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NOWHERE TO RUN, NOWHERE TO HIDE: THE IMPACT OF SARBANES-OXLEY ON SECURITIES ARBITRATION

LYDIE NADIA CABRERA PIERRE-LOUIS†

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Securities arbitration is a "rigged system" that is unfair to investors.

—William F. Galvin, Massachusetts Secretary of the Commonwealth[1]

INTRODUCTION

A. A Hollow Victory

We won. For over two years, we won appeal after appeal in the New York state courts against a former Schwab and Co. independent investment advisor. The arbitration award in favor of our clients was not large by Wall Street standards. It represented our clients' life savings, however, and an opportunity for them to rebuild their lives. Our clients are immigrants from Pakistan with very little education, money, or business savvy. They had no business investing in high risk technology stocks. In fact, they had no idea their investment advisor invested in technology stocks. How could they? They did know what technology stocks were and did not read English very well. Their unscrupulous investment advisor lost their entire $45,000 investment, and he lost it within six months. The National Association of Securities Dealers'[2] arbitrators had no difficulty

[1] *The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 109th Cong. 41 (2005) (statement of William F. Galvin, Secretary, Commonwealth of Massachusetts).

[2] *See generally* About NASD, http://www.nasd.com/AboutNASD/index.htm. The National Association of Securities Dealers ("NASD") is the world's leading private-sector provider of financial regulatory services. NASD has helped bring integrity to the markets—and confidence to investors—for more than sixty years. Under U.S. federal law, virtually every securities firm doing business with the U.S. public is a member of this private, not-for-profit organization. Roughly 5,100 brokerage firms, over 170,325 branch offices, and more than 658,400 registered securities representatives come under NASD's jurisdiction. NASD registers member firms, writes rules to govern their behavior, examines them for compliance, and disciplines those failing to comply. NASD provides education to industry professionals and investors, and it supports member firms in their self-compliance activities. *See id.*

finding that the investment advisor committed fraud and awarded our clients a full recovery plus interest and fees. Sometimes the system does work. Within weeks, the investment advisor filed not one but two appeals alleging a laundry list of sundry state and federal illegalities. We fought every allegation. Finally, after two years, the New York Court of Appeals affirmed the arbitration award and dismissed the investment advisor's allegations as unsubstantiated. It was over. The students informed our clients that we won, and they could begin collection proceedings against the investment advisor. Our clients' gratitude was overwhelming, and it inspired the students to continue working for the less fortunate in our society.

Our euphoria was short lived. Unbeknownst to anyone, the unscrupulous investment advisor filed for bankruptcy during the pendency of the Court of Appeals decision. I held in my hand an order from the Eastern District of New York Bankruptcy Court instructing me to cease and desist from any litigation, administrative proceeding, or collection action against the investment advisor and to attend a meeting of all creditors. For a moment, time really did stand still; then I smiled. We would go, and we would fight. All I needed to know was whether the law was on our side.

B. *The Rise of the Sarbanes-Oxley Act of 2002*

> *What is lacking in the U.S. is a culture of shame. No C.E.O. in the U.S. is considered a thief if he does something wrong. It is a kind of moral cancer.*
>
> —Guido Rossi, former chairman of Telecom Italia[3]

In 2001, a wave of highly publicized scandals broke at prominent public corporations such as Enron,[4] WorldCom, and

[3] Edmund L. Andrews, *U.S. Businesses Dim as Models for Foreigners*, N.Y. TIMES, June 27, 2002, at Al.

[4] Enron began in 1985 as a company that shipped natural gas through pipelines, but changed in the next sixteen years into one of the nation's most dominant energy traders. *See* Enron, Fast Facts for the Media: Company History & Milestones, http://www.enron.com/corp/pressroom. Enron allegedly dealt in illegal, off-balance-sheet transactions and partnerships, which allowed the company to conceal its growing debt problem. *See* Complaint, SEC v. Fastow, No. H-02-3666 (S.D. Tex. Oct. 2, 2002). Enron high-level executives may have known about the company's financial issues and woes for some time. Former Vice President for Corporate Development, Sherron Watkins, warned Enron's Chief Executive Officer

Tyco. The scandals followed closely on the heels of the now infamous bursting of the technology bubble. The corporate structure of the U.S. economy changed ever since the Enron scandal emerged.[5] Thousands of investors and Enron employees lost their savings and pensions because Enron misrepresented its finances.[6] Before Enron's stock crashed, the company's top executives pulled out their investments, but its employees were not allowed to move their pension funds from Enron stock to a money-making investment.[7] The refusal of many Enron executives to testify about their company's demise, and the existence of conflicts of interest between Enron directors and outside consultants are among the primary reasons Congress adopted the Sarbanes-Oxley Act.[8] The Act was an effort to protect against bad governance and reassure investors that it was safe to invest.[9]

Sarbanes-Oxley is a broad package of federal legislation intended to rein in corporate executives run amok and restore investor confidence.[10] Unlike most of the federal initiatives that preceded it, Sarbanes-Oxley established some mandatory rules governing the internal affairs of publicly listed corporations. In

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of impending financial problems based on a number of accounting scandals in August 2001. *Financial Collapse of Enron Corp: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Energy and Commerce*, 107th Cong. 2 (2002) (statement of Sherron Watkins, Vice President of Corporate Development, Enron Corporation).

[5] *See* Enron Chronology, USA TODAY, May 25, 2006, http://www.usatoday.com/money/industries/energy/2006-05-25-enron-chronology_x.htm.

[6] Michael Kopper, the first former Enron executive to plead guilty and be convicted of money laundering and wire fraud, assisted investigators to uncover an elaborate system that concealed Enron's debt and made millions for insiders like Chief Financial Officer Fastow, Kopper, and Kopper's domestic partner. *See* Cooperation Agreement, United States v. Kopper, No. H-02-0560 (S.D. Tex. Aug. 21, 2002). The Enron case is complex because of the number of people and partnerships involved, in addition to the S.E.C. and Department of Justice probes and the class action lawsuits filed by Enron shareholders.

[7] *Cf.* Enron Fraud Info Center, Enron Fraud Information, http://www.enronfraudinfocenter.com/information.php (last visited Jan. 31, 2007) (describing when the fraud was discovered and what type of fraud was committed).

[8] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11 U.S.C, 15 U.S.C., 18 U.S.C., 28 U.S.C., and 29 U.S.C.).

[9] 149 CONG. REC. S12976 (daily ed. Oct. 21, 2003) (statement of Rep. Levin) (discussing the restoration of trust in the financial markets after the Enron "debacle").

[10] *See* S. REP. NO. 107-146, at 2 (2002) (stating that the Act is intended to restore trust in the financial markets after the Enron "debacle").

particular, Sarbanes-Oxley includes changes to many different areas of the law: (1) accounting and auditing procedures, (2) financial disclosures, (3) corporate tax law, (4) securities law, and (5) bankruptcy law. Sarbanes-Oxley's goal is to guarantee "trust in the financial markets by ensuring that the corporate fraud and greed may be better detected, prevented and prosecuted" and to "ensure that such greed does not succeed."[11] Enron misled investors and regulators by using a variety of complicated transactions with putatively separate business entities designed to bolster purported profits, conceal actual losses, and ultimately boost Enron's share price. These practices eventually caught up with the company, and in October 2001, Enron filed the largest bankruptcy in United States history.[12] As a result, Enron shareholders were left with virtually worthless stock.[13] The market fallout from this and other accounting scandals affected virtually every American; the SEC reported that the average household lost $60,000.[14]

In reaction to these events, Sarbanes-Oxley created a new bankruptcy provision, 11 U.S.C. § 523(a)(19),[15] that renders debt from judgments for federal or state securities law violations and debt incurred through common law fraud, deceit, or manipulation in connection with the purchase or sale of a security, non-dischargeable in bankruptcy.[16] This new section was added because Congress recognized a "loophole" in the existing law governing personal bankruptcy, allowing securities law violators to unfairly discharge their debts to defraud investors.[17]

This Article continues my scholarship of loopholes in market regulation,[18] which certain entities or individuals exploit for their

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[11] *Id.*

[12] *See id.* WorldCom now holds the record for largest bankruptcy after it filed in July of 2002. Shawn Young et al., *WorldCom Plans Bankruptcy Filing—Board Approves Move; Operations to Continue During Reorganization*, WALL ST. J., July 22, 2002, at A3.

[13] *See* S. REP. NO. 107-146, at 3.

[14] Jeanne Cummings & Michael Schroeder, *Lesser-Known Candidates Head List for SEC Chief*, WALL ST. J., Nov. 15, 2002, at A3 (noting that the national exchanges as a whole lost five trillion dollars in market value during the same time period).

[15] 11 U.S.C. § 523(a)(19) (Supp. 2003).

[16] *See* S. REP. NO. 107-146, at 10.

[17] *Id.*

[18] *See* Lydie Pierre-Louis, *Controlling a Financial Jurassic Park: Obtaining Jurisdiction over Derivatives by Regulating Illegal Foreign Currency Boiler-Rooms*, 12 FORDHAM J. CORP. & FIN. L. (forthcoming 2007).

own self-interest, and which often, if not always, results in a fraud on the market or on small investors. This article generally explores the loopholes in the application of the U.S. Bankruptcy Code to the securities market. More specifically, Part II of this Article provides an overview of securities arbitration. Part III provides an overview of bankruptcy law. Part IV examines the relevant changes that Sarbanes-Oxley has made to the U.S. Bankruptcy Code, in particular, the substantive changes to § 523(a)(19), which makes a finding of a debtor's fraudulent intent a condition precedent to a non-dischargeability of a claim in bankruptcy. Part V proposes an amendment to NASD Rules & Regulations to require arbitrators to make a finding of fraud in arbitral awards when the fraud has been pled and proven during the proceeding for purposes of § 523(a)(19). In Part VI, this Article concludes that as the securities market continues to expand and loopholes within the law are exploited, the regulatory framework which governs the markets will by necessity continue to develop to remain in tandem with the ever-changing securities markets.

I. SECURITIES ARBITRATION IN A NUTSHELL

When will mankind be convinced and agree to settle their difficulties by arbitration?

—Benjamin Franklin[19]

A. *A Brief History of U.S. Securities Arbitration*

In June 1987, the United States Supreme Court decided the landmark case *Shearson/American Express, Inc. v. McMahon*,[20] which forever altered securities arbitration into the conflict resolution process that currently exists. In *Shearson*, the Supreme Court upheld pre-dispute arbitration as a valid and appropriate manner for settling disputes. Prior to that time, securities arbitration was not viewed as a legitimate alternative to litigation.[21] As the Court stated initially: "Recognizing the advantages that prior agreements for arbitration may provide for

[19] BrainyQuote.com, Benjamin Franklin Quotes, http://www.brainyquote.com/quotes/quotes/b/benjaminfr169230.html (last visited Feb. 2, 2007).

[20] 482 U.S. 220 (1987).

[21] *See* Wilko v. Swan, 346 U.S. 427, 431 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

the solution of commercial controversies, we decide that the intention of Congress concerning the sale of securities is better carried out by holding invalid such an agreement for arbitration of issues arising under the [1933 Securities] Act."[22]

To understand the importance of *Shearson*, it is crucial to understand the legal terrain regarding securities arbitration prior to the decision. We begin at the beginning. The first securities arbitration system was established at the New York Stock Exchange in 1817.[23] The system was designed to provide a forum for disputes between member firms. In 1872, more than fifty years later, the NYSE established a securities arbitration forum for disputes between customers and member firms. It was not until 1935 that the SEC issued a release encouraging its members to "offer customers a standard arbitration agreement."[24] To further complicate the legal arena in 1947, Congress passed the Federal Arbitration Act ("FAA"),[25] which established a strong national policy favoring arbitration as illustrated by numerous Supreme Court cases.[26] The Federal

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[22] *Id.* at 438.

[23] Matthew Eisler, Note, *Difficult, Duplicative and Wasteful?: The NASD's Prohibition of Class Action Arbitration in the Post-*Bazzle *Era*, 28 CARDOZO L. REV. 1891, 1897 (2007).

[24] *The Securities Arbitration System: Hearing Before the Subcomm. on Capital Mkts., Ins., and Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 109th Cong. (2005) (statement of Karen Kupersmith, New York Stock Exchange Director of Arbitration).

[25] The Federal Arbitration Act provides in relevant part that:

> A written provision in any maritime transaction or a contract evidencing a transaction "involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2 (2000).

[26] *See* Perry v. Thomas, 482 U.S. 483, 488 (1987) (holding that section 2 of the Federal Arbitration Act created a body of federal substantive law of arbitrability, enforceable in both state and federal courts, even if there is a state substantive or procedural policy to the contrary); Southland Corp. v. Keating, 465 U.S. 1, 12 (1984) ("Congress declared a national policy favoring arbitration and withdrew [the states' power] to require a judicial forum for the resolution of claims that the contracting parties agreed to solve by arbitration."); Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983) ("The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is in the construction of the contract language itself or an allegation of waiver, delay, or a like defense to

Arbitration Act is viewed by many commentators as having a dampening effect on securities arbitration.

B. *The Implications of the Federal Arbitration Act on Securities Arbitration*

> *Between coercive and non-coercive arbitration runs the dividing line of which we have spoken. The one perverts natural law, and the other strengthens it.*
>
> —John Bates Clark[27]

In *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*, the Supreme Court declined to set aside a California Court of Appeals ruling that held (1) that the parties had agreed to arbitrate under California law and (2) that the Federal Arbitration Act did not preempt the terms of that agreement.[28] The Court rationalized that the Federal Arbitration Act "contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration."[29] The Supreme Court stated that preemption should only take place when a state law actually conflicts with federal law.[30] As such, the Federal Arbitration Act does not create any federal right to arbitration, nor does it necessarily preempt applicable state law.[31] Justice Breyer, in his first opinion for the Supreme Court, *Allied-Bruce Terminix Co. v. Dobson*,[32] wrote that the federal arbitration law applies whenever interstate commerce is involved in any way. The policy favoring arbitration greatly influenced the Supreme Court as evidenced by the court's decision in *Allied-Bruce Terminix*. In *Allied-Bruce Terminix*, the Supreme Court held that the Federal Arbitration Act applies to any transaction which involves or

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arbitrability."); Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 404 (1967) ("A federal court may consider only issues relating to the making and performance of the agreement to arbitrate.").

[27] BrainyQuote.com, John Bates Clark Quotes, http://www.brainyquotes.com/quotes/quotes/j/johnbatesc227163.html (last visited Feb. 2, 2007).

[28] 489 U.S. 468, 472–73 (1989).

[29] *Id.* at 477.

[30] *See id.*; *see also* Robert Coulson, *High Court Jolts Arbitration in California Construction Case*, 44 ARB. J. 2, 47–50 (1989) (providing an excellent analysis of *Volt*).

[31] *See Volt*, 489 U.S. at 477.

[32] 513 U.S. 265 (1995).

affects interstate commerce, even if the parties did not contemplate interstate commerce at all.[33] As such, the Federal Arbitration Act is to be applied with the full extent of Congress' commerce clause power, which means that even apparently local activities,[34] which may only have some minimal impact on interstate commerce, will probably justify application of the Federal Arbitration Act.

The FAA promotes public policies in favor of arbitration in areas such as securities regulation. Some commentators have argued that the informality and simplicity of arbitration render it inappropriate for resolving claims arising under such federal statutes. In *Wilko v. Swan*, the Supreme Court held that federal securities policy would not permit the enforcement of a pre-dispute agreement to arbitrate a claim asserted under section 12(2) of the Securities Act of 1933,[35] even though the parties had agreed to a pre-dispute arbitration clause.[36] The Supreme Court acknowledged that federal arbitration policy favors "prompt, economical and adequate solution of controversies through arbitration,"[37] but ultimately subordinated the FAA to the countervailing policy of "protect[ing] the rights of investors and . . . forbidd[ing] a waiver of any of those rights."[38] The Supreme Court held that relinquishing the right to pursue a Securities Act claim in federal district court violates section 14 of the Act,[39] which forbids waiving compliance with any of the Act's provisions.[40] The Supreme Court officially overruled *Wilko* in *Rodriguez De Quijas v. Shearson/American Express, Inc.* Since that time, all pre-dispute arbitration clauses have been honored as prohibiting litigation on issues arising prior to the filing of an arbitration claim within the securities industry.

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[33] *Id.* at 269–70.

[34] *See id.*

[35] 15 U.S.C. § 77a–77aa (2000).

[36] *See* Wilko v. Swan, 346 U.S. 427, 429–30 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

[37] *Id.* at 438.

[38] *Id.*

[39] *See id.* at 434–35.

[40] *See* 15 U.S.C. § 77n ("Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.").

C. Non-Payment of Securities Arbitration Awards

When a man puts a pistol to my head and tells me to deliver, there is no arbitration.

—Samuel Gompers[41]

Investors cannot employ the services of broker-dealers unless they agree to arbitration in the event of a dispute.[42] The most active arbitration forums are administered by self-regulating organizations such as NASD, which directs many aspects of broker-dealer behavior. The courts have determined that the NASD does not constitute a "state actor" whose authority is synonymous with that of the government.[43] Technically, as a legal matter, the federal government bears no responsibility for the unfortunate predicament that many small investors unwittingly find themselves in when brokerage firms or brokers fail to pay arbitration awards. As a policy matter, however, the federal government has created a regulatory framework[44] that often leads to the unfortunate outcome of non-payment.

As part of its fundamental function in overseeing the securities markets and creating a regulatory framework, the federal government has created the NASD-administered arbitration process in which numerous small investors never recover their life-savings that were lost because of their

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[41] Samuel Gompers, A News Account of an Address in Denver, *reprinted in* 2 THE SAMUEL GOMPERS PAPERS: THE EARLY YEARS OF THE AMERICAN FEDERATION OF LABOR, 1887–90, at 87 (Stuart B. Kaufman ed., 1987).

[42] Constantine N. Katsoris, *The Resolution of Securities Disputes*, 6 FORDHAM J. CORP. & FIN. L. 307, 357 (2001) (stating that arbitration has been "transformed . . . from a basically voluntary procedure to a largely mandatory one"); Kenneth R. Davis, *The Arbitration Claws: Unconscionability in the Securities Industry*, 78 B.U. L. REV. 255, 324 (1998) ("[C]ustomers must submit all claims to arbitration, or they may not open accounts with brokerage houses.").

[43] Perpetual Sec., Inc. v. Tang, 290 F.3d 132, 138 (2d Cir. 2002) ("It is clear that NASD is not a state actor and its requirement of mandatory arbitration is not state action."); D.L. Cromwell Invs., Inc. v. NASD Regulation, Inc., 279 F.3d 155, 162 (2d Cir. 2002) ("It has been found, repeatedly, that the NASD itself is not a government functionary.").

[44] The Federal Arbitration Act expresses a policy against disfavoring arbitration clauses. *See* Doctor's Assocs., Inc. v. Casarotto, 517 U.S. 681, 687 (1996) ("By enacting [section] 2 [of the Federal Arbitration Act] . . . Congress precluded States from singling out arbitration provisions for suspect status, requiring instead that such provisions be placed 'upon the same footing as other contracts.'" (quoting Scherk v. Alberto-Culver Co., 417 U.S. 506, 511 (1974))).

misplaced trust in NASD-supervised broker-dealers. As such, the federal government bears a fair amount of responsibility for an unfortunate predicament that many small investors unwittingly find themselves in when brokerage firms or brokers fail to pay arbitration awards. This responsibility attaches even when the arbitration process produces better outcomes than judicial litigation in securing awards because arbitration is mandatory.[45]

In 2001, approximately 33% of all NASD arbitration awards were not paid-in-full.[46] More surprisingly, approximately 55% of the $100.2 million awarded was not paid.[47] Moreover, in 2001, the rate of unpaid aggregate award amounts was higher than the rate of unpaid cases,[48] that is, brokerage firms or brokers are less likely to pay an arbitration award than a defendant in a typical litigation case who has a court judgment rendered against him.

The NASD has implemented several techniques to ensure that brokerage firms and brokers adequately satisfy NASD arbitration awards. In 1998, the NASD introduced NASD award-monitoring procedures, or a difference of methodologies used to measure the rate of unpaid awards. In 1998, the NASD experienced the greatest arbitration non-payment rate in its history—approximately 64%.[49] As a result, the NASD implemented a comprehensive tool chest of techniques to ensure that brokerage firms and brokers satisfy their arbitration award obligations, including: (1) requiring broker-dealers to certify that

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[45] For an excellent discussion of whether the law continues to play a role in the resolution of brokers' customer disputes, despite the enforceability of pre-dispute arbitration clauses, see generally Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991 (2002).

[46] U.S. GEN. ACCOUNTING OFFICE, FOLLOW-UP REPORT ON MATTERS RELATING TO SECURITIES ARBITRATION 3 (2003), *available at* http://www.gao.gov/new.items/d03162r.pdf [hereinafter GAO 2003].

[47] *Id.* In 2001, out of the 236 awards that were not paid-in-full, 216 of the awarded received no money at all, and 20 of the awardees received a partial payment. *Id.* at 9. In 2001, approximately $55 million was not paid, of that amount $12 million was not paid because the brokerage firm or broker "had requested a hearing, *filed for bankruptcy*, or filed a motion to vacate." *Id.* at 3 n.6 (emphasis added).

[48] In 2001, approximately 55%, or $55 million of the $100.2 million awarded by NASD arbitrators to investors was unpaid. *Id.* at 9.

[49] *Id.* at 3. The 1998 figures had an approximate sampling error of plus or minus 7 or 8%. U.S. GEN. ACCOUNTING OFFICE, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS 34 (2000), *available at* http://www.gao.gov/archive/2000/gg00115.pdf [hereinafter GAO 2000].

they have paid or otherwise complied with an award against them within thirty days after the award has been served; (2) asking claimants directly who won awards to notify it if an award has not been satisfied,[50] (3) requiring member firms to notify NASDR when they have satisfied an award; (4) requiring that claimants notify ODR if they haven't been paid; (5) proposing to the NASD Board that a firm that has been terminated, suspended, or barred be prohibited from enforcing a pre-dispute arbitration agreement clause; (6) advising claimants in writing of the status of a firm so that they can evaluate whether to continue with arbitration; and (7) proposing a rule amendment to provide default proceedings where the terminated or defunct member or associated person doesn't answer or appear, but the claimant affirmatively elects to pursue arbitration.[51]

In February 2004, the SEC approved various NASD rule amendments intended to make it more difficult for brokerage firms or brokers to avoid their arbitration payment obligations.[52] Additionally, in June 2004, the SEC approved NASD by-law amendments that would allow NASD to institute suspension hearings within two years against a former broker seeking to reenter the securities industry when that broker has failed to pay awards.[53] The NASD adoption of a rule prohibiting defunct broker-dealers from enforcing pre-dispute arbitration clauses cures a great deal of the unfairness in imposing on investors a

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[50] *See* GAO 2003, *supra* note 46, at 10.

[51] *See* GAO 2000, *supra* note 49, at 67–68; *see also* Per Jebsen, *How to Fix Unpaid Arbitration Awards*, 26 PACE L. REV. 183, 190 n.31 (2005).

[52] Order Granting Approval of Proposed Rule Change by the NASD, Inc. to Amend Rules 1011, 1014 and 1017, Exchange Act Release No. 34-48969, 68 Fed. Reg. 75,681 (Dec. 22, 2003). NASD announced that it had approved the proposed amendments for comment on August 6, 2002. News Release, NASD, NASD Board Approves Proposed Amendments to Strengthen Authority in Member Application Reviews (Aug. 6, 2002), *available at* http://www.nasd.com/PressRoom/NewsReleases/2002NewsReleases/NASDW_002919; *see also* NASD Notice, http://www.nasd.com/RulesRegulation/NoticestoMembers/2004NoticestoMembers/NASDW_003276.

[53] Order Granting Approval of Proposed Rule Change by the NASD, Inc. Regarding Failure to Pay Arbitration Awards, Exchange Act Release No. 34-49845, 69 Fed. Reg. 33,968 (June 10, 2004). The NASD and SEC have adopted various recommendations from the GAO on how to better inform investors of SIPC's policies. *See* U.S. GEN. ACCOUNTING OFFICE, SECURITIES INVESTOR PROTECTION: UPDATE ON MATTERS RELATED TO THE SECURITIES INVESTOR PROTECTION CORPORATION (2003), *available at* http://www.gao.gov/new.items/ d03811.pdf; *see also* NASD Notice, *supra* note 52.

compulsory process with a predictable outcome of non-payment. In approving the rule, however, regulators stated that defunct firms had a "significantly higher incidence of non-payment of arbitration awards than do active firms."[54]

II. INTERSECTION OF BANKRUPTCY LAW AND SECURITIES ARBITRATION

Bankruptcy is a sacred state, a condition beyond conditions, as theologians might say, and attempts to investigate it are necessarily obscene, like spiritualism. One knows only that he has passed into it and lives beyond us, in a condition not ours.

—John Updike[55]

A. *A Bankruptcy Law Primer*

Bankruptcy law is a construct of federal law. The basic purpose of bankruptcy law is to create a reasonable and fair agreement between the debtor, the individual or corporate entity seeking bankruptcy protection, and the debtor's creditors, individuals, or corporate entities who are owed money by the debtor. Every individual bankruptcy case has two goals: resolving creditors' claims against the debtor and giving the debtor a "fresh start." A bankruptcy case is commenced automatically at the moment that the debtor files a petition for bankruptcy protection or, in an involuntary case, at the moment a petition is filed by the creditors against the debtor. The petition must specify whether the filing is a chapter 7 or chapter 11 filing. Chapter 7 of the Bankruptcy Code governs liquidation. Chapter 11 governs the reorganization of the debtor and the development of a plan to satisfy creditors. By far the most common form of bankruptcy is chapter 7, also known as a straight liquidation bankruptcy.

The primary purpose of a chapter 11 case is to rehabilitate and financially re-organize the debtor. After bankruptcy is filed,

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[54] Order Approving Proposed Rule Change by the NASD, Inc. Relating to Amendments to Rule 10301 of the Code of Arbitration Procedure to Prohibit Terminated, Suspended, Barred or Otherwise Defunct Firms from Enforcing Predispute Arbitration Agreements in the NASD Arbitration Forum, Exchange Act Release No. 34-44158, 66 Fed. Reg. 19,267 (Apr. 6, 2001); *see also* NASD Notice, *supra* note 52.

[55] JOHN UPDIKE, *The Bankrupt Man*, *in* HUGGING THE SHORE: ESSAYS AND CRITICISM 22, 22 (1983).

an independent third party, referred to as the bankruptcy trustee, collects and manages the debtor's bankruptcy estate, liquidates the assets, and distributes the proceeds to the debtor's creditors. When, however, a debtor files for chapter 11 restructuring, rather than having a court-appointed trustee who would manage the debtor during the bankruptcy proceeding, the debtor's management may continue to operate and manage the debtor on daily basis. A debtor who remains in control of the management and daily operations of a corporate entity is referred to as a "debtor-in-possession." At the moment a debtor files a bankruptcy petition, all property of the debtor becomes property of the bankruptcy estate.

Simultaneously, with the filing of the bankruptcy estate, the automatic stay becomes effective. This power of the automatic stay is immediate and absolute; the automatic stay prohibits creditors from collecting on their accounts or taking any other action that may diminish the value of the estate including receiving any payment on outstanding debts. The trustee or the debtor-in-possession continues to pay the administrative expenses of the debtor, including financial and legal counsel.

The debtor has a 120-day exclusivity period to propose a plan of reorganization to the court. The bankruptcy court may extend or diminish the exclusivity period if the debtor provides good cause for such an extension. At the end of the 120-day period, if the debtor has not proposed a plan, the debtor's creditors, equity holders, and other parties-in-interest may file their own plans of reorganization. Alternatively, if the debtor has proposed a reorganization plan, the debtor has an additional sixty days to obtain approval of a consensual plan from creditors. During the sixty day extension period, competing plans may not be filed, unless during the extra sixty days a consensual plan of reorganization was not reached between the creditors and parties-in-interest.

The plan of reorganization must be specific as the distribution of estate, and it must describe with specificity the details of how all the creditors and equity interests are affected. The debtor must disclose the plan's contents to all interested parties. If all the creditors and parties-in-interest consent to the reorganization and the plan meets the statutory confirmation requirements, the bankruptcy court will confirm the plan. If a consensual plan is achieved at the end of the 60 day extension

period, the Bankruptcy Code provides an alternative method of confirmation.

Upon confirmation, the debtor is discharged with the bankruptcy estate's remaining assets reverting to the debtor. The debtor, in exchange for surrendering all of his assets to the court for distribution to the creditors, receives a discharge from the court for the debtor's entire obligation to pay all of his debts. A discharge is a "release of a debtor from personal liability for prebankruptcy debts."[56] Consequently, if the debtor owes an unsecured creditor a debt and that debt is discharged in bankruptcy, the unsecured creditor will only receive a pro rata share of the assets from the bankruptcy estate. Often, the creditor will receive only cents on the dollar or nothing at all.

B. *Bankruptcy Code Renders Arbitration Awards Moot*

> *If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem.*
>
> —JP Getty[57]

Small investors often are confronted with unintended consequences when they entrust their life-savings with unscrupulous brokerage firms or brokers. Not surprisingly, small investors that have been defrauded by their brokerage firm or broker typically allege misconduct revolving around sales practice violations by brokerage firms or brokers, including (1) unsuitable recommendations, (2) churning, (3) unauthorized trading and misrepresentations, or (4) stealing the money outright, and are appalled by the arduous process to recover their money.[58] The defrauded investor must commence an arbitration proceeding by filing a statement of claim, provide testimony at an arbitration hearing, and hopefully obtain a favorable verdict. The entire process, at minimum, will take eighteen months.

The painful reality is that in a significant number of cases, an investor with a duly obtained award is never paid. Oftentimes, it is because the brokerage firm or broker has filed

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[56] BLACK'S LAW DICTIONARY 476 (7th ed. 1999).

[57] WhatQuote.com, Vast Archive of Quotes by Famous Personalities From All Over the World, http://www.whatquote.com/quotes/J--Paul-Getty/427-If-you-owe-the-bank.htm (last visited February 4, 2007).

[58] DAVID E. ROBBINS, 1 SECURITIES ARBITRATION PROCEDURES MANUAL § 5-4 (5th ed. 2006).

for bankruptcy protection under the U.S. Bankruptcy Code. As a result, the brokerage firm or broker becomes, in essence, judgment-proof—the arbitration award cannot be enforced against the brokerage firm or broker and, in fact, the arbitration award is dischargeable in the bankruptcy proceeding. The end result is that small investors, having risked their life-savings with an unscrupulous broker or brokerage firm, undergone that arduous and relatively expensive process of arbitrating their claim against the brokerage firm or broker, and been awarded a favorable decision, are nonetheless ultimately denied satisfaction of their award because the U.S. Bankruptcy Code prohibits the payment of any money judgment that is not approved by the Bankruptcy Court. The analysis typically ends at this juncture. The defrauded small investor is left without any further recourse and a much lighter purse. The unscrupulous brokerage firm or broker receives his discharge order from the bankruptcy court, which effectively wipes out all outstanding debts or money judgments against the brokerage firm or broker, and trots off into the sunset emboldened to defraud yet another investor.

C. *Dischargeability of Securities Arbitration Awards*

I mean, the company had a lot of strong cash flows when it went into bankruptcy.

—Kenneth Lay, Former CEO of Enron[59]

American bankruptcy law promotes its principal policy of allowing individuals to escape the financial and emotional burden of past debt by discharging prior economic liabilities.[60] It

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[59] *Enron's Ken Lay: I Was Fooled*, CBS NEWS, Mar. 13, 2005, http://www.cbsnews.com/stories/2005/03/11/60minutes/main679706.shtml.

[60] *See* H.R. REP. NO. 95-595, at 125 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6086 ("The purpose of straight bankruptcy . . . is to obtain a fresh start, free from creditor harassment and free from the worries and pressures of too much debt."); *see also* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (noting that 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."); Chevy Chase F.S.B. v. Hable (*In re* Hable), 107 B.R. 356, 358 (Bankr. M.D. Fla. 1989) ("The entire bankruptcy scheme was designed in part to give debtors a fresh start in life, free and unencumbered from pressing debts so they could become useful members of society."). Commentators have vigorously discussed policy bases for particular discharge rules. *See generally* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 225–52 (BeardBooks 2001) (1986) (arguing bankruptcy's fresh start policy is largely limited to protection of human capital, not

is important to note that dischargeability differs from the automatic stay,[61] which is triggered immediately upon a debtor's filing for bankruptcy protection. Automatic stay is an immediate bar against the commencement or continuation of any proceeding that would require the debtor to pay on an existing debt.[62] Amendment to the exceptions from the automatic stay is closely connected to the expanded exceptions from discharge.[63]

For over a hundred years, courts have agreed that debts are presumptively dischargeable[64] and that statutory exceptions to discharge[65] must be narrowly construed in order to afford

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property); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1069–70 (1987) (advocating a functional economic theory of discharge which proposes discharge be widely available so that debtors may participate in an open credit economy).

[61] 12 ZOLMAN CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 156.08(2) (2006).

[62] *Id.* § 156.08(2)(a).

[63] *See, e.g.*, Hon. William Houston Brown, *Taking Exception to a Debtor's Discharge: The 2005 Bankruptcy Amendments Make it Easier*, 79 AM. BANKR. L.J. 419, 439 (citing Hon. Bernice B. Donald & Hon. Jennie D. Latta, *The Dischargeability of Property Settlement and Hold Harmless Agreements in Bankruptcy: An Overview of § 523(a)(15)*, 31 FAM. L.Q. 409, 421 (1997) (discussing the "affirmative defenses" of § 523(a)(15)(A) or (B))).

[64] *See, e.g.*, Neal v. Clark, 95 U.S. 704, 709 (1877) (arguing that equity and Congressional intent demand liberal construction of bankruptcy law); Allstate Ins. Co. v. Foreman (*In re* Foreman), 906 F.2d 123, 127 (5th Cir. 1990) (holding that an insurance company seeking repayment of worker's compensation benefits bears the burden of showing that a debt is non-dischargeable and finding an "overarching policy in the Bankruptcy Code in favor of giving the debtor an opportunity for a fresh start"); Schweig v. Hunter (*In re* Hunter), 780 F.2d 1577, 1579 (11th Cir. 1986) (holding that the burden is on a creditor to prove that the debtor made affirmative misrepresentations placing debt within exception to bankruptcy law); *see also* Brown v. Felsen, 442 U.S. 127, 138 (1979) (applying the presumption that all debts are dischargeable unless specifically excepted).

[65] The Bankruptcy Code enumerates exceptions where a court may deny a global discharge. *See* 11 U.S.C. § 727(a) (2000). Most exceptions involve purposeful debtor misconduct tending to subvert the bankruptcy process. *See id.* §§ 727(a)(2)–(7). Discharge obtained under chapters 11, 12, and 13 of the Bankruptcy Code also requires a reorganization plan be confirmed and at least substantially performed. *See* 11 U.S.C. §§ 1112(b)(4), 1112(b)(7), 1208(c)(3)–(8), 1307(c) (2000). Even if a general discharge is granted, the Code prohibits the discharge of certain debts. *See* 11 U.S.C. § 523 (2000 & Supp. 2003). Whether a particular debt is non-dischargeable depends upon the bankruptcy chapter in which the debtor is proceeding. An exhaustive list of non-dischargeable debts appears in § 523, which applies to chapters 7, 11, and 12, and to some chapter 13 cases. Non-dischargeable debts include taxes, alimony, child support, certain tort damages, government-guaranteed education loans, and fraudulently obtained debts. *Id.* In other chapter 13 cases, most of these kinds of debts are dischargeable. *See* 11 U.S.C. § 1328 (2000).

comprehensive relief to honest debtors.[66] It was not until the *Grogan* case that the Supreme Court determined that the burden of proof standard in all § 523(a) cases is preponderance of the evidence.[67] Prior to *Grogan*, the cases had been in complete disarray. The acknowledged importance of the policy favoring discharge had led the majority of lower courts to rule that, at least in some situations, a creditor would have to satisfy a "clear and convincing evidence" standard.[68]

Whether a debt is discharged is of critical importance to both debtor and creditor alike.[69] The importance to an unsecured creditors is huge; if the discharge is granted, the unsecured creditor, which a small investor who has had an arbitration award issued in his favor would be defined in bankruptcy court, will not be paid anything. The disproportionate amount of court time devoted to dischargeability litigation reflects the stakes at risk for all parties. A recent study indicates that dischargeability proceedings under section 523 consume approximately twenty-seven percent of the time bankruptcy judges devote to "case-related" matters and over sixteen percent of their total "work-related" hours. [70]

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[66] *See, e.g.*, Evans v. Dunston (*In re* Dunston), 117 B.R. 632, 636 (Bankr. D. Colo. 1990), *rev'd in part*, 146 B.R. 269 (D. Colo. 1992) ("[The c]ourt must narrowly construe exceptions to discharge against the creditor and in favor of the debtor."); Chevy Chase F.S.B. v. Hable (*In re* Hable), 107 B.R. 356, 357 (Bankr. M.D. Fla. 1989) ("It is . . . axiomatic that the provisions of the Bankruptcy Code dealing with discharge are remedial and should be construed liberally in favor of debtors and against creditors who challenge the scope and extent of the protection granted by the general bankruptcy discharge.").

[67] Grogan v. Garner, 498 U.S. 279, 286–87 (1991) (applying the preponderance standard to all § 523(a) exceptions, even though the case involved only § 523(a)(2)); Hoskins v. Yanks, 931 F.2d 42, 43 (11th Cir. 1991) (construing *Grogan* as applying to all § 523(a) exceptions and applying it to § 523(a)(6)); Texas Am. Bank v. Barron (*In re* Barron), 126 B.R. 255, 258 (Bankr. E.D. Tex. 1991) ("[T]he Supreme Court's recent decision in *Grogan v. Garner* . . . categorically holds that the preponderance of the evidence standard is appropriate in all 11 U.S.C. § 523 dischargeability matters.").

[68] *See, e.g.*, *In re* Weber, 892 F.2d 534, 538 (7th Cir. 1989) (holding that a clear and convincing standard applies to § 523(a)(4)); Knoxville Teachers Credit Union v. Parkey, 790 F.2d 490, 491 (6th Cir. 1986) (holding the same for § 523(a)(2)).

[69] *See, e.g.*, JACKSON, *supra* note 60, at 225 ("[T]he principal advantage bankruptcy offers a debtor that is an individual lies in the benefits associated with discharge.").

[70] Gordon Bermant et al., *A Day in the Life: The Federal Judicial Center's 1988–1989 Bankruptcy Court Time Study*, 65 AM. BANKR. L.J. 491, 497–513 (1991). The figures in this study do not include the additional time spent on general challenges to discharge based on § 727 or indirect opposition to discharge pursuant to sections

There are, however, exceptions to discharge. Typically, discharge is not allowed when the debtor has been proved guilty of certain forms of normatively repugnant conduct,[71] such as fraud or willful and malicious injury.[72] Surprisingly, there is relatively little legislative explanation of these exceptions. Unsurprisingly, the result is considerable confusion, controversy, and litigation.[73]

D. *The Policy Underlying Dischargeability*

Capitalism without bankruptcy is like Christianity without hell.
—Frank Borman[74]

The basic policies underlying the intentional wrongdoing exceptions to discharge do not explain the strange results. Although courts have often stated that Congress, in providing a discharge, did not intend to benefit dishonest debtors, this conclusory assertion is unaccompanied by detailed explanation.[75]

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such as 727, 1129, or 1325.

[71] *See, e.g.*, JACKSON, *supra* note 60, at 225 (stating that individual debtors obtain discharge unless they violate "some norm of behavior specified in the bankruptcy laws").

[72] Section 523(a)(2) excludes from discharge debts obtained under false pretenses, by a false representation, or by actual fraud, and provides the underlying basis for many of the cases dealing with the dischargeability of vicarious debt for another's wrongdoing. Case law repeatedly emphasizes the legislative objective of distinguishing between honest and dishonest debtors. *See, e.g.*, Brown v. Felsen, 442 U.S. 127, 128 (1979) (noting that the opportunity for protection in bankruptcy court is limited to the "honest but unfortunate debtor" (quoting Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)); Neal v. Clark, 95 U.S. 704, 709 (1877) (stating that the bankruptcy act is intended to help "the honest citizen"); Jennen v. Hunter (*In re* Hunter), 771 F.2d 1126, 1130 (8th Cir. 1985) ("Congress established a fraud exception to discharge 'to discourage fraudulent conduct and to ensure that relief intended for honest debtors does not inure to the benefit of the dishonest.' ") (quoting Castner Knott Co. v. Wilson (*In re* Wilson), 12 B.R. 363, 370 (Bankr. M.D. Tenn. 1981)).

[73] *See, e.g.*, Luther Zeigler, Note, *The Fraud Exception to Discharge in Bankruptcy: A Reappraisal*, 38 STAN. L. REV. 891, 904 n.57 (1986) (asserting that the fraud exception, 11 U.S.C. § 523(a)(2), and its statutory precursor, Act of July 1, 1898, ch. 541, § 17a(2), 30 Stat. 544, 550, have been the most frequently litigated exceptions to discharge).

[74] Alexander L. Taylor III, *The Growing Bankruptcy Brigade*, TIME, Oct. 18, 1982, *available at* http://www.time.com/time/magazine/article/0,9171,949605,00.html.

[75] Thul v. Ophaug (*In re* Ophaug), 827 F.2d 340, 343 (8th Cir. 1987) (stating that once a debtor is proven dishonest, there is no entitlement to a "fresh start"); Pacific Bancorporation v. Sears (*In re* Sears), 102 B.R. 781, 785 (Bankr. S.D. Cal.

Some authorities suggest that discharge is denied to dishonest debtors to punish them.[76] Presumably the purpose of this penalty is deterrence; a particular debtor will be deterred from repeating her fraud and other prospective debtors will be deterred from committing fraud altogether.[77]

Others contend that debts fraudulently incurred are non-dischargeable to prevent particular creditors from being victimized.[78] A creditor is assumed to have knowingly accepted all ordinary business risks; a debtor's intentional wrong somehow falls outside the pale of a creditor's legitimate expectations. All other things being equal, creditors so wronged are purportedly entitled to our sympathy and protection, and the wrongdoing debtors are undeserving, as to such debts, of the benefit of a bankruptcy discharge. Thus, the non-dischargeability rule is based primarily on the debtor's being guilty of morally offensive conduct.

1989) (finding that legislative history indicates that the fraud exception was only intended to benefit honest debtors). Commentators have reached similar conclusions. *See, e.g.*, Charles G. Hallinan, *The 'Fresh Start' Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 90–95 (1986) (asserting that the effect of 1984 amendments to the Bankruptcy Code was to narrow the discharge availability found in the broad fresh start concept codified in 1975 version); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1051–52 (1987) (analyzing the 1984 amendments, which bar discharge of debts incurred by false pretences or actual fraud, as recognizing the general goal of bankruptcy to reward only the honest debtor); Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1441 (1985) (viewing the Bankruptcy Code's denial of discharge for fraud and similar misconduct against creditors as an effort to deter these activities).

[76] *See, e.g.*, Birmingham Trust Nat'l Bank v. Case, 755 F.2d 1474, 1477 (11th Cir. 1985) ("[O]ne of the purposes of the fraud exceptions to discharge is to punish the debtor for engaging in fraudulent conduct."); Philip Shuchman, *The Fraud Exception in Consumer Bankruptcy*, 23 STAN. L. REV. 735, 739 (1971) ("[D]enial of the privilege of discharge for a fraudulently procured debt may be best understood from the bankrupt's point of view as a form of civil punishment for his fraud.").

[77] *See Jennen*, 771 F.2d at 1130 ("Congress established a fraud exception to discharge to discourage fraudulent conduct . . . ." (internal quotation marks omitted)).

[78] *See* Fed. Deposit Ins. Corp. v. Smigel (*In re* Smigel), 90 B.R. 935, 939 (Bankr. N.D. Ill. 1988) ("[T]he purpose of excluding from discharge debts obtained by fraud is to protect lenders from dishonest debtors.").

III. SARBANES-OXLEY ACT AMENDS THE BANKRUPTCY CODE

The laws sometimes sleep, but never die.[79]

A. *The Raison D'être for Sarbanes-Oxley*

The SEC adopted the Sarbanes-Oxley Act in an effort to avoid the WorldCom, Enron, and Arthur Andersen scenarios and to reassure investors that "abuses of the system are not, and will not be allowed to become, the norm in American business."[80] Sarbanes-Oxley is Congress's response to the highly-publicized business scandals, pension losses, earnings restatements, and bankruptcies of big corporations. President George W. Bush signed Sarbanes-Oxley into law on July 30, 2002, and called it "the most far-reaching reform of American business practices since the time of Franklin Delano Roosevelt."[81] Sarbanes-Oxley makes any SEC registered company liable for violating Sarbanes-Oxley. Some of the most significant provisions of Sarbanes-Oxley are prohibitions on loans to executive officers, requirements on audit committee standards,[82] requirements for more detailed financial information in SEC filings,[83] guidelines for the relationship between an issuer and an auditor,[84] requirements for disclosing the company's code of ethics,[85] requirements for lawyers,[86] provisions applying to whistleblowers,[87] and sanctions for people who violate Sarbanes-Oxley.[88]

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[79] *The Flaws in Self-Policing: Both the Amex and the Feds Turned a Blind Eye to Big Trouble*, BUS. WK., Apr. 26, 1999, at 108.

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

[81] Sarita Mohanty, *Sarbanes-Oxley: Can One Model Fit All?*, 12 NEW ENG. J. INT'L & COMP. L. 231, 246 (2006).

[82] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–76.

[83] *Id.* § 302, 116 Stat. at 777–78.

[84] *Id.* §§ 201–09, 116 Stat. at 771–75.

[85] *Id.* § 406, 116 Stat. at 789–90.

[86] *Id.* § 307, 116 Stat. at 784.

[87] *Id.* § 806, 116 Stat. at 804. The Labor Department's Occupational Safety and Health Administration ("OSHA") is the federal agency charged with the responsibility for protecting the rights of whistleblowers, not the SEC. OSHA has a "record of helping workers penalized for voicing concerns." Deborah Solomon, *For Financial Whistle-Blowers, New Shield is an Imperfect One: Claims of Employer Reprisal Go to OSHA Investigators Unschooled in Accounting—A Fired CFO Lingers in Limbo*, WALL ST. J., Oct. 4, 2004, at A1.

[88] Sarbanes-Oxley Act of 2002, § 901–06, 116 Stat. at 804–06.

The events involving allegations of unethical conduct by U.S. corporate officers have led to a focus on implementing section 406 of the Sarbanes-Oxley Act into the Securities and Exchange Act.[89] Public companies and auditors have "scrambled" to meet the requirements of the new law.[90] Section 406 is one of the most important sections for chief officers, as it requires disclosure of a company's code of ethics.[91] Sarbanes-Oxley defines a code of ethics as standards necessary to promote "honest and ethical conduct," "full, fair, accurate, timely, and understandable disclosure" in reports and documents that a company files with the SEC or that it publicly discloses, and compliance with any applicable governmental laws, rules, and regulations.[92]

The additional SEC rules expanded the definition, so it now applies to the prompt internal reporting of any ethical code violations to appropriate officials, and it gives rise to liability for any violations. Corporations that adopt a code of ethics must disclose this fact in their annual report on Form 10-K. If they have not adopted a code of ethics, they must disclose their reasons for failing to do so. Companies will allow the public to access the ethics code by attaching a copy of it as an exhibit to their annual report on Form 10-K, posting it on the company's website, or providing copies of the code upon written request.

The final version of section 406, along with the SEC additions, defines a code of ethics as a codification of standards that are reasonably designed to deter wrongdoing and promote: "(1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) Full, fair, accurate, timely, and understandable disclosure [in SEC reports and in other public communications]; (3) Compliance with applicable governmental laws, rules, and regulations;" (4) The prompt internal reporting of violations of the code of ethics to the appropriate person or persons identified in the code [of ethics], and (5) Accountability for adherence to the code [of ethics].[93]

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89 Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release Nos. 33-8177, 34-47235 (Jan. 24, 2003), *available at* http://www.sec.gov/ rules/final/33-8177.htm.

90 J. David Dantzler, Jr. et al., *New Securities Litigation Hazards: The Ripple Effects of Sarbanes-Oxley*, LEGAL BACKGROUNDER, May 23, 2003, at 1.

91 Sarbanes-Oxley Act of 2002, § 406, 116 Stat. at 789–90.

92 *Id.* § 406(c), 116 Stat. at 789–90.

93 *Id.*

B. *A Securities-Based Exception Is Established in the Bankruptcy Code*

Well, we want to make sure there's not securities fraud.
—Don Nickles[94]

Securities arbitration awards typically allege that the broker-dealer engaged in prohibited conduct such as fraud, unsuitability, churning, breach of fiduciary duty, failure to disclose, and violations of NYSE and NASD Rules and Regulations. Sarbanes-Oxley amended the Bankruptcy Code to prohibit the discharge of a securities arbitration award for the violation of any federal or state securities laws of fraud, and the duty to pay arises from a judgment, order, or administrative proceeding.[95]

Section 523(a)(19) is a securities-based exception established in the Bankruptcy Code to prohibit brokerage firms and brokers who defraud investors from filing for bankruptcy protection to avoid paying arbitration awards. The legislative intent behind § 523(a)(19) is quite clear; it was added to the Bankruptcy Code by the Sarbanes Oxley Act of 2002 to "protect investors."[96] Its purpose is to "disallow debts incurred in violation of securities fraud laws from being discharged in bankruptcy."[97] Section 523(a)(19) amended the "Bankruptcy Code to make judgments

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[94] Interview by Gwen Ifill with Senator Don Nickles, *NewsHour With Jim Lehrer* (July 10, 2002), http://www.pbs.org/newshour/bb/congress/july-dec02/nickles_7-10.html.

[95] *See* 11 U.S.C. § 523(a)(19) (Supp. 2003). This statute excepts from an individual's discharge any debt 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; or
>
> (ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and
>
> (B) results . . . 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 debtor; or
>
> (iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

Id.

[96] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 745.

[97] S. REP. NO. 107-146, at 2 (2002).

and settlements based upon securities law violations non-dischargeable, protecting victims' ability to recover their losses."[98] In addition to legislative intent, case law illustrates that § 523(a)(19) clearly authorizes the unsuspecting investor's debts to be excepted from discharge because they arise from the award based upon violations of federal and state securities law and were confirmed by state court judgment.

Since the adoption of § 523(a)(19), there have been very few cases where the new rule has been applied. *In re Gibbons*[99] is one of the few cases where the court held that § 523(a)(19) barred a debtor from discharging a debt in bankruptcy that arose from an arbitration award stemming from a securities fraud. The court in *Gibbons* stated that § 523(a)(19) "unquestionably renders nondischargeable the [brokerage firms or broker's] debt, as the debt is based on a judgment enforcing an arbitral award for common law securities fraud,"[100] and that "by its terms, [it] applies to both statutory claims under the securities laws and common law fraud, so long as it arises in connection with the purchase or sale of a security."[101]

The claims upon which the award was granted in *Gibbons* encompassed common law fraud, deceit, and manipulation in connection with the purchase or sale of securities within the meaning of § 523(a)(19)(ii). Additionally, the defrauded investor's statement of claim in *Gibbons* was based, *inter alia*, upon common law fraud, and the arbitration panel clearly stated that the arbitration award was based upon the claim of fraud. The United States Supreme Court had previously defined fraud under other subsections of § 523(a) to encompass common law fraud as it is defined by the applicable state statute.[102] In *Gibbons*, the arbitration award was confirmed by a judgment. The *Gibbons* court precluded the particulars of the arbitration

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[98] 148 CONG. REC. S1783, S1787 (daily ed. Mar. 12, 2002) (statement of Sen. Leahy). Senator Leahy further stated that § 523(a)(19) "is meant to prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible." 148 CONG. REC. S7418-01 (daily ed. July 26, 2002) (statement of Sen. Leahy).

[99] 289 B.R. 588 (Bankr. S.D.N.Y. 2003).

[100] *Id.* at 590.

[101] *Id.* at 592.

[102] *See* 11 U.S.C. § 523(a)(2)(A) (2000); *see also* Cohen v. De La Cruz, 523 U.S. 213, 215 (1998) ("[Section] 523(a)(2)(A) prevents the discharge of all liability arising from fraud."); Field v. Mans, 516 U.S. 59, 69, 74–75 (1995) (defining fraud to be equivalent to common law fraud).

from being re-litigated in the bankruptcy proceeding because the debts arose from an unscrupulous financial advisor's deceit and manipulation in connection with the sale of securities.

C. *Application of 11 U.S.C. § 523(a)(19) of the Bankruptcy Code to Securities Arbitration Awards*

> *All the great economic ills the world has faced this century can be directly traced back to the London School of Economics.*
> —N.M. Perera[103]

The statement of claim in the *Gibbons* case pled—in addition to fraud—unsuitability and churning. The statement of claim argued, and the arbitration panel agreed that, unsuitability, in this context, was both deceitful and manipulative. The unscrupulous investor took the defrauded investors' life savings and began investing in high risk securities. The whole time, the unscrupulous financial advisor knew this type of investing was not in his clients' best interests because it was completely unsuitable for their risk tolerance levels and financial situations. The unscrupulous investor was only concerned with generating commissions. After all, brokering is a commission-driven profession; the average broker does not make money if his clients do not enter into the trade.[104]

Churning is also a deceitful and manipulative act, which is conducted in connection with the purchase or sale of securities. Churning occurs when a broker makes unnecessary trades for the express purpose of earning commissions. There are three elements necessary for a finding of churning under New York law. They are: (1) control over the account, (2) excessive trading, and (3) the intent to defraud the customer.[105] Churning is not an easy claim to prove. Facts must be pled in particularity in order to establish an inappropriate trading pattern that can be determined to be churned trades.

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[103] Famous Funny Quotes About Finance and Money, http://www.aardvarkarchie.com/quotes/money5.htm (last visited Feb. 2, 2007).

[104] *See* Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law From Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627, 629–30, 648–49 (1996) (analyzing breached trust).

[105] Levine v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 639 F. Supp. 1391, 1394 (S.D.N.Y. 1986).

For example, consider a situation where a financial advisor who conducted over one hundred trades in a discretionary account,[106] exerted *de facto* control over a defrauded investors' investment account and conducted 163 transactions in the that account between June 2001 and February 2002, a mere eight months, which generated a total of $4,100.81 in commissions for the advisor. The arbitration panel had no difficulty finding that the financial advisor had, in fact, churned the investor's account, and clearly established that it was the unscrupulous financial advisor's intent to use the defrauded investors' funds to generate commissions. The advisor, while trying to generate commissions, continuously assured the investors that he would "double or triple"[107] the investments in three months, which was nothing more than an empty promise which failed to materialize. The financial advisor's duplicity left the investor feeling embarrassed and betrayed. Like most victims of fraud, embarrassment and betrayal are emotions that keep many defrauded investors from moving forward to assert their rights.[108]

Inappropriate practices such as unsuitable investment recommendations, churning, and misrepresentations are difficult for investors to understand because it affects the core of their relationship with their broker—their trust. Yet unsuitability, churning, and misrepresentation claims are by far the most common claims made by investors because the investor is led to believe the representations of the broker and, in the process, experience financial losses. The key determinate as to whether a legitimate claim for breach of trust can exist depends upon whether the establishment of the trust relationship was well-founded. The relevant question is whether it is reasonable for the investor to rely on the representations of the broker?

When a financial advisor makes unsuitable investment recommendations or churns an investor's account, the financial advisor violates a breach of fiduciary duty.[109] A brokerage firm

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[106] *See* 6 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 15:17 (2d ed. 2006) (defining and describing a discretionary account).

[107] Statement of Claim of Mohammad Naroor and Shaheen Qureshi, NYSE Arbitration (Oct. 2002).

[108] Jerome E. LaBarre, *Securities Case Development at the Early Stage*, *in* PRACTICING LAW INST., SECURITIES ARBITRATION 1998: REDEFINING PRACTICES AND TECHNIQUES 125, 129 (1998).

[109] *See* 11 U.S.C. § 523(a)(4) (2000) (describing how a debt is not discharged if

or broker arguably owes a fiduciary duty to their clients when a heightened duty can be shown to exist.[110] A heightened duty exists when financial advisors have complete control over investors' accounts, resulting in the unscrupulous financial advisor placing his own interests ahead of his clients, and defrauds the investors. The manner in which the unscrupulous financial advisor benefits by ignoring a fiduciary duty, while at the same time assuring the defrauded investors that they are being helped, is both deceitful and manipulative. Failure to disclose is deceitful and manipulative by nature as it involves lies and omissions. Unscrupulous financial advisors omit material information regarding both the fees and the risk levels associated with the investments, in which they invest the defrauded investors' life savings.

IV. AMENDMENT TO NASD RULES & REGULATIONS

> *October: This is one of the particularly dangerous months to speculate in stocks in. The others are July, January, September, April, November, May, March, June, December, August and February.*
>
> —Mark Twain[111]

In *Wilko*, the Supreme Court discussed the inadequacies of arbitration. The Court questioned whether arbitration was a reasonable substitute for the judicial forum, and explained that arbitrators may not be versed in securities law, and need not provide reasons for their decisions. Additionally, the proceedings are often not transcribed, and the courts have limited powers of review. It was the Supreme Court's view that these procedures conspired against protecting investor rights created by the Securities Act.

Over the years the NASD has done a fantastic job in terms of making the arbitration process fairer by continuously implementing measures to ensure that investor rights are protected in the securities arbitration process. The one inadequacy that has continued to plague the NASD's efforts is the failure of arbitrators to provide reasons for their decisions.

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incurred because of breach of fiduciary duty or fraud).

[110] 12 C.J.S. *Brokers* § 119 (2006).

[111] MARK TWAIN'S PUDD'NHEAD WILSON: RACE, CONFLICT, AND CULTURE 248 (Susan Gillman & Forrest G. Robinson eds., 1990).

Under the present law arbitrators are not required to provide a reason for their decisions.[112] The NASD Rules & Regulations lists the elements that arbitrators are required to include in their awards: (1) names of the parties, (2) names of counsel, (3) summary of the issues including the type of security or product involved, (4) damages, interest, and other relief requested, (5) damages, interest, and other relief awarded, (6) statement of any other important issues considered and resolved (e.g., motions, jurisdictional issues), (7) names of the arbitrators, (8) date the claim was filed, (9) date the award was rendered, (10) number and dates of hearing sessions (including pre-hearing conferences), (11) locations of hearings, and (12) signatures of the arbitrators concurring in the award.[113]

There is no requirement in this exhaustive list for the arbitrators to provide a reason or rationale for the basis of the award. As such, there is no finding of fraud stated in the award. This creates a major problem when the investor attempts to prevent the arbitration award from being discharged in bankruptcy court because it is insufficient that the investor has pled fraud with specificity in the statement of claim and it is equally insufficient that the investor has received a favorable award. The missing calculus that the bankruptcy court requires is a finding of fraud from the underlying arbitration proceeding. As such, the NASD should amend its Rules & Regulations to require arbitrators to make a finding of fraud when one exists for the purposes of § 523(a)(19) of the Bankruptcy Code.

CONCLUSION

It is incumbent on us to facilitate the development of a market structure that best assures that these changes benefit the U.S. securities markets as a whole.

—Arthur Levitt[114]

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[112] Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1214 (2d Cir. 1972) (holding that arbitrators are not required in the first instance to state the basis for their opinions).

[113] NASD MANUAL ONLINE § 10330(e) (2007), http://nasd.complinet.com/nasd/display/display.html?rbid=1189&element_id=1159000927.

[114] *Concerning Market Structure Issues Currently Facing the Commission: Hearing Before the Subcomm. on Sec. of the S. Comm. on Banking, Housing, and Urban Affairs*, 106th Cong. (1999) (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission).

Within the increasingly competitive international environment, the advantage of a sound domestic securities regulatory infrastructure is crucial. It is incumbent upon our legislative body and private sector to find a balance that will permit the securities market to work and develop efficiently with the full confidence of investors, while simultaneously ensuring that investor's rights are fully protected. When such equilibrium fails, it is also incumbent upon our legislative body to take quick and decisive action to ensure that fraud is not afoot.