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NEW OUTER LIMITS FOR THE EXTRATERRITORIAL REACH OF THE U.S. BANKRUPTCY CODE

In this article, the authors discuss a recent Second Circuit decision which, they suggest, could be used to substantially expand the extraterritorial reach of U.S. courts in bankruptcy cases and limit the deference U.S. courts will show to foreign jurisdictions in such cases.

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On February 25, 2019, the U.S. Court of Appeals for the Second Circuit issued a landmark decision, ruling that the trustee liquidating Madoff Securities can recover funds transferred to overseas entities under the Bankruptcy Code's recovery statute.¹

The case involved transfers of funds among Bernard L. Madoff Investment Securities LLC, feeder funds, and foreign investors. During the course of Madoff's Ponzi scheme, the feeder funds served as intermediaries between investors and Madoff Securities. In the case of distributions from Madoff Securities, money would first be transferred from Madoff Securities in New York to feeder funds located in a variety of locations ("Initial Transfers") outside of the United States. The feeder funds would then distribute the money to foreign investors ("Subsequent Transfers"). The primary issue was whether the presumption against extraterritoriality barred the trustee, appointed in the U.S. proceeding of Madoff Securities pending in the Bankruptcy Court for the Southern District

of New York, from recovering Subsequent Transfers made from the foreign feeder funds to foreign investors.

BACKGROUND

The question of extraterritorial application of the recovery statute was first considered in the District Court for the Southern District of New York before Judge Rakoff, who had withdrawn the reference to the Bankruptcy Court of numerous clawback actions seeking to recover fraudulent conveyances. Judge Rakoff applied a two-step test, originating from two Supreme Court cases, *Morrison* and *Nabisco*.² In those cases, the Supreme Court recognized a presumption against extraterritorial application of U.S. federal statutes. The Court stated in those decisions that in order to determine whether foreign application of U.S. laws is blocked by the presumption, a court should determine: (i) whether Congress intended the statute to apply extraterritorially and, if not, (ii) whether the litigation involves

¹ *In re Picard*, 2019 U.S. App. LEXIS 5411 Case No. 17-2992(L) (2d Cir. Feb. 25, 2019).

² *Morrison v. National Australia Bank Ltd.*, 561 U.S. 247 (2010); *RJR Nabisco Inc. v. European Cmty.*, 136 S. Ct. 2090 (2016).

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extraterritorial application of the statute. As to the second prong, the Court noted that to determine whether a particular case involves domestic or extraterritorial application of a statute, a court should look to the statute's "focus."

Judge Rakoff attempted to apply that test to the application of Bankruptcy Code section 550(a)(2), which regulates the recovery of property under the Code's avoidance provisions. He also relied on a previous District Court ruling, which held that a proper conception of a transfer, for the purposes of an extraterritoriality analysis, is one that takes into account all the component events of the transfer, not simply one transaction in the chain.³ As such, Judge Rakoff considered both the Initial and Subsequent Transfers of the fraudulent conveyance claims before him, and determined that the "focus" of section 550(a)(2) was on the Subsequent Transfer (*i.e.*, between the feeder funds and the foreign investors), and thus the application of section 550(a)(2) was extraterritorial. Judge Rakoff went on to find that Congress did not intend for section 550(a)(2) to apply extraterritorially and that comity barred recovery of the Subsequent Transfers. Judge Rakoff ultimately remanded the case to the Bankruptcy Court, with instructions to dismiss those cases found to involve foreign transfers. The Bankruptcy Court acted in accordance with Judge Rakoff's decision, resulting in an appeal to the Second Circuit.

THE SECOND CIRCUIT RULING

1. Recovery in this Case Involves Domestic Application of Section 550(a)(2)

The Second Circuit began its analysis by discussing a recent 2018 Supreme Court case, *WesternGeco LLC v. ION Geophysical Corp.*, which dealt with determining the "focus" of a patent infringement statute.⁴ In that case, the Supreme Court provided that the determination of a statute's focus should not take place in a vacuum, but rather courts should look to whether a particular

statute works in concert with other statutes. The Supreme Court also instructed lower courts to look to the "overriding purpose" of the statute, such as the conduct the statute seeks to regulate or parties it seeks to protect, to determine the statute's "focus."

The Second Circuit applied the *WesternGeco* rationale to section 550(a)(2) and found that the provision worked in tandem with section 548(a)(1)(A), the intentional fraudulent conveyance provision of the Bankruptcy Code. Specifically, the Second Circuit recognized that section 548(a)(1)(A) provided the grounds for the trustee to avoid domestic transfers while section 550(a)(2) provided the means of recovery. Looking to both section 550(a)(2) and 548(a)(1)(A) in tandem, the Second Circuit found that the "focus" of section 550(a)(2) was shaped by section 548(a)(1)(A). The Court went on to find that the language of section 548(a)(1)(A) explicitly limited it to transfers made by the debtor. Thus, the Second Circuit held that the relevant transfer for purposes of an extraterritoriality analysis was the Initial Transfer of U.S. assets from Madoff Securities, a U.S. debtor located in the United States, to the feeder funds, as it was the only transfer made by the debtor.

Having found that the "focus" of section 550(a)(2) was the Initial Transfer, the Second Circuit concluded that the recovery of funds transferred from foreign feeder funds to foreign investors involved the domestic application of section 550(a)(2). As such, it determined that the presumption against extraterritoriality did not bar the trustee from recovering such funds.⁵

2. Comity does not Bar Recovery in this Case

The Second Circuit began its comity analysis by identifying two different applications of comity, prescriptive comity and adjudicative comity. It noted that prescriptive comity addresses whether a court should "presume that Congress, out of respect for foreign sovereigns, limited the application of domestic law on a given set of facts."⁶ It further provided that, as

³ *Maxwell Commun. Corp. PLC by Homan v. Societe Generale PLC (In re Maxwell Commun. Corp. PLC)*, 186 B.R. 807 (S.D.N.Y. 1995), *aff'd*, 93 F.3d 1036 (2d Cir. 1996).

⁴ *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018).

⁵ The Second Circuit explicitly did not address whether or not section 550(a)(2) was intended by Congress to apply extraterritorially.

⁶ *Picard*, 2019 U.S. App. LEXIS 5411 at 26.

applications of prescriptive comity pose a question of statutory interpretation, they are reviewed under a *de novo* standard. Adjudicative comity, on the other hand, addresses whether a court should abstain from exercising jurisdiction over a matter where a foreign nation's courts might be a more appropriate forum for adjudicating that matter. As applications of adjudicative comity are a matter of judicial discretion, they are reviewed under the abuse of discretion standard. The Second Circuit recognized that in this case the lower courts had presented it with a question of prescriptive comity, and thus reviewed *de novo* the contention that international comity barred the trustee from recovering the funds.

The Second Circuit first established that international comity only comes into play when a true conflict exists between U.S. and foreign law. It then acknowledged that the record was ambiguous as to whether a conflict existed, but assumed that one did for the purpose of its analysis. Next, it recognized the particular importance of comity in bankruptcy proceedings, especially when parallel proceedings are in place in the United States and a foreign jurisdiction. However, because Madoff Securities was only a debtor in a U.S. insolvency proceeding, as opposed to the feeder funds, currently in foreign separate insolvency proceedings, the Second Circuit found that no parallel proceedings existed.

Then, in determining whether prescriptive comity was appropriate, the Second Circuit applied the choice-of-law test set forth in *Maxwell*, which basically weighs the interests of the foreign state against the interests of the United States.⁷ The Second Circuit found that the United States had a strong interest in allowing trustees of domestic estates to recover fraudulently transferred property. The fact that the trustee would be pursuing recovery against the same creditors as the foreign proceedings did not constitute a compelling interest in favor of the foreign proceedings. Indeed, the absence of parallel proceedings involving the debtor greatly diminished any foreign interest that might weigh on its analysis. Thus, the Second Circuit held that the U.S. interest in applying its law outweighed the interests of any foreign state in this case, and as such prescriptive comity posed no bar to recovery by the trustee.

Having dealt with the issues of extraterritorial application and comity, the Second Circuit vacated the

judgments of the Bankruptcy Court dismissing the recovery actions and remanded the case for further proceedings consistent with its opinion. A petition by various defendants for panel rehearing and rehearing *en banc* was filed on March 11, 2019.

TAKEAWAY

The Second Circuit's decision has potentially far-reaching consequences in future cross-border cases involving the extraterritorial application of the Bankruptcy Code. The "working in tandem" analysis used by the Second Circuit to determine the "focus" of section 550(a)(2) could potentially be applied across several other provisions of the Bankruptcy Code that function in a similar fashion. For example, section 550 itself references a litany of avoidance provisions, not just section 548. Further, it could be argued that the rationale used by the Second Circuit expands the reach of provisions, such as section 542, which mandate turnover of property (including documents) of a U.S. debtor's estate. Ultimately, the Second Circuit's decision could greatly expand the global reach of the Bankruptcy Code and provide comfort to U.S. creditors at the expense of uncertainty on the part of foreign transferees.

Additionally, the observations made by the Second Circuit in its consideration of comity are significant. Primarily, the explicit distinction between adjudicative and prescriptive comity, and the different standard of review applied to each, could transform comity analyses in future cases. Further, the Second Circuit's disregard of the foreign proceedings in the British Virgin Islands, the Cayman Islands, and Bermuda hinted that it had a narrow conception of comity as opposed to the deference shown by the District Court.⁸ Although much of the Second Circuit's language in the opinion validated the premise that, especially in the bankruptcy context, courts should defer to foreign proceedings, the Second Circuit recognized that foreign jurisdictions should have little to no interest in the Madoff Securities case due to the fact that the foreign insolvency proceedings did not involve the exact same entity. Also, the Second Circuit refused to recognize any profound interest on the part of the foreign countries, despite the fact that the foreign and U.S. proceedings were likely to share the same targets. Ultimately, the Second Circuit's discussion of comity, although arguably *dicta*,

⁷ *In re Maxwell*, 93 F.3d at 1048 ("Comity is a doctrine that takes into account the interests of the United States, the interests of the foreign state, and those mutual interests the family of nations have in just and efficiently functioning rules of international law").

⁸ *Cf. Kryz v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, 768 F.3d 239 (2d Cir. 2014), *aff'd*, 690 F. App'x 761 (2d Cir. 2017) ("Chapter 15 does impose certain requirements and considerations that act as a brake or limitation on comity") (quoting *Ad Hoc Grp. of Vitro Noteholders v. Vitro SAB De CV (In re Vitro SAB De CV)*, 701 F.3d 1031 (5th Cir. 2012)).

may encourage lower courts to consider the question of comity in a more mechanical and limited fashion as opposed to showing deference to foreign courts.

The *In re Picard* decision has the potential to have wide-ranging effects in many bankruptcy cases that involve foreign entities, whether they are debtors,

creditors, or mere recipients of voidable transfers. The Second Circuit's analysis of extraterritorial application of the Bankruptcy Code could be used to substantially expand the reach of U.S. courts around the globe, while its discussion of comity could be used to limit the deference U.S. courts will show to foreign jurisdictions. ■