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U.S. District Court Limits the Extraterritorial Application of U.S. Bankruptcy Law but Important Considerations for Foreign Investors Remain

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On July 6, 2014, Judge Jed S. Rakoff, United States District Judge for the Southern District of New York, declined to extend the reaches of section 550(a) of the Bankruptcy Code abroad to permit the recovery of funds that were alleged to be fraudulently obtained from Bernard L. Madoff Investment Securities LLC in connection with Bernard Madoff's Ponzi scheme. *Securities Investor Protection Corporation v. Bernard L. Madoff Investment Securities LLC (In re Madoff Securities)*, No. 12-mc-115 (JSR) (S.D.N.Y. Jul. 6, 2014). The decision involves the attempted extraterritorial application of section 550(a), which allows a trustee to recover "property transferred . . . to the extent that a transfer is avoided" under bankruptcy law. In essence, Irving Picard, the Trustee, sought to not only seek recovery from feeder funds that invested directly into Madoff funds, but also sought to recover from subsequent transferees. The *Madoff* decision should give comfort to foreign investors that there is a reduced risk that proceeds of their indirect investments in U.S. companies will be clawed back under bankruptcy law—even if such proceeds were obtained fraudulently. There are, however, important limitations to consider. Notably, in *In re Icenhower*, No. 10-55933 (9th Cir. Jul. 3, 2014), a decision issued by the United States Court of Appeals for the Ninth Circuit a mere three days prior to the *Madoff* decision, the Ninth Circuit held that it was appropriate to apply section 550(a) extraterritorially to a subsequent transferee of real property located in Mexico.

The *Madoff* Decision

Background

In his effort to further recover funds for victims of Bernard Madoff's Ponzi scheme, the Trustee overseeing the liquidation of Madoff Securities under the Securities Investor Protection Act (SIPA) attempted to clawback funds transferred to foreign customers of foreign feeder funds—investment vehicles that pooled their own customers' assets for investment with Madoff Securities. These foreign-based feeder funds would, from time to time, withdraw monies from Madoff Securities in New York and transfer those funds to their foreign-based customers on account of their investments. Following the collapse of Madoff Securities in 2008, many of the foreign feeder funds

entered liquidation proceedings in their respective home countries. Thereafter, the Trustee sought to recover allegedly avoidable transfers made to these foreign feeder funds as well as to their subsequent foreign transferees.

Relying on the avoidance provisions of the Bankruptcy Code—which are available to a SIPA trustee—the Trustee sued CACEIS Bank Luxembourg and CACEIS Bank of France to recover stolen funds. Neither bank invested directly with Madoff Securities. Instead, they invested funds with Fairfield Sentry Ltd., of the British Virgin Islands, and Harley International, of the Cayman Islands, two major Madoff Securities feeder funds that are in foreign liquidation proceedings. The Trustee alleged that the banks received approximately $50 million in avoidable transfers from Madoff Securities as subsequent transferees of Fairfield Sentry and Harley. As a result, the Trustee argued that those funds should be clawed back under section 550(a)(2) of the Bankruptcy Code. In response, these banks, among other consolidated defendants, moved to dismiss the Trustee's lawsuits on the grounds that section 550(a) did not apply extraterritorially to permit the recovery of funds transferred from one foreign entity to another.

The Court's Analysis

As an initial matter, the Court observed that it "is a longstanding principle of American law that legislation of Congress, unless contrary authority appears, is meant to apply only within the territorial jurisdiction of the United States." The policy underpinning this presumption is to "protect against unintended clashes between [U.S.] laws and those of other nations which could result in international discord." To determine whether this presumption should apply, the Court followed a two-step analysis: first, whether the factual circumstances at issue required an extraterritorial application of section 550(a); and second, if so, whether Congress intended for the statute to apply extraterritorially. After conducting this two-part test, the Court held that the trustee did not rebut the presumption against extraterritoriality.

As to the first prong of the analysis, the Trustee argued that the regulatory regime governing the liquidation of a Securities Investor Protection Corporation-member broker-dealer, such as Madoff Securities, is inherently domestic. The Court disagreed and observed that the relevant analysis required it to look "to the focus of congressional concern, or, in other words, the transactions that the statute seeks to regulate." The Court found that the Trustee's argument, if adopted, would, among other things, run contrary to established case law holding that tangential or remote connections to the U.S. are not sufficient to support a claim of domestic application of a statute. Instead, the Court focused its analysis on the regulated transactions. The Court examined the text of section 550(a) in conjunction with "the location of the transfers [and their] component events" and determined that the transfers were "predominantly foreign," because they all involved "foreign feeder funds transferring assets abroad to their foreign customers and other foreign transferees." The fact that the chain of transfers originated with Madoff Securities in New York was, by itself, "insufficient to make the recovery of these otherwise thoroughly foreign subsequent transfers into a domestic application of section 550(a)."

Having found that the Trustee sought to apply section 550(a) extraterritorially, the Court then assessed whether Congress intended that result—an analysis that calls for an examination of both the language and context of section 550(a). After parsing the text of section 550(a), the Court concluded that nothing in the language of section 550(a) evidenced Congressional intent for the statute to apply extraterritorially. Despite the absence of textual intent for extraterritorial application, the Trustee asserted that the context of the statute, including surrounding provisions of the Bankruptcy Code, evidenced Congress' intent for section 550(a) to apply extraterritorially. The Trustee noted that the Bankruptcy Code's broad definition of "property of the estate" in section 541 includes certain specified property "wherever located and by whomever held." The Trustee contended that this definition should likewise be incorporated into the avoidance and recovery provisions of the Bankruptcy Code, which use the phrase "an interest of the debtor in property" to define the transfers (including fraudulent transfers) that may be avoided. The Court did not find this argument to be persuasive because, under established precedent, fraudulently transferred property becomes *property of the estate* only after it has been recovered by the trustee, and thus, "section 541 cannot supply any extraterritorial authority that the avoidance and recovery provisions lack on their own."

The Court further observed that Madoff Securities' liquidation under SIPA—a statute with a "predominately domestic focus"—suggested "a lack of intent by Congress to extend its reach extraterritorially." The Court also noted that SIPA's express incorporation of the Bankruptcy Code's avoidance and recovery provisions implied that a SIPA trustee is likewise constrained by applicable "limitations . . . [in] an ordinary bankruptcy," including its jurisdictional constraints. Moreover, the Court was not persuaded by the Trustee's stated public policy concerns that "a U.S. debtor [could] fraudulently transfer all of his assets offshore and then retransfer those assets to avoid the reach of U.S. bankruptcy law." Assuming that any such international fraud occurred, the Trustee could still "utilize the laws of the countries where such transfers occurred to avoid such an evasion while at the same time avoiding international discord."

Apart from the two-part test, the Court found that principles of international comity separately justified the same result. Comity, which is the principle that one nation will extend certain courtesies to other nations by recognizing the validity and effect of their executive, legislative or judicial acts, has been recognized by courts as "especially important in the context of the Bankruptcy Code." The Court found that comity "counsel[ed] against the application of United States law in the present case" because Fairfield Sentry and Harley are currently in liquidation proceedings in their respective home countries and Madoff Securities had merely an "indirect relationship" in respect of "the transfers at issue here."

The *Icenhower* Decision

While the *Madoff* court declined to apply section 550(a) extraterritorially, the Ninth Circuit reached the opposite conclusion. In *Icenhower*, the Ninth Circuit upheld a bankruptcy court's application of section 550(a) to require the return of a coastal villa located in Mexico that once belonged to a bankrupt California couple. Prior to their bankruptcy filing, the property was transferred by the couple to H&G, a domestic shell company they controlled. H&G then resold the villa to subsequent transferees *after* the couple filed for bankruptcy. The transferees were on notice of the bankruptcy.

The bankruptcy trustee filed a lawsuit to unwind these transactions. He alleged that the sale of the villa by the debtors to H&G was fraudulent and that the resale of the villa by H&G to the subsequent transferee was an unauthorized post-petition transfer of property of the estate. Following a bench trial, the bankruptcy court approved the trustee's request to avoid the post-petition transfer of the villa from H&G to the subsequent transferees. The bankruptcy court found that H&G "had no real corporate existence apart from [the debtors]" and "had no business purpose other than as a sham corporation to hold the Debtors' assets." Importantly, the bankruptcy court concluded that H&G was the debtors' alter ego and substantively consolidated H&G with the debtors' bankruptcy estate, resulting in the merger of H&G's assets with those of the debtors. As a result, the villa became part of the bankruptcy estate as of the petition date, and as such, its post-petition transfer was avoidable as if made directly by the debtors. Alternatively, the bankruptcy court held that the sale of the villa from the debtors to H&G was also a fraudulent transfer under bankruptcy and state law. Under either finding, the villa was recoverable from the subsequent transferee under section 550(a). The bankruptcy court's decision was affirmed by the district court and then by Bankruptcy Appellate Panel for the Ninth Circuit. The panel found that the bankruptcy court did not improperly apply U.S. law extraterritorially because Congress intended the extraterritorial application of the Bankruptcy Code as it applies to property of the estate.

On appeal, the Ninth Circuit affirmed the bankruptcy court's decision that the sale of the villa from H&G to the subsequent transferees was an unauthorized post-petition transfer of estate property. It did not, however, address the bankruptcy court's alternate conclusion that the transfer of the villa from the debtors to H&G was fraudulent. Moreover, while the Ninth Circuit observed that a court must generally presume that a federal statute "is primarily concerned with domestic conditions," the Ninth Circuit did not engage in the two-step analysis employed by Judge Rakoff in *Madoff* to determine whether such presumption continued to apply given the circumstances of the case. Rather, the Ninth Circuit simply stated that "Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate." Since the villa was property of the estate due to the substantive consolidation of H&G with the debtors' estate, the Ninth Circuit agreed with the bankruptcy court that the post-petition transfer of the villa could be avoided. As a result, it was properly recoverable under section 550(a).

Ramifications

Undoubtedly, the *Madoff* decision gives comfort to foreign investors that the proceeds of their indirect investments in U.S. companies will not likely be clawed back by a SIPA or bankruptcy trustee—even if such proceeds were obtained fraudulently. While the decision is certainly advantageous to foreign investors, it does not come without certain warnings and limitations.

First, the defendants in question did not invest directly with Madoff Securities but, rather, transacted with another foreign intermediary. It is possible that the outcome of this decision would be different if the defendants invested directly with Madoff Securities because the defendant's connections to the U.S. would not be merely tangential or remote. Second, although foreign investors might be immune from suit based on U.S. fraudulent transfer laws, they can still be liable under applicable foreign law. Third, the Court's holding applied to section 550(a) of the Bankruptcy Code. It is possible that a similarly situated defendant can face other liability based on applicable U.S. law to the extent such law has an extraterritorial reach.

Last, the *Madoff* decision is not binding on all U.S. courts and, as the *Icenhower* decision demonstrates, different results are possible. Although their conclusions are different, it is possible to harmonize these rulings. In *Madoff*, the court expressly found that the transferred funds were *not* yet property of the estate and were therefore beyond the Trustee's reach. Conversely, in *Icenhower*, the Ninth Circuit held that the villa was already property of the estate as of the petition date, making it appropriate for the trustee to recover it as an avoidable post-petition transfer. Beyond this difference, these decisions can be further reconciled based on the fact that the Trustee in *Madoff* was acting under SIPA, a statute that Judge Rakoff observed had a predominantly domestic focus, and thereby demonstrated Congress' intent that the statute not apply extraterritorially. In *Icenhower*, however, SIPA's provisions were not addressed. For these reasons, coupled with the highly fact-specific nature of each case and the susceptibility of a statute to be construed differently among the courts, foreign investors should still be wary of the potential for U.S. law to cause the clawback of all or a portion of the proceeds of their investments in U.S. companies.