an expensive lawsuit to recover their losses, only to be denied any recovery because of a loophole in the bankruptcy code.[23] As one commentator put it, "[t]he defrauded small investor [was] left without any further recourse and a much lighter purse. The unscrupulous brokerage firm or broker receive[ed] [a] discharge order . . . and trot[ted] off into the sunset emboldened to defraud yet another investor."[24] The securities-claims exception is meant to prevent that situation and close the loophole.[25]

The exception to discharge for debt resulting from securities laws violations exempts from discharge all debt that is (1) for the violation of any securities laws; and (2) is memorialized in some final order, such as a judgment, order, or settlement.[26] The provision provides, in relevant part, that any debt

> (19) that—
>
> (a) is for—
>
> (i) the *violation* of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws . . . *and*
>
> (b) results, before, on or after the date from which the petition was filed, from—
>
> (i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;
>
> (ii) any *settlement* agreement entered into by the

---

[21] *See infra* Part III.B.

[22] Pierre-Louis, *supra* note 2, at 321–22.

[23] *Id.* at 322.

[24] *Id.* at 322; *See also supra* note 1 (explaining how a fraudster can continue to defraud despite a regulatory agency or private litigant previously attempting to stop him).

[25] *See* S. REP. NO. 107-146 (2002) ("Current bankruptcy law may permit wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and securities laws violations. This loophole in the law should be closed . . . .").

[26] 11 U.S.C. § 523(a)(19) (2006).

> debtor . . . .[27]

A simple reading seems clear and evidently provides that any settlement agreement or judgment resolving claims of securities laws violations are non-dischargeable in bankruptcy, and thus the loophole that previously existed is ostensibly closed.[28] This interpretation is also consistent among scholars.[29] A careful reading of the statute, however, shows that this common understanding may not be accurate.

The language of the statute is vague, confusing, and perhaps contrary to congressional intent. According to ordinary principles of statutory construction, by using the conjunction "and," the statute lists elements, all of which are required to satisfy the original proposition.[30] Further, the bankruptcy code has its own explicit rules of construction that states the use of the word "or" is non-exclusive so that the conditions can be satisfied by any one of the elements joined by an "or."[31] Thus, by using the word "and," Congress may have consciously avoided the code's definition of "or," and therefore intentionally required that all elements be satisfied for 523(a)(19)'s exception to apply, thereby evidencing specific congressional intent to require both elements, in addition to ordinary principles of statutory construction. Accordingly, the placement of "and" between the two elements of the statute[32] seems to predicate a non-dischargeability determination on: (1) a finding of a violation of securities laws that is (2) memorialized in a settlement or other final order.

This understanding presents an anomaly: there must be a definitive violation memorialized in a settlement. Settlements, however, often do not admit liability.[33] "The whole point of

---

[27] *Id.* (emphasis added).

[28] *See supra* notes 22–24 and accompanying text.

[29] *See, e.g.*, James P. Menton, Jr., *Sarbanes-Oxley and the New Nondischargeable Debt: Drafting Tips for Pre-Bankruptcy Settlements*, 8 COMM. & BUS. LIT. 9 (Winter 2007); Pearson, *supra* note 4; G. Ray Warner, *Accounting Reform Law Adds Broad Securities Fraud Discharge Exception*, AM. BANKR. INST. (Sept. 1, 2002), http://www.abiworld.org/AM/Template.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=32493.

[30] YULE KIM, CONG. RESEARCH SERV., RL 97-589, STATUTORY INTERPRETATION: GENERAL PRINCIPLES AND RECENT TRENDS 8 (Aug. 31, 2008); *see also* Pueblo of Santa Ana v. Kelly, 932 F. Supp. 1284, 1292 (D.N.M. 1996).

[31] *See* 11 U.S.C. § 102(5) (2006).

[32] *See* § 523(a)(19).

[33] *See* Reply Points & Authorities in Support of Motion for Summary Judgment/Summary Adjudication at 4, Mollasgo v. Tills, 419 B.R. 444 (Bankr. S.D.

settlement is to avoid trials and determinations of disputed facts, and to resolve litigation without the need for adjudications of fault or responsibility."[34] Moreover, settlements that neither admit nor deny liability ("no-fault settlements") are desirable to both defendants and plaintiffs—a defendant does not want to admit liability and thereby be exposed to further litigation, and plaintiffs want to save the costs of litigation.[35] Accordingly, if a definitive violation of securities laws is a prerequisite to non-dischargeability, and settlements are unlikely to contain an admission of guilt, Congress never fully closed the loophole. Unscrupulous securities dealers who enter into traditional settlements will still receive bankruptcy protection to the detriment and financial harm of their victims.[36] Further, because most securities claims end in settlements and not judgments,[37] the poorly drafted exception may actually accomplish nothing and provide no protection to investors.

Thus, a careful reading of the statute exposes a contradiction between congressional intent[38] and statutory language, requiring judges and bankruptcy and securities lawyers alike to ponder if Congress meant what it said or if Congress meant what it wrote. This is a question of "critical importance" because the determination of dischargeability can cause millions of dollars to change hands.[39] The significance of dischargeability questions is highlighted by the fact that they consume twenty-seven percent of bankruptcy judges' "case-related" time and over sixteen percent of their total "work-related" time.[40]

Determining the correct interpretation of section 523(a)(19), therefore, is crucial, both because of its impact on investors and

Cal. 2009) (No. 09-90054-LT), 2009 U.S. Bankr. Ct. Motions LEXIS 6255, at *7; *see also* Jean Eaglesham & Chad Bray, *Citi Ruling Could Chill SEC, Street Legal Pacts*, WALL ST. J., Nov. 29, 2011, http://online.wsj.com/article/SB10001424052970203935604577066242448635560.html (describing how a federal district court judge's rejection of an SEC settlement that neither admits nor denies liability of the underlying charges threatens to drain government resources because, since their settlements will be rejected, agencies will be forced to go to trial).

34 Reply Points & Authorities in Support of Motion for Summary Judgment/Summary Adjudication, *supra* note 33, at *7.

35 *See* Eaglesham & Bray, *supra* note 33.

36 *See supra* notes 22–24 and accompanying text.

37 Charles M. Yablon, Essay, *A Dangerous Supplement? Longshot Claims and Private Securities Litigation*, 94 NW. U. L. REV. 567, 586 (2000).

38 *See infra* Part III.B.

39 Pierre-Louis, *supra* note 2, at 324.

40 *Id.*

victims of securities fraud, and because it will affect how securities settlements are drafted.[41] The answer requires careful review of the legislative history and context, as well as consideration of pressing policy concerns. This Comment will review the history and context of section 523(a)(19), as well as canons of statutory construction, and argue that the correct interpretation of the securities-claims exception renders all settlements—even if such settlements fail to definitively establish a violation of securities laws—non-dischargeable in any subsequent bankruptcy proceeding. This Comment then considers the harsh ramifications of that interpretation, as previously introduced with the story of Art Vandelay, the mattress store owner.[42] To reconcile these concerns and further public policy, this Comment then suggests an amendment to the bankruptcy code that creates a distinction between debts incurred through settlements with the government and debts incurred through settlements with private creditors, and distinguishes between debts arising from fraudulent behavior and debts arising from mere technical violations of the securities laws.This Comment argues that an amendment that clarifies section 523(a)(19) and renders only debts arising from fraudulent securities violations non-dischargeable, and further requires private plaintiffs to prove the securities violations while allowing the government to rely on settlements that do not definitively establish violations, is consistent with congressional intent and public policy.

At the time of this writing, only one case, *Mollasgo v. Tills* (*In re Tills*),[43] has attempted to discern the correct interpretation of section 523(a)(19) at length,[44] but there, the bankruptcy court arrived at a

[41] *See* Menton, *supra* note 29 (delineating specific provisions to be included in settlement agreements in order to ensure non-dischargeability).

[42] *See supra* note 4 and accompanying text.

[43] 419 B.R. 444 (Bankr. S.D. Cal. 2009).

[44] Other cases have cited to *Mollasgo*, but no case has provided as detailed an analysis of § 523(a)(19). *See* Nace v. Quibell (*In re* Quibell), 2012 Bankr. LEXIS 1423, at * 19–21 (Bankr. M.D. Pa. Apr. 4, 2012) (citing *Mollasgo*'s recitation of the legislative history behind section 523(a)(19) when dismissing the plaintiff's complaint for failure establish that the money defendant owed plaintiff under a note was related to a cease and desist order issued by the state securities commission); Trimble v. Putman (*In re* Putman), 2011 Bankr. LEXIS 2117, at *7 (Bankr. E.D. Wis. June 2, 2011) (citing *Mollasgo* as support for plaintiffs' argument—which the court ultimately rejected—that collateral estoppel should apply to default judgments with regards to dischargeability determinations under section 523(a)(19)); Voss v. Pudjak (*In re* Pudjak), 462 B.R. 560, 576–79 (Bankr. D.S.C. 2011) (citing *Mollasgo*'s use of an analogy to section 523(a)(11) in interpreting section 523(a)(19), as discussed *infra* at text accompanying notes 129–147, but ultimately coming to a conclusion that

flawed conclusion. Accordingly, after a brief introduction about the widespread corporate fraud giving rise to SOX and section 523(a)(19), Part II of this Comment will describe, in detail, the *Mollasgo* holding. Part III will show how the *Mollasgo* court misapplied precedent, reached a holding that is inconsistent with other jurisdictions, and frustrated congressional intent when it interpreted the statute to require a definitive finding of securities laws violations. This Part will conclude that the correct interpretation of section 523(a)(19) renders all debts arising from securities laws violations non-dischargeable, even if the violations are not actually adjudicated. Part IV will then examine the consequences of the present blanket securities-claims exception to discharge, and will suggest an amendment to the exception, which would distinguish between private creditors and governmental regulators, such as the SEC, and restrict the section's applicability to fraudulent violations in order to serve public policy. Finally, this Comment concludes that such an amendment, which excepts from discharge only those debts that arise from fraudulent violations of the securities laws and requires private plaintiffs to prove the underlying allegations, is consistent with congressional intent and public policy.

II. FROM ENRON TO SOUTHERN CALIFORNIA'S BANKRUPTCY COURT: HOW GREAT FRAUD LED TO OVERREGULATION THAT MUST BE CURED

A. America Hastily Responds to Systemic Corporate Fraud

The addition of section 523(a)(19) came as part of the Sarbanes-Oxley Act, which, like most financial reforms, came about as the result of a major crisis.[45] Sarbanes-Oxley followed Enron, one of the

contradicts the holding of *Mollasgo*);.Wilkes v. Cancelosi (*In re* Cancelosi), 456 B.R. 515, 522 (Bankr. D. Or. 2011) (citing *Mollasgo* for the proposition that section 523(a)(19) has a dual requirement; namely that the debt results from a violation of securities laws, and that the debt be memorialized in a final order or settlement); Nace v. Quibell (*In re* Quibell), 2011 Bankr. LEXIS 3297, at *19 n.5 (Bankr. M.D. Pa. Jan. 28, 2011).

[45] *See* HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 19 (2006) (citing, as other examples, the English Bubble Act passed during the South Sea Bubble and the U.S. federal securities laws passed in response to the 1929 stock market crash); *see also* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) ("Simply put the corporate governance provisions were not a focus of careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases.").

biggest corporate frauds ever perpetrated.[46] Enron started in 1985 as a simple Texas pipeline company, but it quickly developed into one of America's leading corporations creating new markets for energy trading.[47] Enron deliberately used faulty, unconventional accounting to conceal losses, inflate potential profits, and artificially raise its share price.[48] These tactics left shareholders unknowingly holding worthless stock.[49] Enron shocked its shareholders, and the world, when it revealed the true accounting in the second quarter of 2001.[50] Enron's announcement resulted in a sudden $618 million loss for the third quarter of 2001, reduced shareholder equity by $1.2 million, and forced the company into bankruptcy—the then-largest bankruptcy filed in the history of the United States.[51] The extent of the fraud was enormous, costing the average American household $60,000.[52] Rubbing salt in the wounds, many Enron executives who were aware of the fraud during its perpetration[53] took advantage of a Texas homestead law shielding their million-dollar-mansions from creditors while simultaneously filing for bankruptcy.[54] America was

[46] While Enron was the event that called attention to corporate scandals, it was not the only factor leading to SOX. In fact,

> Sarbanes-Oxley would not have been enacted if Enron had been an isolated event. Enron's bankruptcy was soon followed by the financial collapse of approximately a dozen large public companies where there was also strong evidence of reporting violations and audit failures even more egregious than that which occurred in Enron.

JAMES D. COX, ROBERT W. HILLMAN, DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 10 (Wolters Kluwer ed., 6th ed. 2009).

[47] Pierre-Louis, *supra* note 2, at 309 n.4; Lucian Murley, Note, *Closing a Bankruptcy Loop-Hole or Impairing a Debtor's Fresh Start? Sarbanes-Oxley Creates a New Exception to Discharge*, 92 KY. L.J. 317, 317 (2004).

[48] Murley, *supra* note 47, at 317–18.

[49] *Id.*

[50] *Id.*; *see also* Steven G. Schulman, U. Seth Ottensoser & Russel D. Morris, The Sarbanes-Oxley Act: The Impact on Civil Litigation under the Federal Securities Laws from the Plaintiff's Perspective, ALI-ABA Course of Study Sarbanes-Oxley Act: Impact on Civil Litigation under Federal Securities Laws, Dec. 5, 2002 at 297 (281).

[51] Schulman, Ottensoser & Morris, *supra* note 50, at 297. Enron's record bankruptcy was surpassed less than a year later by WorldCom's filing for bankruptcy protection after its own accounting scandal was exposed. *See* Simon Romero & Riva D. Atlas, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, N.Y. TIMES, July 22, 2002, *available at* http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html?pagewanted=all.

[52] Pierre-Louis, *supra* note 2, at 311; Murley, *supra* note 47, at 318.

[53] *See* Pierre-Louis, *supra* note 2, at 309 n.4.

[54] Nelson S. Ebaugh, *The Securities Claim Exemption in Bankruptcy: The Good, the Bad, and the Ugly*, 19 SEC. LITIG. J. (2008), *available at* http://www.ebaughlaw.com/uploads/1/1/9/4/11948411/securities_claim

outraged; Congress needed to act.[55]

Congress responded with Sarbanes-Oxley.[56] SOX is a comprehensive piece of legislation "intended to rein in corporate executives run amok and restore investor confidence" in corporate America.[57] Many embraced it as the answer to corporate greed. For example, President Bush, when he signed it into law, praised the act, remarking that it was one of the "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[58] Harvey Pitt, then SEC Chairman, described the law as assurance that "abuses of the system are not, and will not be allowed to become, the norm in American business."[59]

But SOX, arguably, was nothing more than an emotionally driven, knee-jerk reaction to Enron,[60] much like most readers' initial reaction to the opening story of this Comment.[61] Like many initial emotional reactions, SOX was not appropriately formulated.[62] SOX was introduced to Congress a mere six weeks after the release of the Board of Directors' Official Report on Enron.[63] Despite its obvious quick drafting, there was little Congressional debate over the bill.[64] Hardly any Member of the House spoke on any of the bill's major proposals.[65] Some commentators claim that the Senate only heard from biased witnesses who did not present any evidence on balancing costs and benefits.[66] Rather, the Senate swiftly passed the legislation.[67] "Simply put, the corporate governance provisions were not a focus of

_exemption_in_bankruptcy.pdf.

[55] *See* BUTLER & RIBSTEIN, *supra* note 45, at 19.

[56] *See supra* note 45 and accompanying text.

[57] Pierre-Louis, *supra* note 2, at 310.

[58] BUTLER & RIBSTEIN, *supra* note 45, at 9.

[59] Harvey L. Pitt, SEC Chairman, Remarks Before the Annual Meeting of the American Bar Association Business Law Section (Aug. 12, 2002), *available at* http://www.sec.gov/news/speech/spch579.htm.

[60] *See* BUTLER & RIBSTEIN, *supra* note 45, at 19 (calling the Act "just one example of the 'Sudden Acute Regulatory Syndrome'").

[61] *See supra* note 2 and accompanying text.

[62] *See* BUTLER & RIBSTEIN, *supra* note 45, at 7. ("Congress knew very little when it acted precipitously, in the midst of a regulatory panic" and "Congress acted precipitously, without anything resembling a balanced consideration of the issues.").

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

[64] BUTLER & RIBSTEIN, *supra* note 45, at 20.

[65] *Id.*

[66] *Id.*

[67] *Id.*

careful deliberation by Congress. SOX was emergency legislation, enacted under conditions of limited legislative debate, during a media frenzy involving several high-profile corporate fraud and insolvency cases."[68] Due to the deficient procedure in the bill's passing, it is understandable that the final product has many imperfections.[69] One such imperfection is the vague language of the securities-claims exception to discharge in bankruptcy.[70]

B. Mollasgo *Unraveled*

The only court to squarely attempt to interpret the vague language of section 523(a)(19) is the *Mollasgo* court.[71] The facts of the case are as follows: A creditor lost money in a real estate investment when the debtor allegedly violated state securities laws and perpetrated a fraud.[72] The parties entered into a no-fault settlement agreement, in which neither party admitted fault nor liability.[73] During the course of settlement negotiations, the debtor expressed intentions to file for bankruptcy after signing the settlement.[74] The debtor made no payments of the settlement and voluntarily filed for bankruptcy about a month after settling the claims.[75] The creditor initiated a judicial proceeding to deem the debt non-dischargeable under section 523(a)(19) and moved for summary judgment.[76]

The court denied summary judgment, holding that the plain language of the statute[77] required an established violation of securities laws in order to render the settlement non-dischargeable.[78] According to the court, the settlement in question, by expressly not admitting liability, failed to satisfy this element.[79] To support this contention, the court examined the legislative history and concluded that Congress's intent was to prevent established *wrongdoers* from manipulating the bankruptcy code to shield themselves from

---

[68] Romano, *supra* note 45, at 1528.
[69] *See generally* BUTLER & RIBSTEIN, *supra* note 45.
[70] *See supra* notes 30–39 and accompanying text.
[71] *But see* sources cited *supra* note 44.
[72] Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 448 (Bankr. S.D. Cal. 2009).
[73] *Id.*
[74] *Id.*
[75] *Id.* at 448–49.
[76] *Id.* at 449.
[77] *See supra* note 27 and accompanying text.
[78] *Mollasgo*, 419 B.R. at 451.
[79] *Id.*

investor-litigants.[80]

The court reasoned that without a definitive establishment of a violation, there is no wrongdoer.[81] In reaching this conclusion, the *Mollasgo* court relied heavily on the purported stated purpose of the statute, which is to "make judgments and settlements arising from state and federal securities law *violations* brought by state and federal regulators and private individuals non-dischargeable. Current bankruptcy law may permit *wrongdoers* to discharge their obligations under court judgments or settlements based on securities *fraud* and securities law *violations*."[82] Accordingly, the court concluded that "[t]he [Senate] Report focuses on resolved securities violations, rather than on settled claims of violations."[83] The court further stated, "the Report and the Act's author support the conclusion that *section 523(a)(19)* is intended to target securities laws violators, not to generally penalize all debtors who settle allegations of securities violations."[84] Since the statute only exempts from discharge *wrongdoers'* settlements, the court reasoned that because the creditor in the instant case failed to obtain an admission of liability, the settlement could not benefit from the protection offered by section 523(a)(19).[85] The court conceded that Congress intended to give settlements preclusive effect, but reasoned that preclusive effect could not be granted to the settlement at issue because the agreement expressly failed to resolve the question of liability.[86] The court therefore concluded "that Congress provided plaintiffs with a valuable tool in securities litigation, but also allowed the parties to avoid de facto non-dischargeability through settlement agreement language that expressly avoids any concession of fault or liability."[87]

The court claimed that Supreme Court jurisprudence supported its conclusions.[88] *Mollasgo* relied on *Archer v. Warner*, which held that settlement agreements do not create a novation, and bankruptcy courts should instead look to the circumstances that gave rise to the settlement to determine if it arose from conduct that would render

80 *Id.* at 452.
81 *Id.*
82 *Id.* (quoting S. REP. NO. 107-146 (2002)).
83 *Id.* (citing S. REP. NO. 107-146 (2002)).
84 *Mollasgo*, 419 B.R. at 452.
85 *Id.* at 453.
86 *Id.*
87 *Id.* at 454.
88 *Id.*

the debt non-dischargeable.[89] *Archer* dealt with a claim brought under section 523(a)(2), which excepts from discharge claims that arise out of fraud.[90] *Mollasgo* applied *Archer*'s ruling and, without determining the factual question of liability, held that the settlement was not automatically non-dischargeable.[91] The *Mollasgo* court therefore denied the creditor's summary judgment motion.[92]

The *Mallasgo* court also looked to persuasive authority interpreting section 523(a)(11).[93] Section 523(a)(11) excepts from discharge those debts that stem from "any final judgment, unreviewable order, or consent order . . . *or contained in any settlement agreement* entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity . . . with respect to any depository institution or insured credit union."[94] The *Mallasgo* court therefore looked to *Meyer v. Ridgon*,[95] a case dealing with a section 523(a)(11) settlement, and found further support for the denial of summary judgment in the case before it.[96] In its reasoning, *Mollasgo* cited to a hypothetical that the *Meyer* court created to illustrate the power of section 523(a)(11).[97] The hypothetical illustrated a scenario that would render a settlement non-dischargeable when the debtor admitted liability.[98] Because the hypothetical only dealt with a settlement where the debtor admitted liability, the *Mollasgo* court reasoned that the *Meyer* court would have reached a different holding if the settlement did not admit liability.[99] The *Mollasgo* court also supported its conclusions by pointing out that the *Meyer* court "looked behind the default judgment" to determine if the underlying facts supported a finding of non-dischargeability.[100] The *Mollasgo* court therefore concluded that the interpretation of the similar language in section 523(a)(11) mandates that section 523(a)(19) does not render settlements automatically dischargeable if they fail to expressly admit liability, and rather that courts should carefully

[89] 538 U.S. 314, 322–23 (2003).
[90] *Id.*
[91] *Mollasgo*, 419 B.R. at 454 (citing *Archer*, 538 U.S. at 323).
[92] *See id.*
[93] 11 U.S.C. § 523(a)(11) (2006).
[94] *Id.* (emphasis added).
[95] 36 F.3d 1375 (7th Cir. 1994).
[96] *Mollasgo*, 419 B.R. at 456 (citing *Meyer*, 36 F.3d at 1380).
[97] *Id.*
[98] *Meyer*, 36 F.3d. at 1379.
[99] *Mollasgo*, 419 B.R. at 456.
[100] *Id.*

examine such settlements to ensure that a securities law violation actually occurred.[101]

The *Mollasgo* court then distinguished relevant case law that seemingly supported the creditor's argument that the settlement should be excepted from discharge. The court distinguished *Peterman v. Whitcomb* (*In re Whitcomb*),[102] a case that held a no-fault settlement to be non-dischargeable under section 523(a)(19), on the basis that the debtor in *Whitcomb* agreed that he damaged the creditor.[103] The court also distinguished *Hodges v. Buzzeo* (*In re Buzzeo*), a case holding a similar no-fault settlement non-dischargeable under section 523(a)(19), on the basis that the settlement agreement included a waiver by the debtor of his right to discharge the debt in bankruptcy.[104]

Policy considerations also influenced the *Mollasgo* court. First, the court noted that, generally, settlements are to be encouraged as an amicable resolution of disputes.[105] The court then reasoned that rendering all settlements of securities claims non-dischargeable, even those that do not establish liability, would discourage settlements.[106] The court was also concerned about denying innocent and honest debtors their fresh start,[107] which a blanket exception to discharge of all settlements of securities violations would inevitably do, as demonstrated by Vandelay's story at the beginning of this Comment.[108] The court recognized that automatically rendering all securities claims settlements non-dischargeable will prevent innocent debtors from even pleading their case.[109] Such a result is contrary to the fundamental bankruptcy principal of the fresh start.[110] In short, the very same issues that intuitively perturb the reader of the second hypothetical at the beginning of this Comment bothered the court.[111]

The *Mollasgo* court put forth well-articulated reasons for concluding that section 523(a)(19) requires a definitive finding of a

---

101 *Id.*

102 303 B.R. 806 (Bankr. N.D. Ill. 2004).

103 *Mollasgo*, 419 B.R. at 456 (citing *Whitcomb*, 303 B.R. at 808).

104 *Id.* at 456–57 (citing Hodges v. Buzzeo (*In re* Buzzeo), 365 B.R. 578, 580–81 (Bankr. W.D. Pa. 2007)).

105 *Id.* at 454.

106 *Id.*

107 *Id.* at 454–55.

108 *See supra* note 4 and accompanying text.

109 *Mollasgo*, 419 B.R. at 454–55.

110 *See supra* notes 5–11 and accompanying text.

111 *See supra* note 4 and accompanying text.

securities law violation. The court's reasoning, however, is flawed. A careful analysis reveals that the *Mollasgo* court arrived at its conclusion by misapplying precedent and improperly distinguishing germane persuasive authority.[112] Further, the *Mollasgo* holding is contrary to congressional intent, which supports a conclusion that all settlements of securities laws violations are automatically non-dischargeable, regardless of the absence of an adjudication of liability.[113] Thus, while the court raised some valid policy concerns, it improperly interpreted section 523(a)(19).

III: EXAMINING *MOLLASGO* AND DETERMINING THE TRUE INTERPRETATION OF THE SECURITIES CLAIM EXCEPTION TO DISCHARGE

The reasoning in *Mollasgo* is based on misapplications of precedent, and the court's holding conflicts with congressional intent and the holdings of other jurisdictions.[114] *Mollasgo*'s interpretation of section 523(a)(19) is therefore incorrect, and further analysis is required to solve the question of dischargeability in securities claims. This Part will first refute the *Mollasgo* court's reasoning and then examine congressional intent to arrive at the correct interpretation of section 523(a)(19), namely that the section provides an automatic exception from discharge to all settlements of securities laws violations, even if the settlement does not resolve the question of liability, such as no-fault settlements.

A. *Refuting* Mollasgo

The holding in *Mollasgo* is faulty because it roots itself in a misapplication of precedent. *Mollasgo* relies on *Archer v. Warner*, which held that settlement agreements do not create an absolute novation (replacing the original debt with a new one, which in theory would be unconnected to the fraud and thus not excepted from discharge), but rather that bankruptcy courts should look to the circumstances that gave rise to the settlement to determine if the settlement arises from conduct that would render the debt non-dischargeable.[115]

In *Archer*, the plaintiff-creditor sued the defendant-debtor for money allegedly obtained through fraud.[116] The parties settled the

---

112 *See infra* Part III.A.
113 *See infra* Part III.B.
114 *See infra* Part III.B.
115 Archer v. Warner, 538 U.S. 314, 323 (2003).
116 *Id.* at 316–17.

suit, releasing all claims, but the settlement agreement did not resolve the question of liability.[117] The defendant-debtor subsequently filed for bankruptcy, and the plaintiff-creditor claimed that the settlement debt was non-dischargeable since it was for money obtained by fraud,[118] which is a type of non-dischargeable debt pursuant to section 523(a)(2).[119] Defendant-debtor claimed that the settlement agreement created a novation, that is the defendant-debtor claimed that the settlement debt was the result of the bargaining between the two parties and not a debt for money obtained through fraud.[120] The Court held for the plaintiff-creditor, reasoning that the settlement did not create a total novation,[121] and if the bankruptcy court determined that the defendant-debtor had defrauded plaintiff-creditor, the settlement agreement would be non-dischargeable.[122] *Mollasgo* applied this principle to hold that settlements that fail to resolve liability are not automatically dischargeable under section 523(a)(19), but rather the bankruptcy court must make a liability determination.[123]

Archer, however, is inapplicable to section 523(a)(19) cases. In *Archer*, the settlement at issue resolved claims of fraud, the debt of which is non-dischargeable pursuant to section 523(a)(2), which does not mention settlement agreements.[124] The *Archer* court recognized that allowing fraudulent debtors to escape their burden through bankruptcy is unsound, and thus charged bankruptcy courts to look past the settlement agreement to determine dischargeability.[125] Subsequently, many courts have looked behind settlement agreements when determining dischargeability for section 523(a)(2) cases, and other similar claims.[126] Cases brought under section

[117] *Id.*
[118] *Id.*
[119] 11 U.S.C. § 523(a)(2) (2006).
[120] *Archer*, 538 U.S. at 318.
[121] *Id.* at 323.
[122] *Id.*
[123] Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 453 (Bankr. S.D. Cal. 2009).
[124] 11 U.S.C. § 523(a)(2) (2006).
[125] *Archer*, 538 U.S. at 323 ("We conclude that the Archers' settlement agreement and releases may have worked a kind of novation, but that fact does not bar the Archers from showing that the settlement debt arose out of 'false pretenses, a false representation, or actual fraud,' and consequently is nondischargeable.") (quoting § 523(a)(2)(A)).
[126] *See, e.g.*, Giamo v. DeTrano (*In re* DeTrano), 326 F.3d 319, 322–23 (2d Cir. 2003) (stating that "a debt incurred pursuant to a settlement agreement is nondischargeable in bankruptcy if the agreement settled claims that, if proven, would have created a nondischargeable debt," and further stating that, "[i]f the

523(a)(19), however, should not be subject to the same analysis as fraud cases that fall under section 523(a)(2). Congress intentionally used the phrase "settlement agreements" in section 523(a)(19)(B), thus granting them preclusive effect without being subject to *Archer*'s judicially created doctrine.[127] *Archer*, therefore, is inapplicable to section 523(a)(19) dischargeability claims, and it was improper for the *Mollasgo* court to rely on it.

The *Mollasgo* court further misapplied relevant case law in its reliance on *Meyer v. Ridgon*.[128] Unlike section 523(a)(2), section 523(a)(11) is helpful in determining the nature of the preclusive effect granted to settlements under section 523(a)(19) since section 523(a)(11) excepts from discharge all debts arising from the fraudulent actions committed by persons acting in a fiduciary capacity to a bank, including such debts "contained in a settlement agreement."[129] The *Mollasgo* court recognized this and properly looked to a case discussing section 523(a)(11)'s application to settlements, *Meyer v. Ridgon*, but the *Mollasgo* court attributed an erroneous holding to *Meyer*.[130]

In *Meyer*, the defendant was the president of a bank and was sued for breaching his fiduciary duties.[131] The court entered a default judgment against him for failing to answer the complaint.[132] The defendant then filed for bankruptcy and the plaintiff-creditors petitioned the court to determine that the debt was non-dischargeable pursuant to section 523(a)(11).[133] In its holding, the *Meyer* court stated:

> The plain language of *section 523(a)(11)* . . . alters the common law collateral estoppel rules with respect to default judgments, settlement agreements, and certain administrative agency decisions. . . . [It] requires the bankruptcy court to give preclusive effect to . . . non-court approved settlement agreements, that would not be given

bankruptcy court determines that the debt DeTrano owes pursuant to the settlement agreement 'arises out of' fraud, that debt must be excepted from discharge").

[127] It should be noted that *Hodges v. Buzzeo* (*In re Buzzeo*), 365 B.R. 578 (Bankr. W.D. Pa. 2007), discussed *infra* text accompanying notes 155–159, applies *Archer* to a case brought under § 523(a)(19), but presumably because the debtor raised the very novation argument that *Archer* precludes.

[128] *See supra* notes 93–102 and accompanying text.

[129] § 523(a)(11).

[130] *See* Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 456 (Bankr. S.D. Cal. 2009).

[131] Meyer v. Ridgon, 36 F.3d 1375, 1377 (7th Cir. 1994).

[132] *Id.*

[133] *Id.*

> preclusive effect under the common law. Therefore, we must conclude that Congress intended to preempt the common law by enacting *section 523(a)(11)*.[134]

The *Meyer* court further stated that a bankruptcy court is prohibited from requiring further evidence to determine the dischargeability of debts arising from the settlements or final orders specified in section 523(a)(11);[135] bankruptcy courts must give such settlements and orders an automatic preclusive effect.[136]

Thus, the *Mollasgo* court interpreted *Meyer* incorrectly, and *Meyer* actually supports the proposition that settlements that do not establish liability are nevertheless excepted from discharge under section 523(a)(19). Despite *Meyer*'s holding that section 523(a)(11) grants all settlements and default judgments—which by definition do not determine liability—preclusive effect in subsequent dischargeability proceedings,[137] the *Mollasgo* court used *Meyer* as support for holding that a liability determination is necessary.[138] *Mollasgo* pointed to the fact that the *Meyer* court looked behind the default judgment to determine if the complaint alleged fraudulent conduct that would render the debt non-dischargeable.[139] The *Meyer* court, however, looked behind the default judgment to the complaint because the court was reviewing the case de novo,[140] and the defendant-debtor argued that the original suit was not for conduct that would render the debt non-dischargeable.[141] The court did not look behind the default judgment because it was required to in order to determine dischargeability. Conversely, in *Mollasgo* both parties agreed that the underlying claims, if true, would render the debt non-dischargeable under section 523(a)(19).[142] Thus, *Mollasgo* improperly relied on *Meyer*, which held that all settlements and orders, regardless of the absence of a liability determination, are non-dischargeable under section 523(a)(11).[143]

Further, a proper reading of *Meyer* supports a conclusion that all settlements for securities claims are automatically non-dischargeable,

---

134 *Id.* at 1380 (emphasis added).
135 *Id.* at 1381.
136 *Id.*
137 *See supra* text accompanying notes 130–136.
138 Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 456 (Bankr. S.D. Cal. 2009).
139 *Id.*; *see also Meyer*, 36 F.3d at 1382–85.
140 *Meyer*, 36 F.3d at 1378.
141 *Id.* at 1382.
142 *See generally Mollasgo*, 419 B.R. 444.
143 *Meyer*, 36 F.3d at 1380.

regardless of a definitive finding of liability. As *Mollasgo* notes, "cases involving *section 523(a)(11)* and settlement agreements offer insight into the proper analysis of *section 523(a)(19)*."[144] Analysis of section 523(a)(11) is relevant because "identical words used in different parts of the same act are intended to have the same meaning."[145] Since Congress gave preclusive effect to settlements under section 523(a)(11),[146] it is apparent that Congress also intended to grant all settlements preclusive effect under section 523(a)(19) so that "regulators will now be able to prosecute these con artists with the needed confidence that the victories won in enforcement proceedings will not be nullified in bankruptcy proceedings."[147] Accordingly, just as bankruptcy courts do not need to any additional evidence to determine the non-dischargeability of settlements under section 523(a)(11),[148] settlements for securities laws violations are also granted automatic preclusive effect by section 523(a)(19), regardless of a definitive finding of liability.

The *Mollasgo* court also inappropriately distinguished *Peterman v. Whitcomb* (*In re Whitcomb*)[149] when reaching its holding, and *Mollasgo*'s holding is therefore not in harmony with its sister jurisdiction's interpretation of section 523(a)(19). In *Whitcomb*, the plaintiffs sued the defendant for fraud in connection with the sale of securities.[150] The parties settled the suit with the defendant admitting liability.[151] The plaintiff-creditors then sought a judicial determination that the settlement was non-dischargeable in bankruptcy pursuant to section

[144] *Mollasgo*, 419 B.R. at 455.

[145] Comm'r v. Keystone Consol. Indus., 508 U.S. 152, 159 (1993) (internal quotations and citations omitted).

[146] *See supra* note 134 and accompanying text.

[147] *Meyer*, 36 F.3d at 1380 (quoting 136 CONG. REC. H13288, 13289 (daily ed. Oct. 27, 1990) (statement of Rep. Brooks)). Note that this statement is from the legislative history of the enactment of § 523(a)(11) and supports the conclusion that Congress used the same terms in sections 523(a)(11) and (a)(19) in order to give preclusive effect to settlements under both sections. *See infra* Part III.B for a lengthy discussion of similar Congressional statements in the history of § 523(a)(19). Similarly, the court in *Voss v. Pujdak (In re Pujdak)*, used this reasoning to hold that a default judgment has preclusive effect, without looking behind the judgment, in dischargeability determinations under § 523(a)(19). 462 B.R. 560, 576–79 (Bankr. D.S.C. 2011). *But see* Trimble v. Putman (*In re* Putman), 2011 Bankr. LEXIS 2117, at *7 (Bankr. E.D. Wis. June 2, 2011) (refusing to apply collateral estoppel principles to a default judgment in a dischargeability determination under § 523(a)(19)).

[148] *See supra* note 136 and accompanying text.

[149] 303 B.R. 806 (Bankr. N.D. Ill. 2004).

[150] *Id.* at 807.

[151] *Id.* at 807–08.

523(a)(19) and the court deemed the debt non-dischargeable.[152] The *Mollasgo* court distinguished *Whitcomb* on the basis that the defendant admitted to harming the plaintiff-creditors.[153] The *Whitcomb* court, however, noted while judging on the pleadings that the first element of section 523(a)(19), a violation, was proven because the "[c]omplaint *alleged* that the debt results from fraud . . . ."[154] Thus, the *Whitcomb* court indicated that an *allegation* that a debt results from securities fraud is sufficient to meet the first requirement of section 523(a)(19), a violation, and render a debt non-dischargeable, even absent an admission to the allegations. Accordingly, *Mollasgo*'s holding is not in accord with the Northern District of Illinois's apparent interpretation of section 523(a)(19).

The *Mollasgo* court also wrongly distinguished *Hodges v. Buzzeo* (*In re Buzzeo*).[155] In *Buzzeo* the plaintiffs sued the defendant for the fraudulent sale of securities in violation of state securities laws.[156] The parties entered into a settlement agreement that failed to resolve liability, but the defendant waived his right to dischargeability.[157] Based on this waiver, the *Mollasgo* court distinguished *Buzzeo*'s holding that the settlement was not dischargeable pursuant to section 523(a)(19).[158] The *Buzzeo* decision, however, could not have turned on the dischargeability waiver since a waiver of dischargeability prior to petitioning for bankruptcy is unenforceable as against public policy.[159] Accordingly, *Buzzeo* must have granted summary judgment to the creditor because the settlement agreement is simply not

[152] *Id.* at 807.

[153] Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 456 (Bankr. S.D. Cal. 2009).

[154] *Whitcomb*, 303 B.R. at 810 (emphasis added).

[155] 365 B.R. 578 (Bankr. W.D. Pa. 2007); *see also Mollasgo*, 419 B.R. at 456.

[156] *Buzzeo*, 365 B.R. at 580.

[157] *Id.*

[158] *Mollasgo*, 419 B.R. at 456–57 (citing *Buzzeo*, 365 B.R. at 580–81). *In re Schwartz* erroneously made the same distinction when denying summary judgment in similar circumstances to those of *Mollasgo*. Star High Yield Inv. Mgmt. Corp. v. Schwartz (*In re* Schwartz), No. 07-30508, 2007 Bankr. LEXIS 3594 at *12 n.4 (Bankr. S.D. Tex. Oct. 17, 2007). In *Schwartz*, the court was concerned with the debtor's summary judgment motion, in which defendant-debtor argued a novation theory that *Archer* precluded. *Id.* Nevertheless, *Schwartz*, in passing, distinguished *Buzzeo* because of the waiver when denying creditor's cross motion for summary judgment. *Id.*

[159] 11 U.S.C. § 524(a)(2) (2006) ("A discharge in a case under this title . . . operates as an injunction against the commencement or continuation of an action . . . whether or not discharge of such debt is waived."); Cheripka v. Republic Ins. Co (*In re* Cheripka), No. 91-3249, 1991 U.S. App. LEXIS 30343 (3d Cir. Dec. 31, 1991), *aff'd en banc by an equally divided court*, 1992 U.S. App. LEXIS 38449 (3d Cir. Feb. 24, 1992).

dischargeable since section 523(a)(19) renders all settlements of securities violations non-dischargeable, regardless of whether or not liability is established. Thus, *Mollasgo*'s holding is also not aligned with the Western District of Pennsylvania's evident interpretation of section 523(a)(19).

In addition to misinterpreting the above cases, the *Mollasgo* court is apparently not in accord with other jurisdictions, as well. In *Faris v. Bahram Amir Jafari* (*In re Beharm Amir Jafari*) the defendant allegedly defrauded the plaintiff-investors in connection with the sale of securities, in violation of securities laws.[160] The plaintiffs took no other action besides seeking a judicial determination of non-dischargeability for a debt that the defendant had yet to incur.[161] The court therefore denied the plaintiff-creditors' summary judgment motion to determine the debt non-dischargeable under section 523(a)(19) because at the time of the hearing "[p]laintiffs had not yet filed an action in another forum to obtain an order, judgment or decree, holding the Debtor liable for securities violations or securities fraud. *Nor [had] they entered into a settlement agreement with the Debtor resolving a claim for securities violations or securities fraud*."[162] Thus, the *Faris* court seemingly held that a settlement agreement could satisfy the requirements of section 523(a)(19) without any further determination of liability.[163]

Additionally, *Frost v. Civiello* (*In re Civiello*) supports a conclusion inapposite of *Mollasgo*'s.[164] In *Civiello*, the defendant sold non-registered securities in violation of state securities laws.[165] The Ohio Division of Securities, the institution responsible for enforcing Ohio Securities Laws,[166] issued defendant a Cease and Desist Order.[167] The Cease and Desist Order did not determine liability, nor was there any

[160] 401 B.R. 494, 495 (Bankr. D. Colo. 2009).

[161] *Id.*

[162] *Id.* at 495 (emphasis added).

[163] An ambiguous statement appears later in the opinion that could be read to contradict the court's earlier reasoning. *See* 401 B.R. at 499 ("Thus, the Court concludes that, absent a settlement agreement or other consensual determination of liability, Subsection B evidences a conscious choice to have the *liability determination* occur outside the bankruptcy forum . . . ."). This statement can be explained, however, since the plaintiff-creditor was asking the court to determine liability and render a debt non-dischargeable.

[164] 348 B.R. 459 (Bankr. N.D. Ohio 2006).

[165] *Id.* at 461.

[166] *Id.* at 464.

[167] *Id.*

adjudicatory hearing.[168] The court held that the Cease and Desist Order, which did not determine liability, was sufficient to satisfy the violation of section 523(a)(19).[169]

Nace v. Quibell (*In re Quibell*) also supports the argument that a Cease and Desist letter is sufficient to establish the "violation" requirement of section 523(a)(19).[170] In *Quibell*, the Pennsylvania Securities Commission issued a Cease and Desist letter to a company, which the defendant-debtor promoted as an investment to the plaintiff, for violations of state securities laws.[171] The defendant-debtor owed the plaintiff money on a note that the defendant-debtor gave the plaintiff "for reasons that [were] unclear on the record," but apparently related to the company that received a Cease and Desist Order.[172] The court denied summary judgment for the plaintiff on the issue of dischargeability of the note under section 523(a)(19), because the plaintiff "failed to establish a nexus between the Cease and Desist Order and the judgment note,"[173] and thus could not establish that the debt was for a violation of securities laws.[174] This reasoning suggests that had the plaintiff established the nexus, the Cease and Desist Order would have been sufficient to establish a violation of securities laws for purposes of dischargeability under section 523(a)(19),[175] and thus *Mollasgo*'s requirement of an affirmative establishment of liability is not in accord. The above cases suggest that other jurisdictions do not interpret section 523(a)(19) as *Mollasgo* does, but rather they hold that settlements that do not resolve liability are nevertheless non-dischargeable under section 523(a)(19).

[168] *Id.* at 462.
[169] *Id.* at 465–66.
[170] *See* 2012 Bankr. LEXIS 1423 (Bankr. M.D. Pa. Apr. 4, 2012).
[171] *Id.* at *6.
[172] *Id.* at *19.
[173] *Id.* at *19–20.
[174] *Id.* at *20.
[175] Other language in the opinion may suggest that a Cease and Desist order is not sufficient to establish the requisite violation of securities laws for the purposes of section 523(a)(19). *Id.* at *18 ("But *even if* the issuance of a Cease and Desist Order establishes that a violation of Pennsylvania Securities Laws occurred," the debt would still be dischargeable since the plaintiff could not establish a connection between the defendant and the Cease and Desist order (emphasis added)). *But see* Nace v. Quibell (*In re* Quibell), 2012 Bankr. LEXIS 1423, at * 19–21 (Bankr. M.D. Pa. Apr. 4, 2012) (stating, when dismissing the complaint, that had the plaintiff established a nexus between the defendant-debtor and the Cease and Desist Order, a violation of securities laws would have been established for the purposes of section 523(a)(19)).

B. Mollasgo *is Contrary to Congress's Intent that All Settlements for Securities Violations be Non-Dischargeable*

The legislative history indicates that the *Mollasgo* holding is contrary to the true intent of the statute. As one commentator noted, "[t]he legislative intent behind § 523(a)(19) is quite clear; it was added to protect investors."[176] In adding the securities-claims exception to discharge, Congress sought to close a loophole that allowed fraudsters to use the bankruptcy code to avoid debts for their wrongdoing.[177] As the section-by-section analysis states:

> Under current laws, state regulators are often forced to "reprove" their fraud cases in bankruptcy court to prevent discharge because remedial statutes often have different technical elements than the analogous common law causes of action. *Moreover, settlements may not have the same collateral estoppel effect as judgments obtained through fully litigated legal proceedings.* In short, with their resources already stretched to the breaking point, state regulators must plow the same ground twice in securities fraud cases. By ensuring securities law judgments and settlements in state cases are non-dischargeable, precious state enforcement resources will be preserved and directed at preventing fraud in the first place.[178]

The record further states that the section

> make[s] judgments and settlements arising from state and federal law violations brought by state and federal regulators and private individuals non-dischargeable. Current bankruptcy law may permit wrongdoers to discharge their obligations under court judgments or settlements based on securities fraud and securities law violations. This loophole in the law should be closed . . . .[179]

Thus the section-by-section analysis makes clear that the statute is intended to give all settlements relating to securities laws violations a collateral estoppel effect that they would normally not receive.[180]

The section-by-section analysis is authoritative because courts frequently rely on section-by-section analyses when discerning the legislature's intent.[181] Additionally, the section-by-section analysis

[176] Pierre-Louis, *supra* note 2, at 329–30 (internal quotations omitted).
[177] S. REP. NO. 107-146, at 10 (2002); *see also supra* text accompanying notes 22–24.
[178] S. REP. NO. 107-146, at 10 (2002) (emphasis added).
[179] *Id.*
[180] *See id.*
[181] *See, e.g.*, Smith v. Gibbons (*In re* Gibbons), 289 B.R. 588, 594 (2003) (giving

explicitly states that the analysis is intended "to provide guidance in the legal interpretation of these provisions."[182] Further, Congress previously granted settlements preclusive effect in section 523(a)(11).[183] Congress is aware of the terms it uses in other sections and their effect on new sections if used again.[184] Accordingly, Congress intended to give settlements under section 523(a)(19) the same preclusive effect they are afforded under section 523(a)(11). *Mollasgo*, therefore, was in error by stating that Congress "focuse[d] on resolved securities violations, rather than on settled claims of securities violations."[185] Interpreting the statute to require settlements to be accompanied by litigated findings of liability is illogical since parties enter into settlement agreements as a way to avoid litigation, and thus settlement agreements will rarely present actual findings.[186] Such an interpretation would render the statutory phrase "any settlement agreement" meaningless.[187]

Canons of statutory construction also support the conclusion that all securities claims settlements, regardless of liability determinations, are non-dischargeable in bankruptcy. *Mollasgo* based its theory on the vague statutory language and the statute's use of the word "and," which seemingly requires the presence of all enumerated elements for the dischargability exception to apply.[188] But "and" does not always mean "and"; it can sometimes mean "or."[189] When "a strict grammatical construction will frustrate evident legislative intent, a court may read 'and' as 'or' . . . ."[190] This is especially true when Congress rushes complex legislation through both houses,[191] as was

"substantial weight" to the section-by-section analysis behind section 523(a)(19)).

[182] 148 CONG. REC. S7418 (daily ed. July 26, 2002) (statement of Sen. Leahy).

[183] *See supra* text accompanying notes 129–147.

[184] Sambur, *supra* note 63, at 571; *see also* Lorillard v. Pons, 434 U.S. 575, 581 (1978) ("Congress normally can be presumed to have had knowledge of the interpretation" of prior terms "at least insofar as it affects the new statute."); United States v. Palozie, 166 F.3d 502, 504–05 (2d. Cir. 1999) (stating that when Congress enacts a new law using identical language that has already been interpreted by the courts, it is presumed that Congress intended the interpreted meaning).

[185] Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 452 (Bankr. S.D. Cal. 2009).

[186] *See* Halpern v. First Ga. Bank (*In re* Halpern), 810 F.2d 1061, 1064 (11th Cir. 1987); Hutchens v. Temples (*In re* Temples), No. 05-9134, 2006 Bankr. LEXIS 3174 (Bankr. N.D. Ga. Sept. 29, 2006).

[187] 11 U.S.C. § 523(a)(19) (2006).

[188] *See supra* text accompanying notes 77–80 and 30–37.

[189] KIM, *supra* note 30, at 8.

[190] *Id.* (internal quotations omitted).

[191] *See id.*; DeSylva v. Ballentine, 351 U.S. 570, 573 (1956) ("[T]he word 'or' is often used as a careless substitute for the word 'and.'").

the case with SOX.[192] Further, statutes should always be construed in a way that does not render any part superfluous.[193] But if *Mollasgo*'s holding is correct, then the statute is superfluous. Simply put, if a definitive violation of securities laws was always required then there would never be a chance for settlements, which do not determine liability, to be deemed non-dischargeable.[194]

Lastly, *Mollasgo*'s holding is detrimental to public policy goals, at least when it is applied to government agencies. The *Mollasgo* court reasoned that rendering all securities litigation settlements non-dischargeable would discourage debtors from entering into settlement agreements and thereby open the floodgates to litigation.[195] Although this argument has some merit, it ignores the fact that subjecting settlements to litigation in bankruptcy court will discourage plaintiffs from settling claims. Since the purpose of the statute was to preserve "precious state enforcement resources" and save regulators from having to "plow the same ground twice," it seems that Congress intended to encourage governmental plaintiffs to settle.[196] Thus, making settlements unattractive to government-plaintiffs appears irrational. Indeed, the government's need to save its resources is at the crux of a current debate over a federal judge's rejection of an SEC settlement with a defendant-bank that neither admitted nor denied liability.[197] It is undeniable that automatically rendering securities settlements non-dischargeable is unfair to some factually innocent but prosecuted debtors, but that result is the

[192] *See supra* text accompanying notes 60–70.

[193] KIM, *supra* note 30, at 12; *see also* Astoria Fed. Sav. & Loan Ass'n v. Solimino, 501 U.S. 104, 112 (1991).

[194] *See* Reply Points & Authorities in Support of Motion for Summary Judgment/Summary Adjudication, *supra* note 33, at *7.

[195] Mollasgo v. Tills (*In re* Tills), 419 B.R. 444, 454 (Bankr. S.D. Cal. 2009).

[196] S. REP. NO. 107-146 (2002).

[197] *See* Eaglesham & Bray, *supra* note 33; Edward Wyatt, *Judge Blocks Citigroup Settlement With SEC*, N.Y. TIMES (Nov. 28, 2011), http://www.nytimes.com/2011/11/29/business/judge-rejects-sec-accord-with-citi.html?pagewanted=all ("The [SEC] . . . must settle most of the cases it brings because it does not have the money or the staff to battle deep-pocketed Wall Street firms in court. Wall Street firms will rarely admit wrongdoing, the agency says, because that can be used against them in investor lawsuits."); Jake Zamansky, *Rakoff Rejection of Citi / SEC Settlement Pierces Wall Street's Alice-in-Wonderland Thinking*, FORBES (Nov. 29, 2011, 2:44 PM), http://www.forbes.com/sites/jakezamansky/2011/11/29/rakoff-rejection-of-citi-sec-settlement-pierces-wall-streets-alice-in-wonderland-thinking/ (arguing that rejection of no-fault settlements is proper because it disallows companies to write off fraud as a cost of business and prevents the SEC from obtaining "wrist-slap" settlements for conduct that is not actually a violation of the law).

conscious decision of the legislature. Innocent debtors can avoid non-dischargeability by refusing to settle and pursuing litigation.

After examining the legislative record, it is apparent that Congress intended to grant preclusive effect to securities-claims settlements that do not establish liability. Further, principles of statutory construction validate this interpretation. *Mollasgo*'s argument to the contrary is ill founded, as it is based on misapplied precedent and is inconsistent with other jurisdictions' interpretations. Rather, the correct interpretation of section 523(a)(19) renders all securities claims settlements non-dischargeable in bankruptcy; even those that fail to establish liability for securities violations. We are thus faced with the policy dilemma posited in the beginning of this Comment.

IV. POLICY CONCERNS DICTATE A NECESSARY AMENDMENT TO SECTION 523(A)(19)

Congress may have intended that section 523(a)(19) except from discharge all settlements related to securities violations, but the question remains if that action serves public policy. As *Mollasgo* noted, section 523(a)(19) seriously hampers the longstanding, fundamental "fresh start" goal of bankruptcy.[198] The ramifications are highlighted by Art Vandelay's story, presented in this Comment's introduction.[199]

The scope of section 523(a)(19) reaches beyond what Congress sought to address.[200] For example, while the enactment was in response to corporate scandals, the section's applicability is not so limited and applies even to small privately held securities of companies that are not publicly traded.[201] Further, there are numerous technical violations of securities laws that a debtor could inadvertently violate without any fraudulent intent.[202] Given Congress's intent to curb corporate fraud, it seems wrong to punish securities violators that acted without any scienter or fraudulent intent.[203] Additionally, section 523(a)(19) only applies to individual debtors, and not corporations.[204] Thus, individuals will feel the full

198 *Mollasgo*, 419 B.R. at 454–55.
199 *See supra* text accompanying note 4.
200 *See supra* Part III.B.
201 Warner, *supra* note 29, at 44.
202 *Id.*; Pearson, *supra* note 4.
203 *See supra* Part III.B.
204 *See* 11 U.S.C. § 523(a) (2006) ("A discharge under [the various bankruptcy

force of Congress's reactionary regulatory force aimed at fraudulent corporations like Enron, which are outside the scope of the discharge exception.[205]

The securities-claim exception also gives a windfall to private litigants. Most securities fraud cases are brought by private litigants and resemble ordinary tort claims.[206] Additionally, most securities claims settle for amounts dramatically smaller than the plaintiffs' original demands.[207] The reason such cases settle is because securities defendants are risk-averse, pessimistic, and unwilling to expose themselves to further liability.[208] Therefore, the fact that a case settles does not reflect that the underlying claims were meritorious. Section 523(a)(19) gives these private plaintiffs a windfall by exempting their settlements from discharge in bankruptcy even though it is possible, if not probable, that liability would never have been established if the claims were actually litigated. This exemption thus gives plaintiffs tremendous bargaining power at the settlement table[209] by allowing them to extract settlements of dubious claims from risk-averse defendants and have the settlement obligation survive the debtor's subsequent bankruptcy.

chapters] does not discharge *an individual debtor* from any debt" that is listed in this section.) (emphasis added); § 1141 (indicating that in a bankruptcy filed under Chapter 11 there is no securities laws violations exception to discharge); *In re* WorldCom, Inc., 329 B.R. 10, 13 (Bankr. S.D.N.Y. 2005) ("The simple answer to this contention is that Section 523(a)(19) is applicable only to individual debtors. It has no application to corporate debtors such as WorldCom . . . . If the drafters [of SOX] were indeed . . . confused . . . it will be for Congress to change the statute, not this Court."); Ebaugh, *supra* note 54.

[205] Individuals may have some protection, however, since debts arising from securities claims are subordinated to other debts. 11 U.S.C. § 510(b) (2006). But subordination offers little peace of mind since it will only result in the debtor avoiding such obligations if the debtor runs out of money to pay other debts. Furthermore, an individual who files for bankruptcy under Chapter 13 will be able to discharge debts for securities law violations that section 523(a)(19) would otherwise except from an individual's discharge. § 1328. A "hardship discharge" under Chapter 13, however, would not discharge the debt that is excepted by section 523(a)(19). § 1328(c). Accordingly, only individuals who file for bankruptcy protection under Chapter 7, or receive a hardship discharge under Chapter 13, will have debt arising from securities law violations excepted from discharge. For a comprehensive yet comprehensible explanation of the various chapters of bankruptcy and their respective nuances, see BANKR. JUDGES DIV., *supra* note 5.

[206] Yablon, *supra* note 37, at 571–72.

[207] *See id.* at 586.

[208] *Id.* at 588.

[209] *See generally* Joseph A. Grundfest & Peter H. Huang, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267 (2006) (explaining the economics of negotiating and settlements).

This result is contrary to the general federal policy of discouraging private securities claims. Congress passed the Private Securities Litigation Reform Act ("PSLRA") because of abusive tactics by private securities plaintiffs.[210] Since then, case law developed in a way that reduces the likelihood that plaintiffs will bring and win civil securities suits.[211] Private plaintiffs now face procedural barriers and are effectively discouraged from using courts to resolve their private securities claims.[212] It seems odd, therefore, that section 523(a)(19) would grant such bargaining power to plaintiffs in private securities suits.

An amendment to the code would alleviate these public policy concerns. First, the windfall to private plaintiffs can easily be avoided. Additionally, congressional intent, public policy, and section 523(a)(19) can all be aligned if an amendment to section 523(a)(19) excepts only debt that arises out of fraudulent securities laws violations and does not allow an automatic exception for settlements entered into with private litigants, unless liability for the fraudulent violations is established.

Such an amendment will avoid section 523(a)(19)'s harsh treatment of non-fraudulent, technical violations of securities laws. An amendment can stipulate that only debts arising out of violations committed with fraudulent intent are non-dischargeable, whether they are owed to the government or private plaintiffs.[213] By allowing private plaintiffs to benefit from this provision, innocent investors who obtain judgments or settlements that admit liability against those who defrauded them will not be able to be duped again.[214] It is acceptable to allow private plaintiffs to obtain automatically non-dischargeable *judgments* for their securities claims because the facts were actually adjudicated after plaintiffs met the heightened standards of the PSLRA.[215] Moreover, judgments that private plaintiffs obtain do not pose the risk that automatically non-dischargeable settlements do in regards to strong-arming risk-averse defendants at the settlement table.[216] Likewise, there is no public

---

[210] PSLRA, 15 U.S.C. 78u-4 (2006); *see also* Yablon, *supra* note 37, at 569.

[211] Geraldine Szott Moohr, *The Balance Among Corporate Criminal Liability, Private Civil Suits, and Regulatory Enforcement*, 46 AM. CRIM. L. REV. 1459, 1474 (2009).

[212] *Id.*

[213] *See generally* Sambur, *supra* note 63 (arguing that the current version of § 523(a)(19) only applies to fraudulent violations prosecuted by the government).

[214] *See supra* text accompanying notes 21–24.

[215] *See supra* text, accompanying notes 220–22.

[216] *See supra* text accompanying notes 205–11.

policy concern when settlements that admit liability are automatically non-dischargeable. Additionally, limiting section 523(a)(19) to fraudulent violations will remove concerns about punishing innocent debtors in technical violation of laws,.[217] Such an amendment would also align the effects of section 523(a)(19) with congressional intent to curb *fraud*.[218]

An amendment could also stipulate that only no-fault settlements entered into with government regulators are automatically non-dischargeable, and thus private litigants cannot use section 523(a)(19) to strong-arm defendants into settling non-meritorious claims for larger amounts.[219] This would resolve the inherent tension between the policy goals of the PSLRA—to curb frivolous private securities claims—and the current effects of section 523(a)(19). Rendering the government the only creditor that can obtain automatically non-dischargeable no-fault settlements will also prevent some unjust results, like those presented in Art Vandelay's story.

Limiting section 523(a)(19)'s applicability to no-fault settlements with government creditors also aligns the section with congressional intent. Congress passed the section in order to save government resources and prevent regulators from having to re-litigate securities claims against fraudulent debtors.[220] Allowing private litigants to use section 523(a)(19) to automatically except from discharge settlements that do not establish liability does not further this purported goal. While one can argue that by facilitating private securities claims through section 523(a)(19) the government will be relieved from having to prosecute as many claims and thereby save resources, Congress expressly rejected this option when passing the PSLRA.[221] Accordingly, limiting section 523(a)(19)'s automatic exception for no-fault settlements to government-debtors is the only way to reconcile congressional intent behind both section 523(a)(19)'s and PSLRA's enactments. Private plaintiffs' settlements may still be found non-dischargeable if the fraudulent violations of securities laws are actually proven or admitted to, thus preventing fraudsters from utilizing legal loopholes and granting protection to

[217] *See* Pearson, *supra* note 4.
[218] S. REP. NO. 107-146 (2002); *see also supra* Part III.B.
[219] *See generally* Yablon, *supra* note 37, and Grundfest & Huang, *supra* note 209 (describing how non-meritorious securities claims force risk-averse defendants to settle cases for more than the actual settlement is worth).
[220] S. REP. NO. 107-146 (2002); *see also supra* Part III.B.
[221] *See supra* text accompanying notes 206–09.

innocent creditors without running afoul of the policy behind the PSLRA.[222] Lastly, singling out the government as a preferred creditor is not a novel idea, as the bankruptcy code distinguishes between government and non-government creditors in other sections.[223] Thus, proposing an amendment to do so with section 523(a)(19) is not a radical suggestion, and any argument that the bankruptcy code should treat all creditors equally is a position that Congress has already rejected.

In sum, an amendment that limits non-dischargeability to fraudulent securities violations and distinguishes between governmental and private creditors with regards to no-fault settlements—but still automatically excepts from discharge private plaintiffs' judgments and settlements where liability is otherwise established—will remedy the unintended consequences of section 523(a)(19) and reshape the section to reflect Congress's original intent.

V. CONCLUSION

In enacting section 523(a)(19), Congress sought to remedy one problem but created another. In its attempt to remedy corporate fraud in the wake of Enron and other shocking scandals, it usurped important policy considerations—the fresh start, for example—that the bankruptcy code is intended to further. The current securities-claims exception to discharge, as written in section 523(a)(19) of the bankruptcy code, is vague and overbroad. The plain language seems to except from discharge all settlements of securities laws violations while simultaneously requiring a definitive finding of liability, which settlements often do not provide.

The vagueness that the poorly crafted language creates is eroded upon examination of the legislative intent. Congress's intent plainly was to except all settlements of securities laws violations from discharge in bankruptcy. This results, however, in a statute that harms the innocent and unfortunate debtor while letting some culprits run free. A settlement of a weak case based on alleged technical violations will survive a bankruptcy petition and the exception is inapplicable to the fraudulent corporations that inspired Congress to act. While Congress's intentions are laudable, the language of the statute does not accurately reflect them. This stark

[222] *See supra* notes 210–11 and accompanying text.

[223] *See, e.g.*, 11 U.S.C. § 523(a)(7) (2006) (excepting certain fines owed to the government from discharge); *see also* Sambur, *supra* note 63.

contrast manifested itself recently in *Mollasgo*. *Mollasgo*, driven by policy concerns, misinterpreted the true meaning of the securities-claims exception from discharge. Its reasoning was based on misapplied precedent and faulty distinctions. Thus, while the *Mollasgo* court's holding that settlements are excepted from discharge only when liability for securities laws violations is established softens the inappropriate bite of section 523(a)(19), it does so wrongly because it is up to Congress to correct its own mistakes.

Rather, the legislature must heed the lesson of *Mollasgo* and amend the section to reflect public policy. The government has a legitimate interest in saving resources, but the current statute is overbroad and infringes upon the fresh start policy of bankruptcy. Policy favors holding Pennypacker to his settlement but not Vandelay. An amendment that distinguishes between no-fault settlements with the government and private creditors, as well as renders the section inapplicable to non-fraudulent, technical violations of the law will strike the proper balance between saving government resources while protecting against securities fraud and preserving the fresh start for those who deserve it. Until Congress passes an amendment, section 523(a)(19) of the bankruptcy code will continue to punish the innocent and allow fraudsters to navigate through loopholes.