HARVARD BUSINESS LAW REVIEW Online

FATALLY FOREIGN: EXTRATERRITORIAL RECOVERY OF AVOIDABLE TRANSFERS AND PRINCIPLES OF COMITY IN THE MADOFF SECURITIES SIPA LIQUIDATION PROCEEDING

*Timothy Graulich, Brian M. Resnick, and Kevin J. Coco**

Bernie Madoff's investment firm, Bernard L. Madoff Investment Securities LLC (Madoff Securities), famously imploded in December 2008 under the weight of the largest Ponzi scheme in U.S. history.[1] Some of Madoff's largest customers were offshore "feeder funds" that pooled capital from various investors around the world principally in order to "feed" investments into Madoff Securities. In many cases the vast majority, or all, of the capital in the feeder funds was channeled directly to, and as investments in, Madoff Securities. When feeder funds received distributions from Madoff Securities, they would often in turn distribute assets to their own customers, many of whom were foreign institutions and individuals. In an important recent decision from the United States District Court for the Southern District of New York, the court dismissed recovery claims asserted by the Madoff Securities trustee against foreign subsequent transferees that had received distributions from foreign Madoff feeder funds on the basis that section 550(a)(2) of the Bankruptcy Code[2] does not apply extraterritorially under the circumstances and, alternatively, international comity considerations prohibit recovery from these foreign entities.

I. Cross-Border Clawbacks

The trustee appointed under the Securities Investor Protection Act (SIPA) to administer the Madoff Securities estate has engaged in a multiyear global effort to recoup

* Timothy Graulich and Brian M. Resnick are partners in the Insolvency and Restructuring Group of Davis Polk & Wardwell LLP, and Kevin J. Coco is an associate in that group.

[1] *See* Robert Frank, *Madoff Jailed After Admitting Epic Scam*, WSJ.COM (Mar. 13, 2009), http://www.wsj.com/articles/SB123685693449906551.

[2] 11 U.S.C § 550(a)(2) (2012).

funds for the estate's customers and creditors using the powers of SIPA and the Bankruptcy Code.[3] This effort extended to several offshore feeder funds that received distributions from Madoff Securities, many of which are subject to liquidation proceedings in their respective foreign jurisdictions. In addition to claims against the feeder funds themselves, the Trustee brought avoidance and recovery actions against the foreign customers of the funds that had received subsequent distributions. As a statutory matter, the Trustee pursued clawbacks against these foreign subsequent transferees under section 550(a)(2),[4] which allows a trustee to recover property that is the subject of an avoided transfer from "any immediate or mediate transferee" of an initial transferee. The foreign subsequent transferees moved to withdraw the reference to the bankruptcy court, and the U.S. District Court for the Southern District of New York granted their request and consolidated the cases with respect to the issue of whether section 550(a)(2), as incorporated into SIPA, applies extraterritorially such that the Trustee can recover transfers made from foreign feeder funds to foreign investors in those funds.[5]

II. Extraterritorial Applications

The foreign subsequent transferees moved to dismiss the Trustee's complaints on the basis that section 550(a)(2) does not apply extraterritorially and therefore cannot be used by the Trustee to claw back transfers made abroad by a foreign feeder fund to its foreign customer. In the consolidated case, *Securities Investor Corp. v. Bernard L. Madoff Investment Securities LLC*,[6] Judge Jed S. Rakoff granted the motion to dismiss, holding that (i) the application of 550(a)(2) to the particular facts of the case would constitute an extraterritorial application of the statute,[7] (ii) Congress did not clearly intend such an application,[8] and (iii) even if the statute could be applied extraterritorially, principals of international comity would preclude such an application under the circumstances.[9]

Judge Rakoff began his opinion by recalling the longstanding presumption that congressional legislation is meant to apply only within the United States in the absence of

[3] *See generally* THE MADOFF RECOVERY INITIATIVE: SUBSTANTIVELY CONSOLIDATED SIPA LIQUIDATION OF BERNARD L. MADOFF INVESTMENT SECURITIES LLC & BERNARD L. MADOFF, http://www.madofftrustee.com (last visited Mar. 2, 2015).

[4] 11 U.S.C § 550(a)(2).

[5] *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 513 B.R. 222, 225 (S.D.N.Y. July 28, 2014).

[6] *Id.*

[7] *Id.* at 228.

[8] *Id.* at 231.

[9] *Id.*

contrary intent.[10] Citing the recent Supreme Court decision in *Morrison v. Nat'l Australia Bank Ltd.*,[11] Judge Rakoff wrote that the court must first determine whether the factual circumstances of the case require extraterritorial (as opposed to domestic) application of the relevant statute.[12] In answering "yes" to this inquiry, Judge Rakoff evaluated the "focus" of the transactions that section 550(a) seeks to regulate.[13] For their part, the Trustee and the Securities Investor Protection Corporation (SIPC) interpreted the inquiry broadly by arguing that the focus in a SIPA liquidation is the domestic broker-dealer and the maximization of its assets, meaning that any application of section 550(a) and other Bankruptcy Code provisions incorporated into SIPA is inherently domestic.[14] Judge Rakoff rejected this approach in favor of the more specific interpretation advocated by the defendants, which analyzes the regulatory focus of section 550(a).[15] The statute focuses on the nature of the transactions at issue – here, transfers between foreign parties abroad, rather than the U.S. debtor more generally, leading the court to conclude that the Trustee's attempted recovery of the "predominantly foreign" transactions would require an extraterritorial application of section 550(a).[16] The court repeatedly highlighted the foreign-to-foreign aspect of the transfers and the fact that they did not come directly from the U.S. debtor.[17]

III. Congressional Intent

The second step of the *Morrison* analysis is whether Congress intended the statute to apply extraterritorially. Under *Morrison*, the congressional intent must be affirmative and clear in order to overcome the presumption.[18] The Trustee and SIPC had argued that, although extraterritorial intent is not present in the plain language of section 550(a), the court should look to section 541(a)[19] for statutory context, which provides that "property of the estate" is estate property "wherever located and by whomever held," and is understood generally to apply regardless of whether the property is present in the United States.[20] According to the Trustee and SIPC, the words "wherever located and by whomever held" are incorporated into the Bankruptcy Code's avoidance and recovery

[10] *Id.* at 226.
[11] 561 U.S. 247 (2010).
[12] *See Sec. Investor Prot. Corp.*, 513 B.R. at 226 (citing *Morrison*, 561 U.S. at 264–73).
[13] *See id.* at 226.
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.* at 225, 232.
[18] 561 U.S. at 255 (quoting E.E.O.C. v. Arabian Am. Oil Co., 499 U.S. 244, 248 (1991)).
[19] 11 U.S.C. § 541(a).
[20] *Sec. Investor Prot. Corp.*, 513 B.R. at 228.

provisions, meaning that Congress intended section 550(a) to apply extraterritorially.[21] The court dismissed this argument as "clever [but] neither logical nor persuasive" and cited Supreme Court and Second Circuit precedent to explain that "fraudulently transferred property becomes property of the estate only after it has been recovered by the Trustee."[22] Responding to the Trustee's policy-based contention that refusing to apply section 550(a) extraterritorially would permit a U.S. debtor to transfer its assets abroad and then retransfer them to another foreign entity, thus escaping liability, the court noted that such concerns "must be balanced against the presumption against extraterritoriality[,]" which is intended to avoid international conflict.[23] The court ultimately held that the Trustee had not adequately rebutted the presumption against extraterritoriality and was therefore prohibited from utilizing section 550(a) to recover transfers to the foreign investors of the offshore feeder funds.[24]

IV. Comity Matters

In an alternative ruling, Judge Rakoff determined that even if the Trustee were to overcome the presumption against extraterritoriality, recovery from the foreign subsequent transferees in this case would be prohibited by considerations of international comity.[25] International comity is "the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation."[26] In the United States, comity requires a comparison of U.S. interests against foreign interests. Here, the court recognized that many of the other Madoff feeder funds are subject to liquidation proceedings in their home countries where their own avoidance and recovery statutes govern.[27] As the defendants noted in their briefing, the British Virgin Islands trial court and appellate court had already addressed, and rejected, one feeder fund liquidator's attempt to recover these same transfers pursuant to local common law.[28] The defendants criticized the Trustee's approach as seeking a type of unfair double recovery, arguing that the Trustee should not be permitted to first recover initial transfers to the feeder funds and then recover subsequent transfers to the feeder fund's customers, but rather should be

[21] *Id.* at 228–29.
[22] *Id.* at 229.
[23] *Id.* at 231 (quoting In re Midland Euro Exch. Inc., 347 B.R. 708, 718 (Bankr. C.D. Cal. 2006)).
[24] *Id*.
[25] *Id*. at 232.
[26] JPMorgan Chase Bank v. Altos Hornos de Mexico, S.A. de C.V., 412 F.3d 418, 423 (2d Cir. 2005) (quoting Hilton v. Guyot, 159 U.S. 113, 164 (1895)).
[27] *See Sec. Investor Prot. Corp.*, 513 B.R. at 232.
[28] *Id*. (quoting Decl. of Marco E. Schnabl dated July 13, 2012, Ex. C., No. 12 Misc. 115, ECF No. 236 (S.D.N.Y. filed July 13, 2012)).

required to stand in line alongside the feeder fund customers and share as a creditor of the feeder fund's estate.[29] On the other hand, SIPC focused on U.S. interests in stating that comity is not implicated where the Trustee attempts to recover property stolen from investors in a U.S. broker-dealer as part of a Ponzi scheme with its "center of gravity" in the U.S.[30] In the end, Judge Rakoff agreed with the defendants with respect to the comity issue, describing the proceedings before him as an attempt by the Trustee to "reach around" the foreign proceedings and pull in foreign investors with no direct relationship to the U.S. estate and no reason to expect that U.S. law would apply to distributions received from foreign investment funds.[31]

V. International Deference

Comity is an influential thread woven throughout Judge Rakoff's opinion. Indeed, the longstanding presumption against extraterritoriality, which the *Madoff* court established as its analytical starting point, is itself a comity-based rule that was recognized more than twenty years ago by the Supreme Court as an effort to "protect against unintended clashes between our laws and those of other nations which could result in international discord."[32] Judge Rakoff repeated this principle in finding that section 550(a)(2) does not apply extraterritorially, further commenting that the Trustee's proposed actions "could raise serious issues of international comity."[33]

More broadly, the *Madoff* decision illustrates a growing (albeit not universal) trend in both U.S. and non-U.S. courts' willingness to employ comity principles to address cross-border insolvency disputes. Beginning with the 1996 *In re Maxwell Communications Corp.*[34] case, in which the U.S. bankruptcy judge cooperated effectively with her U.K. counterpart to improvise and implement a cross-border protocol between simultaneous bankruptcy cases,[35] courts in many countries have moved toward a practice that substantially defers to the insolvency laws of the home country. This trend follows the Second Circuit's observation in the *Maxwell* decision that "[c]omity is especially important in the context of the Bankruptcy Code."[36] The *Maxwell* case initiated a series of discussions and decisions endorsing the doctrine of universalism, which posits that a single set

[29] Transcript of Oral Argument. at 29 (Sept. 28, 2012), *Sec. Investor Prot. Corp.*, 513 B.R. 222.
[30] *Id.* at 15-16.
[31] *See Sec. Investor Prot. Corp.*, 513 B.R. at 232.
[32] EEOC v. Arabian American Oil Co., 499 U.S. 244, 248 (1991).
[33] *Sec. Investor Prot. Corp.*, 513 B.R. at 227.
[34] 93 F.3d 1036 (2d Cir. 1996).
[35] *Id.* at 1054-55.
[36] *Id.* at 1048.

of governing rules promotes market symmetry, or that, since modern markets are global, the same legal rules should apply in a consistent manner across borders.[37] Eventually, in 1997, the United Nations Commission on International Trade Law promulgated the Model Law on cross-border insolvency, which employs universalism and comity as its guiding principles.[38] Since then, more than twenty countries have adopted some version of the Model Law, including the United States Congress when it passed chapter 15 of the Bankruptcy Code in 2005.[39]

The *Madoff* decision reflects a universalist approach and courts' growing hesitation to reach over international borders where competing insolvency regimes govern. Universalism seeks not only to defer to the laws of the country with the greater interest but also recognizes that economic actors, when transacting, have a right to rely on their expectation that the "home" jurisdiction's laws will govern.[40] Otherwise, global markets may suffer from unpredictability, inefficiency and, some would argue, unfairness.

VI. Further Applications

The *Madoff* ruling should give a measure of comfort to foreign customers of foreign investment funds regarding the ability of a U.S. trustee to utilize U.S. bankruptcy law to claw back their distributions. However, in exploring potential future applications of Judge Rakoff's *Madoff* decision, it is useful to consider whether a slight change in circumstances would lead to a different outcome. For instance, consider a situation where an offshore feeder fund is created by a U.S. broker-dealer for the purpose of helping investors avoid U.S. taxes. In that case, a trustee could argue that the feeder fund is a "sham entity" and seek a ruling from the U.S. bankruptcy court that the offshore entity and U.S. entity should be treated together as a single estate pursuant to a substantive consolidation or alter ego theory. Accordingly, if the offshore fund made distributions to its foreign customers, the trustee may argue that such transfers were not foreign-to-foreign transac-

[37] LAW BUSINESS RESEARCH LTD, THE INTERNATIONAL INSOLVENCY REVIEW 2 (Donald S. Bernstein ed., 2d ed. 2014).

[38] *See* UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW, UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY WITH GUIDE TO ENACTMENT AND INTERPRETATION 109 (2014), *available at* www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html.

[39] 11 U.S.C. § 1501 (2005); STATUS – UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY (1997), http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html (last visited Mar. 2, 2015).

[40] *See, e.g.*, Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Laws and Choice of Forum*, 65 AM. BANKR. L.J. 457, 461 (1991).

tions as in *Madoff* but instead U.S.-to-foreign transfers that are recoverable under a purely domestic application of section 550(a).[41]

Just three days prior to the *Madoff* decision, the Ninth Circuit addressed a similar scenario in *Kismet Acquisition, LLC v. Icenhower*.[42] In *Icenhower*, a U.S. debtor transferred a Mexican coastal villa to a Nevada shell company during the pre-petition period and then, post-petition, the shell company sold the asset to a Mexican couple.[43] The Ninth Circuit upheld the rulings of both lower courts, confirming that the shell company was the alter ego of the debtor and should be substantively consolidated with the bankruptcy estate.[44] Section 549(a) of the Bankruptcy Code,[45] which permits a trustee to avoid post-petition transfers of property of the estate, applied in this case. As a result of the substantive consolidation finding, property of the debtor's estate as of the petition date included the villa in the hands of the shell company and the successor to the trustee was able to claw back the villa into the estate. [46] The court explained that, under *Morrison* and applicable Ninth Circuit precedent, Congress intended an extraterritorial application of the Bankruptcy Code as it applies to property of the estate, including with respect to section 549(a).[47]

The *Icenhower* decision suggests that *Madoff* may have been decided differently if the feeder funds were consolidated into the Madoff Securities estate, even considering the fact that section 548(a) uses the term "interest of the debtor in property" rather than "property of the estate."[48] The Trustee may have found more success if, for example, he was able to show that Madoff Securities and the feeder funds colluded to defraud other Madoff customers by distributing assets to the foreign subsequent transferees. In an alternative scenario, the defendants' arguments may have been stronger if the feeder funds at issue invested a smaller portion of their assets in Madoff Securities (say 5% rather than 95% or 100%). Under those facts, as a due process matter, it would seem even less appropriate to bring the foreign subsequent transferees into the Madoff Securities bankruptcy case.

[41] 11 U.S.C. § 550(a).
[42] 757 F.3d 1044 (9th Cir. 2014).
[43] *Id.* at 1048.
[44] *Id.* at 1053.
[45] 11 U.S.C. § 549(a) (2012).
[46] *Icenhower*, 757 F.3d at 1051.
[47] *Id.* at 1050.
[48] *See* 11 U.S. Code § 548(a) (2012).

With respect to comity, it is important to note that the doctrine requires a comparison of jurisdictional interests that does not always result in deference. In a recent chapter 15 case, *In re Elpida Memory Inc.*,[49] the bankruptcy court conducted a de novo review of a sale transaction that had been previously approved by the Japanese bankruptcy court in the main proceeding, stating that comity "is not the end all be all of the [Chapter 15] statute."[50] In *Madoff*, the court found persuasive the fact that many of the feeder funds were undergoing liquidation proceedings in their respective home countries.[51] Consequently, the Trustee could seek recovery from subsequent transferees pursuant to the laws of the feeder funds' home countries.[52] Without those facts, or if the feeder funds' home jurisdictions had been ones with undeveloped insolvency laws such that the U.S. retained a stronger interest in seeing the subsequent transfers recovered from the feeder funds' customers, the result may have been different.

Ultimately, extraterritorial application of the Bankruptcy Code and international comity require courts to examine congressional intent while balancing the competing interests of different jurisdictions. Absent contrary intent within the statute, debtors and trustees in cases under both SIPA and the Bankruptcy Code likely face an uphill battle in overcoming the presumption against extraterritoriality. The recent gravitation toward universalism and respect for foreign laws reinforces that presumption and seeks to establish international deference as the governing baseline.

[49] No. 12-10947 CSS, 2012 WL 6090194 (Bankr. D. Del. Nov. 20, 2012).
[50] *Id.* at *8.
[51] *See Sec. Investor Prot. Corp*., 513 B.R. at 232.
[52] *Id.*