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Code to Code

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Unharnessing the Governmental-Unit Stay Exception: *SEC v. Miller*



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The Second Circuit's recent decision in *SEC v. Miller*¹ provides a timely opportunity to review the governmental-unit exception (hereafter, the "government exception") to the automatic stay provision under § 362(a) of the Bankruptcy Code. Under the government exception, the automatic-stay provisions contained in § 362(a)(1), (2), (3) and (6) do not prohibit the government from commencing, continuing or enforcing actions against the debtor or property of the debtor's estate despite the filing of a bankruptcy petition.

However, the government exception is not without its limits, as the government — like other creditors — is not permitted under the government exception to take action seeking to enforce a money judgment against the debtor. As described in greater detail below, the policy for this government exception carve-out is this: Although the government should be permitted to regulate and enforce the law, when it acts simply as a creditor it should not be permitted to leap-frog ahead of other creditors under the Bankruptcy Code's distribution scheme. The question before the *Miller* court was whether an order issued by the Securities and Exchange Commission (SEC) constituted the enforcement of its regulatory powers, or was instead an effort to secure a money judgment.

This article provides a brief overview of the government exception, as well as the money-judgment exception to the government exception. Next, the article provides a primer of the three-factor test set forth by the Second Circuit in *SEC v. Brennan*,² the predecessor to *Miller*. The article also examines the *Miller* decision and concludes with an analysis of the decision, highlighting the main takeaways for practitioners.

A Primer on Government Exception

Any analysis of the government exception must begin with a quick trip down a well-worn path: § 362(a) of the Bankruptcy Code. The automatic stay is triggered by the filing of the bankruptcy petition and halts practically all proceedings or collection efforts against the debtor or property of the debtor's estate. This includes "the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case" and "any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate."³ The underlying purpose of the automatic stay is threefold: (1) provide temporary, but immediate, relief to the debtor; (2) prevent the dissipation of the debtor's assets before distribution to creditors; and (3) centralize all disputes concerning the debtor's property within the bankruptcy court.⁴ Despite the bankruptcy stay's seemingly universal application, § 362(b) establishes several exceptions, including the government exception, which provides that the filing of a bankruptcy petition

does not operate as a stay ... under paragraph (1), (2), (3) [or] (6) ... of subsection (a) of this section, of the commencement or continuation of an action or proceeding by a governmental unit ... to enforce such governmental unit's ... police and regulatory power, including the enforcement of a judgment other than a money judgment, obtained in an action or proceeding by the governmental unit to enforce such governmental unit's ... police or regulatory power.⁵

1 808 F.3d 623 (2d Cir. 2015).

2 *SEC v. Brennan*, 230 F.3d 65 (2d Cir. 2000).

3 11 U.S.C. § 362 (a)(2) and (3).

4 *Penn Terra Ltd. v. Dep't of Envtl. Res.*, 733 F.2d 267, 271 (3d Cir. 1984); *In re United States Lines Inc.*, 197 F.3d 631, 640 (2d Cir. 1999).

5 11 U.S.C. § 362(b)(4).

In enacting this exception, Congress sought to prevent debtors from utilizing the bankruptcy court to frustrate the government's role as police and regulatory enforcer.⁶ Accordingly, by way of example, "where a governmental unit is suing a debtor to prevent or stop violations of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay."⁷

The government exception is not without boundaries. While the government may exercise its police and regulatory authority free from the confines of § 362(a)(1), (2), (3) and (6), any conduct seeking the "enforcement ... [of] a money judgment" does not fall within the government exception and is subject to the automatic stay.⁸ When the government seeks to enforce a money judgment, it acts like any other creditor and is therefore subject to the bankruptcy court's jurisdiction.⁹ Congress intended this harness to the government exception to prevent "the government from gaining preferential treatment in bankruptcy proceedings to the detriment of other creditors."¹⁰ With these principles in mind, the Second Circuit was called upon to analyze the government exception in *Brennan*, wherein it established a three-factor test in which it considered (1) the factual nature of the government's action, (2) the procedural posture of the case in which the government was acting, and (3) whether the government's action was consistent with the underlying policies of § 362(a) and (b).

Three-Factor Brennan Test

In *Brennan*, the SEC brought an enforcement action against the defendant.¹¹ After a bench trial, the court found that the defendant had engaged in "a massive and continuing" fraud, and entered judgment requiring him to disgorge \$75 million in profits and pre-judgment interest.¹² After judgment was entered, the defendant voluntarily sought bankruptcy protection.¹³ After the petition was filed, the SEC sought an order that would require the defendant to repatriate assets that he held in an offshore trust and to transfer those assets into the court's registry.¹⁴ Writing for the Second Circuit, Judge Jose A. Cabranes held that the order was an attempt to collect a money judgment and therefore fell squarely within the exception to the government exception.¹⁵ Accordingly, the SEC's action was prohibited by the automatic stay.¹⁶

First Factor: Factual Nature of the Order

The *Brennan* court began its analysis by considering the nature of the order authorizing the government action. The court noted that while the government exception permits the entry or fixing of a money judgment,¹⁷ the repatriation order required the actual transfer of Brennan's assets and was indicative of an enforcement of a money judgment.

⁶ *City of New York v. Exxon Corp.*, 932 F.2d 1020, 1024 (2d Cir. 1991).

⁷ *SEC v. Brennan*, 230 F.3d 65, 71 (2d Cir. 2000).

⁸ 11 U.S.C. § 362(b)(4).

⁹ *Id.* at 74.

¹⁰ S. Rep. No. 95-989 at 52 (1978); H.R. Rep. 95-595 at 343 (1978).

¹¹ *Id.* at 67.

¹² *Id.* at 68.

¹³ *Id.*

¹⁴ *Id.* at 69.

¹⁵ *Id.* at 71.

¹⁶ *Id.*

¹⁷ *Id.*

Second Factor: Procedural Posture

The Second Circuit next considered the procedural posture of the order. The court stated:

The line between [unstayed] police or regulation power on the one hand, and [stayed] enforcement of a money judgment on the other, [must] be drawn at entry of judgment.... [Thus,] up to the moment when liability is definitively fixed by entry of judgment, the government is acting in its police or regulatory capacity.... However, once liability is fixed and a money judgment has been entered, the government necessarily acts only to vindicate its own interest in collecting its judgment.¹⁸

On this basis, the *Brennan* court concluded that since the repatriation order was entered years *after* the judgment was entered, it constituted the enforcement of a money judgment.¹⁹

Third Factor: Policy Implications

Finally, the *Brennan* court identified several relevant policy implications. The court recognized that the purpose of the automatic stay provision was to enable "the bankruptcy court to centralize all disputes concerning property of the debtor's estate so that reorganization can proceed efficiently,"²⁰ and that the purpose of the government exception was to "prevent a debtor from frustrating necessary governmental functions by seeking refuge in bankruptcy court."²¹ The court concluded that these policies weighed against applying the government exception, noting that the SEC only requested the repatriation order in the district court after a similar request was rejected by the bankruptcy court.²² Thus, the repatriation order raised policy concerns related to forum-shopping, as well as the inefficiency of duplicative proceedings.

Describing the question as "a close one," the Second Circuit held that the SEC's actions were an attempt to enforce a money judgment.²³ On this basis, the court concluded that the SEC's order was subject to the automatic stay under § 362(a). It was this decision, and the rationales therein, that created the framework for the *Miller* court.

Second Circuit's Decision in *SEC v. Miller*

The *Miller* case arose out of a civil enforcement action brought by the SEC against Samuel and Charles Wyly, two brothers who were the officers, directors and shareholders of four publicly traded companies.²⁴ The Wyly brothers received stock options over a dozen years from their companies and then transferred the options through a series of offshore trusts.²⁵ From these trusts, the Wyly brothers exercised the options and traded in securities, netting more than \$550 million in profits while failing to disclose their beneficial interest to U.S. regulators.²⁶ In 2010, the SEC caught up with the brothers, bringing an enforcement action against them alleging securities fraud.²⁷ In 2011, Charles Wyly died and his widow took over his role in the proceedings.

¹⁸ *Brennan*, *supra*, 230 F.3d at 72-73.

¹⁹ *Id.* at 73.

²⁰ *Id.* at 75.

²¹ *Id.*

²² *Id.*

²³ *Id.* at 71.

²⁴ *Miller*, *supra*, 808 F.3d at 625-26.

²⁵ *Id.* at 626.

²⁶ *Id.*

²⁷ *Id.*

In 2014, a jury verdict found the brothers liable for nine counts of securities fraud.²⁸ In a separate remedies phase of the case, the district court ordered the disgorgement of profits in the amount of \$299 million.²⁹ Concerned that the brothers would fraudulently convey assets beyond its reach, the SEC sought an action to temporarily freeze the assets of the Wyly brothers and their families.³⁰ While the SEC's application was pending, Samuel Wyly and Charles' widow each filed separate bankruptcy petitions.³¹ Post-petition, the Wyllys argued that the SEC's request for an asset freeze violated the automatic stay provisions of the Bankruptcy Code.³² The district court disagreed and granted the SEC's application,³³ and an appeal to the Second Circuit followed.³⁴

One of the issues before the Second Circuit was whether the asset-freeze order was exempt from the bankruptcy stay under the government exception.³⁵ Samuel Wyly and other defendants argued that the disgorgement of profits was inherently a "money judgment" and that the freeze order was therefore subject to the stay.³⁶ The SEC disagreed, arguing that the freeze order was within their regulatory authority and thus fell neatly within the government exception.³⁷ Notably, both parties invoked *Brennan* in support of their respective positions.³⁸

The court analyzed the case under the three-factor test articulated in *Brennan*. Judge Cabranes, once again writing for the court, concluded that the asset-freeze order in *Miller* was clearly distinguishable from the repatriation order in *Brennan*.

In considering the factual nature of the order, the court concluded that the asset-freeze order in *Miller* did not require the modification or transfer of any assets and sought only to "preserve the status quo in anticipation of [the] final judgment."³⁹ Thus, the court held that the order entered in *Miller* was "significantly less onerous" than the repatriation order in *Brennan*, and accordingly, this factor weighed in favor of the government exception.

The court next considered the procedural posture of the case. When the SEC requested the asset freeze, the district court had not yet entered final judgment. The court noted that pre-judgment government action is more indicative of enforcement under police or regulatory authority, rather than the collection of a money judgment.⁴⁰ Accordingly, the court concluded that this factor also weighed in favor of the government exception.

The *Miller* court also emphasized that while the procedural posture factor is important, it is not always dispositive. While the *Brennan* opinion seemed to suggest that pre-judgment orders are always exempt from the stay, while post-judgment orders are not, the court did not issue a bright-line rule on this point.⁴¹ Judge Cabranes noted that such a simplistic standard would allow "procedural end-runs" that would "defeat the spirit and purpose of the statute."⁴² So, while tim-

ing is still an important factor, a court's focus must remain on whether an order constitutes "enforcement of a judgment other than a money judgment."⁴³

Finally, the court considered whether the asset freeze was consistent with several important bankruptcy policies and concluded that the order was narrowly crafted to permit its lifting once the assets were under the bankruptcy court's control.⁴⁴ Both the Second Circuit and the bankruptcy court endorsed the asset freeze as "neatly avoiding duplication efforts between the SEC Action and these bankruptcy cases."⁴⁵ Therefore, the limited nature of the asset freeze was consistent with the policies and purposes of the automatic stay and its exceptions.

Analysis/Conclusion

For practitioners, the *Miller* opinion provides additional guidance regarding the extent of the government exception. A court will likely recognize the government exception when the government action does not cause the transfer or modification of the debtor's assets, the order is made prior to judgment and the order is otherwise consistent with the policies underlying § 362. Alternatively, governmental action that imposes the post-judgment transfer of assets and implicates concerns regarding forum-shopping or the duplication of efforts is likely to constitute the enforcement of a money judgment and will be subject to the automatic stay.

The *Miller* and *Brennan* opinions do leave some questions unanswered. For example, how does a court evaluate orders where some factors weigh in favor of the government exception and others do not? How would a court evaluate a pre-judgment order that imposed the transfer of assets into the court registry? How would a court evaluate a post-judgment order narrowly tailored so as to not intrude upon the bankruptcy court's jurisdiction? While *Miller* and *Brennan* provide guideposts to the government exception, it is still difficult to anticipate how a court will rule in other circumstances.

Practitioners are also likely to be puzzled over the policy implications of the government exception. While the government exception ensures that police and regulatory efforts are not frustrated by the filing of a bankruptcy petition, the exception does have the potential to frustrate and undermine the underlying policies of the bankruptcy system, including distributions made under the Bankruptcy Code's priority scheme. The government exception can limit a debtor's ability to obtain immediate relief from governmental proceedings. At the very least, creditors would be burdened by the cloud of uncertainty that the government activity would bring to the bankruptcy proceeding. Finally, the government exception restricts the bankruptcy court's ability to bring all proceedings under its control and effectuate the efficient resolution of the bankruptcy case. **abi**

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²⁸ *Id.*
²⁹ The district court also accepted an alternative measure of damages based on a theory of unjust enrichment. Under this theory, the disgorgement order was calculated at \$174 million. This theory would only apply if the first measure of disgorgement failed on appeal. See *SEC v. Wyly*, 71 F. Supp. 3d 399, 403-04 (S.D.N.Y. 2014).
³⁰ *Miller*, *supra*, 808 F.3d at 627-28.
³¹ *Id.* at 628.
³² *Id.*
³³ *Id.*
³⁴ *Id.* at 629.
³⁵ *Id.* at 630.
³⁶ *Id.* at 631.
³⁷ *Id.*
³⁸ *SEC v. Brennan*, 230 F.3d 65 (2d Cir. 2000).
³⁹ *Miller*, *supra*, 808 F.3d at 632.
⁴⁰ *Id.* at 633.
⁴¹ *Id.*
⁴² *Id.*

⁴³ *Id.*
⁴⁴ *Miller*, *supra*, 808 F.3d at 634.
⁴⁵ *Id.*; see also *In re Wyly*, 526 B.R. 194, 196 n.4 (Bankr. N.D. Tex. 2015).