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Code to Code

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Global Practitioners Beware

U.S. Code's Avoidance Provisions Might Have International Reach

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In the September 2014 issue,[1] 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*[2] (the "avoidance action") and a trustee's avoidance powers vested under the Bankruptcy Code.[3] 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)*[4] and Hon. **Sean H. Lane** in *In re Arcapita Bank B.S.C.(c)*[5] 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.*[6]

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"),[7] 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

1 For an article regarding the presumption against extraterritoriality in the context of *SIPC v. Bernard L. Madoff Inv. Sec.*, 513 B.R. 222 (S.D.N.Y. 2014), *see* Patrick M. Birney, "Revisiting Presumption Against Extraterritoriality in Avoidance Actions," XXXIII *ABI Journal* 9, 28-29, 70-71, September 2014, *available at* abi.org/abi-journal. This article provides an update since that decision and includes content from the 2014 article.

2 *SIPC v. Bernard L. Madoff Inv. Secs.*, 513 B.R. 222 (S.D.N.Y. 2014).

3 *See, e.g.*, Thomas R. Slome and Jessica G. Berman, "Can § 547 Be Used to Avoid Foreign Transaction?: The Extraterritorial Application of Preference Laws," XXX *ABI Journal* 2, 46-47, 57, March 2011; David B. Stratton, "Reflections on the Extraterritorial Application of the Bankruptcy Code," XXIV *ABI Journal* 7, 44, September 2005. Both articles are *available at* abi.org/abi-journal.

4 *Weisfeiner v. Blavatnik (In re Lyondell)*, 543 B.R. 127 (Bankr. S.D.N.Y. 2016). For an insightful discussion regarding the *Blavatnik* decision, *see* Eduardo J. Glas, "*Lyondell* Bucks Precedents that Say § 548 Has No Extraterritorial Reach," XXXV *ABI Journal* 4, 30-31, 86, April 2016, *available at* abi.org/abi-journal.

5 *Official Committee of Unsecured Creditors of Arcapita Bank B.S.C.(c) v. Bahrain Islamic Bank (In Arcapita Bank B.S.C.(c))*, 575 B.R. 229 (Bankr. S.D.N.Y. 2017).

6 *In re Ampal-Am. Israel Corp.*, 562 B.R. 601 (Bankr. S.D.N.Y. 2017). Farther south on the Northeast corridor, Hon. **Kevin Gross** concluded in *Emerald Capital Advisors Corp. v. Bayerische Moteren Werke Aktiengesellschaft (In re FAH Liquidating Corp.)*, 572 B.R. 117 (Bankr. D. Del. 2017), that presumption against extraterritoriality was overcome because Congress intended the Bankruptcy Code's fraudulent-conveyance provisions to reach certain foreign transfers.

7 917 F.3d 85 (2d Cir. 2019).

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."[8] Historically, sovereigns have legislated extraterritorially in certain instances,[9] including policing the conduct of its own citizens.[10] In the U.S., Congress has both implicit authority[11] and express authority[12] 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.[13]

Congress's constitutional authority to legislate extraterritorially is not plenary,[14] although U.S. courts have consistently recognized Congress's authority to extend statutory reach outside the territorial boundaries of the U.S.[15] At the outset, the Second Circuit's extraterritoriality decision reminds practitioners that the Code's avoidance provisions do not expressly indicate an extraterritorial reach.[16]

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.[17] According to the Second Circuit's extraterritoriality decision, "The presumption against extraterritoriality is a canon of statutory construction."[18] This article's authors have previously pointed to a synthesis of three rules of construction that form the presumption's foundation.[19]

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."[20] 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.]."[21] Third, Congress is presumed to have enacted legislation that does not conflict with international law.[22] 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."[23]

In turn, U.S. courts have justified their application of the presumption through four underlying judicial principles.[24] 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."[25] Safeguarding certainty provides the underpinnings of the second principle.[26] Courts wish to minimize "judicial-speculation-made-law"[27] and maximize "a stable background against which Congress can legislate with predictable effects."[28]

Protection "against unintended clashes between [U.S.] law and those of other nations [that] could result in international discord"[29] provides the third basis for the presumption. Finally, the presumption is premised on "Congress's role in the lawmaking process and limit[ing] activist judicial interpretation."[30] 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.[31]

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.[32] The tribunal relied on *WesternGeco LLC v. ION Geophysical Corp.*,[33] a 2018 Supreme Court decision, for guidance on the extraterritorial reach of a statute.[34] "The focus of a statute is the object of its solitude, which can include the conduct it

8 Austin L. Parrish, "Evading Legislative Jurisdiction," 87 *Notre Dame L. Rev.* 1673, 1679 and n.19 (2012) ("Under international law, states may regulate foreign conduct based upon ... territoriality, nationality, protective principle, passive personality, and universality.").
9 *Id.*
10 *Id.*
11 The U.S. Constitution does not expressly prohibit Congress from legislating extraterritorially.
12 *See generally* Charles Doyle, "Extraterritorial Application of Criminal Law: An Abbreviated Sketch," Cong. Research Serv., RS22497 (2012) (discussing doctrine of extraterritoriality in context of criminal conduct).
13 *Id.* at 1-2.
14 *Id.* at 6-7.
15 *Id.* at 1-2.
16 Second Circuit Extraterritoriality Decision, 917 F.3d at 95.
17 Doyle, *supra* n.12 at 4.
18 Second Circuit Extraterritoriality Decision, 917 F.3d at 95 (citing *RJR Nabisco Inc., v. European Cmty.*, 136 S. Ct. 2090, 2100 (2016)).
19 *See* Birney, *supra* n.1.
20 Doyle, *supra* n.12 at 1 (citing *Morrison v. Nat'l Australia*, 130 S. Ct. 2869, 2877 (2010)).
21 Birney, *supra* n.1 (citing *United States v. Bowman*, 260 U.S. 94, 97-98, 102 (1922); *Am. Banana Co. v. United Fruit Co.*, 213 U.S. 347, 355-56 (1909)).
22 *Id.* (citing *Weinberger v. Rossi*, 456 U.S. 25, 32 (1982)).
23 Second Circuit Extraterritoriality Decision, 917 F.3d at 95 (internal quotations and citations omitted).
24 David Keenan and Sabrina P. Shroff, "Taking the Presumption Against Extraterritoriality Seriously in Criminal Cases after *Morrison* and *Kiobel*," 45 *Loy. U. Chi. L.J.* 71, 87 (2013-2014). The weight given to each of the principles varies over time. *Id.*
25 *Id.*
26 *Id.* at 88.
27 *Id.*
28 *Id.*
29 *Id.* (citing *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991)).
30 *Id.* (citing *Aramco*, 499 U.S. at 248).
31 Second Circuit Extraterritoriality Decision, 917 F.3d at 95.
32 *Id.* at 91.
33 *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018).
34 Second Circuit Extraterritoriality Decision, 917 F.3d at 96 (citing *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018)).

seeks to regulate as well as the parties and interests its seeks to protect or vindicate."[35]

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."[36] 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.[37] Notably, the Second Circuit's extraterritoriality decision remained silent on whether either of these two components, standing alone, would trigger the same conclusion.[38]

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":[39] "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."[40] Accordingly, the presumption against extraterritoriality did not prohibit the trustee from seeking to recover transfers from the foreign feeder funds and the foreign investors.[41]

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. abi

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35 *Id.*
36 *Id.* at 98.
37 *Id.* at 99.
38 *Id.* at 100.
39 *Id.*
40 *Id.*
41 The Second Circuit also determined that principles of international comity could not circumscribe the trustee's statutory authority to pursue his avoidance claims. The court stated that U.S. law was not regulating the foreign investor's relationship with the foreign feeder fund. Instead, it was regulating Madoff Securities' transfer of funds to the foreign feeder fund.