Practicum

Second Circuit Permits Madoff Trustee to Pursue Transfers Made Between Foreign Entities

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In the latest development in the decade-long legal battle to recover funds impacted by Bernard Madoff's Ponzi scheme, the Second Circuit earlier this year held that Irving H. Picard, the trustee for the liquidation of Bernard L. Madoff Investment Securities LLC ("Madoff Securities"), may prosecute billions of dollars in fraudulent transfer claims against foreign investors who ultimately received funds from Madoff Securities prior to its collapse, even though they were recipients of subsequent transfers that took place entirely overseas.[1] The court's decision represents a significant departure from the presumption against extraterritorial application of U.S. law, which will not only vastly expand the trustee's sources of recovery in the Madoff litigation, but will also subject international investors with no U.S. operations to avoidance claims arising out of other U.S. bankruptcy proceedings.

It is a longstanding canon of statutory construction that federal legislation is presumed to apply solely within the territorial jurisdiction of the United States unless clear evidence of a contrary intent is expressed by Congress in either the statutory text or legislative history.[2] The Supreme Court has promulgated a two-step approach to determine whether a claim is foreclosed by the presumption against extraterritoriality. First, a court is to examine the statute to determine whether there is clear evidence to rebut the presumption. If the presumption has indeed been rebutted, the inquiry ends and the statute may be applied to foreign conduct.[3]

If the presumption against extraterritoriality is not clearly rebutted by the statute, the court must determine whether the dispute involves a domestic application of U.S. law by determining the statute's "focus." If conduct relevant to the statute's focus occurred in the United States, "the case involves a permissible domestic application even if other conduct occurred abroad."[4] However, if the relevant conduct occurred outside of the United States, "the case involves an impermissible extraterritorial application regardless of any conduct that occurred in U.S. territory."[5]

In the context of bankruptcy proceedings, the presumption against extraterritoriality is particularly relevant to a trustee or debtor-in-possession's power to avoid fraudulent or preferential transfers and to recover the transferred assets, as such avoidance claims frequently concern transfers made by U.S. entities to foreign transferees. This is precisely what occurred in *Picard*. Even with the guidance offered by the Supreme Court in *Morrison* and its progeny, though, courts have struggled to adopt a consistent approach to determine whether the avoidance provisions of the Bankruptcy Code apply extraterritorially. Different language in the Code's different avoidance provisions has led to different decisions regarding whether Congress intended those provisions to reach assets outside of the United States.[6]

In *Picard*, the trustee brought avoidance claims against hundreds of foreign investors who made investments in foreign "feeder funds" that pooled their investments and placed them with Madoff Securities. The trustee initially brought avoidance claims against the feeder funds, which were unquestionably subject to the avoidance provisions of the Bankruptcy Code because they had a direct nexus to the United States. However, since many of the feeder funds went bankrupt themselves, due to their investment in Madoff Securities, the trustee proceeded to commence actions against the individual foreign investors, i.e., subsequent transferees who received transfers prior to Madoff Securities' insolvency.

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The U.S. Bankruptcy Court for the Southern District of New York, following remand from the District Court, dismissed the trustee's claims, holding that the transactions from the feeder funds to their investors were foreign in nature, and the statutory text and legislative history do not reflect that the trustee's avoidance power should extend overseas. Accordingly, the court ruled that the trustee's claims were barred by the presumption against extraterritoriality, as well as by principles of international comity, which require deference to a foreign nation's courts where they hold a superior interest in adjudicating a dispute.[7]

The Second Circuit reversed the lower court, first analyzing the avoidance and recovery provisions relied upon by the trustee, Bankruptcy Code §§ 548(a)(1) and 550(a)(2). The Circuit Court held that the "focus" of these provisions, working in tandem, is the recovery of assets fraudulently transferred from the estate, including those that went to subsequent transferees.[8] The Circuit Court also held that the conduct relevant to this focus is not the foreign investors' receipt of assets from the feeder funds but, rather, the initial transfers made from Madoff Securities to the feeder funds. They depleted the estate and are thus subject to recovery by the trustee, even if subsequently transferred to other non-U.S. entities. Accordingly, the Circuit Court ruled that the initial transfers were domestic in nature and could, therefore, be avoided and recovered even without any statutory text or legislative history mandating extraterritorial application.[9]

For similar reasons, the Circuit Court held that the claims are not barred by principles of international comity, since the United States has a compelling interest in regulating debtors' transfers outside the country.[10] It should be noted, though, that the Circuit Court only decided the comity question as a matter of prescriptive comity, which is reviewed *de novo*, as opposed to adjudicative comity, which is reviewed under an abuse of discretion standard, on the ground that the appellees' adjudicative comity argument was not adequately preserved on appeal.[11]

Following the Circuit Court's decision, the defendants moved the court, first for a rehearing *en banc*, and then to stay the various actions against the foreign investors pending defendants' appeal to the Supreme Court. In each motion, the defendants claimed that the "focus" of Section 550(a)(2) is limited to initial and subsequent transferees only, rather than successive subsequent transferees. The defendants also claimed that the Second Circuit improperly applied a *de novo* standard of review to the District Court's decision regarding international comity, and should have deferred to foreign proceedings involving the feeder funds. The Second Circuit denied the defendants' motion for rehearing *en banc* on April 3, 2019, and granted their motion to stay proceedings on April 23, 2019, issuing both decisions without discussion.

It remains to be seen whether the Supreme Court will grant the defendants' petition for *certiorari*, which was filed before the extended deadline of August 30, 2019.[12] However, for now at least, the Second Circuit has vastly expanded the international reach of U.S. bankruptcy courts, particularly the U.S. Bankruptcy Court for the Southern District of New York, where many cross-border bankruptcy proceedings get filed and determined. In light of this development, global investors of all stripes who received transfers not only from Madoff Securities, but those that emanated from any bankrupt entity in the United States, should now be wary of potential clawback claims and take appropriate action, including retention of U.S. counsel.

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Endnotes

1. *See In re Picard*, 917 F.3d 85 (2d Cir. 2019).
2. *See, e.g., Morrison v. National Australia Bank Ltd.*, 561 U.S. 247, 255 (2010).
3. *See id.*; *see also RJR Nabisco, Inc. v. European Cmty.*, 136 S. Ct. 2090, 2101 (2016).
4. *Nabisco*, 136 S. Ct. at 2101; *accord Morrison*, 561 U.S. at 266-67.
5. *Id.*
6. Over just the past few years, courts have held that the Bankruptcy Code's avoidance provisions do not apply extraterritorially in *In re CIL Limited*, 2018 WL 329893 (Bankr. S.D.N.Y. Jan. 5, 2018) and *Spizz v. Goldfarb Seligman & Co. (In re Ampal-Am. Israel Corp.)*, 562 B.R. 601 (Bankr. S.D.N.Y. 2017), but declined to dismiss claims on grounds of extraterritoriality in *In re FAH Liquidating Corp.*, 572 B.R. 117 (Bankr. D. Del. 2017) and *Weisfelner v. Blavatnik (In re Lyondell)*, 543 B.R. 127 (Bankr. S.D.N.Y. 2016).
7. *See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (SIPC II)*, AP 08-01789 (SMB), 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016) (citing *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (SIPC I)*, 513 B.R. 222 (S.D.N.Y.), *supplemented by* 12-MC-115, 2014 WL 3778155 (S.D.N.Y. July 28, 2014)).
8. *See Picard*, 917 F.3d at 97-100.
9. *See id.* at 100-01 (citing *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018)).
10. *See id.* at *100-05.
11. *See id.* at 102 n. 14. Prescriptive comity concerns whether a court will presume Congress intended to limit a statute's application out of respect to foreign sovereigns, while adjudicative comity concerns whether a court should abstain from exercising jurisdiction in deference to a foreign court. *See id.* at 100-01.
12. *See HSBC Holdings PLC, et al. v. Irving H. Picard*, 917 F.3d 85 (2d Cir. 2019), *petition for cert. filed* Aug. 29, 2019 (No. 19-277).