I Didn’t Do It: Third-Party Debtors and the Securities Law Violation Exception to Discharge

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INTRODUCTION

Meet the Wilcoxes, Marvin and Pamela. Marvin and Pamela were investors in a Ponzi scheme operated by Marsha Schubert, who defrauded investors out of more than $9 million. Instead of investing participants’ money legitimately, Schubert would use the money to pay out “profits” to other participants. These “profits” were solely the product of the Ponzi scheme—there were no legitimate profitable investments. The Wilcoxes benefited from the scheme, in the form of purported profits, to the tune of $500,000. The Oklahoma Department of Securities brought a state court action against the Wilcoxes and others who had benefited from the Ponzi scheme, alleging that they were liable for unjust enrichment and arguing that they should be required to disgorge any profits they received from the scheme. The state court ruled in favor of the Department of Securities and ordered the Wilcoxes to repay those funds. After the state court ruled in favor of the Department of Securities, the Wilcoxes filed a


1 A “Ponzi” scheme is a term generally used to describe an investment scheme which is not really supported by any underlying business venture. The investors are paid profits from the principal sums paid in by newly attracted investors. Usually those who invest in the scheme are promised large returns on their principal investments. The initial investors are indeed paid the sizable promised returns. This attracts additional investors. More and more investors need to be attracted into the scheme so that the growing number of investors on top can get paid. The person who runs this scheme typically uses some of the money invested for personal use. Usually this pyramid collapses and most investors not only do not get paid their profits, but also lose their principal investments.

In re Randy, 189 Bankr 425, 437 n 17 (Bankr ND Ill 1995).

2 Oklahoma Department of Securities v Wilcox, 691 F3d 1171, 1173 (10th Cir 2012).

3 Id.
Chapter 7 bankruptcy action seeking discharge of their debts—including the state court judgment requiring them to disgorge their profits from the Ponzi scheme.4

Violations of securities laws, of which Schubert's Ponzi scheme is just one example, often create losers: those who are harmed by a particular violation. But they can also create winners like the Wilcoxes: third parties who, through knowledge of the violation or through dumb luck—but not through any personal wrongdoing—benefit from the violation. These winners are usually not allowed to keep those ill-gotten gains and are required to disgorge their profits.5 In the meantime, though, their good fortune may turn bad—they could become insolvent and might file for bankruptcy.

In general, an individual debtor can discharge his debts in bankruptcy.6 But Congress has created several debt-specific exceptions to discharge.7 For instance, a debtor cannot discharge debts incurred through fraud or as a result of an intentional tort.8 With the passage of the Sarbanes-Oxley Act,9 Congress added another debt-specific discharge exception to the Bankruptcy Code: debts for the violation of federal or state securities laws cannot be discharged in bankruptcy.10 But the provision is ambiguous: Is the exception limited to debts incurred by securities

4 Id. The Oklahoma state district court ordered the Wilcoxes to return all their profits from the Ponzi scheme. The Wilcoxes appealed to the Oklahoma Supreme Court, which ruled that repayment of profits by innocent investors was appropriate only if those investors had received an unreasonable rate of return. The court remanded to the district court so that it could apply the new standard. See Oklahoma Department of Securities v Blair, 231 P3d 645, 669 (Okla 2010). On remand, the district court declined to apply the new standard on the grounds that the Wilcoxes were not innocent investors. The Wilcoxes appealed once again, but the Oklahoma Supreme Court affirmed. See Oklahoma Department of Securities v Wilcox, 267 P3d 106, 111 (Okla 2011). The Wilcoxes later filed for bankruptcy, and the Oklahoma Department of Securities initiated adverse proceedings to avoid discharge of their disgorgement debt. The bankruptcy court ruled that the debt was nondischargeable and the district court affirmed the bankruptcy court’s ruling. See Oklahoma Department of Securities v Wilcox, 2010 WL 567988, *4 (WD Okla 2010). The Wilcoxes subsequently appealed.


6 11 USC § 727.

7 See, for example, 11 USC § 523(a).

8 See 11 USC § 523(a)(2) (excepting debts obtained through false pretenses, false representations, actual fraud, or materially false written statements); 11 USC § 523(a)(4) (excepting debts “for fraud or defalcation while acting in a fiduciary capacity”); 11 USC § 523(a)(6) (excepting debts “for willful and malicious injury”).


violators directly, or does it also apply to the debts of third parties that indirectly benefit from a securities violation?

Several courts have dealt with this issue, appealing to statutory text, legislative intent, and general policy considerations. This Comment takes a different tack, starting from the premise that the right of discharge functions to allocate risk between debtors and creditors. Part I of the Comment gives some background about the right of individual discharge, reviewing the moral and economic justifications for discharge. The securities violation exception to discharge is described in Part II, and the approaches that courts take to the problem of third-party securities debtors is outlined in Part III. Part IV offers an alternative approach to the problem. The aim of third-party securities liability is deterrence—limiting the damage that results from securities violations by giving third parties an incentive to put a stop to them before losses mount. Thus, third-party securities violation debts should be nondischargeable in bankruptcy. The approach outlined in this Comment is consistent with both the risk-allocation function of bankruptcy law and Sarbanes-Oxley's strategy of enlisting third-party gatekeepers to prevent securities violations.

I. THE RIGHT OF INDIVIDUAL DISCHARGE

Discharge, which frees an individual debtor's future assets from debts incurred prior to bankruptcy, is a resident alien of the Bankruptcy Code. On the one hand, the bankruptcy process has little to do with the substantive rights of creditors and debtors; its primary function has historically been to create a forum for the orderly allocation of a debtor's assets among its creditors.\(^\text{11}\) That function is conceptually distinct from, and does not directly implicate, whether those creditors should be able to reach a debtor's future assets.\(^\text{12}\) Discharge can be granted without a collective distribution process; a collective process can also distribute assets without granting discharge. Indeed, when England’s first bankruptcy statute was passed in 1542, no right of discharge was included, and none would be introduced until 1705.\(^\text{13}\)


\(^{12}\) See id at 1396.

\(^{13}\) See Margaret Howard, A Theory of Discharge in Consumer Bankruptcy, 48 Ohio St L J 1047, 1049 (1987).
On the other hand, the right of discharge has, ever since its introduction, been embedded in bankruptcy law. There is a good historical reason for this association: when it was first introduced, discharge was intended to give the individual debtor an incentive to cooperate in the discovery and distribution of his assets, thereby facilitating bankruptcy's collection function. There is also a good practical reason for it. Debtors who are allowed to discharge debts in exchange for surrendering certain assets will only do so if those debts exceed the value of the surrendered assets. In such circumstances, collection rules that set the stage for a costly race to the debtor's assets are a poor fit: creditors want to ensure both that they all share in the debtor's assets and that their individual collection actions do not decrease the overall value of those assets. Bankruptcy's collective process is designed to achieve both aims by coordinating creditors' recovery efforts. Accordingly, it is an appropriate process once a debtor decides to exercise his discharge right.

While these considerations explain discharge's place in bankruptcy law, they do not explain the nature and scope of that right. Scholars have attempted to explain the present contours of the discharge right by appealing to two different kinds of considerations: moral and economic. The moral explanation for discharge is grounded in the idea that the honest but unfortunate debtor is entitled to continue free from liabilities incurred in the past. The economic explanation, by contrast, argues that granting debtors a right of discharge—which shifts much of the risk of credit from debtors to creditors—is warranted on efficiency grounds.

A. Moral Theory of Discharge

The watchword of bankruptcy rhetoric is that the purpose of discharge is to “relieve the honest debtor from the weight of

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14 See id.
15 See id at 1049–50.
16 See Jackson, 98 Harv L Rev at 1396 (cited in note 11).
17 See id.
18 See id.
19 See id at 1396–97.
21 See Howard, 48 Ohio St L J at 1050–57 (cited in note 13).
22 See Jackson, 98 Harv L Rev at 1398–1404 (cited in note 11).
oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." This statement can be understood as a succinct expression of the moral theory of discharge: that the honest but unfortunate debtor deserves a fresh start, and therefore ought to be able to place his future income beyond the reach of his prebankruptcy creditors.

Proponents of the moral theory of discharge find support for their theory in the various exceptions to discharge codified in bankruptcy law. For example, debtors—even if they have not committed any wrongdoing—cannot obtain a discharge if they have received one within the previous six years. This provision can be understood to embody a moral presumption that the debtor who seeks to obtain two discharges in a six-year period is so financially irresponsible so as to be undeserving of a fresh start.

The moral theory of discharge is perhaps best reflected in bankruptcy law’s distinction between honest (and therefore worthy) debtors, and dishonest (unworthy) debtors. This distinction appears in two different contexts. One has been referred to as “procedural” honesty and relates to how the debtor behaves in the context of the bankruptcy proceeding itself: whether the debtor is forthright in the process of identifying, collecting, and distributing her assets. Bankruptcy law treats the procedurally dishonest debtor harshly, by denying discharge outright to debtors who, among other things, intentionally conceal property affected by the bankruptcy, unjustifiably fail to keep adequate records, or knowingly make false oaths.

Debtors can also exhibit “substantive” dishonesty or unworthiness by engaging in misconduct outside the bankruptcy process itself but that later gives rise to claims in bankruptcy. On the moral theory of discharge, debtors who are substantively

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24 11 USC § 727(a)(9). This exception does not apply: (1) if the prior discharge was granted under Chapter 13 and 100 percent of the unsecured claims were paid in the prior case; or (2) if 70 percent of the unsecured claims were paid, the repayment plan was proposed by the debtor in good faith, and it was the debtor’s best effort. See 11 USC § 727(a)(9).
25 Howard, 48 Ohio St L J at 1052 (cited in note 13).
26 See id at 1053.
27 See 11 USC § 727(a). See also Howard, 48 Ohio St L J at 1053–54 (cited in note 13).
28 Howard, 48 Ohio St L J at 1054 (cited in note 13).
unworthy are also not entitled to discharge. Thus the Bankruptcy Commission's recommendation that

[claims arising from conduct of the debtor egregiously violating community standards, such as claims for fraud, larceny, embezzlement, willful and malicious wrongs, and civil penalties, should not be discharged because social policy directs, impliedly at least, that the debtor should not be able to escape his responsibility through the bankruptcy process.]

This view is reflected in certain debt-specific exceptions to discharge, including those that exempt from discharge debts for willful and malicious torts, for damages resulting from drunk driving, and for fraud or embezzlement. Rather than denying discharge to the substantively unworthy debtor outright, these exceptions deny discharge only with respect to those debts that result from the debtor's wrongdoing.

However, as an explanatory theory of the scope and contours of the discharge right, the moral theory falls short. It offers little guidance as to when wrongdoing is severe enough to warrant denial of discharge. At the extremes, answers are clear enough: a debtor who acts with willful intent to defraud should be denied discharge, but the naive optimist who simply overestimates his chances of repaying his debt should probably not be. But "[w]hether debtor misconduct exists in [discharge] cases seems a matter of the eye of the beholder." What about the negligent debtor who fails to exercise reasonable care in conducting his financial affairs? Or the reckless debtor who recognizes the likelihood that he will not repay his debts but takes them on regardless?

Moreover, the moral theory does not explain why bankruptcy law does not deny discharge in certain clear-cut cases of debtor wrongdoing. For instance, debts obtained through fraud are nondischargeable—but only if the creditor reasonably, or justifiably,
relied on the debtor's fraud. Section 523(a)(2)(B) provides that debts obtained through false written statements about the debtor's financial condition are only excluded from discharge if the creditor to whom the debt is owed reasonably relied on those false statements.\[36\] Similarly, the Supreme Court has read § 523(a)(2)(A) to mean that debts obtained through other false representations are nondischargeable only if the creditor justifiably relied on those representations.\[37\] Accordingly, if the creditor unreasonably or unjustifiably relied on the debtor's misinformation, the debt remains dischargeable despite the debtor's misconduct.\[38\] The economic theory of discharge attempts to resolve these questions.\[39\]

B. Economic Theory of Discharge

Unlike the moral theory of discharge, the economic theory does not attempt to distinguish among debtors on the basis of their moral worthiness. Instead, it distinguishes among them based on their ability to bear the risk of default. On this account, discharge functions analogously to excuse doctrine in contract law.\[40\] Excuse doctrine allows someone who has made an enforceable promise not to perform on that promise in the event of certain unforeseen circumstances.\[41\] Economic analysis of contract law suggests that, when applying excuse doctrine, courts should impose the risk of extraordinary events on the party to the contract best able to bear that risk, because that is what rational contracting parties would have agreed to in the first place.\[42\] This rule saves the parties to the contract the costs of negotiating and formalizing an agreement regarding unforeseen

\[36\] See 11 USC § 523(a)(2)(B).

\[37\] See Field v Mans, 516 US 59, 74–75 (1995) ("[W]e hold that § 523(a)(2)(A) requires justifiable, but not reasonable, reliance.").


\[39\] The moral theory of discharge also does not explain why the right of discharge cannot be bargained away—why presumptively honest debtors cannot forgo the right to discharge in exchange for easier access to credit. See In re Gurrola, 328 Bankr 158, 170 (BAP 9th Cir 2005) ("[T]he defense of discharge in bankruptcy is now an absolute, nonwaivable defense.").


\[41\] See id at 102–06.

events in advance.\textsuperscript{43} Discharge functions similarly by excusing
debtors from payment in the event of default: it imposes the
risks of extending credit on creditors, who are better able to bear
it.\textsuperscript{44}

1. The risk-allocation justification for discharge.

“A particular party is the superior risk bearer either be-
cause it is better positioned to prevent the risk from occurring or
because it can better insure against that risk.”\textsuperscript{45} Creditors of an
individual debtor—usually also creditors of many individual
debtors—gain experience through repeated interactions with
debtors, and may therefore be better than any particular debtor
at appraising the risks of extending credit to that debtor and
monitoring his borrowing.\textsuperscript{46} In addition, debtors might be sys-
tematically worse at assessing and acting on those risks on ac-
count of: (1) the social externalities of default and (2) behavioral
and cognitive biases that lead individuals to underestimate the
risks of credit.\textsuperscript{47}

Default does not just impose costs on individual debtors; it
imposes costs both on family and friends that are dependent on
the debtor and on society in general. Family members and
friends who rely on the debtor for support are directly harmed
when the debtor can no longer support them.\textsuperscript{48} More broadly, so-
ciety is harmed when an insolvent debtor is forced to take

\textsuperscript{43} See Posner and Rosenfield, 6 J Legal Stud at 88–89 (cited in note 42).

\textsuperscript{44} See Jackson, 98 Harv L Rev at 1400 (cited in note 11). The analogy to excuse doc-
trine only goes so far. After all, excuse doctrine is only a default rule; parties to a con-
tact can agree to disregard excuse doctrine and shift the risk of a particular event, or of
unforeseen events generally, onto one party or another. Debtors and creditors, by con-
trast, cannot contract around the right of discharge.

Note that debtors may want to waive the right of discharge in order to gain access to
cheaper credit. Economic analysis suggests that the effect of mandated discharge should
be higher interest rates and less borrowing than there otherwise would be. See Lawrence
(1989); Jackson, 98 Harv L Rev at 1427 n 111 (cited in note 11). However, endowment
effects might complicate that prediction: debtors may attach more value to discharge
once it has been mandated, which would partially mitigate the effect of higher rates on
willingness to borrow. See Jonathan Gruber, \textit{The Incidence of Mandated Maternity Bene-

\textsuperscript{45} Margaret Howard, \textit{Shifting Risk and Fixing Blame: The Vexing Problem of Cred-

\textsuperscript{46} See Jackson, 98 Harv L Rev at 1400 (cited in note 11).

\textsuperscript{47} See id at 1405.

\textsuperscript{48} See id at 1419.
advantage of the social safety net, or when he shifts his energies and resources from productive work to leisure—which his creditors cannot reach. When deciding whether to take on additional debt, the individual debtor—even if he is perfectly individually rational—may not take these costs into account.

Perhaps more significantly, debtors are not fully rational—they suffer from well-documented cognitive and behavioral biases. People are known to exhibit a persistent tendency to underestimate future risks. What’s more, even if they do fully appreciate the future risks associated with a certain course of currently gratifying behavior, they fail to control the impulses that favor current gratification. Instead, they exhibit consistent preferences for current over future consumption (in a way that cannot be fully explained by the rational tendency to discount future benefits). The inability both to appreciate future risks and to give future risks their due weight by deferring gratification might lead individuals to choose the current consumption benefits of credit even when those benefits are outweighed by credit’s future costs. Creditors are thus better positioned to prevent debtors from overburdening themselves with debt and becoming insolvent.

Creditors are also better able than individual debtors to insure against risk through diversification. Although individual debtors are able to limit their exposure to risk by investing capital in various assets, the majority of their capital is inevitably their human capital—their ability to earn income in the future—which cannot be easily diversified. Creditors, by contrast, are able to diversify by distributing risk among their various debtors. Thus, they are also lower-cost insurers than

49 See id at 1420.
52 See Jackson, 98 Harv L Rev at 1408-10 (cited in note 11).
53 See id at 1408-14. Professor Jackson argues that the nonwaivability of discharge can also be explained by appealing to these factors. For the same reasons that debtors are likely to underestimate the costs of taking on debt, they are likely to underestimate the costs of waiving their discharge right. By mandating the availability of a nonwaivable discharge right—thereby encouraging creditors to monitor debtor borrowing—bankruptcy law approximates the decision that fully rational debtors concerned with maximizing overall welfare would make. See id at 1405-24.
54 See id at 1400.
individual debtors.\textsuperscript{55} As superior risk bearers to debtors, creditors ought to bear the risks of credit; discharge shifts those risks from individual debtors to creditors.\textsuperscript{56}

2. Debt-specific exceptions to discharge.

The risk-allocation theory of discharge also explains the shape of the discharge right, by making sense of some of the debt-specific exceptions to discharge. For example, § 523(a)(2) excepts from discharge debts that were obtained through false statements or fraud.\textsuperscript{57} While creditors may normally be better than debtors at bearing the risks of credit, this is not the case when a debtor intentionally conceals information regarding the debt from his creditor. In those circumstances, the debtor is better positioned than the creditor to bear the risks associated with default.\textsuperscript{58} It therefore makes sense to impose the cost of default on the debtor rather than the creditor, by excepting from discharge any debt obtained through fraud.\textsuperscript{59}

\textsuperscript{55} See Howard, 75 Am Bankr L J at 80–81 (cited in note 45).

\textsuperscript{56} While creditors are superior risk bearers ex ante, debtors might be better at avoiding risk ex post—better positioned to minimize the prospect of insolvency once credit has been extended. Accordingly, the availability of discharge might give rise to concerns about moral hazard: shifting the cost of insolvency from debtors to creditors disincentivizes debtors from taking what steps they can to avoid insolvency after credit is extended. However, while discharge shifts some of the costs of default to creditors, it does not shift all of them: discharge is not available in the case of certain kinds of debtor misbehavior, such as fraud. See id at 84. Obtaining discharge is also costly for debtors: (1) in order to exercise their discharge right, debtors must surrender their nonexempt assets (which can be worth more to the debtors than to creditors) and (2) by exercising their discharge right, debtors put future creditors on notice (for example, through a lower credit score) that they might exercise it again, thereby reducing their access to future credit. See Jackson, 98 Harv L Rev at 1426–27 (cited in note 11). Creditors can also protect themselves against the moral hazard created by discharge by setting the criteria that debtors must satisfy in order to qualify for loans and by monitoring borrowers for changes in their financial condition that would implicate future lending decisions. See Howard, 75 Am Bankr L J at 84 (cited in note 45). Further, discharge operates against the backdrop of moral hazard that results from the availability of social insurance programs. The knowledge that social insurance programs are available induces the individual debtor to underestimate the true costs of his decisions. By encouraging creditors to police extensions of credit, the right of discharge minimizes this already-existing moral hazard created by social insurance programs. See Jackson, 98 Harv L Rev at 1402 (cited in note 11).

\textsuperscript{57} 11 USC § 523(a)(2).

\textsuperscript{58} See In re Leventhal, 194 Bankr 26, 30 (Bankr SDNY 1996) (rejecting the “assumption of risk” theory in circumstances where a debtor obtained credit by means of fraud); Howard, 75 Am Bankr L J at 80 (cited in note 45).

\textsuperscript{59} See Howard, 75 Am Bankr L J at 80 (cited in note 45).
However, we have already encountered an exception to this general rule. Debts obtained through fraud are nondischargeable only if the creditor reasonably, or justifiably, relied on the debtor’s fraud. As we have already noted, the moral theory of discharge—which explains the availability of discharge based on the debtor’s worthiness—has no satisfactory explanation for why the fraudulent debtor can take advantage of the discharge right when his creditors relied on him unreasonably or unjustifiably.

But the economic theory of discharge does. The purpose of discharge, according to the risk-allocation account, is to incentivize creditors to monitor the risks taken by their debtors by shifting those risks from debtors to creditors. A rule that rewarded any creditor who innocently relied on a debtor’s misrepresentations would create a disincentive for creditors to investigate the creditworthiness of potential borrowers carefully—it would encourage them “not to look beyond [the debtor’s] representations to other sources of information about the debtor’s ability to repay.”60 By contrast, the actual rule—which only rewards creditors who reasonably or justifiably relied on a debtor’s misrepresentations—ensures that the fraud exception does not eliminate creditors’ incentive to monitor.

Consider another debt-specific exception to discharge: § 523(a)(8) provides that, subject to certain exceptions, student loans are nondischargeable in bankruptcy.61 This means that by taking out student loans in order to finance their educations—that is, to finance the acquisition of human capital—students effectively designate some portion of their future earnings to repaying those loans without any recourse in bankruptcy.62 But unlike other decisions to take on debt, the decision to take on debt to acquire human capital does not seem to indicate an irrational preference for present consumption over future consumption. If anything, it reflects the opposite—a desire to favor the future over the present.63 In other words, the presumption that

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60 Id at 131, quoting Luther Zeigler, Note, The Fraud Exception to Discharge in Bankruptcy: A Reappraisal, 38 Stan L Rev 891, 907 (1986).
61 11 USC § 523(a)(8).
62 See Jackson, 98 Harv L Rev at 1430–31 n 121 (cited in note 11).
63 See id. But see generally Note, Ending Student Loan Exceptionalism: The Case for Risk-Based Pricing and Dischargeability, 126 Harv L Rev 587 (2012) (questioning the presumption that most students will be able to repay their student loans and arguing for the repeal of § 523(a)(8)).
warrants making other kinds of individual debt dischargeable in bankruptcy does not apply to student loan debt.64

II. SECTION 523(A)(19): THE SECURITIES VIOLATION EXCEPTION

In response to the high-profile scandals at Enron and other large, publicly traded companies, Congress passed the Sarbanes-Oxley Act.65 Sarbanes-Oxley created new securities-law violations and toughened penalties for previously existing violations.66 Moreover, it gave the Securities and Exchange Commission (SEC) broad latitude to regulate the activities of gatekeepers—parties like lawyers, auditors, underwriters, lenders, and stock analysts, who sell products or provide services that are necessary for others wishing to enter a market or engage in certain activities.67 Specifically, Sarbanes-Oxley directs the SEC to promulgate rules governing auditor and stock analyst independence and requiring lawyers to report wrongdoing by public companies.68 These requirements are aimed at harnessing the power of gatekeepers by enlisting them to monitor for and thereby prevent securities violations.69

In addition to effecting substantive changes in securities law, the Sarbanes-Oxley Act also amended the Bankruptcy Code. Following the Enron debacle, executives who had been aware of the ongoing fraud were able to escape debts incurred through violations of securities law by filing for bankruptcy and having those debts discharged.70 To close this loophole, the Sarbanes-Oxley Act added a provision to § 523(a) that makes debt

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64 See Jackson, 98 Harv L Rev at 1430–31 n 121 (cited in note 11).
65 Sarbanes-Oxley, 116 Stat at 745.
70 See The Corporate and Criminal Fraud Accountability Act of 2002, S Rep No 107-146, 107th Cong, 2d Sess 10 (2002). Many executives were also able to take advantage of Texas's liberal property exemption rules, which allow debtors to shield the full value of their homes from creditors. In doing so, they placed their multimillion-dollar mansions outside the reach of defrauded investors. See Nelson S. Ebaugh, The Securities Claim Exemption in Bankruptcy: The Good, the Bad, and the Ugly, 19 Sec Litig J 14, 15 (Fall 2008).
incurred for securities violations nondischargeable in bankruptcy.\footnote{Sarbanes-Oxley § 803(3), 116 Stat at 801.} Section 523(a)(19) currently provides,\footnote{The provision was amended by § 1404(a) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 to clarify that it even covers debts recoverable under a securities claim that had not been reduced to judgment before the debtor filed for bankruptcy. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 § 1404(a), Pub L No 109-8, 119 Stat 23, 215.} in relevant part, that an individual debtor cannot discharge a 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; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results, before, on, or after the date on 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 debtor;

(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.\footnote{11 USC § 523(a)(19).}

While in many ways similar to the § 523(a)(2) exception for debts incurred through fraud, this provision expands upon that exemption both substantively and procedurally. Perhaps the most notable substantive expansion is that the securities violation exception enables some defrauded investors to secure non-dischargeable judgments without proving that the debtor had any knowledge of wrongdoing.\footnote{See Ebaugh, 19 Sec Litig J at 14 (cited in note 70).} Common law fraud claims of the kind that would qualify for the § 523(a)(2) exception require
proof of scienter. Accordingly, securing a nondischargeable debt for fraud requires proof that the fraudulent debtor knew about the falsity of his misrepresentations. In contrast, securities law imposes strict liability for several violations: For instance, the Securities Act of 1933 imposes strict liability on a securities issuer in the event that a registration statement contains a material misrepresentation or omission. In addition, the same Securities Act makes someone strictly liable for misrepresentations or omissions made in, or about, a prospectus. Finally, states that have adopted the Revised Uniform Securities Act of 1985 impose strict liability on sellers of securities who are not licensed brokers, who sell unregistered securities, or who make misrepresentations or omissions in the course of a sale. Thus, a creditor who wants to secure a nondischargeable judgment for a securities violation under § 523(a)(19) need not necessarily prove that the violator knew, or even was negligently ignorant, of the violation. Indeed, several courts have found debts for

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75 See Restatement (Second) of Torts § 526 (1977):

A misrepresentation is fraudulent if the maker (a) knows or believes that the matter is not as he represents it to be, (b) does not have the confidence in the accuracy of his representation that he states or implies, or (c) knows that he does not have the basis for his representation that he states or implies.

76 See, for example, Palmacci v Umpierrez, 121 F3d 781, 787 (1st Cir 1997) (explaining that a debtor makes a false representation when he does not intend to perform his promise, but not when he decides at a later point not to follow through); In re McGuire, 284 Bankr 481, 490 (Bankr D Colo 2002) (holding that a debt for violation of federal securities law does not qualify for the § 523(a)(2)(A) exception for fraud debts absent a showing of fraudulent intent).

77 Pub L No 73-22, 48 Stat 74, codified as amended at 15 USC § 77a et seq.

78 Securities Act of 1933 § 11(a), 48 Stat at 82, codified at 15 USC § 77k. See also Herman & MacLean v Huddleston, 459 US 375, 382 (1983).


81 See Revised Uniform Securities Act (RUSA) § 201.

82 See RUSA § 301.

83 See RUSA § 501(2).

84 See RUSA § 605(a)–(b) (imposing strict liability on unlicensed brokers and sellers of unregistered securities, and negligence liability for misstatements and omissions in disclosures made to buyers of securities).
strict liability securities violations nondischargeable in bankruptcy.85

Moreover, the provision added by Sarbanes-Oxley substantively expands the scope of nondischargeability even for those securities violation debts that do require proof of the debtor’s knowledge. Under § 523(a)(2), defrauded investors seeking nondischargeable judgments for fraudulent violations of securities law must prove that they actually relied on the debtor’s fraudulent misrepresentations.86 The addition of § 523(a)(19), which renders all debts for securities violations nondischargeable, eliminates the requirement for actual reliance by incorporating securities law’s fraud-on-the-market doctrine into the standard for nondischargeable debts.87 Fraud-on-the-market doctrine allows a purchaser of securities to sustain a cause of action for misrepresentations regarding the sale or purchase of a security without proving actual reliance; all the purchaser must show is that the seller made a material misrepresentation and that market prices reacted to that misrepresentation. Accordingly, under § 523(a)(19) a debtor’s misleading statement regarding the purchase or sale of a security is sufficient to render the resulting debt nondischargeable, even absent the creditor’s actual reliance or even knowledge of a false statement.88

Section 523(a)(19) also makes it procedurally easier to secure a nondischargeable fraud judgment. To ensure that a debtor cannot discharge a fraud debt under § 523(a)(2), a creditor must file a complaint objecting to dischargeability within sixty days after the first date set for the meeting of creditors.89 If she does not, she waives her right to obtain a nondischargeability

85 See, for example, In re Williams, 370 Bankr 397, 401–02 (Bankr MD Fla 2007) (holding a debt for the sale of an unregistered security nondischargeable in bankruptcy); In re Civello, 348 Bankr 459, 464 (Bankr ND Ohio 2006).
86 See 11 USC § 523(a)(2). See also Field v Mans, 516 US 59, 73–75 (1995) (ruling that a creditor must have justifiably relied on a debtor’s fraudulent misrepresentation in order for a fraud debt to be nondischargeable under § 523(a)(2)(A)).
87 See 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, 330–31 (2003–2004) (noting that § 523(a)(19) adopts fraud-on-the-market theory). See also Basic Inc v Levinson, 485 US 224, 241–48 (1988) (ruling that the fraud-on-the-market theory can create a rebuttable presumption of reliance with respect to violations of Rule 10b-5, the SEC rule prohibiting fraud or deceit in connection with the purchase or sale of securities); Thomas Lee Hazen, The Law of Securities Regulation 812 (West 3d ed 1996) (noting that fraud-on-the-market theory allows a plaintiff to satisfy Rule 10b-5’s reliance requirement absent actual reliance).
89 FRBP 4007(c).
order. Some jurisdictions enforce this rule even if the court failed to give the required notice of the sixty-day deadline.\textsuperscript{90} However, § 523(a)(19) does not contain such a filing deadline.\textsuperscript{91} Accordingly, a creditor that fails to file a complaint seeking nondischargeability of a fraud debt under § 523(a)(2) would still be able to file a complaint under § 523(a)(19) if the fraud is in connection with the purchase or sale of any security.\textsuperscript{92}

By amending § 523(a) to include an exception to discharge for securities violations, Congress also sought to remedy a situation that forced regulators to "plow the same ground twice in securities fraud cases."\textsuperscript{93} Prior to the addition of § 523(a)(19), state regulators were often forced to relitigate fraud cases in bankruptcy court to prevent discharge because of technical differences between remedial statutes and their analogous common law causes of action. In addition, settlements were not given the same collateral estoppel effect in bankruptcy court as judgments obtained through fully litigated proceedings.\textsuperscript{94} Section 523(a)(19), which renders debts for securities violations nondischargeable, was intended to solve the problem of translation between remedial statutes and the common law.\textsuperscript{95} Further, by explicitly including debts resulting from "any settlement agreement entered into by the debtor,"\textsuperscript{96} the securities violation provision makes it easier to obtain a nondischargeability judgment when the initial case on which the debt was based was not fully litigated.\textsuperscript{97}

While the Sarbanes-Oxley Act in general—and the securities violation discharge exception in particular—was targeted at preventing high-profile securities violations, its impact is much wider in scope. As part of its expansion of gatekeeper liability,
Sarbanes-Oxley imposes broad duties on the management of companies to monitor various transactions, increasing the ability of shareholders to hold managers personally liable under federal securities laws for failure to do so. The provision excepting debts for securities violations from discharge ensures that debts arising out of violations of these duties are nondischargeable in bankruptcy.

Similarly, Sarbanes-Oxley gives the SEC regulatory authority to discipline any person whom it finds “to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations issued thereunder.” It also requires the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC, including a requirement to report any evidence of a material violation of securities law or breach of fiduciary duty by a company to the chief legal counsel of the company, its chief executive officer, or its board of directors. The provision excepting debts for securities violations from discharge ensures that attorneys who violate these standards cannot discharge debts that result from those violations in bankruptcy.

Although Congress may have intended § 523(a)(19) to cover the hypothetical situation in which the corporate executives responsible for a major public securities scandal—or their lawyers—attempt to seek refuge in bankruptcy, the more common case is one in which a small-time securities violator, like an individual broker, is found guilty of a securities violation and then files for bankruptcy when overwhelmed by the magnitude of the penalty.

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100 15 USC § 78d-3.
101 15 USC § 7245.
102 See Nickles, 59 Ark L Rev at 428 (cited in note 98).
Recall the Wilcoxes, investors in a Ponzi scheme who were required to disgorge their profits from the scheme. When the Wilcoxes attempted to discharge their disgorgement debts in bankruptcy, the Oklahoma Department of Securities brought an adversary proceeding, arguing that the Wilcoxes could not discharge their debts because the debts were for a securities violation within the meaning of § 523(a)(19). This raised a problem of interpretation for the court: Does the discharge exception for securities violations apply only to debts of those who committed the violations or also to debts of third parties that result from the securities violations of others? Courts faced with this issue have advanced arguments based on statutory language, legislative history, and considerations of public policy.

A. Statutory Construction

Section 523(a)(19) provides that a debtor cannot discharge a debt that is “for” a securities violation. Courts have differed over how to interpret the plain meaning of the statute—specifically, what it means for a debt to be “for” a securities violation.

In the Ninth Circuit case In re Sherman, the court noted that the plain meaning of “for” is broad: it can plausibly encompass anything from “the penalty on account of” to “in requital of.” While the third-party securities violation debtor might be understood to owe a debt as “the penalty on account of” the securities violation, it cannot be said that that debt is “in requital of” the securities violation because the debt does not result from the third party committing any violation. The court therefore ruled that the debt was dischargeable—it didn’t fall within the meaning of § 523(a)(19). The dissenting judge argued that in context, the word “for” means “‘because of,’ ‘on account of,’ ‘as a result of,’ ‘having (the thing mentioned) as a reason or cause.’”

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104 See Oklahoma Department of Securities v Wilcox, 2010 WL 567988, *1 (WD Okla).
105 658 F3d 1009 (9th Cir 2011), revd on other grounds, 133 S Ct 1754 (2013).
106 Sherman, 658 F3d at 1013.
107 Id.
108 Id at 1019.
109 Id (Fisher dissenting).
This, the judge continued, includes debt owed by a third party for a securities violation that she did not commit.110

In the Wilcox case,111 the majority ruled that under the plain meaning of the statute, the debt was not covered by the § 523(a)(19) exception. It was not a debt "for a violation" of securities laws; rather it was a debt "for unjust enrichment resulting from someone else's violation" of securities laws.112 By contrast, the dissent argued that because the word "for" in this statute means "[r]epresenting" or "as representative of," third-party securities violation debts are included in the plain meaning of the statute;113 it is "possible for an obligation—in particular a court judgment for unjust enrichment—to represent or be representative of a federal or state securities violation committed by someone other than the person against whom the judgment was entered."114

In addition to dividing on the plain meaning of the word "for," judges have differed as to how to interpret the absence of any explicit textual requirement that the underlying securities violation be committed by the debtor. Courts have noted the contrast with several of the other exceptions to discharge that explicitly target debts resulting from the debtor's conduct.115 The question is whether the absence of such targeting in § 523(a)(19) carries any interpretive force.

According to several judges, the omission of "by the debtor" in § 523(a)(19)(A)(i) demonstrates that it was intended to cover both debtors who violate securities law themselves and others to whom the exception might reasonably apply.116 Others, however, have suggested that the omission should not be accorded

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110 Sherman, 658 F3d at 1019 (Fisher dissenting).
111 Oklahoma Department of Securities v Wilcox, 691 F3d 1171 (10th Cir 2012).
112 Id at 1175.
113 Id at 1181–82 (Briscoe dissenting), quoting Oxford English Dictionary (2d ed 1989) (online version).
114 Oklahoma Department of Securities, 691 F3d at 1182 (Briscoe dissenting).
115 See, for example, 11 USC § 523(a)(2)(B) (excepting fraudulent written statements "that the debtor caused to be made or published with intent to deceive"); 11 USC § 523(a)(6) (excepting debts "for willful and malicious injury by the debtor to another entity or to the property of another entity"); 11 USC § 523(a)(8)(B) (excepting educational loans "incurred by a debtor who is an individual"); 11 USC § 523(a)(9) (excepting debts "for death or personal injury caused by the debtor's operation of a motor vehicle, vessel, or aircraft [while intoxicated]"); 11 USC § 523(a)(15) (excepting spousal and child support payments "incurred by the debtor" in the course of divorce or separation proceedings).
116 See Sherman, 658 F3d at 1021 (Fisher dissenting); Wilcox, 691 F3d at 1182 (Briscoe dissenting); Oklahoma Department of Securities v Mathews, 423 Bankr 684, 689 (WD Okla 2010).
interpretive weight. After all, other § 523(a) discharge exceptions make no explicit reference to the debtor's conduct, but they are still best interpreted (the argument goes) as targeting only debtors who are also wrongdoers.\footnote{See Sherman, 658 F3d at 1014 (comparing the securities violation exception to other discharge exceptions that, while they make no explicit reference to the debtor's conduct, are "best interpreted as targeting only debtors who are also wrongdoers").} For example, § 523(a)(2)(A) excepts from discharge debts "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by [] false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition."\footnote{11 USC § 523(a)(2).} Similarly, § 523(a)(4) excepts from discharge debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."\footnote{11 USC § 523(a)(4).} While these exceptions do not refer specifically to the debtor's conduct, they are naturally interpreted as refusing a fresh start only to the dishonest debtor himself. By the same token, § 523(a)(19) should be interpreted as refusing discharge only to the securities violator himself, not third-party debtors whose debts resulted from another's securities violation.\footnote{See Sherman, 658 F3d at 1014. But see In re M.M. Winkler & Associates, 239 F3d 746, 751 (5th Cir 2001) (holding that debt that resulted from the fraud of an innocent party's associate, and for which the innocent party was vicariously liable, was non-dischargeable).}

B. Legislative History

Courts attempting to resolve the question have also appealed to legislative history. In the Wilcox case, the Tenth Circuit noted that an earlier draft of the securities violation provision "excepted from discharge a judgment that 'arises under a claim relating to' securities violations."\footnote{Wilcox, 691 F3d at 1175, quoting S Rep No 107-146 at 27 (cited in note 70).} The language was subsequently changed to except only a judgment that "is for" a securities violation.\footnote{11 USC § 523(a)(19)(A).} This change, the court reasoned, suggests that Congress intended to limit the reach of the provision, and it should therefore be interpreted narrowly—to exclude third-party debtors who owe money as a result of another person's securities violation.\footnote{Wilcox, 691 F3d at 1175.}
In addition to the textual history of the provision, courts have looked to the legislative record to shed light on the provision's purpose. At least one court has acknowledged that Congress did not actually anticipate the problem of third-party securities violation debtors. Nevertheless, some courts have searched the legislative record for an indication of what Congress would have intended had it anticipated the question. They have noted that the express purpose of the exception was to ensure that parties who are guilty of securities violations are penalized in bankruptcy, just like parties who are guilty of similar misconduct.

These courts have observed that the legislative record "consistently refers to 'hold[ing] accountable those who incur debts by violating our securities laws' and explains 'the bill protects victims' rights to recover from those who have cheated them,'" concluding that it is "evident from the text of § 523(a)(19)(A) that Congress intended to penalize the perpetrators of such schemes by denying them relief from their debts." If the exception was indeed added to punish securities violators, then it would follow that it was not added to punish nonviolators. The punitive justification for making securities debts nondischargeable supports a reading that limits the discharge exception only to situations in which the debtor personally violated securities law.

C. Policy Considerations

The legislative record, however, is ambiguous. As several judges have noted, the congressional record indicates that the exception was intended both to "prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible"—that is, to further goals of both punishment and compensation. Contrary to the purely punitive justification, this dual justification—aiming at both

124 See Sherman, 658 F.3d at 1016.
125 See id; Wilcox, 691 F.3d at 1175–76.
126 See Sherman, 658 F.3d at 1016–18; Wilcox, 691 F.3d at 1175–77.
127 Wilcox, 691 F.3d at 1175–76 (emphasis omitted). See also Sherman, 658 F.3d at 1016.
128 See Sherman, 658 F.3d at 1016; Wilcox, 691 F.3d at 1175.
129 Legislative History of Title VII of HR 2673: The Sarbanes-Oxley Act of 2002, 107th Cong, 2d Sess, in 148 Cong Rec S7418 (July 26, 2002). See also Wilcox, 691 F.3d at 1175; id at 1182–83 (Briscoe dissenting).
130 See notes 128–28 and accompanying text.
punishment and compensation—might support the reading that a securities violation debt is covered by the discharge exception even when the debtor did not himself commit the securities violation.131

Ultimately, both those who have argued in favor of reading the securities violation provision narrowly (to exclude third-party securities debtors) and those who have argued in favor of reading the provision broadly (to include third-party securities debtors) appeal to public policy arguments. Those in favor of reading the provision narrowly argue that this reading furthers bankruptcy law's general goal of giving the honest but unfortunate debtor a "fresh start."132 Exceptions to discharge should be limited to those debtors who seek to abuse the bankruptcy system in order to avoid the consequences of their misconduct. Accordingly, third-party securities violation debtors who have not committed any misconduct should receive a fresh start.133

Those who contend that the provision should be read broadly argue that this issue implicates more than just bankruptcy law. While the fresh start policy might militate in favor of a narrow reading, there is more at stake here: securities policy aims at depriving wrongdoers of unjust enrichment and compensating defrauded investors by pursuing disgorgement actions against those who have been unjustly enriched by securities violations.134 Allowing those who have been unjustly enriched through a securities violation—even if they did not personally commit the securities violation—to discharge the debts they owe as a result would frustrate that compensatory purpose. Thus, third-party securities debtors who have been unjustly enriched should not be able to discharge their securities-related debts—even if the debts did not arise out of their own wrongdoing.135

IV. A RISK-ALLOCATION APPROACH

Ultimately, both approaches that courts have adopted are unconvincing; none of the textual, legislative-history, or public

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131 See Sherman, 658 F3d at 1016 (evaluating the government's argument); Wilcox, 691 F3d at 1182–83 (Briscoe dissenting).
132 See Sherman, 658 F3d at 1014–15; Wilcox, 691 F3d at 1174.
133 See Sherman, 658 F3d at 1014–15; Wilcox, 691 F3d at 1174.
135 See Sherman, 658 F3d at 1021–24 (Fisher dissenting); Sherman, 406 Bankr at 887.
policy arguments clearly point to reading the statute narrowly or broadly. But courts have also been too quick to reduce the question to a conflict between bankruptcy policy—ensuring that the honest debtor gets a “fresh start”—and securities policy. These approaches take as a given that, as a matter of bankruptcy policy, the innocent third-party debtor is entitled to a fresh start. But this is not always the case: in other contexts—specifically, cases of vicarious liability—courts have found debts nondischargeable even though the debtor did not personally engage in the misconduct that qualified them for nondischargeability. Close attention to those cases of vicarious liability reveals their consistency with the broader aim of discharge—to efficiently allocate risk by imposing it on the least-cost avoider—and suggests a different way of resolving the question at hand.

The question here can therefore be understood not as a conflict between bankruptcy policy and securities policy, but as an internal question of bankruptcy law: Would withholding discharge from third-party securities violation debtors further the risk-allocation goal of discharge? To the extent that third-party liability for securities violations is intended to encourage those third parties to monitor for and report securities violations, the answer is yes. Indeed, framing the question at hand as one of risk allocation reveals not conflict, but general consistency, between the risk-allocation aims of bankruptcy law and securities law—specifically, the Sarbanes-Oxley Act’s strategy of enlisting gatekeepers to prevent securities violations.

136 See notes 126–28 and accompanying text.

One can characterize the issue in [Ohio v Kovacs, 469 US 274 (1985),] as a conflict between environmental law and bankruptcy, but this characterization may not focus matters as sharply as one that treats the case as a conflict over whether Kovacs’s obligation to the state of Ohio should be treated differently from his obligation to other creditors . . . .

138 Risk-allocation arguments are by no means foreign to bankruptcy law. For instance, the claims of shareholders alleging fraud in the issuance of stock are subordinated to the claims of general unsecured creditors on the grounds that shareholders are better at bearing both the risks of illegality in the issuance of stock and the risks of insolvency. See In re Telegroup, Inc, 281 F3d 133, 139 (3d Cir 2002); In re Granite Partners, LP, 208 Bankr 332, 336 (Bankr SDNY 1997).
A. Does § 523(a) Require Personal Wrongdoing?

Exceptions to discharge can be divided into two categories. The first category, type-based exceptions,

relates to public policy matters. Thus, at § 523(a)(1), taxes are made non-dischargeable; at § 523(a)(3), unlisted debts are made non-dischargeable; at § 523(a)(5), alimony, maintenance, and child support obligations are made non-dischargeable; at § 523(a)(7), a fine, penalty, or forfeiture to the government is made non-dischargeable; at § 523(a)(8), student loans are made non-dischargeable; at § 523(a)(9), drunk driving debts are made non-dischargeable; and at § 523(a)(10), debts surviving a prior bankruptcy are made non-dischargeable.139

The second category, fault-based exceptions,

may be characterized as debts which ought not to be dischargeable because they arose from wrongful acts. This category is comprised of those debts set forth at § 523(a)(2), debts due to false and fraudulent acts; at § 523(a)(4), debts due to fraud or defalcation of a fiduciary, embezzlement, or larceny; and § 523(a)(6), debts arising from willful and malicious injury.140

More succinctly, exceptions to discharge can be divided into debts that are owed to creditors who are thought to be particularly important and debts that arise out of particular wrongful conduct.

The nondischargeability of type-based exceptions to discharge, like tax debts and child support obligations, does not depend on the personal wrongdoing of the debtor.141 Thus, it should come as no surprise that courts have found that third-party tax debtors cannot discharge tax debts in bankruptcy, regardless of whether they were initially responsible for incurring the tax liability. What matters in those cases is not whether the third party

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139 In re Futscher, 58 Bankr 14, 17 (Bankr SD Ohio 1985).
140 Id.
141 See 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, 566 (2003) (“Sometimes, the type of debt that is due determines the outcome of a discharge proceeding. In these situations, the conduct of the debtor is irrelevant.”).
incurred the tax liability initially, but whether the liability ought to still be treated as tax liability.142

Less obvious is whether the same is true for fault-based exceptions to discharge, like those for debts obtained through fraud or debts for securities violations. But we can hazard a tentative answer. Note that some securities violations are strict liability violations—they give rise to liability even if the violator did not knowingly or even negligently commit any wrongdoing.143 When the securities violation exception to discharge was first enacted, commentators differed as to whether it should apply to strict liability securities violations or not.144 Some argued that only debts that arise out of culpable conduct—actual wrongdoing—should be nondischargeable in bankruptcy.145 However, courts have since regularly found debts arising from strict liability securities violations nondischargeable.146 Thus, it is clear that at least some fault-based exceptions to discharge—including § 523(a)(19)—do not depend on the personal wrongdoing of the debtor.

Nevertheless, one might object that although fault-based exceptions to discharge do not depend on the personal wrongdoing of the debtor, they do depend on the personal violation of the debtor. That is, although debtors are not able to discharge debts that arose out of certain nonculpable conduct, it must still be the case that those debts arose out of their own conduct.

This objection, too, is misguided. Section 523(a)(2)(A) excepts from discharge debts for “money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by [ ] false pretenses, a false representation, or actual fraud.”147 This gives rise to a question similar to the one faced here: Can an individual debtor discharge debts for someone

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142 See, for example, McKowen v Internal Revenue Service, 370 F3d 1023, 1025 (10th Cir 2004).
143 See notes 77–85 and accompanying text.
146 See In re Williams, 370 Bankr 397, 400–02 (Bankr MD Fla 2007); In re Civiello, 348 Bankr 459, 464 (Bankr ND Ohio 2006). See also Ebaugh, 19 Sec Litig J at 14 (cited in note 70).
147 11 USC § 523(a)(2).
else’s fraud? In the Sixth Circuit case *In re Ledford*, the court ruled that for the purposes of § 523(a)(2)(A), the fraud of one member of a partnership can be imputed to another member who had no knowledge of it. In doing so, the court relied on the Supreme Court’s decision in *Strang v Bradner*, which predates the Bankruptcy Code. According to *Strang*, fraud perpetrated by one partner not only makes the other partner vicariously liable for the fraud (following traditional rules of vicarious liability), but also makes the other partner’s debt nondischargeable. In other words, this particular fault-based exception to discharge does not depend on the debtor’s personal wrongdoing. The extension of nondischargeability to vicariously liable debtors is not only found in the context of the § 523(a)(2)(A) exception for debts obtained through fraud. In the Ninth Circuit case *In re Cecchini*, the court ruled that a debtor who was vicariously liable in tort for an act of conversion committed by his partner could not discharge that debt because it was covered by § 523(a)(6), which excepts debts resulting from “willful and malicious injury.” The court ruled this way even though § 523(a)(6) specifically provides that only debts that are “for willful and malicious injury by the debtor to another entity or to the property of another entity” are included in the exception. Courts routinely apply fault-based exceptions to discharge even when debtors are not themselves culpable for the relevant fault—and even when the explicit language of the provision suggests otherwise.

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149 See id at 1561.
150 114 US 555 (1885).
151 *Ledford*, 970 F2d at 1561.
152 See *Strang*, 114 US at 561.
153 780 F2d 1440 (9th Cir 1986).
154 Id at 1443–44.
155 11 USC § 523(a)(6) (emphasis added).
156 See *In re Bullington*, 167 Bankr 157, 163 (Bankr WD Mo 1994) (holding that one partner’s intentional tort can be imputed to another partner such that it is nondischargeable to them as well). But see *In re Austin*, 36 Bankr 306, 311–12 (Bankr MD Tenn 1984) (holding that the debt of a rock concert promoter is dischargeable even if it results from a death caused willfully and maliciously by a concert patron for whose conduct the promoter is vicariously liable under nonbankruptcy law); *In re Davis*, 23 Bankr 633, 635 (Bankr WD Ky 1982) (allowing discharge of a sheriff’s debt from injury to the plaintiff because the intent of other parties was not imputable for the purposes of bankruptcy law).
B. Lessons from Vicarious Liability

The vicarious liability cases suggest that fault-based exceptions to discharge are not limited to cases where the debtor herself has engaged in the relevant disfavored activity. Further, contrary to what some courts have asserted, the language of the securities violation provision might not be dispositive—courts have applied fault-based exceptions to third-party debtors even when the text of the relevant exception explicitly specifies that the misconduct must be the debtor's.

But the vicarious liability cases also suggest a rationale for when nondischargeability should, and when it should not, be extended to third-party debtors. Recall that according to the economic theory of discharge, the purpose of discharge is to allocate the risk of credit in an economically efficient way. When creditors are better positioned to bear the risks of credit, bankruptcy law imposes those risks on them by granting debtors a discharge right. However, when debtors are better positioned to bear the risks of credit—for example, if they have withheld relevant information from their creditors—bankruptcy law imposes those risks on these debtors by not allowing them to take advantage of discharge.

Note that when it comes to activities like fraud and intentional torts, there are two distinct risks involved: the risk that, once the fraud or tort has occurred, the debtor will become insolvent, and the risk of the fraud or tort occurring in the first place. Accordingly, there are two different questions to ask: Who, as between the creditor and the debtor, is better positioned to bear the risks of default on credit extended as the result of fraud or

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157 See Part III.A.
158 Simply noting that law generally treats agents and principals alike is insufficient. After all, the law does not always treat principals and agents the same way. For example, courts have historically been reticent to impose punitive damages on vicariously liable parties. See, for example, Maisenbacker v Society Concordia of Danbury, 42 A 67, 70 (Conn 1899); Craven v Bloomingdale, 64 NE 169, 171 (NY 1902). Accordingly, the nondischargeability of vicarious liability debts cannot be explained solely on the basis of the traditional legal conception of the principal-agent relationship. See Steven H. Resnicoff, Is It Morally Wrong to Depend on the Honesty of Your Partner or Spouse? Bankruptcy Dischargeability of Vicarious Debt, 42 Case W Res L Rev 147, 165–66 (1992). Moreover, since the rationale for the nondischargeability of vicarious liability debts is not explained by the traditional legal conception of the principal-agent relationship, it is also not limited to situations involving vicarious liability.
159 See Part I.B.1.
160 See id.
intentional tort? And who is better positioned to bear the risk of fraudulent or intentionally tortious activity?\(^{161}\)

It is difficult to determine who, as between a creditor and a vicariously liable fraud or tort debtor, is better positioned to bear the risk of the debtor's default. Unlike in the case of the standard consumer bankruptcy, there is no reason to think that creditors or debtors in this kind of case are systematically better at either preventing default or insuring against it through diversification.\(^{162}\) But there is another risk involved here: the risk of the fraud or tort occurring in the first place. And economic analysis suggests that the doctrine of vicarious liability imposes liability on the lower-cost monitor.\(^{163}\) That is, the law imposes vicarious liability on principals or partners precisely because they are better situated than other creditors to monitor the risks of their debtor agents or partners—whether those creditors are voluntary (as in the case of normal credit transactions) or involuntary (as in the case of torts).\(^{164}\) The doctrine of vicarious liability shifts the risk associated with fraudulent or intentionally tortious activity from the creditors of fraudulent or intentionally tortious parties to lower-cost monitors—those parties' principals and partners.

This line of reasoning has implications for the scope of individual discharge. Notions of optimal deterrence suggest that tort and fraud claims should not be dischargeable.\(^{165}\) If fraud and intentional-tort debts are dischargeable, an individual debtor evaluating the expected cost of fraud or tort will take into account the probability that his liability will be discharged in bankruptcy. Thus, the debtor's expected costs of engaging in fraud will be lower than the expected costs of the fraud as a whole—the debtor will be underdeterred from engaging in fraud.\(^{166}\)

\(^{161}\) See Howard, 48 Ohio St L J at 1068–69 n 155 (cited in note 13).

\(^{162}\) See id.


\(^{164}\) See id at 1234–38, 1256.

\(^{165}\) Jackson, 98 Harv L Rev at 1425 n 101 (cited in note 11). Nonetheless, despite what optimal deterrence might suggest, only "willful and malicious" torts are nondischargeable. 11 USC § 523(a)(6).

\(^{166}\) See Alan Schwartz, Products Liability, Corporate Structure, and Bankruptcy: Toxic Substances and the Remote Risk Relationship, 14 J Legal Stud 689, 714–18 (1985); Christopher M.E. Painter, Note, Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times, 36 Stan L Rev 1045, 1066–68 (1984). Judgment proofing through bankruptcy is not just a theoretical possibility; its prevalence has been well
Similarly, if vicarious-liability-fraud debts are dischargeable, a principal or a partner evaluating the expected cost of failing to monitor his agent or partner for fraud will take into account the probability that his vicarious liability will be discharged. Accordingly, her expected cost of failing to monitor will be lower than the expected social cost of her failure to monitor—she will engage in an inefficiently low level of monitoring. By making vicarious-liability-fraud debts nondischargeable in bankruptcy, bankruptcy law not only shifts the risks of fraudulent and intentionally tortious activity from the creditors of fraudulent and intentionally tortious parties to lower-cost monitors—it does so in a way that ensures that those lower-cost monitors will engage in an efficient level of monitoring.

C. Discharging Third-Party Securities Debts

As this Comment has shown, fault-based exceptions to default are not limited to instances of debtor wrongdoing. Debts, including debts for fraud, can be nondischargeable even if the underlying fault lies with someone else. The guiding principle in determining dischargeability is risk allocation: whether it is the risk of default in the case of the standard consumer debtor, or the risk of tortious or fraudulent activity in the case of the vicariously liable debtor.

Both kinds of risks—the risk of insolvency and the risk of an underlying securities-law violation—exist in the case of third-party securities-law debtors that are required to disgorge profits in the aftermath of a securities violation. To illustrate the distinction, consider the following example: Suppose that several real estate developers want to cash out on their investment in two properties. To that end, they incorporate High Life Co ("High Life") to own and develop the properties. Each property is valued on High Life's books at $6 million. After taking account of liabilities, the equity value of the company is $10 million. Accordingly, the public offering will seek to raise that amount for the 100 percent equity interest in the two properties. To support the offering price, High Life's prospectus states that each property's valuation reflects an independent estimate based on its


167 See Part IV.A.

168 See Part IV.B.
value as the site of a future high-rise apartment building. But in reality, while the company’s statement about the appraisal value of one property is true, the statement about the value of the other isn’t; the company knows that it will be unable to obtain the permits necessary to develop the second property, rendering it virtually worthless.

Someone who invests $100,000 has an equity interest which would be worth $100,000 if the property values represented in the prospectus were accurate, but is actually worth only $50,000. The immediate paper loss of $50,000 that this investor incurs as a direct result of the misrepresentation corresponds to the risk of a securities-law violation. However, not all of High Life’s investors will realize this loss. Some will extract all or a portion of their original investment before the violation is discovered. Some—the winners—may even withdraw more than they invested. These other investors may be required to disgorge some of the money they withdrew to be distributed among the losers. Any erosion in their ability to disgorge that money due to personal misfortune corresponds to the risk of insolvency.\(^{169}\)

Whether those disgorgement debts are dischargeable in bankruptcy ought to be settled on appeal to notions of risk allocation.

1. Encouraging optimal monitoring for securities-law violations.

As is the case with vicariously liable debtors, it is difficult to determine who, as between third-party securities debtors and their creditors, is better positioned to bear the risks of insolvency. That is, there is no reason to think that either will be systematically better situated to prevent insolvency or to insure against it through diversification.\(^{170}\) Moreover, before drawing any conclusions about the ideal allocation of the risk of securities-law violations between third-party securities debtors and their creditors, we need to know more about them. Broadly, we can distinguish between two kinds of investors: (1) those who know, or are in a position to find out, about a securities-law violation; and (2) those who are not in a position to discover the securities-law violation.\(^{171}\) Although most unsophisticated investors

\(^{169}\) See id.

\(^{170}\) See text accompanying notes 162–64.

\(^{171}\) See generally Klarita Sadiraj and Arthur Schram, Informed and Uninformed Investors in an Experimental Ponzi Scheme (University of Amsterdam Working Paper, Feb 1999), online at http://www1.fee.uva.nl/creed/pdffiles/Pyramid11.PDF (visited Nov 24,
will be unable to discover a securities-law violation through monitoring, there might be informed or skeptical investors that we want to encourage to ask difficult questions and bring securities-law violations to light.172

To the extent that the law governing the distribution of assets in the aftermath of a securities-law violation tracks the distinction between sophisticated and unsophisticated investors by requiring the former—but not the latter—to disgorge the money that they withdraw from an illegal securities scheme, then the analysis of these third-party securities debtors follows almost directly from the analysis of vicariously liable fraud debtors. Like those third parties who are found vicariously liable for fraud, sophisticated investors are, by hypothesis, better positioned than others to monitor for, and alert the authorities to, securities-law violations. Requiring that they disgorge the money that they extract eliminates any incentive they have not to report those violations.173 Further, allowing them to discharge their disgorgement debts in bankruptcy would result in suboptimal deterrence, by increasing the difference between the expected cost of failing to monitor (which is discounted by the probability of insolvency) and the expected benefit of failing to monitor.

The foregoing analysis is premised on the assumption that the law governing the distribution of assets after a securities-law violation attempts to incentivize monitoring for securities-law violations by investors. This invites the following question: Does the law in fact aim at identifying those investors who could and should have monitored securities-law violators? Put simply, does the law actually distinguish between sophisticated and unsophisticated investors?

2013) (distinguishing between informed and uninformed Ponzi investors and describing their behavior in an experimental setting).

172 For a discussion of private-party gatekeepers, see Frank Partnoy, Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime, 79 Wash U L Q 491, 540–46 (2001) (arguing for a modified strict liability regime for private gatekeepers to financial markets); Kraakman, 2 J L, Econ, & Org at 53–55 (cited in note 67) (analyzing "liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers").

2. Distinguishing between sophisticated and unsophisticated third parties.

If the goal of the law is to minimize the harm caused by securities-law violations by encouraging lower-cost monitors to monitor for violations and blow the whistle before much money is lost, then debts that result from a failure to monitor should not be dischargeable in bankruptcy. Still, whether that is indeed the goal of the law is not immediately obvious. But several legal doctrines suggest, at least in part, that it is.

Much like fraud, violations of securities law can give rise to common law vicarious liability.\(^{174}\) In addition, securities law expands the scope of statutory liability for securities-law violations to include any of the violator’s “controlling persons.”\(^{175}\) Controlling persons are liable for securities violations that they either knew about or had reasonable grounds to know about.\(^{176}\) The purpose of expanding liability to include controlling persons is to encourage controlling persons to “minimize the chance” of securities violations, by “us[ing their] power to influence” potential securities violators and by “attempt[ing] to monitor” them and “act[ing] appropriately where [they] erred.”\(^{177}\) Controlling persons generally include individuals with well-defined legal responsibilities, like directors and officers of a corporation, but can also include those, like certain shareholders, who have indirect means of discipline and influence.\(^{178}\)

Common law vicarious liability and statutory controlling-person liability are meant to encourage those third parties who are best situated to monitor for, and deter, securities violations. Accordingly, the goal of optimal deterrence suggests that debts for both vicarious liability and controlling-person liability should be nondischargeable in bankruptcy. While courts have long recognized that debtors who were vicariously liable for securities

\(^{174}\) See Hollinger v Titan Capital Corp, 914 F2d 1564, 1573–74 (9th Cir 1990).

\(^{175}\) See 15 USC §§ 77o, 78t.


\(^{178}\) See Myzel v Fields, 386 F2d 718, 738–39 (8th Cir 1967) (holding that shareholders were liable as controlling persons for nondisclosures and misrepresentations of stock value made by other shareholders); In re Complete Management Inc Securities Litigation, 153 F Supp 2d 314, 331 (SDNY 2001) (“The test of whether an individual is a controlling person for the purposes of § 20(a) is not a categorical one that turns solely on the individual’s status as an officer or director. Rather, the inquiry is a functional one.”).
fraud could not discharge those debts in bankruptcy, those courts were reticent to render debts arising from controlling-person liability nondischargeable. But with the addition of § 523(a)(19), it is now likely that debts resulting from controlling-person liability are also nondischargeable in bankruptcy.

Common law and statutory vicarious liability for securities violations are not the only legal doctrines that aim to incentivize third-party monitoring of potential securities violators. In the aftermath of a Ponzi scheme—once the primary wrongdoer's resources have been exhausted—the wreckage is usually cleaned up by bankruptcy law. The trustee in bankruptcy can use fraudulent conveyance or restitution law to recapture some of the payments made to those Ponzi investors that have extracted some of, or even more than, their initial investments—the winners—to be distributed among the losing investors. The trustee can recover profits, and even principal, by showing that these winning investors acted in bad faith. Further, if a winning investor is deemed to have participated in the fraud, then the burden of proof shifts—it is up to the winning investor to affirmatively demonstrate good faith. Importantly, good and bad faith are measured according to an objective standard—"if a reasonable investor would have seen red flags and taken action, then all investors should do."

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179 See In re Reuter, 686 F3d 511, 517–18 (8th Cir 2012).
180 See In re Miller, 276 F3d 424, 429 (8th Cir 2002); In re Villa, 261 F3d 1148, 1150–52 (11th Cir 2001).
181 See In re Reuter, 427 Bankr 727, 765–66 (Bankr WD Mo 2010) ("If Plaintiffs had in fact established that Brown, Williams or any other person controlled by Debtor engaged in primary violations of the securities laws such that Debtor was liable as a controlling person, that liability is itself a securities law violation and may thus be nondischargeable under § 523(a)(19)."; In re Kummerfeld, 444 Bankr 28, 50–51 (Bankr SDNY 2011) (refusing to grant summary judgment, ruling that control-person liability debt was nondischargeable under § 523(a)(19) solely because a genuine issue of material fact existed concerning debtor's affirmative defenses to controlling-person liability); In re Treadwell, 423 Bankr 309, 317 (BAP 8th Cir 2010) (noting that the conclusion in Miller was premised on the fact that at that time the Bankruptcy Code did "not contain a specific exception to discharge for securities law violations").
182 See McDermott, 72 Am Bankr L J at 159–84 (cited in note 5).
183 See 11 USC § 548(a)(1)(B). See also In re Cottrill, 118 Bankr 535, 537 (Bankr SD Ohio 1990) (noting that "the Trustee has the burden of establishing that the transaction was fraudulent").
184 See 11 USC § 548(a)(1)(A).
185 Saul Levmore, Rethinking Ponzi-Scheme Remedies in and out of Bankruptcy, 92 BU L Rev 969, 972 (2012). See also In re Agricultural Research and Technology Group, Inc, 916 F2d 528, 535–36 (9th Cir 1990) ("These pronouncements indicate that courts look to what the transferee objectively 'knew or should have known' in questions of good
Restitution and Unjust Enrichment outlines some of the factors that warrant inquiry by the investor, including the “defendant's experience as an investor.”\(^\text{186}\) The law that governs the recovery of assets from third-party equity investors is substantively similar.\(^\text{187}\)

This objective good faith standard essentially distinguishes between sophisticated winners who could have brought a securities violation to an early end and unsophisticated, but lucky, winners.\(^\text{188}\) In doing so, it identifies the lower-cost monitors—those investors who might have suspected that a securities violation had occurred or was occurring. By requiring them to disgorge any profits that they made by failing to monitor (or failing to disclose), the law encourages sophisticated investors to discover, and blow the whistle on, securities violations before more money is lost. Disgorgement thus increases the likelihood that sophisticated investors will monitor for securities violations.\(^\text{189}\) Further, notions of optimal deterrence suggest that if those sophisticated investors, having been required to disgorge, become insolvent and file for bankruptcy, they should not be able to discharge their disgorgement liability.\(^\text{190}\)
Consider the Wilcoxes again. According to the Oklahoma court that required them to disgorge their profits, they were not innocent investors at all. At best they “acted with reckless disregard for the legitimacy of Schubert’s [Ponzi] scheme”; at worst they “were actively involved” in the scheme. Put differently, they were the second-lowest cost avoiders (after Schubert herself)—ideally positioned to bring an end to Schubert’s scheme before it sucked in more victims. The Oklahoma Supreme Court was correct in requiring them to disgorge their profits from the scheme: doing otherwise would have allowed them to benefit from their failure to blow the whistle on Schubert’s scheme. But the Tenth Circuit erred in allowing them to discharge that liability in bankruptcy. In doing so, it blunted the incentive effect created by disgorgement liability.

D. Final Considerations

Bankruptcy law—especially the law relating to individual bankruptcies—is fraught with controversial moral and political questions, with answers that can seem incoherent when considered as a whole. In particular, the scope of the individual right of discharge, and the exceptions to that right, often seem like

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191 Oklahoma Department of Securities v Wilcox, 267 P3d 106, 108 (Okla 2011).

192 It is not clear that the Oklahoma court actually applied the distinction between sophisticated and unsophisticated investors in Schubert’s scheme. Rather the court seems to have required all of the winning investors to disgorge any “unreasonably high dividends” that they received. Oklahoma Department of Securities v Blair, 231 P3d 645, 663, 670 (Okla 2010). See also Elizabeth Blair Wozobski, Note, More Money, More Problems: How Oklahoma’s Novel Approach to Ponzi Scheme Clawbacks in Oklahoma Department of Securities ex rel. Faught v. Blair Means More Uncertainty for Investors, 64 Okla L Rev 805, 822–25 (2012). The failure to distinguish between sophisticated and unsophisticated winners—effectively creating an insurance regime through which the losses of losing investors are offset out of the gains of winning investors—might create moral hazard by decreasing the incentives of individual investors to monitor for potential violations. See Levmore, 92 BU L Rev at 989 (cited in note 185); Cherry and Wong, 94 Minn L Rev at 410 (cited in note 189).

193 In Sherman, 658 F3d at 1010–11, the other case to consider the issue of third-party securities violation debts, the SEC argued that an attorney’s obligation to disgorge funds he had received—but not earned—on contingency from clients who had themselves received the funds in violation of securities laws was nondischargeable under § 523(a)(19). The attorney, who arrived on the scene well after the securities violation had occurred, was in no position to prevent the securities fraud from happening. Accordingly, the court’s decision to allow the discharge of his disgorgement obligation is consistent with the proposed approach. Indeed, the court rightly suggested that the SEC might have been more successful had it claimed that the obligation was nondischargeable under the § 523(a)(4) discharge exception “for fraud or defalcation while acting in a fiduciary capacity.” Id at 1017, quoting 11 USC § 523(a)(4).
little more than the legislative product of interest group horse trading.\textsuperscript{194} As such, it might appear as if there is no comprehensive rhyme or reason to the discharge right and its exceptions. There is undoubtedly some truth to this view; certain exceptions to discharge seem like obvious concessions to interest group politics.\textsuperscript{195} The § 523(a)(19) exception for violations of securities law can easily be understood as an ill-considered legislative reaction to a traumatic series of high-profile frauds.\textsuperscript{196}

At the same time, interpretation of ambiguous statutory provisions requires giving principled justifications to those provisions. By identifying a descriptive theory within bankruptcy law jurisprudence—the notion that discharge is used to efficiently allocate certain risks of credit between debtors and creditors—and using it to answer a normative question of statutory interpretation, this Comment offers a small measure of coherence to the Bankruptcy Code's exception to discharge. Specifically, this Comment argues that when the law imposes liability on a particular party because it identifies that party as a lower-cost monitor for potential wrongdoing, then bankruptcy law should not allow that party to discharge that liability by filing for bankruptcy. Allowing for the possibility of discharge results in underdeterrence. This approach is implicit in the line of cases that renders the fraud and intentional-tort debts of vicariously liable third parties nondischargeable in bankruptcy.\textsuperscript{197} Accordingly, it can be further extended to third-party debts for securities violations. When securities law requires a winning investor to disgorge profits from a securities violation as a form of deterrence, then bankruptcy law should not allow that disgorgement debt to be discharged in bankruptcy.\textsuperscript{198}

The risk-allocation approach proposed by this Comment is also broadly consistent with the general orientation of the Sar-


\textsuperscript{195} See, for example, 11 USC § 523(a)(9) (excepting from discharge debts “for death or personal injury caused by the debtor’s operation of a motor vehicle, vessel, or aircraft if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance”); Karen Gross, \textit{Preserving a Fresh Start for the Individual Debtor: The Case for Narrow Construction of the Consumer Credit Amendments}, 135 U Pa L Rev 59, 75–81 (1986) (describing the Consumer Credit Amendments to the Bankruptcy Code as the result of the “consumer credit industry’s lobbying efforts”).

\textsuperscript{196} See text accompanying notes 65–70.

\textsuperscript{197} See Part IV.B.

\textsuperscript{198} See Part IV.C.
banes-Oxley Act. As part of its comprehensive effort to prevent corporate fraud, Sarbanes-Oxley not only created new securities violations and instituted tougher penalties for violations, but also directed the SEC to enlist third-party gatekeepers to monitor for securities violations by others—in part by expanding the scope of gatekeeper liability. The risk-allocation approach to the securities violation discharge exception can be understood as ensuring the effectiveness of that expanded gatekeeper liability. Put differently, to the extent that law incentivizes certain gatekeepers (for example, sophisticated Ponzi scheme investors) to monitor for, and prevent, securities violations by imposing liability on them, bankruptcy law should not undermine that incentive by allowing them to discharge that liability.

It might be argued that this approach ignores the moral imperative that animates bankruptcy law in general and discharge in particular: to “relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.” In other words, this approach ignores the goal of the Bankruptcy Code to extend discharge to every “honest but unfortunate debtor.” But it is not obvious that the moral explanation for discharge provides a better—that is, more coherent—account of the exceptions to discharge. For one, it does not explain why only particular kinds of moral misconduct are singled out for opprobrium. Moreover, it does not explain those exceptions to discharge that do not seem to involve any dishonesty, like those accompanying strict liability violations of security laws (or even those

199 See text accompanying notes 66–69.
200 That is not to say that law currently imposes optimal liability on gatekeepers, only that, by allowing for discharge, bankruptcy law undermines the incentive effects created by gatekeeper liability. For more on optimal measures of gatekeeper liability, see Hamdani, 77 S Cal L Rev at 102–06 (cited in note 69).
202 Local Loan, 292 US at 244.
203 See Lawrence Ponoroff, Vicarious Thrills: The Case for Application of Agency Rules in Bankruptcy Dischargeability Litigation, 70 Tulane L Rev 2515, 2560 (1996) (noting that a “debtor’s moral virtue” is not “an essential factor in explaining the discharge exceptions”).
204 See text accompanying notes 34–38.
accompanying debt for vicarious liability, itself a form of strict liability).205

In addition, it is not obvious that the moral theory of discharge would reach a different resolution to the problem of third-party securities debtors. To the extent that the moral theory of discharge can account for the nondischargeability of vicarious liability debts, it is because the vicariously liable party should have done more to prevent the underlying wrong. His failure to do so rendered him undeserving of discharge.206 A similar argument can be made in the context of third-party securities debts. The law requires sophisticated third parties to disgorge profits in the event that they should have monitored for an underlying violation of securities law and failed to do so. This failure arguably makes them undeserving of bankruptcy law's fresh start, which is reserved only for "honest but unfortunate debtor[s]."207 For those who favor the moral theory of discharge, this argument—which leads to the same conclusion—may be more satisfying than one that relies on an economic theory of discharge.

CONCLUSION

This Comment addresses the question of whether third-party debts for violations of securities law—that is, the debts of those other than the primary violator—should be dischargeable in bankruptcy. It argues that since the aim of individual discharge is to allocate the risks of credit—both the risks of insolvency and the risks of the behavior giving rise to the extension of credit—between debtors and creditors, the focus of the inquiry should be whether third-party securities debtors are better situated than their creditors to minimize the risk of securities-law violations. To the extent that the law that imposes third-party securities liability identifies those who are better situated to monitor and put an end to securities-law violations, optimal deterrence suggests that that liability should not be dischargeable in bankruptcy. Accordingly, if a debtor's liability arises out of a legal doctrine that does just that—including, but not limited to, vicarious liability and restitution liability for a

205 See Parts III and IV.A.
206 See Jane Stapleton, Product Liability 191 (Butterworths 1994) (defending vicarious liability on the moral ground that principals operate under a "profit motive . . . in creating the opportunity for [their agents] to act").
207 Local Loan, 292 US at 244.
fraudulent conveyance—then his debt should not be dischargeable. This result lends coherence to an area of the law where it is otherwise lacking.