

MEMORANDUM

October 19, 1987

TO: David S. Ruder, Chairman
FROM: Daniel L. Goelzer, General Counsel
SUBJECT: Proposed Statute to Settle SEC/IRS Dispute Over
Priority of SEC Disgorgement Claims

by Paul Johnson

I recommend a proposed statute (attached) to settle ultimately SEC/IRS disputes over priority to disgorgement funds. The proposed statute is intended to codify and expand on existing law in our present litigation in SEC v. Levine and related cases. The statute would be prospective. It would not apply to these cases.

It would give the Commission a lien with respect to claims for disgorgement. This lien would arise (1) when we obtain a freeze order in order to satisfy a disgorgement claim; the lien would date from the date of the original filing of the Commission's complaint, and (2) in the event we did not obtain a freeze order, upon entry of a judgment of disgorgement, from the date of the entry of that judgment. To perfect this lien against certain subsequent purchasers and encumbrancers of the property without notice, the draft statute has a filing provision modeled after the IRS provision, 26 U.S.C. 6323. The Commission would have to file the order or judgment in the appropriate place required for filing of such documents by federal and state law to perfect its lien against such subsequent purchasers and encumbrancers.

In my view, this proposed statute would give the Commission a status comparable to the IRS when it invokes its extraordinary powers to create a lien. In those circumstances, IRS has the status of a secured creditor dating from the time of its jeopardy assessment. The only persons who would have priority over an SEC claim under this proposed statute would be:

- ° persons who have perfected a lien on property prior in time to the effective date of the SEC lien, such as, for example, a bank holding a mortgage on real estate; and

- ° persons who have received property from the defendant for value in the ordinary course of business without notice of the SEC lien before the SEC has perfected that lien by filing.

The staff is not in agreement whether and the extent to which the proposed statute should alter any provision of the Bankruptcy Code. The relevant provisions of the Bankruptcy Code provide as follows:

- ° A trustee in bankruptcy may set aside as a preference any interest in property acquired from the debtor, other than in the ordinary course of business, for the 90-day period prior to the filing of the petition. See 11 U.S.C. 547. There is a question whether, in the event of bankruptcy the lien created by the proposed statute could be set aside as a preference under this provision of the bankruptcy statute if the bankruptcy petition is filed within 90 days of the commencement of the Commission's action or the obtaining of the Commission's judgment. A basic issue is whether disgorgement obtained by the Commission for the possible purpose of providing restitution to market traders is a transfer "for or on account of an antecedent debt owed by the debtor before the transfer was made," as required by Section 547(b)(2) of the Bankruptcy Code.
- ° Except for the possibility that an SEC lien may be viewed as a preference, the SEC would have the status of a secured creditor in the event of bankruptcy; i.e., the SEC would be entitled to foreclose on the property to satisfy its claim or, if the automatic stay is not lifted to prevent foreclosure, payments or "adequate protection" for its security interest during the period of bankruptcy.
- ° In bankruptcy, the bankruptcy statute accords IRS a priority for distributions of allowed tax claims over allowed unsecured claims. See 11 U.S.C. 507(a)(7) and 726.
- ° In the event that the lien is set aside as a preference, the Commission would be left only with the arguments under existing law to give it a priority over IRS claims, i.e., that the money or property sought is not property of the estate because it represents the proceeds of fraud and a constructive trust for the benefit of the victims should be imposed.

- ° In bankruptcy, claims of public investors for damages or rescission arising from the purchase or sale of a security of the debtor or of an affiliate of the debtor (defined, peculiarly, in Section 101(2) of the Bankruptcy Code, to include 20% holders of stock and persons operating property under lease agreements) are subordinated to allowed unsecured claims. See 11 U.S.C. 510(b). This bankruptcy provision was enacted in the 1978 Code over the Commission's objection. It was intended to subordinate investor securities fraud claims against issuers. This subordination provision, or the general equitable subordination provision (11 U.S.C. 510(c)), arguably may be construed to subordinate any disgorgement claim made by the SEC on behalf of such investors; the bankruptcy court is likely to look to the persons to whom we would propose to distribute any disgorged money in establishing the priority the SEC may have to such funds. Again, the SEC and investors always remain free to argue that the money is not the property of the estate because of constructive trust principles.
- ° The investor subordination principle of Section 510(b) would not seem to have any applicability to disgorgement claims of insider trading cases except in the unusual situation where the insider trader would be an affiliate (or 20% or more holder of the stock of a debtor.) This is not to say, however, that arguments might not be made that SEC disgorgement claims should nonetheless be equitably subordinated under Section 510(c).

The proposed statute accords the same treatment to all disgorgement claims made by the Commission, whether for insider trading type cases or for other types of securities frauds or wrongdoing. Since our authority to seek disgorgement is the same in all cases, I see no logical basis for distinguishing between types of disgorgement. ITSA penalties are not included in this proposed statute; since ITSA penalties, like IRS tax claims, are to be paid to the Treasury, there seems no reason to give one priority over the other.

Attachment

A BILL

To amend the Securities Exchange Act of 1934 to provide for a lien in property subject to certain orders entered by courts in favor of the Securities and Exchange Commission.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Section 21 of the Securities Exchange Act of 1934 (15 U.S.C. 78u) is amended --

by inserting after subsection (h) the following new subsection:

"(i)(1) When the relief sought or obtained in an action instituted by the Commission pursuant to the federal securities laws includes the recovery of funds or other property from any person, and an order is entered by the court that prohibits or limits the encumbrance, sale, transfer or other disposition of that person's property, the amount of the Commission's claim (including any interest) shall be a lien, in favor of the Commission, upon all property and rights to property, real or personal, subject to the order. When such an order is entered, the lien thereby imposed shall be deemed to have arisen at the time the Commission filed its request for the order.

"(2) When a judgment entered by the court in an action instituted by the Commission pursuant to the securities laws orders or otherwise requires any person to make a payment because of violations of the securities laws, the amount of the judgment shall be a lien, in favor of the Commission, upon all property and rights to property, real or personal, of that person. The lien upon such property shall arise at the time the judgment is entered, except as to funds or property subject to a lien imposed by subsection (1) of this subsection, as to which the lien shall be deemed to have arisen at the time specified in that paragraph.

"(3) The lien imposed by subsections (1) and (2) shall not be valid as against any purchaser for value, holder of a security interest, mechanic's lienor, or judgment lien creditor unless such a

person had actual notice thereof [as defined in 26 U.S.C. 6323(i)] or notice thereof which meets the requirements of subsection (4) has been filed by the Commission or its delegate.

"(4) Place for filing notice; form.--

(A) Place for filing.--The notice referred to in subsection (3) shall be filed--

(i) Under State laws.--

(1) Real property.--In the case of real property, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; and

(2) Personal property.--In the case of personal property, whether tangible or intangible, in one office within the State (or the county, or other governmental subdivision), as designated by the laws of such State, in which the property subject to the lien is situated; or

(ii) With clerk of district court.--In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State has not by law designated one office which meets the requirements of subparagraph (i); or

(iii) With Recorder of Deeds of the District of Columbia.--In the office of the Recorder of Deeds of the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(B) Situs of property subject to lien.--For purposes of subparagraph (i), property shall be deemed to be situated--

(i) Real property.--In the case of real property, at its physical location; or

(ii) Personal property.--In the case of personal property, whether tangible or intangible, at the residence of the person subject to the order or judgment set forth in subsections (1) or (2) at the time the notice of lien is filed, or as provided in the order of the court.

For purposes of subparagraph (B)(ii), the residence of a corporation or partnership shall be deemed to be the place at which the principal executive office of the business is located, and the residence of a person whose residence is without the United States shall be deemed to be in the District of Columbia, or as provided in the order of the court.

(C) Form.--The form and content of the notice referred to in subsection (C)(1) shall be prescribed by the Commission. Such notice shall be valid notwithstanding any other provision of law regarding the form or content of a notice of lien.

Section 2. This act shall take effect on _____, and shall apply to any order or judgment specified herein in any action instituted by the Commission that is pending on that date.