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Section 523(a)(19) Conflicts with Two Circuit Interpretations

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On Feb. 15, 2017, the U.S. Court of Appeals for the Eleventh Circuit held that a debtor does not need to have committed a securities violation to have his/her debt excepted from discharge under 11 U.S.C. § 523(a)(19) as long as the judgment is for a securities violation. If the debtor is a party to the judgment and the judgment is for a securities violation, whether the debtor is the one who violated a securities law is irrelevant.[1] The Eleventh Circuit's decision conflicts with decisions from both the Ninth and Tenth Circuit Courts of Appeals, though the Tenth Circuit might as well agree with the Eleventh Circuit's holding on the same set of facts. Section 523(a)(19)[2] makes nondischargeable a debt that "(1) is for violation of securities laws (§ 523(a)(19)(A)); and (2) results from a judgment, order, consent order, decree or settlement agreement (§ 523(a)(19)(B)).")[3]

In *Process Technologies Services v. Jon Lunsford (In re Lunsford)*, Process Technologies Services (PTS)[4] sued Jon Lunsford, his LLC co-founder, Mike Cook, and his LLC, MIPCO, under the Mississippi Securities Act to rescind the purchase price of MIPCO securities because of oral and written misrepresentations made during the sale of securities. Lunsford filed for bankruptcy, and after the stay was lifted, the matter was arbitrated in Mississippi, where the arbitrator found that Lunsford, Cook and MIPCO were jointly and severally liable to PTS for violations of the Mississippi Securities Act.

The debt owed by Lunsford to PTS was incorporated into a state court judgment confirming the arbitrator's decision and findings that Lunsford, along with his LLC co-founder and MIPCO, violated the Mississippi's Securities Act. PTS then initiated an adversary proceeding in the U.S. Bankruptcy Court for the Northern District of Georgia, where it secured a judgment on the pleadings.[5]

The district court affirmed the judgment.[6] On appeal to the Eleventh Circuit, Lunsford claimed that the arbitrator had not found that he individually had violated the Mississippi Securities Act; a § 523(a)(19) discharge exception required a finding that the debtor himself had violated the securities laws; and the Mississippi judgment had been obtained by fraud. The Eleventh Circuit in a 2-1 decision[7] held:

> Lunsford's arguments fail: the bankruptcy court made a finding of fact that Lunsford violated securities laws; alternatively, section 523(a)(19)(A) applies irrespective of debtor conduct; and Lunsford is estopped from arguing that the award was procured by fraud.[8]

This article focuses on the alternative holding, which, expanded, stated as follows:

> Even if the bankruptcy court had not made a finding that Lunsford violated securities laws, we would reject his argument that the Bankruptcy Code prohibits discharge of a debt that is for the violation of state securities laws only when the debtor violated the securities laws, not when the debtor's liability arises from securities violations committed by a third party.[9]

In making its alternative holding, the Eleventh Circuit noted that for a debt to be excepted from discharge under § 523(a)(19), there must be two findings:

> [T]he debt must be "for" a violation of securities laws, § 523(a)(19)(A), and the debt must also "result ... from" a court order or "any settlement agreement entered into *by the debtor*," § 523(a)(19)(B)(i)-(ii).[10]

The *Lunsford* court recognized the contrary holding in the Tenth Circuit, but noted that the judgment in *Okla. Dep't of Sec., ex. rel. Faught v. Wilcox*[11] was for unjust enrichment, not a violation of securities laws, while "Lunsford's debt does not

1 *In re Lunsford*, 848 F.3d 963, 968 (11th Cir. 2017) ("[S]ection 523(a)(19)(A) precludes discharge regardless of whether the debtor violated securities laws as long as the securities violation caused the debt.").

2 11 U.S.C. § 523(a)(19) provides that a chapter 7 discharge does not discharge a debt that:
(A) is for —
(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), *any of the State securities laws*, or any regulation or order issued under such Federal or State securities laws; or ...
(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; … or
(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor (emphasis added).

3 *In re Loughery*, 457 B.R. 904, 907 (Bankr. N.D. Ga. 2011).

4 Jones Walker LLP represented PTS, with Ms. Hester arguing the case and Mr. Barber assisting on the brief.

5 *In re Jon E. Lunsford Sr., Process Technologies Servs. LLC v. Jon E. Lunsford Sr.*, Case 14-05128-crm (Bankr. N.D. Ga. April 21, 2015).

6 *Process Technologies Servs. LLC v. Jon E. Lunsford Sr.*, No. 1-15-cv-2323-SCJ (N.D. Ga. March 7, 2016).

7 Hon. Robin Rosenbaum concurred and dissented. "I concur in only our holding that the bankruptcy court correctly concluded that the arbitration award found that Lunsford violated securities laws, so § 523(a)(19)(A)'s preclusion applies to the debt at issue in this case. I would leave the issue addressed by the alternative holding to a case where it is better developed." *Lunsford*, 848 F.3d at 970.

8 *Id.* at 965.

9 *Id.* at 967.

10 *Id.* at 968 (emphasis added).

11 691 F.3d 1171, 1173, 1175 (10th Cir. 2012).

arise from a judgment against him for unjust enrichment. Lunsford was a party to the same decision in which the state courts entered a judgment against MIPCO for a violation of securities laws."[12]

The Tenth Circuit's language in *Wilcox* could give cover to either side of the argument in the *Lunsford* case. The *Wilcox* court stated that early investors in a Ponzi scheme had judgments entered against them for unjust enrichment from the proceeds of the scheme, and the court was required to decide whether the judgments entered against those early investors qualified as a nondischargeable debt under 11 U.S.C. § 523(a)(19). The Tenth Circuit noted that the debtors were not charged with securities violations and that the judgment was not for violations of a securities law but for unjust enrichment resulting from someone else's violation of those statutes.[13] The *Wilcox* court also stated in a footnote:

> However the level of culpability of the debtors has no bearing on our interpretation of 523(a)(19), which only requires us to determine if the judgments at issue are for a violation of securities laws. The Department chose not to prosecute Mathews or the Wilcoxes for securities violations. Our task is not to determine whether they committed such violations but whether the judgment against them is "for" securities violations. We therefore focus not on the underlying facts but on the nature of the judgments at issue.[14]

The *Wilcox* debtors were not sued for violations of securities laws, thus the nature of the judgment in *Wilcox* was not for a violation of the securities laws but for unjust enrichment. As the *Wilcox* court noted, had the *Wilcox* debtors been charged with securities law violations, their debt would not have been discharged.[15] This part of the decision corresponds with the later reasoning in the Eleventh Circuit's *Lunsford* decision.

Yet the *Wilcox* court ended its 2-1 decision by stating, "Permitting debtors, who were not personally found to be in violation of securities laws, to obtain relief from a judgment intended only to redistribute funds among multiple victims of a Ponzi scheme is in accordance with the plain language of the statute."[16] Consequently, the *Wilcox* case is cited for the proposition that a debtor himself must have been found to have violated a securities law in order to have a judgment incorporating that debt excepted from discharge,[17] as the *Wilcox* dissenting judge noted.[18] *Wilcox* has also been cited for the proposition that § 523(a)(19) did not apply because the judgment was not for a violation of securities laws.[19]

The attorney in *Sherman*, the conflicting Ninth Circuit Court of Appeals case, was likewise not charged with a violation of the securities laws but for a breach of a fiduciary duty. Although his judgment could have been found nondischargeable under § 523(a)(4), the Securities and Exchange Commission (SEC) was time-barred to assert an exception to discharge under that section. Thus, the nature of the judgment against Sherman was not one for securities law violations but for breach of fiduciary duty.[20] As the Ninth Circuit in *Sherman* asserted, had the SEC charged Sherman with a securities violation, his debt could also have been nondischargeable:

> If the third party in question has actually aided or abetted a securities violation, that party may be prosecuted for a violation of securities laws in addition to the primary violator ... the SEC's concession that Sherman had not violated any securities laws undermines its subsequent attempts to leverage this appearance of culpability into any legal consequence.[21]

Under the facts of the case, however, the *Sherman* court held (also in a 2-1 decision) that "11 U.S.C. § 523(a)(19) prevents the discharge of debts for securities-related wrongdoings only in cases where the debtor is responsible for that wrongdoing."[22] In neither *Wilcox* nor *Sherman* was the judgment in which the debt was incorporated a judgment for a securities violation.

The dissenting judge in *Wilcox* wrote a dissent that was in step with the Eleventh Circuit's later analysis of whether a debtor must be personally involved in violations of federal or state securities laws.[23] As in *Sherman*, however, the judgment against Wilcox, which was presented for a finding of nondischargeability, was not a judgment for violation of the securities laws.[24]

The dissenting opinion in *Sherman* was also in keeping with the Eleventh Circuit's later analysis of when a debt is "for" violation of securities laws, as the judge stated, "I would adhere to the plain language of § 523(a)(19) and affirm [the judge's] sensible decision. A debt is 'for' a violation of the securities laws when it is caused by such a violation. Sherman's debt is caused by a securities law violation because he is legally obligated to disgorge the ill-gotten gains of such a violation that he held in trust for the violator."[25] The challenge in *Sherman*, as it was in *Wilcox*, was that the judgment against Sherman, which was submitted for exception from discharge, was not a judgment for a securities violation but a judgment of disgorgement of funds for breach of fiduciary duty.[26] In neither *Wilcox* nor

12 *Lunsford*, 848 F.3d at 968-69.
13 *Wilcox*, 691 F.3d at 1175.
14 *Id.* at 1174 n.5.
15 "The Department ... declined to prosecute the [debtors] for securities laws violations. Had it done so successfully, any judgment it obtained would no doubt be considered nondischargeable under § 523(a)(19)." *Wilcox*, 691 F.3d at 1177.
16 *Id.*
17 *See In re Behrends*, 111416 FED10, 15-1420 No. 15-1420 (10th Cir. Nov. 14, 2016) (unpublished opinion) ("Behrends's failure to defend means that he admitted all the facts plaintiffs asserted in their Claim which specifically alleged that these actions and/or omissions violated" Colorado state securities laws).
18 "First, and most significantly, the majority misinterprets 11 U.S.C. § 523(a)(19) to render nondischargeable only those debts that arose from the debtor's personal violation of federal or state securities laws. Nothing in the plain language of § 523(a)(19), particularly when read together with the rest of the statute, supports such an interpretation. Instead, § 523(a)(19) must be read more broadly to encompass not only those debts that arose from the debtor's own violation of federal or state securities laws, but also those debts that are representative of violations of federal or state securities laws committed by others. Second, the majority fails to recognize that, even under its unduly narrow interpretation of § 523(a)(19), the judgment entered against the Wilcoxes in the Oklahoma state courts is nondischargeable because the Wilcoxes were found to have knowingly participated in violating Oklahoma state securities laws." *Wilcox*, 691 F.3d at 1177.
19 *In re Gilley*, 2013 Bankr. LEXIS 3383 *9 (Bankr. M.D.N.C. Aug. 19, 2013) ("Unlike *Gilley*, however, the defendants in *Wilcox* were not charged with a violation of securities laws, a fact which the Tenth Circuit emphasized in refusing to find the debt nondischargeable under section 523(a)(19). *Id.* at 1175."); *In re Thoennes*, 536 B.R. 680 (Bankr. D.S.C. 2015) ("The Tenth Circuit found that, based on the plain language of the statute, the debts did not fall under § 523(a)(19) because the judgments were not 'for a violation' of securities laws due to the fact that the debtors were not charged with securities violations and were only found liable for unjust enrichment, even though the matter involved a third party's violation of securities laws.").
20 *In re Sherman*, 658 F.3d 1009, 1017-18 (9th Cir. 2011).
21 *Id.* at 1018.
22 *Id.* at 1019.
23 *Wilcox*, 691 F.3d at 1182-83 (dissent) ("[I]t is entirely consistent with the Act to treat as nondischargeable any debts that arose from violations of federal or state securities laws, regardless of whether or not the debtor was personally involved in those violations.").
24 *Id.* at 1175.
25 *In re Sherman*, 658 F.3d at 1024.
26 *Id.* at 1018.

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Sherman did the judgment at issue satisfy the second prong of § 523(a)(19) as a judgment incorporating a violation of the securities laws.

On the other hand, the dissenting judge in *Lunsford* declined to join in the panel's alternative holding because she wanted a more detailed briefing on the issue:

> [Al]though the judgments that were the cause of the debts at issue in *Wilcox* were for unjust enrichment, they nonetheless also seem to be " debt as a result of," *see* Maj. Op. at 9 (citations and quotation marks omitted), a securities-fraud violation and therefore nondischargeable under § 523(a)(19)(A). Yet the panel suggests that § 523(a)(19)(A)'s preclusion did not apply to the Wilcox investors' situation because "[t]he judgments at issue [in *Wilcox*] [were] not 'for a violation' of securities laws but for unjust enrichment resulting from someone else's violation of those statutes." *Id*. at 9 (quoting *Wilcox*, 691 F.3d at 1175). This internal inconsistency in the panel's reasoning will no doubt create confusion about how courts and litigants in this Circuit are to construe and apply our alternative holding.
>
> Maybe the panel reaches this conclusion because the judgment against the Wilcox investors was not, in name, a judgment for securities violations, though this interpretation would seem to require us to construe the meaning of " judgment" in § 523(a)(19)(B)'s language.[27]

Where the Eleventh Circuit's *Lunsford* analysis prevails over that of the Tenth Circuit in *Wilcox* or the Ninth Circuit in *Sherman* is its recognition that there is a two-part requirement to a § 523(a)(19) discharge exception: (1) the debt that is presented for a finding of nondischargeability must be incorporated into a judgment and the judgment must be for a securities violation; and (2) the debtor must be a party to that judgment. Failure of either prong eliminates nondischargeability. In the Eleventh Circuit and arguably the Tenth Circuit, if the debt to be excepted from discharge is incorporated into a judgment or consent order for violation of the securities laws and the debtor is a party to the judgment or the consent order, then the debt is excepted from discharge under § 523(a)(19) — whether or not the debtor individually violated securities laws. abi

27 *Lunsford*, 848 F.3d at 970.