Global Practitioners Beware
U.S. Code’s Avoidance Provisions Might Have International Reach

In the September 2014 issue, an article discussed the extraterritorial application of federal statutory law and the presumption against extraterritoriality in the context of the July 6, 2014, decision in SIPC v. Bernard L. Madoff Investment Securities (the “avoidance action”) and a trustee’s avoidance powers vested under the Bankruptcy Code. Much has happened on extraterritoriality in the Southern District of New York since the decision and the initial article on the topic nearly five years ago, including the post-remand decision dismissing the avoidance action.

Meanwhile, both Hon. Robert E. Gerber (now retired) in Weisfeiner v. Blavatnik (In re Lyondell) and Hon. Sean H. Lane in In re Arcapita Bank B.S.C.(c) rejected extraterritoriality defenses raised to defeat avoidance actions. On the other hand, Hon. Stuart M. Bernstein concluded that the avoidance provisions of the Code, including § 547(b), did not apply extraterritorially in In re Ampal-Am. Israel Corp.

Now, an update is warranted on the status of the avoidance action following the Second Circuit’s decision in In re Irving H. Picard, Trustee for the Liquidation of Bernard L. Madoff Investment Securities LLC (the “Second Circuit’s extraterritoriality decision”), which vacated the bankruptcy court’s dismissal of the avoidance action commenced by trustee Irving H. Picard (Baker & Hostetler LLP; New York), who was overseeing bankruptcy litigation related to Bernard L. Madoff’s massive Ponzi scheme. The Second Circuit concluded that the presumption against extraterritorial application of the Bankruptcy Code did not apply to the avoidance action.

This article will refresh the recollection regarding the extraterritorial application of federal statutory law and the presumption against extraterritoriality. Using the Second Circuit’s extraterritoriality decision as the framework, the article will re-examine the applicability of the presumption against extraterritoriality in the context of avoidance proceedings commenced under the Code. However, this might not be the last chapter regarding the avoidance action. In late April, the tribunal that issued the Second Circuit’s extraterritoriality decision granted a stay of the decision pending a writ of certiorari that the affected parties intend to file in July.

Madoff’s Massive Ponzi Scheme
Although still etched in our minds, posterity protocol requires a summary of the facts underlying the Second Circuit’s extraterritoriality decision. The trustee’s claims arose from the epic collapse of Bernard L. Madoff Investment Securities LLC (the “Madoff Securities”) following Madoff’s disclosure of a Ponzi scheme in December 2008, in the midst of the tumultuous financial crisis spawned from the collapse of the U.S. housing market. Madoff’s was a classic Ponzi scheme, although answers remain elusive to this day regarding his ability to hide the funds.
fraud from investors and regulators over multiple decades. Instead of investing money from his clients into financial instruments (as his investors (and regulators) believed), Madoff — by and through Madoff Securities — simply commingled funds into a checking account, then made investor distributions from the checking account.

Many of the investors in Madoff Securities were feeder funds from outside the U.S. A nondomestic feeder fund would obtain investments from foreign investors and pool the investments, then feed the investments to Madoff Securities. When Madoff Securities made disbursements, they would pass through the feeder fund and back to the original, foreign investors. The trustee sued the foreign investors, among others, under the Code’s statutory avoidance powers. The Second Circuit’s extraterritoriality decision involves the trustee’s litigation related to the foreign investors.

Legislating Extraterritorially

The application of one country’s laws to conduct occurring beyond the local jurisdiction is commonly referred to as “extraterritoriality.” Historically, sovereigns have legislated extraterritorially in certain instances, including policing the conduct of its own citizens. In the U.S., Congress has both implicit authority and express authority to legislate extraterritorially. For example, the power to define and punish felonies on the high seas and the power under the necessary and proper clause have been referenced in the past as the source of Congress’s authority to enact extraterritorial criminal legislation primarily in the maritime context.

Congress’s constitutional authority to legislate extraterritorially is not plenary, although U.S. courts have consistently recognized Congress’s authority to extend statutory reach outside the territorial boundaries of the U.S. At the outset, the Second Circuit’s extraterritoriality decision reminds practitioners that the Code’s avoidance provisions do not expressly indicate an extraterritorial reach.

The Presumption Against Extraterritoriality

Congress has almost unfettered discretion to legislate extraterritorially, but it generally must expressly manifest an intent to apply statutory provisions extraterritorially. Without such manifest intent, U.S. courts are called upon to employ statutory construction and interpretation in deciding the extraterritorial reach of a law. According to the Second Circuit’s extraterritoriality decision, “The presumption against extraterritoriality is a canon of statutory construction.”

The Second Circuit’s Extraterritoriality Decision

The Second Circuit’s extraterritoriality decision primarily concentrated on whether § 550(a)(2) of the Bankruptcy Code violated the presumption against extraterritoriality and consequently blocked the trustee from utilizing the provision to recover property from a foreign subsequent transferee. The tribunal relied on WesternGeco LLC v. ION Geophysical Corp., a 2018 Supreme Court decision, for guidance on the extraterritorial reach of a statute. The focus of a statute is the object of its solitude, which can include the conduct it

synthesis of three rules of construction that form the presumption’s foundation.

First, if a federal statute is void of express language related to its extraterritorial application, courts will limit its reach to within domestic boundaries, absent a “clear indication of some broader intent.” Next, the “nature and purpose of a statute [might] provide an indication of whether Congress intended a statute to apply beyond the confines of the U.S.” Third, Congress is presumed to have enacted legislation that does not conflict with international law. As such, “This canon helps avoid the international discord that can result when U.S. law is applied to conduct in foreign countries. It also reflects the common-sense notion that Congress generally legislates with domestic concerns in mind.”

In turn, U.S. courts have justified their application of the presumption through four underlying judicial principles. The presumption is primarily premised on a “general observation that Congress ordinarily legislates with respect to domestic, not foreign, matters [and] it knows how to give extraterritorial effect to its statutes when it wants to.” Safeguarding certainty provides the underpinnings of the second principle. Courts wish to minimize “judicial-speculation-made-law” and maximize “a stable background against which Congress can legislate with predictable effects.”

Protection “against unintended clashes between [U.S.] law and those of other nations [that] could result in international discord” provides the third basis for the presumption. Finally, the presumption is premised on “Congress’s role in the lawmaking process and limiting[ing] activist judicial interpretation.” The trustee’s avoidance actions were dependent on the Bankruptcy Code’s extraterritorial reach, which the lower courts concluded was contrary to the presumption against extraterritoriality.
seeks to regulate as well as the parties and interests its seeks to protect or vindicate.”

From there, the Second Circuit’s extraterritoriality decision critically synthesized §§ 548(a)(1)(A) and 550(a)(2) of the Bankruptcy Code in order to understand the “focus” of § 550, as well as the specific conduct that the provisions were intended to regulate. “Section 550(a) works in tandem with section 548(a)(1)(A) by enabling the Trustee to recover fraudulently transferred property. Recovery is the business end of avoidance.” When interpreting these provisions together, the Second Circuit concluded that the avoidance and recovery from a foreign feeder fund from Madoff under these sections constituted the regulation of “domestic activity” involving (1) a U.S. debtor (Madoff Securities) and (2) the alleged fraudulent transfer of property from a New York-based bank account. Notably, the Second Circuit’s extraterritoriality decision remained silent on whether either of these two components, standing alone, would trigger the same conclusion.

The tribunal also noted that a failure to vacate the bankruptcy court order could provide a proverbial escape route that would make otherwise-avoidable transfers “recovery-proof”:

“The presumption against extraterritoriality is not a limit upon Congress’s power to legislate but a canon of construction meant to guide our understanding of a statute’s meaning. We cannot imagine how it should guide us to read the Code’s creditor-protection provisions in this self-defeating way.” Accordingly, the presumption against extraterritoriality did not prohibit the trustee from seeking to recover transfers from the foreign feeder funds and the foreign investors.

Conclusion

The U.S. Bankruptcy Code’s avoidance powers have international reach. The Second Circuit’s extraterritoriality decision closes a route to circumvent the Code’s avoidance powers with respect to actual fraudulent transfers occurring domestically where both the initial and subsequent transferees are foreign persons or entities. It represents binding precedent in the Second Circuit, with the potential to be used as persuasive precedent in other circuits. As a result, in U.S. bankruptcy cases, the risk of clawback increases to non-U.S. investors in non-U.S. entities.


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