

# Corporate & Financial Weekly Digest

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## **Ninth Circuit Allows Discharge of Debt Related to Securities Law Violation**

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The U.S. Court of Appeals for the Ninth Circuit has found that debts relating to a securities law violation could be discharged in a Chapter 7 bankruptcy proceeding if the debtor himself was not responsible for violating federal securities laws.

The debtor, an attorney, represented his client in an Securities and Exchange Commission enforcement action. A receiver appointed in the enforcement action directed the debtor to disgorge sums for legal fees the debtor received from his client on retainer but had not yet used. The debtor filed for bankruptcy and sought to discharge his obligation to disgorge the retainer account sums.

Section 523(a)(19) of the bankruptcy code provides that a debtor should not be discharged from any debt that is for “the violation of any of the Federal securities laws.” The debtor argued that the section required that the debtor himself violate the securities laws. The bankruptcy court agreed and found that because the debtor did not violate any securities laws – but merely held funds belonging to a person who had – the debt was dischargeable. The district court, taking a broader view, found that the section was not so limited and refused to discharge the debt.

The Circuit Court agreed with the bankruptcy court. It found that the bankruptcy code includes protections against attempting to conceal assets or defraud creditors, or otherwise failing to disgorge available assets, and further found that there was no additional need to expand the scope of the discharge-exception law to cover innocent debtors. Accordingly, the Circuit Court held that the discharge exception prevents the discharge of debts for securities-related wrongdoing only in cases where the debtor is responsible for the wrongdoing, but that innocent debtors who may have received funds derived from a securities violation remain entitled to a complete discharge of any resulting disgorgement order.

*Sherman v. Securities and Exchange Commission*, No. 09-55880, D.C. No. 2:08-cv-02517-CAS (9th Cir. Sept. 19, 2011).

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