7th, 9th Circuit cases to affect federal equity receiverships

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The Securities and Exchange Commission, Federal Trade Commission, and Commodities Futures Trading Commission often seek appointment of receivers in civil enforcement actions, including those alleging operation of Ponzi-like investment schemes. Receivers are generally tasked with taking over entities used to perpetrate schemes, conducting forensic accountings, reporting their findings to the appointing court and recovering funds where possible, for distribution to defrauded investors.

Recently, the 7th and 9th U.S. Circuit Courts of Appeals addressed three key issues that arise in federal equity receiverships - the impact of a claims bar date, distribution priority between investors and creditors and the limits on a receiver's ability to recover from third-parties who file bankruptcy.

In *CFTC v. Lake Shore Asset Management Ltd. et al.*, 646 F.3d 401 (7th Cir. 2011), Judge Richard Posner addressed two important issues that arise in many federal equity receiverships - allowance of late-filed claims and priority in distribution between investors and creditors.

The court first addressed the appropriate standard for determining whether a late-filed claim should be allowed. Notice of the deadline to submit claims had been mailed to the investor, an Andorran bank, and the bank had failed to submit a claim. The district court disallowed the claim and the bank appealed.

The 7th Circuit held that excusable neglect under Federal Rule of Civil Procedure Section 60(b)(1) is the appropriate standard for determining whether a claim should be allowed to be filed late. It described excusable neglect as an "all-relevant circumstances" standard that balances the excuse of the claimant, the consequences to the claimant if relief is denied and the consequences to the receivership estate if relief is granted.

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Criminal
US probe of Armstrong dropped in rare fashion
In the first official acknowledgement of the U.S. attorney's criminal probe of cycling legend Lance Armstrong, prosecutors took the rare step of saying, "Case closed."

Government
Search committee for AOC director ramps up
As a search committee ramps up its nationwide efforts to hire a permanent director of the state's Administrative Office of the Courts, opinions on just what kind of leader is needed already runs the gamut.

Judges and Judiciary
Justice Paul Coffee – Division 6's very own pick-me-up
In a world of change, there are some constants that keep us grounded. By **Arthur Gilbert** of the 2nd District Court of Appeal

Mergers & Acquisitions
Acquisitions: A unique defense for publicly traded companies under attack
A special state law protects directors from actions challenging the acquisition of their company. By **Chet Kronenberg**, **Ben Gold** and **Colin Rolfs** of Simpson Thacher & Bartlett LLP

Law Practice
Greenberg adds partner to health care litigation practice
Greenberg Traurig LLP is expanding its pharmaceutical, medical device and health care litigation practice group with an addition from Reed Smith LLP, the firm announced last week.

Litigation
Civil suit against convicted producer Spector settles
Imprisoned music producer Phil Spector, convicted of murdering an actress at his Alhambra mansion in 2003, has settled a wrongful-death lawsuit with the victim's mother on the ninth anniversary of the killing.

Firm emerges in school sex abuse claims
Kiesel, Boucher & Larson LLP, a veteran of the sex abuse litigation against the Roman Catholic Church, is once again center stage in a high-profile child molestation scandal.

Criminal
L.A's DA race heats up in advance of official nomination period
The district attorney's office has been the domain of Steve Cooley for over a decade but that will likely change come November .

Education
Pepperdine law vice dean, professor

The court found that the bank's neglect was not excusable. Even if the proper person at the bank did not receive notice, the bank had actual knowledge of the case and the receiver's appointment, and made the incorrect assumption that it would receive distributions automatically without taking action. Although the consequences of disallowing the claim were substantial (i.e. no distributions from the receivership estate), the consequences to the receivership estate if relief was granted were also significant in that the receiver would have to recalculate distributions to all other investors, and the reduction in distributions would likely "stir a hornet's nest" of objections from other investors.

Note, although distributions were made before the appeal was decided, a reserve sufficient to cover the bank's pro rata distribution, should its claim be allowed, was maintained by the receiver. Had the bank not acted until after distributions were made, the appeal might have been dismissed as moot.

The second issue involved the priority in distribution between investors and non-investor creditors. An entity identified as GAMAG contended that it was not an investor, but a non-investor creditor due to the nature of its relationship with the receivership entities, and therefore was entitled to priority over investors. The 7th Circuit found that there was no meaningful difference between Lake Shore's relationships with GAMAG and with other investors. Accordingly, it affirmed the district court's denial of GAMAG's request for priority.

More interesting than the result, however, is that the 7th Circuit apparently agreed in dicta that if GAMAG had properly been deemed a creditor, it would have been entitled to priority. The court stated that "creditors are usually paid ahead of shareholders in insolvency proceedings, whether the proceedings take the form of bankruptcy or of receivership." It explained that the priority creditors enjoy over investors "mirrors the contractual allocation of risk and reward" for the success of the business. The decision likens receiverships to bankruptcy cases in several places. Other courts have drawn the same comparison, but many also note that there are significant differences. Some courts have local rules that address the issue. See Central District of California, Local Rule 66-8 (providing that receiverships should be administered in accordance with bankruptcy practice).

The 7th Circuit could have simply rejected the argument that GAMAG was a creditor and affirmed on that basis. Instead, the decision indicates that the priority scheme in bankruptcy should apply and a distribution plan should not be approved unless non-investor creditors are given priority over investors. This would be a significant change in equity receivership law, which for many years has left the issue of distribution priority among investors and non-investor creditors to the district court's broad discretion to achieve equity under the unique circumstances of each case.

In *Sherman v. SEC (In re Sherman)*, 2011 DJDAR 14223 (Sept. 19, 2011), the 9th Circuit addressed the scope of Bankruptcy Code Section 523(a)(19), which excepts from discharge debts for the violation of federal or state securities laws, or common law fraud in connection with the purchase or sale of security. The court held that amounts an attorney was ordered to disgorge in connection with an SEC enforcement action were not excepted from his bankruptcy discharge. The attorney had represented securities laws violators, but had not himself violated securities laws.

In 1997, the SEC instituted an enforcement action against several companies, which led to the appointment of a receiver. Richard Sherman represented some of the defendants in the enforcement action. The receiver obtained orders directing Sherman to disgorge funds that were determined to be ill-gotten gains, some of which Sherman had withdrawn from his trust account and some of which he received in a contingency case. The SEC conceded that Sherman had not committed any securities violations himself.

Four days before the hearing on the disgorgement motion, Sherman and his wife filed a petition for Chapter 7 bankruptcy. The Shermans were later granted a discharge. In a subsequent adversary proceeding, Sherman sought a declaration that his obligation to disgorge funds had been discharged notwithstanding Section 523(a)(19). The bankruptcy court granted summary judgment in favor of Sherman. It concluded that the disgorgement order did not arise from a violation of securities laws. It further ruled that "Section 523(a)(19) was intended to apply to 'wrongdoers' and not to persons who are simply found to owe a debt which the SEC is authorized to enforce."

The SEC appealed to the district court, which reversed. The court adopted a broader interpretation of Section 523(a)(19), treating as paramount the

leaving
L. Timothy Perrin, vice dean and law professor at Pepperdine University School of Law, will take over as president of Lubbock Christian University in Lubbock, Texas on June 1.

Perspective
Taking the stand: Scripts are for actors, not witnesses
Is the use of a script a breach of professional ethics? By **Jason de Bretteville** of Sullivan & Cromwell LLP

Juvenile
Open juvenile dependency courts deserve a chance
Our present system is not working, and we should not be wedded to a failing approach. By **Ellen Chaitin** of the San Francisco County Superior Court

U.S. Court of Appeals for the 9th Circuit
Blind man loses arbitration award
A blind man who was fired after selling coffee and pastries for years from a tiny snack shop in the lobby of a federal courthouse in downtown Los Angeles cannot claim a $140,000 arbitration award, a 9th Circuit panel ruled Friday.

9th Circuit sides with environmental group over forest plan
A divided 9th Circuit panel partially struck down a plan to dramatically increase logging, road building and grazing in the more than 400-mile span of Sierra Nevada national forests Friday.

Discipline
San Diego lawyer faces State Bar complaint
A lawyer who once advertised heavily in San Diego now faces a slew of discipline charges from the State Bar.

Labor/Employment
Jobs in legal sector lag
While 2011 marked a year of overall recovery for the U.S. labor market, the legal industry remained stagnant in job growth.

Discipline
Disciplinary Actions
Here are summaries of lawyer disciplinary actions taken recently by the state Supreme Court or the Bar Court, listing attorney by name, age, city of residence and date of the court's action.

Corporate
Another music label sued over digital royalties
The music industry's number three is the latest label to be hit with a class action suit mounted by musicians seeking to claw back digital royalties.

7th, 9th Circuit cases to affect federal equity receiverships
Two decisions may significantly alter the law governing federal equity receiverships. By **Ted Fates** and **Joshua A. del Castillo** of Allen Matkins Leck Gamble Mallory & Natsis LLP

Judicial Profile
Maureen Duffy-Lewis

Sarbanes-Oxley Act's goal of "protect[ing] investors by improving accuracy and reliability of corporate disclosures made pursuant to the securities laws." It expressed particular concern that "[r]eading a limitation into the SEC's ability to enforce its powers to obtain disgorgement of ill-gotten funds in an appropriate case...would frustrate the ability of the SEC to enforce the federal securities laws." Sherman appealed.

While affirming the general proposition that ill-gotten gains may be disgorged from innocent third-parties, the 9th Circuit agreed with the bankruptcy court that Section 523(a)(19) prevents the discharge of debts for securities-related wrongdoings only in cases where the debtor is responsible for the wrongdoing. It emphasized the goals of the Bankruptcy Code, including granting debtors a "fresh start," and the U.S. Supreme Court's rule of construing discharge exceptions narrowly. As a result, the court said, "in cases...where neither party claims the debtor is responsible for any securities-related wrongdoing...the debtor must be treated like an 'innocent' for the purposes of [Section] 523(a)(19)." Judge Raymond C. Fisher issued a spirited dissent, arguing that the funds at issue were the product of securities fraud, merely held in trust by Sherman, and therefore Section 523(a)(19) should apply. Judge Fisher emphasized the central role disgorgement plays in enforcing securities laws.

Section 523(a)(19) was added to the Bankruptcy Code in 2002, and few appellate courts have addressed this issue. Given the relative absence of case law on the issue, it is too early to tell whether the *Sherman* decision will notably impact Section 523(a)(19) jurisprudence. Notably, the 9th Circuit's opinion does not affect alternative methods of pursuing disgorgement. Rather, it merely limits the application of Section 523(a)(19) to situations where the debtor has violated securities laws. Both the *Sherman* opinion and its dissent suggest that a different tactic - constructive trust for instance (assuming the funds could be traced) - might have yielded a different result. Nonetheless, it will be interesting to see whether other circuits follow the 9th Circuit's majority opinion or Judge Fisher's dissent.

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Superior Court Judge Los Angeles County (Los Angeles)

Corporate Counsel
Mark S. Zemelman
Vice President and General Counsel for Kaiser Foundation Hospitals and Kaiser Foundation Health Plan Oakland

California Supreme Court
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The state Supreme Court has a new opportunity to address the mixed-motive defense in an employment case that has been fully briefed for more than a year, which means oral argument is likely to come this year.