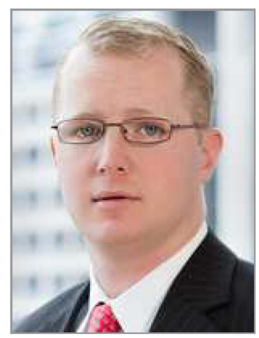
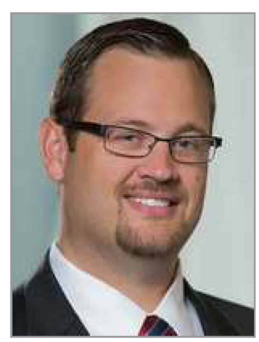
Implications Of 2nd Circ.'s Madoff Foreign Clawback Opinion

By **Ron Meisler, Carl Tullson and Matthew Beebe** (March 8, 2019, 6:19 PM EST)

Ron Meisler



Carl Tullson



Matthew Beebe

On Feb. 25, 2019, the U.S. Court of Appeals for the Second Circuit vacated the bankruptcy court's dismissal of avoidance actions brought by Irving Picard, the trustee for the liquidation of Bernard L. Madoff Investment Securities LLC, or BLMIS, under the Securities Investor Protection Act of 1970.[1]

The trustee sought to avoid and recover the transfer of funds by BLMIS to foreign investors through foreign feeder funds[2] as actual fraudulent transfers under Sections 548(a)(1)(A) and 550(a)(2). Reversing the bankruptcy court, the Second Circuit held that the focus of the Bankruptcy Code's provisions allowing the recovery from subsequent transferees, the "business end of avoidance," must be viewed in tandem with the provisions of the Bankruptcy Code authorizing avoidance of the underlying actual fraudulent transfer, in this case the initial transfer of funds from a U.S. bank account by a U.S. debtor — BLMIS — to the feeder funds. Because the initial transfer by the debtor is the proper focus of the Bankruptcy Code's avoidance and recovery powers, the Second Circuit held that the presumption against extraterritoriality and principles of comity did not apply to the avoidance actions.

The Madoff opinion leaves open whether the avoidance powers under the Bankruptcy Code apply extraterritorially, i.e., when the debtor's allegedly fraudulent conduct occurs outside of the United States, and therefore cases decided at the lower courts within the Second Circuit remain divided as to whether the avoidance provisions of the Bankruptcy Code apply extraterritorially. However, the Madoff decision provides helpful guidance for how parties should analyze whether extraterritorial application of the Bankruptcy Code is needed to unwind and recover a fraudulent transfer.

Background

The avoidance actions arose out of the notorious Ponzi scheme orchestrated by Bernard Madoff that collapsed in 2008. Madoff's fraudulent scheme involved commingling funds from investors into a checking account rather than investing those funds. When investors sought to withdraw funds, investors received a check from that checking account.

Many of the direct investors in BLMIS were feeder funds, including the three main foreign feeder funds at issue in the appeals, two of which are organized in the British Virgin Islands and one of which is organized in the Cayman Islands. The feeder funds placed all or substantially all of their assets in BLMIS investments and are currently in separate liquidation proceedings in foreign jurisdictions.[3]

The transfers at issue occurred when a foreign investor in the foreign feeder funds withdrew funds invested in BLMIS.[4] To withdraw the funds, the feeder fund would make a withdrawal request to BLMIS, which then would transfer the funds to the feeder funds (initial transfer). The funds would then be transferred from the feeder fund to the investor (subsequent transfer).[5]

The Second Circuit illustrated the transfers as follows:

All of the investor defendants in the appeals are foreign subsequent transferees.[6]

Proceedings Below

As a procedural matter, the district court initially "withdrew the reference" of jurisdiction from the bankruptcy court back to the district court for the limited purpose of determining "whether SIPA or the Bankruptcy Code as applied by SIPA apply extraterritorially."[7] The district court held that the trustee could not proceed because the presumption against extraterritoriality limited the scope of Section 550(a)(2) and prohibited the trustee from recovering funds transferred between two foreign entities (i.e., the subsequent transfer).[8] Alternatively, the district court held that Section 550(a)(2) was limited by the principles of international comity, particularly with respect to feeder funds that were in separate liquidation proceedings in foreign jurisdictions.[9] The avoidance actions were then remanded back to the bankruptcy court.

The bankruptcy court accordingly dismissed the avoidance actions against the investors (the subsequent transferees) pursuant to the presumption against extraterritoriality and international comity principles, stating that "the focus is the location of the transfer and not the location of the parties to the transfer; and a transfer from one foreign account to another foreign account is still a foreign transfer."[10]

Second Circuit Decision

As noted above, the Second Circuit held that neither the presumption against extraterritoriality nor international comity limited the reach of the trustee's power to recover actual fraudulent transfers that occurred domestically — even where a foreign subsequent transferee received the property from a foreign initial transferee.

The presumption against extraterritoriality provides that "'[a]bsent clearly expressed congressional intent to the contrary, federal laws will be construed to have only domestic application.'"[11] An action therefore may proceed only if (1) "the statute indicates its extraterritorial reach" or (2) "the case involves a domestic application of the statute."[12] The Second Circuit here addressed only the second question, finding that the relevant transfer at issue — from the debtor to the relevant feeder fund — was domestic in nature.

The Second Circuit reasoned that it must look to the avoidance provision asserted by the trustee, Section 548(a)(1)(A), to determine the focus of Section 550 and the conduct it seeks to regulate. Reading Sections 548(a)(1)(A) and 550 in tandem, the Second Circuit held that the avoidance and recovery of the initial transfer from the debtor to the feeder fund under these sections constituted the regulation of "domestic activity" involving (1) a U.S. debtor (BLMIS) and (2) the alleged fraudulent transfer of property from U.S. bank accounts.[13] However, the Second Circuit expressed no opinion on whether either factor standing alone would support a finding that a transfer was domestic.[14]

The Second Circuit noted that if it were to hold otherwise, it would open a loophole that would allow a fraudster to circumvent the avoidance powers of the Bankruptcy Code merely by transferring funds through two foreign entities.[15] The presumption against extraterritoriality therefore did not prohibit the trustee from pursuing the avoidance actions.

Finally, the Second Circuit held that principles of international comity similarly did not limit the trustee's ability to pursue the avoidance actions. The court reasoned that U.S. law was not regulating the foreign investor's relationship with the feeder funds but rather was regulating "the debtor's property transfers to" the feeder funds.[16] Moreover, the Second Circuit noted that although the avoidance actions will affect the foreign, subsequent transferee investors, "[w]hen these investors chose to buy into feeder funds that placed all or substantially all of their assets with [BLMIS], they knew where their money was going."[17]

Key Takeaways

Although the Madoff opinion means that the avoidance powers under the Bankruptcy Code have international reach, the Second Circuit expressly did not opine on whether Congress intended the avoidance powers of the Bankruptcy Code to have extraterritorial reach.[18]

Due to this limitation, the opinion does not resolve a split of authority among bankruptcy courts in the Southern District of New York regarding the extraterritorial reach of the Bankruptcy Code's avoidance powers.[19] Moreover, a court seeking to exercise the avoidance powers of the Bankruptcy Code must establish personal jurisdiction over the transferee, whether the statute is applied extraterritorially or not.

Parties seeking to bring avoidance actions related to foreign transfers or transferees must therefore remain wary of this split of authority in the Southern District of New York unless the transfer falls under the narrow ambit of the Second Circuit's holding in the appeals. Nonetheless, the Second Circuit has closed a potential loophole to circumvent the avoidance powers under Chapter 5 of the Bankruptcy Code, at least with respect to actual fraudulent transfers.

Ron E. Meisler is a partner, Carl T. Tullson is counsel and Matthew D. Beebe is an associate at Skadden Arps Slate Meagher & Flom LLP.

[1] In re Picard, --- F.3d ----, Case No. 17-2992(L), 2019 WL 903978 (2d Cir. Feb. 25, 2019).

[2] "A feeder fund is an entity that pools money from numerous investors and then places it into a 'master fund' on their behalf. A master fund — what [BLMIS] advertised its funds to be — pools investments from multiple feeder funds and then invests the money." In re Picard, 2019 WL 903978, at *2.

[3] Id.

[4] The Second Circuit assumed, for purposes of the appeals, that "the Trustee could trace the money back to [BLMIS]." Id. at *3, n.3.

[5] Id. at *2.

[6] Id. at *3.

[7] Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Madoff Sec.), 513 B.R. 222, 226 (S.D.N.Y. 2014). District courts have original jurisdiction over proceedings under the Bankruptcy Code but are permitted to refer those matters to the bankruptcy courts and typically do so by issuing a standing order of reference that automatically refers bankruptcy matters to the bankruptcy courts. However, a district court must withdraw that reference to the bankruptcy courts if resolution of the proceedings requires the consideration of nonbankruptcy federal laws "regulating organizations or activities affecting interstate commerce." 28 U.S.C. § 157(d). Here, the district court withdrew the reference to the bankruptcy court because it determined that resolving the proceedings required consideration of both bankruptcy law and SIPA.

[8] In re Picard, 2019 WL 903978, at *3.

[9] See id.

[10] See Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, Adv. No. 08-01789 (SMB), 2016 WL 6900689, at *14, 16, 19 (Bankr. S.D.N.Y. Nov. 22, 2016).

[11] In re Picard, 2019 WL 903978, at *4 (quoting RJR Nabisco, Inc. v. European Cmty., 136 S. Ct. 2090, 2100 (2016)).

[12] Id. at *5.

[13] Id. at *9.

[14] Id. at *9 n.9.

[15] Id. at *9.

[16] Id. at *14.

[17] Id.

[18] Id. at *9.

[19] Compare Weisfelner v. Blavatnik (In re Lyondell Chem. Co.), 543 B.R. 127, 153-55 (Bankr. S.D.N.Y. 2016) ("It would be inconsistent (such that Congress could not have intended) that property located anywhere in the world could be property of the estate once recovered under section 550, but that a trustee could not avoid the fraudulent transfer and recover that property if the center of gravity of the fraudulent transfer were outside of the United States."); In re FAH Liquidating Corp., 572 B.R. 117, 125 & n.6 (Bankr. D. Del. 2017) (recognizing split and adopting the reasoning in Lyondell and holding that Section 548 applies extraterritorially); with Lamonica v. CEVA Grp. PLC (In re CIL Ltd.), 582 B.R. 46, 92 (Bankr. S.D.N.Y. 2018) ("Congress has not expressed an affirmative intent for sections 548 and 550 to be applied extraterritorially, and nothing in the text of those sections indicates such an intent."); Spizz v. Goldfarb Seligman & Co. (In re Ampal-Am. Israel Corp.), 562 B.R. 601, 612 (Bankr. S.D.N.Y. 2017).