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Alert

District Court Blocks Bankruptcy Trustee's Foreign Entanglement

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U.S. District Judge Jed S. Rakoff of the Southern District of New York held on July 6, 2014 that the Madoff Securities SIPA trustee could not recover customer funds subsequently transferred abroad by "foreign feeder funds" to their foreign "customers, managers, and the like." *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC* (*In re Madoff Securities*), 2014 WL 2998557, *1 (S.D.N.Y. July 6, 2014). The trustee had sued not only certain feeder funds for having received "allegedly avoidable transfers," but also their "immediate and mediate transferees." *Id.* at *1. Essentially, the trustee sought to "recover [the] subsequent transfers — transfers made abroad between a foreign transferor and a foreign transferee." *Id.*

The court merely dismissed the trustee's recovery claims "to the extent that they seek to recover purely foreign transfers." *Id.* at *8. But for the notoriety of the Madoff case, the result here should be unsurprising.

The Relevant Code Section
The trustee's claim against the subsequent transferees here turned on a Bankruptcy Code ("Code") section that reads in relevant part:

> [T]o the extent that a transfer is avoided under … [the Code], 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 U.S.C. § 550(a) (emphasis added).

The Securities Investors Protection Act ("SIPA") enables a trustee "to utilize the Bankruptcy Code's avoidance and recovery provisions to reclaim customer property." 2014 WL 2998557, *6. Nothing in SIPA, however "expressly provides[s] for extraterritorial application." *Id.* Indeed, "SIPA's predominantly domestic focus suggests a lack of intent by Congress to extend its reach extraterritorially." *Id.*

According to the court, "Congress [never] intended for this section to apply to foreign transfers." *Id.* at *4. Although the trustee argued that Code Section 541 defines "property of the estate" to include certain property "wherever located and by whomever held," this only means that the trustee obtains title "over all of the debtors' property, regardless of whether it is physically present in the United States." *Id.* The court found the trustee's argument to be "clever" but "neither logical nor persuasive." *Id.* at *5. Until the trustee recovers "property of the estate," it is not the "debtor's property." *Id.* at *5.

In the words of the Second Circuit, "property is not to be considered property of the estate until it is recovered." *Id.* (quoting *In re Colonial Realty Co.*, 980 F.2d 125, 131 (2d Cir. 1992)). Therefore, reasoned the court, Code Section 541(a)(1) "cannot supply any extraterritorial authority that the avoidance and recovery provisions lack on their own." 2014 WL 2998557, at *5.

Presumption Against Extraterritorial Application

The foreign defendants moved to dismiss the complaint, arguing that Code Section 550 (a)(2) "does not apply extraterritorially and therefore does not reach subsequent transfers made abroad by one foreign entity to another." *Id.* at *2. They relied on leading U.S. Supreme Court precedent: "It is a 'longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.'" *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (quoting *EEOC v. Arabian American Oil Co.*, 499 U.S. 244, 248 (1991)). According to the Supreme Court, as quoted by the district court in *Madoff Securities*, this "'presumption against extraterritorial application of federal statutes' serves to protect against unintended clashes between our laws and those of other nations which could result in international discord." 2014 WL 2998557, at *2 (quoting 499 U.S. at 248).

The court first rejected the trustee's argument that his suit was "domestic." *Id.* at *3. In the words of the court, "a mere connection to a U.S. debtor, be it tangential or remote, is insufficient on its own to make every application of the Bankruptcy Code domestic." *Id.*

The "relevant transferors and transferees [in this case] are predominantly foreign: foreign feeder funds transferring assets abroad to their foreign customers and other foreign transferees." *Id.* Although the trustee was seeking "to make the recovery of these otherwise thoroughly foreign subsequent transfers into a domestic application of [Code Section 550(a)]," his claims would still require "extraterritorial application of [Code Section] 550(a)." *Id.* Moreover, the defendants' use of "correspondent banks in the United States to process dollar-denominated transfers" was hardly enough to make these foreign transfers domestic. *Id.* at *3 n.1.

The court also rejected the trustee's argument that the U.S. debtor here had fraudulently transferred assets "offshore and then [arranged for the] retransfer [of] those assets to avoid the reach of U.S. bankruptcy law." *Id.* Because "the Trustee here may be able to utilize the laws of the countries where such transfers occurred to avoid such an evasion while at the same time avoiding international discord," the court explained, these defendants were not being "more favorably … treated" than other "customer-beneficiaries of the SIPA estate," as the trustee "disingenuous[ly]" argued. *Id.* They would "stand to benefit little, if at all, from the customer-property estate through their now-defunct feeder funds." *Id.*

Comity

Principles of international comity would further preclude the trustee from maintaining his suit under Code Section 550(a). "Comity 'is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.'" *Id.* at *7 (quoting *In re Maxwell Commc'n Corp.*, 93 F.3d 1036, 1046 (2d Cir. 1996)). Indeed, according to the Second Circuit, "[c]omity is especially important in the context of the Bankruptcy Code." *Maxwell*, 93 F.3d. at 1048. In this case, "many of the feeder funds are currently involved in their own liquidation proceedings in their home countries," with "their own rules concerning on what bases

the recipient of a transfer from a debtor should be required to disgorge it." *Id.* at *7. Because of the remote, "indirect relationship" between Madoff Securities and the transfers "at issue here, these foreign jurisdictions have a greater interest in applying their own laws than does the United States." *Id*.

Conclusion

This recent *Madoff Securities* decision is hardly novel in view of Supreme Court and Second Circuit precedent. The court saw through the trustee's attempt "to use SIPA [and the Code] to reach around … foreign liquidations in order to make claims to assets on behalf of the SIPA customer property estate." *Id.* There was no need to apply U.S. law in a U.S. bankruptcy court.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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