10-6057
IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

In Re:
Robert William Mathews,
Debtor,

OKLAHOMA DEPARTMENT OF SECURITIES
Ex Rel. IRVING L. FAUGHT, Administrator,
Plaintiff/Appellee,

vs.

ROBERT WILLIAM MATHEWS,
Defendant/Appellant.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF OKLAHOMA
CASE NO.: CIV -09-185D
Honorable Timothy DeGiusti, District Judge

BRIEF FOR APPELLEE
OKLAHOMA DEPARTMENT OF SECURITIES

Gerri Kavanaugh (OBA #16732)
Amanda Cornmesser (OBA # 20044)
Oklahoma Department of Securities
First National Center, Suite 860
120 N. Robinson
Oklahoma City, Oklahoma 73102
(405)280-7700
(405)280-7742 facsimile
Counsel for Plaintiff/Appellee,
Oklahoma Department of Securities

Oral Argument Requested

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PRIOR OR RELATED APPEALS

A related appeal is pending before this Court. *Oklahoma Department of Securities v. Wilcox (In re Wilcox)*, Case No. 10-6056.

Plaintiff/Appellee, Oklahoma Department of Securities *ex rel.* Irving L. Faught, Administrator (Department), herein responds to *The Brief in Chief of the Appellant Robert William Mathews*. This appeal arises from an order entered by the United States District Court for the Western District of Oklahoma (District Court) affirming the summary judgment entered by the United States Bankruptcy Court for the Western District of Oklahoma (Bankruptcy Court) in favor of the Department against Defendant/Appellant Robert William Mathews (Debtor). The District Court and the Bankruptcy Court determined that the debt at issue was non-dischargeable under 11 U.S.C. § 523(a)(19).

ISSUE ON APPEAL

Whether a debt for the disgorgement of the proceeds of a securities law violation is excepted from discharge under 11 U.S.C. § 523(a)(19) when the violation of the securities laws for which the debt was incurred was committed by a person other than the debtor.

STATEMENT OF THE CASE

Between 2001 and 2004, Marsha Schubert, individually and doing business as Schubert and Associates (Schubert), operated a "Ponzi Scheme" in which she promised that funds received from participants would be invested, but instead used the funds to pay purported profits to other participants. To support the Ponzi scheme, Schubert engaged in a check kiting scheme that created a "float" between several bank accounts through which she paid purported investment returns. (Appendix at 70-71 and 83-84).

The Department sued Schubert in state court and an order was entered against Schubert for violations of the Oklahoma securities laws. (App. at 241-242 and 251-256). Schubert subsequently entered guilty pleas in both federal and state criminal cases to charges in connection with the fraudulent scheme and was convicted accordingly. (App. at 257-278 and 279–293).

In connection with the Ponzi scheme and the check kiting scheme, Schubert transferred approximately $87,000,000 to Debtor and Debtor transferred approximately $86,000,000 back to Schubert. (App. at 71-73, and 82-84). As a result, Debtor received profits of at least $524,826.19. (App. at 424-425).

The Department sued Debtor and other persons who received cash and/or other property from Schubert that were the proceeds of the Ponzi scheme (Relief Defendants) and for which the Relief Defendants gave inadequate or no consideration. (App. at 294-326). Upon the Department's motion for summary judgment, the trial court determined that Debtor had been unjustly enriched by Schubert's violations of the Oklahoma securities laws and ordered Debtor to disgorge the net proceeds of that fraud. (App. at 392-448 and 453-456).

Although Debtor did not appeal, several Relief Defendants appealed their disgorgement judgments, and in April 2007, the Oklahoma Court of Civil Appeals affirmed. (App. at 457–488). The Oklahoma Supreme Court granted certiorari and in February 2010, issued its opinion affirming that the Department has standing to seek recovery of funds transferred to innocent investors in a Ponzi scheme, but reversing and remanding to the trial court for reconsideration of the amount to be disgorged under a new standard for recovery. *Oklahoma Dept. of Sec. ex rel. Faught v. Blair*, 2010 OK 16, 231 P.3d 645, as corrected (Apr. 6, 2010), reh'g denied (Apr. 12, 2010).

After the disgorgement order was issued by the trial court, but before the Oklahoma Supreme Court ruled in *Blair*, Debtor filed for protection under the bankruptcy laws. (App. at 69 and 82). Debtor had a few other insignificant debts for which he requested a discharge, but his bankruptcy filing was intended primarily to discharge the disgorgement judgment. (Brief of Appellants at p. 8). The Department brought an adversary proceeding against Debtor objecting to the discharge of the disgorgement judgment pursuant to the exceptions to discharge enumerated in Section

523(a)(2) and (a)(19). (App. at 69-81). The Department brought a nearly identical adversary proceeding against Marvin and Pamela Wilcox (Wilcoxes). The two cases were consolidated for purposes of trial. (App. at 91-92).

The Department moved for summary judgment against Debtor and the Wilcoxes. The Department asserted that Schubert violated the securities laws of the state of Oklahoma and of the United States by her conduct of the Ponzi scheme. The Department also alleged that Debtor and the Wilcoxes violated the Oklahoma securities laws because they materially aided Schubert's violations by allowing their checking accounts to be used in the check kiting scheme and actively referring new participants to the Ponzi scheme. (App. at 93-133). Debtor admitted the factual allegation made by the Department, but denied that he had the state of mind necessary to be found liable for materially aiding the fraud. (App. at 134–177).

The Bankruptcy Court determined, however, that it was not necessary to consider Debtor and the Wilcoxes' level of involvement in the securities fraud to find that the debts are non-dischargeable under Section 523(a)(19). The Bankruptcy Court granted summary judgment in favor of the Department finding that there were sufficient undisputed facts to hold that the debts owed to the Department by Debtor and the Wilcoxes are non-dischargeable under Section 523(a)(19). (App. at 560-566 and 567-568). Debtor appealed the Bankruptcy Court Judgment, the District Court affirmed and this appeal ensued. (App. at 56–63 and 65–67).

STATEMENT OF FACTS

1. On October 14, 2004, the Department filed suit against Schubert in the District Court of Logan County, State of Oklahoma, for violations of the Oklahoma Uniform Securities Act of 2004, Okla. Stat. tit. 71, §§ 1-101 through 1-701 (Supp. 2003), and the Oklahoma Securities Act, Okla. Stat. tit. 71, §§ 1-413, 501, 701-703 (1991 & Supp. 2003). (App. at 307-313).

2. On November 15, 2004, upon the stipulation and consent of Schubert, the Logan County District Court determined that Schubert violated the Oklahoma securities laws and permanently enjoined Schubert from offering and selling securities and acting as a broker-dealer in Oklahoma, retained the previously appointed receiver for the benefit of the investors and creditors of Schubert and ordered Schubert to make restitution in an amount to be determined at the conclusion of the receivership (Logan County Order). (App. at 241-250).

3. On May 5, 2005, Schubert entered a guilty plea in the United States District Court for the Western District of Oklahoma to one count of

money laundering in connection with the securities fraud. Schubert was sentenced to 10 years in prison and ordered to pay restitution in the amount of Nine Million One Hundred Fourteen Thousand Seven Hundred Forty-Four Dollars ($9,114,744.00). *United States of America v. Marsha Kay Schubert,* CR 05-078. (App. at 257–267 and 268–278).

4. On September 9, 2005, Schubert entered a guilty plea in the District Court of Logan County, State of Oklahoma, to fourteen (14) counts of obtaining money by false pretenses in connection with the securities fraud. Schubert was sentenced to 25 years in prison and ordered to pay restitution in the amount of Nine Million One Hundred Fourteen Thousand Seven Hundred Forty-Four Dollars ($9,114,744.00). *State of Oklahoma v. Marsha Kay Schubert,* No. CF-2004-391. Marsha Schubert stated as the factual basis for her plea that she obtained money in a Ponzi scheme in which she promised that the funds would be invested but instead, used the funds to pay prior investors involved in the securities fraud. (App. at 279–289 and 290-293).

5. On May 11, 2005, the Department sued Debtor and over one hundred other Relief Defendants in the District Court of Oklahoma County (Oklahoma County Court), for disgorgement of the net profits they received from Schubert for which the Relief Defendants gave inadequate or no

consideration (Oklahoma County Petition). *Oklahoma Department of Securities v. Mathews*, CJ-2005-3796 (App. at 294–326).

6. On October 24, 2006, the Department filed a motion for summary judgment against Debtor, alleging that he had been unjustly enriched by receipt of monies from Schubert in the Ponzi scheme (Oklahoma County Motion for Summary Judgment). The Oklahoma County Motion for Summary Judgment did not address Debtor's personal activity in connection with the check kiting scheme that was used to support the Ponzi scheme. (App. at 392-452).

7. In December 2006, the Oklahoma County Court determined that Debtor had been unjustly enriched by Schubert's violations of the Oklahoma securities laws and ordered Debtor to disgorge the net proceeds of that fraud in the amount of Five Hundred Twenty-Four Thousand Eight Hundred Twenty-Six Dollars and Nineteen Cents ($524,826.19) (Oklahoma County Judgment). (App. at 453-456).

8. Though Debtor did not join in the appeal, several Relief Defendants appealed the disgorgement orders entered against them and the Oklahoma Court of Civil Appeals affirmed those orders on April 13, 2007. (App. at 457-488).

9. The Oklahoma Supreme Court granted certiorari, and on February 23, 2010, issued its opinion determining that the Department has standing to seek recovery of Ponzi scheme funds, but reversing and remanding the disgorgement orders to the Oklahoma County Court for reconsideration of the amount to be disgorged under a new standard for recovery of funds in Ponzi scheme cases. *Oklahoma Dept. of Sec. ex rel. Faught v. Blair*, 2010 OK 16, 231 P.3d 645, as corrected (Apr. 6, 2010), reh'g denied (Apr. 12, 2010).

10. On January 18, 2007, while the appeal of the disgorgement orders was pending, Debtor filed for bankruptcy protection. *In re Mathews*, United States Bankruptcy Court for the Western District of Oklahoma, Ch. 7 Case No. BK 07-10108 BH. (App. at 69 and 82). Debtor filed his bankruptcy petition because of the Oklahoma County Judgment. (Appellant's Brief at 8).

11. On July 16, 2007, the Department filed an adversary proceeding against Debtor objecting to his discharge of the Oklahoma County Judgment on the basis of Section 523(a)(2) and (a)(19). *Oklahoma Department of Securities v. Mathews,* United States Bankruptcy Court for the Western District of Oklahoma, Case No. 07-01140 BH. (App. at 69-81).

12. On May 30, 2008, the Department filed its motion for summary

judgment in the adversary proceeding, seeking to deny the Debtor's discharge of the Oklahoma County Judgment. In its motion for summary judgment, the Department argued that the Oklahoma County Judgment should be non-dischargeable under Section 523(a)(2) because Debtor materially aided the Ponzi scheme through his participation in the check kiting scheme that kept the Ponzi scheme afloat. The Department also argued that the Oklahoma County Judgment should be non-dischargeable under Section 523(a)(19) based on the securities law violation evidenced by the Logan County Judgment against Schubert, Schubert's criminal convictions and the Oklahoma County Judgment. (App. at 93-133).

13. Debtor admitted the factual allegation made by the Department, but denied that he had the state of mind necessary to be found liable for materially aiding the fraud. (App. at 134-177).

14. On December 12, 2008, the Bankruptcy Court granted summary judgment in favor of the Department and against the Debtor, finding that there were sufficient undisputed facts to hold that the debt owed to the Department by Debtor embodied by the Oklahoma County Judgment was non-dischargeable in bankruptcy under Section 523(a)(19) (Bankruptcy Court Judgment). The Bankruptcy Court Judgment did not address the Department's argument under Section 523(a)(2). (App. at 560-566 and 567-

568).

15. Debtor appealed the Bankruptcy Court Judgment and on February 10, 2010, the United States District Court for the Western District of Oklahoma affirmed the Bankruptcy Court Judgment. (App. at 56–63 and 64).

SUMMARY OF ARGUMENT

The Oklahoma County Judgment is for a violation of state securities laws and is, therefore, non-dischargeable under Section 523(a)(19). The plain language of Section 523(a)(19), which excepts from discharge "any debt that is for the violation of … any of the state securities laws" does not require that the violation of the securities laws be committed by the debtor. For purposes of disgorgement, there is no meaningful difference between the wrongdoer and a third party recipient of ill-gotten funds where the recipient gave no value for the funds. Allowing the recipient to discharge such a debt in bankruptcy in essence benefits the wrongdoer and allows the wrongdoer to insulate the funds from recovery. Denying discharge to a third party recipient of ill-gotten funds will deter future securities law violations.

ARGUMENT

I. The plain language of Section 523(a)(19) does not require that the violation of the securities laws be committed by the debtor.

A. Section 523(a)(19)

While the Bankruptcy Code generally favors the interests of the debtor in obtaining a "fresh start," Congress has recognized that there are times when that interest is trumped by the competing interest in protecting the victims of fraud. *Grogan v. Garner*, 498 U.S. 279, 287 (1991). Section 523(a)(19) of the Bankruptcy Code establishes such an exception. Section 523(a)(19) provides, in pertinent part, for the non-dischargeability of 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 of 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; or

> (iii) any court or administrative order for damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

Courts have noted that the plain language of Section 523(a)(19) indicates that its coverage is broad. *In re Civiello*, 348 B.R. 459 (Bankr.N.D.Ohio 2006). The legislative history behind Section 523(a)(19) provides that the purpose of this exception is to protect investors and hold accountable those who violate securities laws. *Id.* at 463. The plain language of Section 523(a)(19)(A)(i) does not require that the violation of the securities laws be committed, directly or indirectly, by the debtor.

B. Relevant caselaw

At least two courts, besides the District Court in the case at bar, have recently considered the application of Section 523(a)(19) to non-violator recipients of Ponzi scheme funds and determined that it is not necessary for the debtor to be the violator to deny discharge of the debt. *Securities and Exchange Commission v. Sherman (In re Sherman),* 406 B.R. 883 (C.D. Cal 2009), *appeal docketed*, No. 09-55880 (9th Cir. June 10, 2009); *Crawford v. Myers (In re Myers)*, Case No. 09-1211 SBB (Bankr. D. Colo., July 20, 2009)[1].

[1] *Myers*, an unpublished opinion, is included as an addendum to the Department's brief.

In *Sherman,* the court found that allowing the non-violator debtor to discharge the debt would frustrate the enforcement of the securities laws. *Sherman* at 887. The court analogized the position of a non-violator debtor with that of a constructive trustee of funds who, though not holding the funds wrongfully, must return them when ordered and may not avoid that obligation in bankruptcy. *Id.*

In *Myers*, a court-appointed receiver sought to have a debt arising from a Ponzi scheme excepted from the discharge of a non-violator debtor and the debtor moved to dismiss. *Myers* at 2. That court conducted a lengthy review of the legislative history of Section 523(a)(19) and concluded that, along with the plain language of the statute, Section 523(a)(19) was broad enough to include debts arising from securities fraud violations committed by third parties. *Id.* at 4-7. The *Myers* court further concluded that it would be inappropriate to limit Congress' language. *Id.* at 7.

C. Congressional intent

As Debtor has pointed out, Congress, when enacting legislation, is presumed to have knowledge of how it has previously used particular terms and how those terms will affect new provisions of the law. *Lorillard v. Pons*, 434 U.S. 575, 581 (1978). Throughout Section 523(a), Congress refers to actions "by the debtor" where it intends to ensure that only the debtor's personal conduct can result in a debt being excepted from discharge. For instance, Congress created an exception to discharge in Section 523(a)(6) "for willful and malicious injury **by the debtor**"; in Section 523(a)(9) "for death or personal injury caused **by the debtor's** operation of a motor vehicle" while intoxicated; in Section 523(a)(12) "for malicious or reckless failure to fulfill any commitment **by the debtor** to a Federal depository institution's regulatory agency"; and in Section 523(a)(15) for certain domestic obligations "incurred **by the debtor** in the course of a divorce or separation".

Even within Section 523(a)(19) Congress twice uses "by the debtor" to effectively distinguish between judgments entered in judicial proceedings from settlement agreements and other types of payments owed by the debtor. In Section 523(a)(19)(B)(ii), a settlement agreement must be "entered into **by the debtor**" to trigger the exception from discharge. In Section 523(a)(19)(B)(iii), Congress excepts from discharge court ordered payments, including restitutionary and disgorgement payments, "owed by the debtor." However, the plain language of Section 523(a)(19)(B)(i) does not require that the debt at issue result from a judgment or order against the debtor.

Further, the Section 523(a)(19)(B)(iii) exception for court and administrative ordered payments owed by debtors would, but for the added "by the debtor", seem to have been covered by the Section 523(a)(19)(B)(i) exception for judicial or administrative orders. The otherwise apparent duplication of the two sections gives even greater significance to Congress' use of "by the debtor" limiting language in Section 523(a)(19)(B)(iii). First, it would follow that Congress did not intend for the Section 523(a)(19)(B)(i) exception to require an order directly against the debtor. Second, it suggests Congress' intent that the order be issued against the debtor for purposes of Section 523(a)(19)(B)(iii). Third, Congress easily could have limited the Section 523(a)(19)(B)(iii) exception to court and administrative payments "owed by the violator" rather than "owed by the debtor". As clearly stated on the face of the document itself, the Oklahoma County Judgment is a court ordered disgorgement payment owed by the Debtor. (App. at 453-456).

While Congress twice used "by the debtor" in Section 523(a)(19)(B), Congress did not use it at all in Section 523(a)(19)(A). Had Congress meant that the violation of securities laws must be committed by the debtor, Congress would have used such limiting language.

D. Cases cited by Debtor are irrelevant

Debtor cites several cases for his proposition that there is a consensus by the courts that the violation of securities laws for which the debt accrued must have been committed by the debtor. Clearly, in light of the *Sherman* and *Myers* cases cited above, there is no such consensus, since both of those courts found that Section 523(a)(19) applied to non-violator relief defendants who had been unjustly enriched by receipt of money from a violator. *Sherman* at 887; *Myers* at 7.

Unlike *Sherman* and *Myers*, none of the cases cited by Debtors are directly on point. In each of the cases cited by Debtors, it was the debtor who was alleged to have violated the securities laws. *e.g. Peterman v. Whitcomb (In re Whitcomb)*, 303 B.R. 806 (Bankr. N.D. Ill. 2004) (debt owed by debtor wrongdoer nondischargeable); *Barnes v. Dupree (In re Dupree)*, 336 B.R. 520 (Bankr. M.D. Fla. 2005)(arbitration award issued against debtor wrongdoer nondischargeable though not yet reduced to judgment); *MCI Worldcom Network Services, Inc. v. Graphnet, Inc.*, CIV. 00-5255 (WHW), 2005 WL 1116163 (D.N.J. May 11, 2005) (settlement agreement supporting the debt was based on a contract dispute, not on a violation of the securities laws); *Shaefer v. Demar (In re Demar)*, 373 B.R. 232 (E.D.N.Y. 2007)(creditor alleged debtor was wrongdoer, but was unable to prove that settlement agreement supporting the debt was based on a violation of the securities laws).

In these cases, it would be natural for the courts to speak in terms of the debtor being the wrongdoer. Obviously, Congress meant for Section

523(a)(19) to apply to the wrongdoer. The fact that the courts in the cases cited by Debtor apply Section 523(a)(19) to debts of alleged wrongdoers does not mean that Section 523(a)(19) covers only debts of wrongdoers or that the plain language of the statute should be construed in such a limiting manner.

E. Conclusion

The Department maintains that the debt in question directly results from violations of the securities laws. The Logan County Order and Schubert's guilty plea and convictions satisfy the Section 523(a)(19)(A) requirement that the debt at issue be for violations of securities laws. The debt at issue results directly from the Logan County Order against Schubert for violations of the Oklahoma securities laws and therefore satisfies Section 523(a)(19)(B)(i). Further, the Oklahoma County Judgment is for court ordered disgorgement of proceeds generated by the securities violations committed by Schubert, but owed by Debtor which also satisfies Section 523(a)(19)(B)(iii).

II. Non-violators who receive the proceeds of illegal conduct should be required to disgorge the ill-gotten gains the same as the violator.

A. The *Blair* decision

On February 23, 2010, the Oklahoma Supreme Court issued its opinion determining that the Department has standing to seek recovery of Ponzi scheme funds, but reversing and remanding the disgorgement orders to the Oklahoma County Court for reconsideration of the amount of liability under a new standard for recovery of funds in Ponzi scheme cases. *Oklahoma Department of Securities v. Blair*, 231 P.3d 645 (2010). The Oklahoma Supreme Court recognized in *Blair* that the money the Department was attempting to recover from the Relief Defendants was for violations of the Oklahoma securities laws by Schubert. *Blair* at 649 - 651.

The Oklahoma Supreme Court determined that "equitable recovery against an innocent investor must be based upon that investor's receipt of an unreasonably high dividend on his or her investment." *Blair* at 669. The Court also stated that "innocent investors ignorant of the Ponzi scheme may not hide behind their ignorance when unreasonably high dividends are paid to them and then claim that their high dividends are insulated from equity." *Id.*

As set forth in great detail in the Department's motion for summary judgment filed in the Bankruptcy Court, the Department alleges that Debtor materially aided the securities fraud. (App. at 93-133). Even if the Oklahoma Supreme Court's new standard were applied to Debtor, he would still clearly owe the amount by which he was unjustly enriched because 1) he was not an innocent investor by virtue of his perpetuation of the fraud and 2) he received unreasonably high dividends that put him on notice that the Schubert investment program was not legitimate.

B. Disgorgement deters securities violations

The Bankruptcy Court Judgment and the District Court's order affirming it were issued during the course of the Relief Defendants' appeal of the disgorgement judgments. The Bankruptcy Court and the District Court relied on the opinion issued by the Oklahoma Court of Civil Appeals. (App. at 56-63, 457-488 and 560-566). Debtor has suggested that because the Oklahoma Court of Civil Appeals decision was vacated, the District Court and Bankruptcy Court erred in their judgments.

However, the District Court's order affirming the Bankruptcy Court Judgment is consistent with the *Blair* decision. Although the *Blair* decision places some limitations on recovery[2], it affirms an established principle in securities law that disgorgement of ill-gotten gains of a securities fraud can

[2] The Department firmly believes that even if Debtor had been a party to the appeal filed by some of the Relief Defendants, the limitations would not apply to this Debtor because he was not an innocent investor and he received an unreasonably high "return".

be extended to a non-violator to effect full relief under the securities laws. See *Securities and Exchange Commission v. Colello*, 139 F.3d 674 (1998); *Securities and Exchange Commission v. Egan*, 856 F.Supp 401 (N.D. Ill. 1993); *Securities and Exchange Commission v. Cherif*, 933 F.2d 403, 414 n. 11 (7th Cir. 1991). In *Egan*, the court found no meaningful difference between wrongdoers and a third party for purposes of disgorgement:

> "the deterrence purpose is not dependent on that status—for it is just as important to discourage illegal conduct by taking the proceeds of that illegality from those who have given no current value for the ill-gotten gains that have been turned over to them (even though they themselves have not directly engaged in the illegal activity)."

Egan at 401, fn 3.

Cases addressing the automatic stay provision under the Bankruptcy Code provide further support to this argument. *In re D'Angelo,* 409 B.R. 296, 298 (Bankr. D. N.J. 2009); *Securities and Exchange Commission v. Smith* 2005 WL 2875546 (S.D. Ohio 2005). The *In re D'Angelo* court held:

> "(t)he fact that this debtor is not a wrongdoer, but allegedly the recipient of financial benefit from the fraud, does not alter the analysis that a disgorgement remedy fosters the public purpose behind the state's securities laws".

Id. at 298. The *In re D'Angelo* court excepted from the automatic stay an action by a state securities regulator seeking disgorgement from an innocent recipient of securities fraud proceeds. *Id.* at 296 – 297.

C. Conclusion

The *Sherman* court did not believe that Congress intended for a violator to be able to insulate the proceeds of a securities violation from disgorgement by transferring the proceeds to another person. *Sherman* at 887, fn 2. If the violator had retained the proceeds and then filed for bankruptcy, any debt in connection with that violation would clearly be non-dischargeable. However, violators, in an attempt to hide assets or reward someone who aids their scheme, often transfer their ill-gotten gains to a family member, a favored friend or a close business associate. Although the recipient may truly not know that he has received the fruits of a fraud, allowing that person to keep the ill-gotten gains would in essence benefit the violator and encourage potential violators to direct their ill-gotten gains in such ways as to avoid recovery.

Debtor has received funds that are directly the fruits of Schubert's securities law violations and in equity and good conscience ought not be allowed to retain them. Refusing Debtor's discharge of this debt will deter violations of the securities laws.

III. The culpability of the Debtor is not material to the issue before the Court.

Debtor points to only one fact that he claims is still at issue thereby making summary judgment inappropriate. Debtor claims that there is an unresolved question of fact as to whether he personally violated any securities laws[3]. The Bankruptcy Court determined, however, that it was not necessary to consider Debtor and the Wilcoxes' level of involvement in the securities fraud to find that the debts are non-dischargeable under Section 523(a)(19). (App. at 560-566).

As recognized by the District Court and the Bankruptcy Court, Schubert's securities law violation triggered the Section 523(a)(19) exception, the Oklahoma County Judgment was for Schubert's violations of the securities laws, and, in equity and good conscience, Debtor should not be allowed to retain the ill-gotten funds resulting from the Ponzi scheme. Therefore, the Debtor's intentions are not material to a determination of the question of law at issue.

CONCLUSION

The Department respectfully requests that this Court find that the debt owed by Debtor is non-dischargeable under 11 U.S.C. § 523(a)(19).

[3] The Department maintains that Debtor personally violated Oklahoma's securities laws, but acknowledges that as of yet, no finding has been made that he did.

ORAL ARGUMENT

The Department requests oral argument because this is an issue of first impression in this Circuit and is under consideration in the Ninth Circuit Court of Appeals in the *Sherman* case.

Submitted by:

s/ Gerri Kavanaugh

Gerri Kavanaugh, OBA #16732
Amanda Cornmesser, OBA # 20044
Oklahoma Department of Securities
First National Center, Suite 860
120 N. Robinson
Oklahoma City, Oklahoma 73102
(405)280-7700
(405)280-7742 facsimile
Counsel for Plaintiff/Appellee,
Oklahoma Department of Securities

CERTIFICATE OF SERVICE

I hereby certify that on the 26th of July, 2010, I electronically transmitted the foregoing document to the Clerk of Court using the ECF System. Based on the records currently on file, the Clerk of Court will transmit a Notice of Electronic Filing to the following ECF registrants:

Robert N. Sheets
Robert J. Haupt
Phillips Murrah P.C.
Corporate Tower
101 N. Robinson, Thirteenth Floor
Oklahoma City, OK 73102
Attorneys for Defendants/Appellants

I further certify that on the 26th of July, 2010, seven true and correct copies of the foregoing Brief of Appellee were dispatched to the U.S. Postal Service for delivery within 2 business days to:

Ms. Elisabeth A. Shumaker
Clerk of the Court
United States Court of Appeals for the Tenth Circuit
Byron White United States Courthouse
1823 Stout Street
Denver, Colorado 80257

Certifications Under ECF Procedures

The undersigned certifies, pursuant to the Court's ECF procedures adopted in General Order 95-01 as follows:

1. All required privacy redactions have been made;
2. The hard copy of the foregoing document submitted to the Clerk of Court is an exact copy of the ECF submission;
3. The ECF submission of this document was scanned for viruses with the most recent version of a commercial virus scanning program (the Symantec Enterprise edition of Norton Antivirus, updated daily) and, according to the program, is free of viruses.

s/ Gerri Kavanaugh

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF COLORADO
The Honorable Judge Sidney Brooks

In re: DENNIS GENE MYERS and DONNA GAYLE MYERS Debtor	)	No. 09-11622 SBB Chapter 7
KELLY M. CRAWFORD, as the RECEIVER FOR GEORGE D. HUDGINS, individually and d/b/a GEORGE D. HUDGINS, LLC., and d/b/a 3737 FINANCIAL PARTNERS Plaintiff, vs. DENNIS GENE MYERS and DONNA GAYLE MYERS Defendant.	)	Adversary Proceeding No: 09-1211 SBB)

ORDER ON MOTION TO DISMISS COMPLAINT

THIS MATTER comes before the Court for consideration of the Motion to Dismiss Complaint for Failure to State a Claim Upon Which Relief Can Be Granted filed by Dennis Myers and Donna Myers ("Defendants") on May 13, 2009 (Docket #4), and the Response thereto filed by Kelly M. Crawford as Receiver ("Plaintiff") on June 1, 2009 (Docket #7).

I. BACKGROUND FACTS

The facts of this case are not in dispute. On February 4, 2009, Defendants filed in this Court for bankruptcy protection under Chapter 7 of the Bankruptcy Code. On April 2, 2009, the U.S. District Court for the Eastern District of Texas issued an order arising in a case against George Hudgins ("Mr. Hudgins") requiring restitution to investors in a Ponzi scheme perpetrated by Mr. Hudgins in the amount of $70,864,679.00 (Docket #1, ¶13). Pursuant to the Consent

Order of Preliminary Injunction and Other Equitable Relief in the Eastern District of Texas, Tyler Division, it appointed as "Receiver" Mr. Kelly Crawford, who is also the Plaintiff in this case, and authorized him to institute necessary proceedings to recover proceeds for collection of Receivership Assets from the aforementioned Ponzi scheme. (Docket #1, ¶6). Any money recovered is to be credited against the judgment owed by Mr. Hudgins and is for the benefit of investors who lost money in the scheme (Docket #7 at 2).

The Defendants were among a number of investors who innocently placed funds in Hudgins' Ponzi scheme and received false profits from the scheme over and above their investments. The Defendants specifically profited by an amount of $302,704.00. The moneys the Receiver are attempting to retrieve include these profits.

On April 10, 2009, the Plaintiff commenced this Adversary Proceeding (Docket #1). The Plaintiff asks this Court to find that the profits received by the Defendants through the Ponzi scheme be deemed non-dischargeable pursuant to 11 U.S.C. §523(a)(19).[1] The Plaintiff's Complaint does not allege securities fraud violations by the Defendants, but rather grounds its Complaint on securities fraud violations of a third party, specifically Mr. Hudgins (Docket #1). The Defendants maintain that §523(a)(19) requires the underlying securities violation be committed by a debtor. The Defendants state that due to the Complaint basing its §523(a)(19) exception on Mr. Hudgins' securities violations it fails to state a claim upon which relief can be granted and therefore should be dismissed (Docket # 4).

II. STANDARD OF REVIEW

The purpose of a motion to dismiss under Fed. R. Civ. P. 12(b)(6) is to test the legal sufficiency of the complaint assuming all the factual allegations in the complaint are true. *Mobley v. McCormick*, 40 F.3d. 337, 340 (10th Cir. 1994). In making this determination, the court must determine whether the complaint contains enough facts to state a claim for relief that is plausible on its face. *Bell Atlantic Corp. v. Twombly,* 550 U.S. 544, 547 (2007); *Robbins v. Oklahoma,* 519 F.3d 1242, 1247 (10th Cir.2008) (requiring sufficient factual specificity in support of claims, which, if assumed to be true, demonstrate that the plaintiff has "plausibly (not just speculatively) stated a claim for relief."). Rule 12(b)(6) does not require detailed factual allegations, but the complaint must set forth grounds of the plaintiff's entitlement to relief through more than labels, conclusions or a formulaic recitation of the elements for a cause of action. *Twombly,* 550 U.S. at 555.

In other words, the plaintiff must allege facts sufficient to state a claim which is plausible - rather than merely conceivable - on its face. *See id.* at 570. The court must still accept the facts alleged in the complaint as true, even if they are doubtful, *id.* at 555-556, and it must make all reasonable inferences in favor of the plaintiff. *Tal v. Hogan*, 453 F.3d 1244, 1252 (10th Cir.2006). But the factual allegations, viewed in this light, " must be enough to raise a right to

[1]All section references will be to Title 11 of the United States Code unless stated otherwise.

relief above the speculative level." *Twombly*, 550 U.S. at 545. The mere metaphysical possibility that some plaintiff could prove some set of facts in support of the pleaded claims is insufficient; the complaint must give the court reason to believe that this plaintiff has a reasonable likelihood of mustering factual support for these claims." *Ridge at Red Hawk, L.L.C. v. Schneider*, 493 F.3d 1174, 1177 (10th Cir. 2007).

III. DISCUSSION

A. Fed. R. Civ. P. 9(b) Specificity Requirements

The Defendants assert that the Plaintiff failed to meet the specificity requirements when pleading "fraud" under Fed.R.Civ.P. 9(b) (Docket # 4,¶14).[2] Federal Rule of Civil Procedure 9(b) provides: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other conditions of mind of a person may be averred generally."

Following the "straightforward language" of Rule 9(b), the Tenth Circuit has held that "Rule 9(b) requires only the identification of the circumstances constituting fraud, and that it does not require any particularity in connection with an averment of intent, knowledge or condition of mind." *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1252 (10th Cir.1997) (*citing Seattle-First Nat'l Bank v. Carlstedt*, 800 F.2d 1008, 1011 (10th Cir.1986)).

Simply stated, Rule 9(b) requires plaintiff to set forth "the time, place and contents of the false representation, the identity of the party making the false statements and the consequences thereof." *Schwartz*, 124 F.3d at 1252 (citations omitted). *See also Nal II, Ltd. v. Tonkin*, 705 F.Supp. 522, 525-26 (D.Kan.1989) (Rule 9(b) requires plaintiff to set forth "who, what, where, and when" of alleged fraud); *Smith v. MCI Telecomms. Corp.*, 678 F.Supp. 823, 825 (D. Kan.1987) (fraud claim must describe time, place and content of false representation; identity of person making representation; and what was obtained or given thereby). The Court must read the requirements of Rule 9(b) in conjunction with Rule 8, which calls for pleadings to be "simple, concise, and direct, ... and to be construed as to do substantial justice." *See Schwartz*, 124 F.3d at 1252; *see also Seattle-First*, 800 F.2d at 1011; *Cayman Exploration Corp. v. United Gas Pipe Line Co.*, 873 F.2d 1357, 1362 (10th Cir. 1989) (Rule 9(b) must be read in harmony with simplified notice pleading provisions of Rule 8).

The purpose of Rule 9(b) is "to afford defendant fair notice of plaintiff's claims and the factual ground upon which [they] are based . . . ." *Schwartz*, 124 F.3d at 1252 (*citing Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 987 (10th Cir.1992); *Ross v. Bolton*, 904 F.2d 819, 823 (2d Cir.1990)); *see also VNA Plus, Inc. v. Apria Healthcare Group, Inc.*, 29 F.Supp.2d 1253, 1258 (D. Kan.1998); *N.L. Indus., Inc. v. Gulf & Western Indus., Inc.*, 650 F.Supp. 1115,

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[2]The Defendants' Motion does not thoroughly articulate the grounds upon which it asserts the complaint is deficient under Rule 9(b); regardless the Court will broadly address a Rule 9(b) specificity argument.

1129-30 (D. Kan.1986) (purpose of Rule 9(b) to enable defending party to prepare effective response to charges of fraud and to protect defending party from unfounded charges of wrongdoing which might injure its reputation and goodwill).

Notwithstanding the Plaintiff's arguments concerning the applicability of Fed.R.Civ.P. 9 to this case, the Court finds that the facts alleged within the Complaint are pled with sufficient specificity to fully afford the Defendants fair notice of the factual grounds upon which the Plaintiff's claim is based and satisfy Fed.R.Civ.P. 9 (Docket # 7 at 2-3).

A. Title 11 U.S.C. §523(a)(19)

Title 11 U.S.C. provides that:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title dos not discharge an individual debtor from any debt – (19) that –
- (A) is for –
  - (i) the violation of any of the Federal securities laws, any of the State securities law…; 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; 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.[3]

"Essentially, this statute precludes dischargeability if two conditions are met. First, the Plaintiffs must establish that the debt is for violation of securities laws or for fraud in connection with the purchase or sale of a security (the "Subsection A requirement"). In addition, the debt must be memorialized in a judicial or administrative order or settlement agreement (the "Subsection B requirement"). If Plaintiffs cannot establish both requirements, their claim will fail." *In re Jafari,* 401 B.R. 494, 496 (Bankr.D.Colo. 2009); *see also In re Buzzeo,* 365 B.R. 578, 582 (Bankr.W.D.Pa. 2007).

The Defendants assert that neither of these requirements are met (Docket #4, ¶12). The Defendants accurately note that the Plaintiff must overcome a presumption that all debts are dischargeable unless specifically excepted by the Bankruptcy Code. *Brown v. Felson,* 442 U.S. 127, 128 (1979). Also, the Defendants add that it is well established that exceptions to discharge are construed strictly against creditors and liberally in favor of honest debtors. *In re Portner* 109B.R. 977 (Bankr.D.Colo. 1989).

Taking the facts claimed as true, there is a debt against Defendants arising from Hudgins

[3] 11 U.S.C. § 523(a)(19)

violations of securities laws in connection with the purchase or sale of a security and memorialized in a judicial or administrative order or settlement.[4] However, the Defendants argue that §523(a)(19) is not applicable where the underlying securities fraud violations are from a third party (Docket #4, ¶15). The Plaintiff asserts that the statutory language of §523(a)(19) only requires that a judgment exist and that the debt of the judgment be for securities fraud, which he maintains the claim contains. Consequently, the parties dispute over dischargeability under §523(a)(19) largely hinges on whether the statute subjects debts arising from securities fraud violations committed by third parties or must the debtor be the perpetrator of the fraud violation.

1. Subsection (A) Requirement

"Subsection (A)" requires that for nondischargeability the 'debt'[5] must be for a "violation of any of the Federal securities laws, any of the State securities law . . . ." A clear reading of the statutory language does not require that the "violation" be one of the debtor, but neither does it provide that the "violation" under the statute include those of third parties. Subsection A only requires that the debt be for any violation of Federal or State securities fraud or common law fraud. Section 523(a)(19) is a relatively new addition to the bankruptcy code since it became law in 2002. There are no judicial opinions addressing this issue or directly supporting a resolution for either interpretation. Therefore, to undertake an analysis of the proper interpretation this Court will review the legislative history of the section and other courts' interpretation of §523(a)(19)'s language.

Section 523(a)(19) was added to the list of nondischargeable debts as a part of the Sarbanes-Oxley Act in 2002. Title VII of Sarbanes-Oxley was entitled "The Corporate and Criminal Fraud Accountability Act of 2002," ("Accountability Act") and was authored by Senator Patrick Leahy. The purpose of the Accountability Act was "[t]o disallow debts incurred in violation of securities fraud law from being discharged in bankruptcy . . . . " *Gibbons v. Smith (In re Gibbons),* 289 B.R. 558, 591(quoting from the S.Rep. NO.107-146, at 2 (2002)).

Section 523(a)(19) was added to "[a]mend the Bankruptcy Code to make judgments and settlements based upon securities law violations' non-dischargeability, protecting victims' ability to recover their losses." *Id.* at 592 (quoting 148 Cong. Rec. S1787 (daily ed. March 12, 2002)

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[4]At this juncture the Defendants do not argue that the order in connection with Mr. Hudgins case fails to qualify as a violation of a security law memorialized by a Court order pursuant to §523(a)(19).

[5] Title 11 U.S.C. §101 (12) states "[t]he term 'debt' means liability on a claim." Title 11 U.S.C. §101(5) states that "[t]he term 'claim' means-- (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured." The Defendants' Motion does not dispute the funds sought for retrieval by the Receiver meeting the definition of "debt."

(statement of Senator Leahy));*see also* S.Rep. No. 107-146 (2002). The Senate Committee Report noted that at the time of its consideration the existing law allowed "wrongdoers to discharge their obligations under court judgment or settlements based on securities fraud and other securities violations . . . ." The Committee Report reasoned that "[t]his loophole in the law should be closed to help defrauded investors recoup their losses and to hold accountable those who violate securities law after . . . [a] suit results in a judgment or settlement against the wrongdoer." S.Rep. No. 107-146 (2002).

Moreover, in Senator Leahy's section by section analysis of the bill he stated: "This provision [523(a)(19)] is meant to prevent wrongdoers from using the bankruptcy laws as a shield and to allow defrauded investors to recover as much as possible. *To the maximum extent possible, this provision should be applied to existing bankruptcies*." The provisions *apply to all judgments and settlements arising from state and federal securities laws violations* entered in the future regardless of when the case was filed. 148 CONG. REC. S7418 (daily ed. July 26, 2002)(statement of Senator Leahy)(italics added).

In reviewing §523(a)(19)'s legislative history two objectives of the legislation clearly emanate: (1) to hold wrongdoers of security fraud accountable for their debts and actions, and (2) to recover as much as possible for defrauded investors. The Defendants' before the Court do not qualify under the former objective, but clearly satisfy the latter. The legislative history's intention of §523(a)(19) is that it be applied broadly in bankruptcy cases to all judgments and settlements. *Gibbons,* 289 at 593 ("The legislative history . . . demonstrates an intention to apply §523(a)(1) as broadly as possible in pending bankruptcy cases."); *see also In re Civiello*, 348 B.R. 459, 464 (Bankr.N.D. Ohio 2006)(noting that a broad interpretation of this section is also supported by Congress's later amendment of §523(a)(19) contained in the Bankruptcy Protection Abuse Prevention and Consumer Protection Act of 2005, wherein it broadened the time frame from which a debt from the violations may arise, adding the language "before, on or after the date on which the petition was filed." 11 U.S.C. 523(a)(19)(B)")).

A broad reading of the statute corresponds with the objectives elicited by Congress and support a third party's violations of securities fraud meeting the statutory requirement of a "violation" within Subsection (A). Moreover, to add limiting language that would only apply to the debtor's violations is something Congress apparently chose not to do and this Court should not extend its interpretation beyond the plain meaning conveyed from the statute. *See Union Bank v. Wolas*, 502 U.S. 151, 158 (1991). (Congress' failure to foresee "all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning," and request to add limiting language to a statute implies an "exceptionally heavy" burden.).

Viewing the Defendant's claims as true, the Subsection A component of the statute may be satisfied from the Plaintiff's Complaint.

2. Subsection (B) Requirement

Subsection B requires the debt arise from a judicial or administrative order or settlement agreement. The Defendants make a similar argument with regard to Subsection B, wherein they claim that the order must be against the debtor. Looking at the statute on its face the language of §523(a)(19)(B) is broken into three separate subparts. Subpart (i) simply states the debt may arise from "any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding." The following two subparts require (ii) the debt arise from a "settlement agreement entered into *by the debtor*" or (iii) that the debt arise from "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.*" Consequently, both parts (ii) and (iii) possess the qualifiers "by the debtor." (Italics added). The language "by the debtor" is noticeably absent from part (i) concerning judgments and orders.

From the statutory language and our earlier finding of Congress's intent that this legislation be interpreted broadly, this Court finds that Congress intended to include within §523(a)(19) those judgments against third parties where a debtor's interest in property is implicated. Thus the Defendants' obligation to the Receiver, and indeed their obligation to Mr. Hudgins' defrauded investors through the Receiver, results from the judgment adjudicating Hudgins' liability for his securities fraud. *See e.g., In re Civello*, 348 B.R. 459, 466 (Bankr. N.D. Ohio 2006) (finding that cease and desist order lacking any benefit to victims of securities fraud nonetheless qualified as "judgment" under 11 U.S.C. 523 (a)(19)).

Viewing the Defendant's claims as true, the Subsection B component of the statute may be satisfied from the Plaintiff's Complaint.

IV. CONCLUSION AND ORDER

Assuming all factual allegations of the Plaintiff's Complaint are true the Plaintiff may succeed in his §523(a)(19) action. Consequently, it is improper for this Court to grant the Defendant's Motion to Dismiss.

IT IS THEREFORE ORDERED that the Defendant's Motion to Dismiss (Docket #4) is DENIED. Defendants shall file their Answer to the Complaint on or before **August 3, 2009**.

Dated this 20th day of July, 2009.

BY THE COURT:

Sid Brooks

Sidney B. Brooks,
United States Bankruptcy Judge