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Southern District of New York Holds in *Madoff* That the Bankruptcy Code Cannot Be Used to Recover Extraterritorial Transfers

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Dealing a major blow to the trustee's efforts to recover fraudulent transfers on behalf of the bankruptcy estate of the company run by Bernard Madoff, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York held in *SIPC v. Bernard L. Madoff Investment Securities LLC*[1] that the Bankruptcy Code cannot be used to recover fraudulent transfers of funds that occur entirely outside the United States. The decision is likely to have far-reaching implications for other cross-border insolvency cases.

Background

Certain foreign investment funds (so-called "feeder funds") that had pooled their customers' assets for the purpose of investing with Madoff withdrew funds from their Madoff accounts and subsequently transferred the funds abroad to various foreign entities, including their customers and certain banks. The Madoff trustee sued both the feeder funds (most of which were themselves in liquidation proceedings in their home countries following the collapse of the Madoff empire) and the subsequent transferees under section 550 of the Bankruptcy Code in an attempt to recover the transfers as fraudulent conveyances.[2] Although

[1] No. 12-mc-115 (S.D.N.Y. July 7, 2014).

[2] Section 550(a) provides in relevant part that "to the extent that a transfer is avoided under [certain specified sections of the Bankruptcy Code, including section 548 relating to fraudulent transfers], the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from – (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee." 11 USC. § 550(a).

section 550 authorizes trustees and debtors-in-possession to recover a debtor's fraudulent transfers not only from the direct recipients of the transfers but also, in some instances, from subsequent transferees, the subsequent transferees moved to dismiss the complaint on the ground that section 550 did not apply extraterritorially and thus did not enable the trustee to set aside transfers from a foreign transferor to a foreign transferee.

The Presumption Against Extraterritoriality

The court focused initially on whether the application of section 550, under the facts of the case, would constitute an extraterritorial application of the statute. Citing the Supreme Court's decision in *Morrision v. Nat'l Australia Bank, Ltd.*,[3] the court noted that there is a long-standing legal presumption that federal statutes are intended to apply only within the territorial jurisdiction of the United States unless a clear contrary intent can be discerned from the statute and its context. The presumption against extraterritorial application of federal statutes, the court observed, furthers the important policy goal of avoiding clashes between US laws and those of other nations. The court rejected the trustee's argument that, because Congressional concern with regard to a liquidation under the Securities Investors Protection Act of 1970 ("SIPA") – a statute that incorporates by reference a number of provisions from the Bankruptcy Code, including section 550 – is the regulation of broker-dealers doing business in the US, the application of section 550 under the facts was inherently domestic and thus did not require extraterritorial application. The court found that a tangential or remote connection to a US debtor is insufficient to render every application of the Bankruptcy Code domestic, and, in any event, such an approach would be problematic from the standpoint of international comity.

The court observed that section 550 (a recovery provision) and section 548 (a fraudulent transfer avoidance provision) each focuses on the property that has been transferred and the nature of the transaction rather than on the debtor itself. It found that, although the chain of transfers originated with Madoff in New York, the transfers (and the transferees) in question were predominantly foreign (*i.e.*, foreign feeder funds had transferred funds abroad to foreign transferees). Thus, the required application of section 550 was extraterritorial.

The court next focused on whether Congress had intended that section 550 be applied extraterritorially. It noted that under the Supreme Court's precedent in *Morrison*, there is a presumption that federal statutes are concerned primarily with domestic matters unless there is a clearly expressed intention by Congress to give that statute extraterritorial effect. The court determined that there was nothing in the language of section 550 to suggest such an intention, so it then looked to the context of that section, including surrounding provisions of the Bankruptcy Code, to see if such an intention could be found. It rejected the trustee's contention that such an intention is established by section 541 of the Bankruptcy Code, which defines "property of the estate" broadly enough to capture "property wherever located and by whomever held," and which is indirectly incorporated into the Bankruptcy Code's avoidance and recovery provisions. It found that argument "neither logical nor persuasive" because the Bankruptcy Code's broad definition of property of the estate does not imply that property is to be treated as property of the estate under section 541 prior to its recovery by the estate. Under the Second Circuit's decision in *In re Colonial Realty Co.*,[4] property of the debtor that has been fraudulently transferred is not considered property of the estate until it has been recaptured. Thus, the court in *Madoff* concluded that nothing in the Bankruptcy Code overcame the presumption that section 550 should not be applied extraterritorially.

[3] 130 S. Ct. 2869 (2010).

[4] 980 F.2d 125 (2d Cir. 1992).

The court similarly found that nothing in section 78fff-(c)(3) of SIPA (which empowers a SIPA trustee to use the avoidance and recovery provisions of the Bankruptcy Code to recover customer property) overcame that presumption. The court found that SIPA has a predominantly domestic focus, which suggests that Congress did not intend to expand its reach beyond US borders.

Despite the trustee's contention that a failure to apply section 550 extraterritorially would allow US debtors to fraudulently convey all of their assets offshore and then retransfer those assets to circumvent the reach of the US bankruptcy law, the court was not persuaded. It observed that the desire to avoid loopholes in the law must be weighed against the important policy served by the presumption against extraterritorial application of federal statutes – *i.e.*, preventing squabbles between nations in the application of their respective laws. If any intentional fraud were found, the trustee might well have the ability to pursue his rights under the laws of the countries where the transfers occurred and thereby simultaneously avoid discord between the US and other countries.

The court also rejected the trustee's argument that if extraterritorial application were not permitted, defendants that received transfers outside of the US would be treated more favorably than customer-beneficiaries of the SIPA estate. The court found the trustee's argument to be "disingenuous," as it was inconsistent with his position in prior litigation that indirect customers of Madoff, that invested through feeder funds, like many of the defendants in the present litigation, were not creditors of the US bankruptcy estate.

The court held that the trustee had failed to rebut the presumption against extraterritorial application of federal statutes and was not entitled to use section 550 to pursue recovery of subsequent transfers that were purely foreign.

The Need to Consider Principles of International Comity

Although the foregoing ruling was dispositive, the court also held, in the alternative, that even if the trustee had rebutted the presumption, he would be precluded from using section 550 to pursue foreign transfers based upon principles of international comity. In performing the comity analysis, the court compared the interests of the US with those of the foreign jurisdictions, and noted that comity is particularly important in the context of bankruptcy. Under the facts, many of the feeder funds were already in liquidation proceedings in their home countries, and those countries had an interest in applying their own rules concerning avoidance of fraudulent transfers. It would be inappropriate, in the court's view, for the trustee to use SIPA to circumvent such foreign liquidations in order to make claims under a US statute with regard to which the defendants had no direct relationship. The investors in the foreign funds had no reason to believe that their relationships with the feeder funds would be governed by US law. Thus, the court found that the US did not have as great an interest in applying its own laws as the foreign jurisdictions did in applying theirs. The court dismissed the trustee's claims to the extent that they sought to recover purely foreign transfers and remanded to the bankruptcy court for further proceedings consistent with its opinion.

Conclusion

Judge Rakoff's decision makes clear that the avoidance and recovery powers of a trustee under the Bankruptcy Code in the international arena are limited by both the legal presumption against applying federal statutes extraterritorially and long-standing principles of comity. These limitations will have significant ramifications not only for the Madoff trustee, but also for debtors in possession and trustees in other cases. In addition to the restrictions imposed on asset recovery under section 550, it is possible that the decision could be used as a basis for attempting to chip away at other rights and protections afforded the estate under the Bankruptcy Code, such as the automatic stay, that generally have been regarded as having worldwide applicability.

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