Ruling on Extraterritoriality May Protect Foreign Investors in US Bankruptcies

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The Bankruptcy Code authorizes a bankruptcy trustee to avoid (*i.e.*, obtain the return of) certain types of prepetition property transfers so that the bankrupt estate can be divided among creditors fairly. For example, a trustee may bring actions to set aside transfers made within a specified period before the bankruptcy (preferences) and transfers made deliberately to defraud creditors (fraudulent transfers). Section 550(a) of the Bankruptcy Code also permits a trustee to "follow the money" to recover the property (or its value) either from the initial transferee who first received the property from the bankrupt party, or from subsequent transferees, so long as there is no double recovery. But how far — and where — can the money be followed? While the Bankruptcy Code's reach with respect to initial transfers remains unsettled,[1] a Southern District of New York opinion rendered in the Madoff bankruptcy provides comfort to foreign investors that the proceeds of their indirect investments in U.S. companies may be outside the reach of bankruptcy or Securities Investor Protection Act (SIPA) trustees.

After Bernard Madoff's multibillion-dollar Ponzi scheme collapsed in December 2008, Irving Picard was appointed trustee pursuant to the SIPA statute to administer the Madoff estate — that is, to recover money and redistribute it to creditors of the estate, namely, Madoff's direct investors. Since December 2008, Picard has filed numerous "clawback" suits seeking to recover initial and subsequent transfers that originated with the Madoff estate. Included in these actions are clawback claims against alleged subsequent transferees located in some 27 countries. A number of these foreign subsequent transferees challenged the trustee's authority to recover allegedly Madoff-originated funds from them, arguing before Judge Jed Rakoff that Section 550(a)(2) of the Bankruptcy Code, which empowers a trustee to recover funds from subsequent transferees, did not apply extraterritorially.

In a July 7, 2014, opinion, Judge Rakoff held that Bankruptcy Code Section 550(a) does not apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor (except in cases of actual fraud).[2] In a subsequent transfer case — where debtor funds flow from (1) debtor to initial transferee, then (2) from the initial transferee to a subsequent transferee — the focus is *not* the domestic or foreign character of the initial transfer transaction, Judge Rakoff explained. Rather, the focus is the subsequent transfer itself, with the key inquiry being whether "the relevant transfers and transferees are predominantly foreign." Importantly, the court determined that a "predominantly foreign" transaction may have some U.S. connection, yet remain outside the Bankruptcy Code's reach: "Mere connection to a U.S. debtor, be it tangential or remote, is insufficient" to render an otherwise foreign transaction domestic. According to Judge Rakoff, the fact that a chain of transactions originated with a U.S. debtor, or even that a subsequent transfer was processed through a U.S. correspondent bank, would not, standing alone, be enough to render a transaction domestic and thus within the ambit of the Bankruptcy Code.

Although rendered in the SIPA trustee context, Judge Rakoff's broad-based reasoning and holding that Section 550(a) does not "apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor" may have wide application, unless reversed on appeal.[3] The opinion holds, in effect, that a trustee's ability to follow the money only extends to subsequent transfers with a substantial

U.S. nexus. Foreign financial market participants can thus take comfort that payments they received abroad from another foreign transferor or financial intermediary will not be upended by a U.S. trustee on allegations that these payments originated in a U.S. bankrupt estate with which the innocent foreign party may not have had any contact. This conclusion applies only to cases *not* involving fraud and, therefore, does not invite malefactors to make foreign subsequent transfers expecting geography to take tainted transfers beyond the reach of U.S. trustees.

[1] Compare *In re French*, 440 F.3d 145 (4th Cir. 2006) (finding that Bankruptcy Code Section 548 applied extraterritorially to transfer of foreign property) with *In re Midland Euro Corp.*, 347 B.R. 708 (Bankr. C.D. Cal. 2006) (finding precisely to the contrary).

[2] *Sec. Inv. Protection Corp. v. Bernard L. Madoff Inv. Sec., LLC*, 513 B.R. 222 (S.D.N.Y. 2014).

[3] Judge Rakoff's decision is not currently appealable and will not be ripe for appeal until applied by the Bankruptcy Court in pending motions to dismiss.