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Revisiting Presumption Against Extraterritoriality in Avoidance Actions

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The July 6, 2014, decision in *SIPC v. Bernard L. Madoff Investment Securities LLC* (the "*Madoff* extraterritoriality decision")[1] provides a timely opportunity to revisit the "presumption against extraterritoriality" in the context of a trustee's avoidance powers vested under the Bankruptcy Code.[2] In the latest decision spawned from the *Madoff* Ponzi scheme and the ensuing consolidated liquidation proceedings filed under the Securities Investor Protection Act of 1970 (SIPA), U.S. District Court Judge Jed S. Rakoff dismissed an avoidance action after concluding that § 550(a) of the Bankruptcy Code could not operate outside the territorial boundaries of the U.S. The *Madoff* extraterritoriality decision provides practical guidance regarding the extraterritorial application of the Bankruptcy Code's avoidance provisions and, specifically, a trustee's ability to pursue fraudulent conveyance actions against foreign-based subsequent transferees of nondebtor property.

This article provides a brief discussion regarding the extraterritorial application of federal statutory law and examines the presumption against extraterritoriality. With the *Madoff* extraterritoriality decision as the backdrop, the article concludes with an examination of the applicability of the presumption against extraterritoriality in the context of avoidance proceedings commenced under the Bankruptcy Code.

Congress's Ability to Legislate Extraterritorially

"Extraterritoriality" has been defined as the application of one country's laws to events or actions occurring outside its territorial boundaries.[3] International law allows sovereigns to legislate extraterritorially in a number of circumstances,[4] including, for example, policing the conduct of its own citizens.[5] In turn, the U.S. Constitution does not prohibit Congress from legislating extraterritorially,[6] and in many instances, expressly authorizes Congress to pass extraterritorial legislation.[7]

> 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 a maritime context. The powers have been read broadly to permit overseas application of federal criminal law, even extending to an American vessel at anchor within the territory of another nation.[8]

Thus, when Congress enacts legislation that is intended to reach events or actions outside the territorial boundaries of the U.S., it is exercising its power to legislate extraterritorially.[9] Although Congress's constitutional authority to legislate extraterritorially is not without its limits,[10] courts have consistently concluded that Congress has almost unfettered discretion to apply statutory provisions to govern events or actions outside the territorial boundaries of the U.S.[11]

The Presumption Against Extraterritoriality

As noted, Congress has almost unfettered discretion to legislate extraterritorially. However, if Congress has not evinced the extraterritorial effect of a statutory provision, the issue, if in dispute, becomes a matter of statutory construction and interpretation.[12] The presumption against extraterritoriality is a judge-made canon of statutory construction and interpretation regarding the territorial reach of federal statutes.[13] Commentators point to a synthesis of three rules of construction that form the presumption's foundation: (1) a federal statute that is silent on its extraterritorial applicability will be interpreted to have only domestic reach, absent a "clear indication of some broader intent";[14] (2) the "nature and purpose of a statute may provide an indication of whether Congress intended a statute to

1 2014 WL 2998557 (S.D.N.Y. July 6, 2014).
2 *See, e.g.*, Thomas Slome and Jessica Berman, "Can § 547 Be Used to Avoid Foreign Transactions? The Extraterritorial Application of Preference Laws," 30 *Amer. Bankr. Inst. J.* 46 (March 2011), and David B. Stratton, "Reflections on the Extraterritorial Application of the Bankruptcy Code," 24 *Amer. Bankr. Inst. J.* 44 (September 2005).
3 Austin L. Parrish, "Evading Legislative Jurisdiction," 87 *Notre Dame L. Rev.* 1673, 1679 and n.19 (2004)(2012) ("Under international law, states may regulate foreign conduct based upon ... territoriality, nationality, protective principle, passive personality, and universality.").
4 *Id.*
5 *Id.*
6 *See, generally*, Charles Doyle, "Extraterritorial Application of Criminal Law," *Congressional Research Service*, Feb. 15, 2012, *available at* http://fas.org/sgp/crs/misc/94-166.pdf (discussing doctrine of extraterritoriality in context of criminal conduct) (last visited July 28, 2014).
7 *Id.*
8 *Id.* at 1-2.
9 Parrish, *supra* n.3, at 1679.
10 Doyle, *supra* n.6, at 6-7.
11 *Id.* at 8.
12 Doyle, *supra* n.6, at 4.
13 *Kiobel v. Royal Dutch Petroleum Co.*, 133 S. Ct. 1659, 1664 (2013).
14 Doyle, *supra* n.6, at 8 (citing *Morrison v. National Australia*, 130 S. Ct. 2869, 2877 (2010)).

apply beyond the confines of the United States";[15] and (3) Congress is presumed to have enacted legislation that does not conflict with international law.[16]

In turn, four essential principles justify the presumption's application[17] and the weight given to these principles by the U.S Supreme Court has varied over time.[18] In the first instance, presumption is premised upon the "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."[19] The second principle is based on safeguarding certainty[20] in the application of the relevant federal statute, thus minimizing "judicial-speculation-made-law"[21] and maximizing "a stable background against which Congress can legislate with predictable effects."[22] The third justification for the presumption is to "protect against unintended clashes between [U.S.] laws and those of other nations [that] could result in international discord."[23] The fourth principle supporting the presumption is the affirmation of "Congress's role in the law-making process and limit[ing] activist judicial interpretation."[24]

Avoidance Actions and the Presumption Against Extraterritoriality

As discussed, in those instances where there is no legislative provision addressing the territorial boundaries of a federal statute, the presumption against extraterritoriality exists. At least one commentator has noted difficulty in finding "any affirmative evidence of congressional intent to apply the avoidance mechanisms of the Code extraterritorially."[25] The Bankruptcy Code, including most notably its avoidance provisions, lacks specific statutory provisions addressing its extraterritorial reach.[26] Nevertheless, a majority of courts that have addressed the issue have applied the Bankruptcy Code extraterritorially, or have labeled the event or conduct giving rise to the claim as arising domestically.[27]

The analytical framework employed by Judge Rakoff in the *Madoff* extraterritorial decision provides practical guidance regarding the extraterritorial application of the Bankruptcy Code's avoidance provisions. By way of factual background, the SIPA trustee and the Securities Investor Protection Corp. (SIPC) commenced multiple fraudulent conveyance actions against foreign entities that allegedly received Madoff investment dollars from foreign "feeder funds."[28] The *Madoff* extraterritorial decision focused on one of the fraudulent conveyance actions commenced against two banks headquartered and primarily doing business in Europe (collectively, the "foreign banks"). The foreign banks invested close to 100 percent of their funds in two foreign feeder funds, one located in the British Virgin Islands and the other the Cayman Islands. The foreign banks allegedly received $50 million in recoverable subsequent transfers from the foreign feeder funds. The SIPA trustee and the SIPC sought to reclaim those alleged transfers under § 550(a)(2) of the Bankruptcy Code.[29]

The *Madoff* extraterritorial decision relied on the two-step analytical approach utilized by the U.S. Supreme Court in *Morrison v. Nat'l Australia Bank Ltd.*:[30] "First, whether the factual circumstances at issue require an extraterritorial application of the relevant statutory provision, and second, if so, whether Congress intended for the statute to apply extraterritorially."[31] The Supreme Court in Morrison directed lower courts in the first instance to focus on the congressional concern or the transactions that the federal statute sought to regulate.[32]

SIPC and the SIPA trustee argued that the regulation of the SIPC-member U.S. broker/dealer was the focus of SIPA's incorporation of the Bankruptcy Code's trustee powers,[33] and as such, the Code's avoidance provisions were inherently domestic.[34] Rejecting this expansive interpretation of SIPA, Judge Rakoff made the following statement:

> This argument proves too much. It cannot be that any connection to a domestic debtor, no matter how remote, automatically transforms every use of the various provisions of the Bankruptcy Code in a SIPA bankruptcy into purely domestic applications of those provisions.[35]

The *Madoff* extraterritoriality decision then turned to the regulatory focus of the Code's avoidance and recovery provisions:

> On a straightforward reading of section 550(a), [the focus is] on "the property transferred" and the fact of its transfer, not the debtor. Moreover, Section 548, the avoidance provision that is primarily at issue ... focuses on the nature of the transaction in which the property is transferred, not merely the debtor itself.... Accordingly, under *Morrison*, the transaction being regulated by section 550(a)(2) is the transfer of property to a subsequent transferee, not the relationship of that property to a perhaps-distant debtor.[36]

15 *Id.* (citing *United States v. Bowman*, 260 U.S. 94, 97-98, 102 (1922); *American Banana Co. v. United Fruit Co.*, 213 U.S. 347, 355-56 (1909)).
16 *Id.* at 10 (citing *Weinberger v. Rossi*, 456 U.S. 25, 32 (1982)).
17 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).
18 *Id.*
19 *Id.*
20 *Id.* at 88.
21 *Id.*
22 *Id.*
23 *Id.* (citing *EEOC v. Arabian Am. Oil Co. (Aramco)*, 499 U.S. 244, 248 (1991)).
24 *Id.* at 89.
25 T. Brandon Welch, "Avoidance Power of Bankruptcy Code," 24 *Emory Bankr. Dev. J.* 561, 586 (2008) (referring to plain language of Bankruptcy Code, legislative history and congressional support to substantiate his conclusion).
26 *Id.*
27 *See id.* at 561, n.63, for a synopsis of decisional law supporting the application of the Bankruptcy Code extraterritorially or defining the event or conduct as occurring domestically; *see also Kismet Acquisition LLC v. Icenhower (In re Icenhower)*, ___ F.2d ____, No. 10-55933, 2014 WL 2978491 (9th Cir. July 3, 2013); *French v. Liebmann (In re French)*, 440 F.3d 145 (4th Cir. 2006).
28 Foreign "feeder funds" were foreign investment funds that pooled their customers' assets and invested those assets with Madoff Investment Securities LLC.
29 Pursuant to § 550(a)(2) of the Bankruptcy Code, "to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, 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 … (2) any immediate or mediate transferee of such initial transferee." The foreign banks were alleged subsequent transferees of the Madoff funds and subject to the provisions of § 550(a)(2).
30 130 S. Ct. 2869 (2010). *Morrison* did not involve a provision within the Bankruptcy Code, but rather section 10(b) of the Securities Exchange Act of 1934. *See supra* n.1, at *2.
31 *Supra* n.1, at *2 (citing *Morrison*, 2130 S. Ct. at 2877-88, and *In re Maxwell Commc'n Corp.*, 165 B.R. 807, 816 (S.D.N.Y 1995) (*"Maxwell I"*)).
32 *Morrison*, 2130 S. Ct. at 2877-88.
33 *See* Travis R. Searles and Patrick M. Birney, "Should SIPA Trustee Have Greater Power Than Chapter 7 Trustee to Pursue Third-Party Claims?," 31 *Amer. Bankr. Inst. J.* 30 (May 2012), for a summary explanation of SIPA and the trustee's powers arising thereunder.
34 *Madoff* Extraterritorial Decision, 2014 WL 2998557, at *2.
35 *Id.*
36 *Id.* at *3.

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The Court concluded that the foreign banks and their alleged receipt of Madoff dollars from the foreign feeder funds involved predominantly foreign transactions that could be subject to clawback under § 550(a)(2) via extraterritorial application.[37] The *Madoff* extraterritorial decision turned next to the second component of the extraterritoriality analysis: Whether Congress clearly intended an extraterritorial application of § 550(a):[38]

> Unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, [courts] must presume [that] it is primarily concerned with domestic conditions. When a statute gives no clear indication of an extraterritorial application, it has none.[39]

The court broke this analysis into two further components: First, did the plain language of § 550(a) cause it to be applied extraterritorially, and if not, did Congress nevertheless intend that § 550(a) apply extraterritorially based on a broader interpretation of the section in light of relevant surrounding provisions?[40]

In attempting to rebut the presumption against extraterritoriality, the SIPA trustee concentrated on § 541, the "property of the estate" provision of the Bankruptcy Code. The trustee maintained that the phrase "wherever located" in § 541(a) was intended to give a trustee title over all of the debtor's property, regardless of whether it was physically present in the U.S. In turn, he argued for the integration of § 541 with the Code's avoidance and recovery provisions, which use the phrase "an interest of the debtor in property" to define transfers subject to avoidance. Under the SIPA trustee's hypothesis, once these provisions were read congruently, it was clear that Congress intended for § 550(a) to apply extraterritorially. Relying in part on the Second Circuit's decision in *In re Colonial Realty Co.*,[41] the *Madoff* extraterritorial decision rejected the SIPA trustee's theory.

> Whether "property of the estate" includes property "wherever located" is irrelevant to the instant inquiry: fraudulently transferred property becomes property of the estate *only after* it has been recovered by the trustee, so Section 541 cannot supply any extraterritorial authority that the avoidance and recovery provisions lack on their own.[42]

As further support for dismissing the claims of the SIPA trustee and SIPC, the *Madoff* extraterritorial decision also noted that considerations of international comity precluded the extraterritorial application of § 550(a)(2) insofar as the foreign feeder funds were the subject of their own liquidation proceedings in their home countries:

> The trustee is seeking to use SIPA to reach around such foreign liquidations in order to make claims to assets on behalf of the SIPA customer-property estate — a specialized estate created solely by a U.S. statute, with which the defendants here have no direct relationship. Without any agreement to the contrary (which the trustee does not suggest exists), investors in these foreign funds had no reason to expect that U.S. law would apply to their relationships with the feeder funds.[43]

Given the tangential relationship among the foreign banks and Madoff's New York-based securities business, Judge Rakoff concluded that those overseeing the foreign liquidation proceedings had a stronger interest in applying their own laws than did the U.S.

Conclusion

Based on the standards outlined by the U.S. Supreme Court in *Morrison*, the *Madoff* extraterritoriality decision instructs practitioners that the presumption against extraterritoriality, coupled with considerations of international comity, precludes the application of the Bankruptcy Code's avoidance provisions to claw-back extraterritorial transfers between nondebtor entities that did not involve debtor property — if the transferees are the subject of their own foreign insolvency proceedings. abi

37 *Id.*
38 *Id.* at *4.
39 *Id.* (citing *Morrison*, 130 S. Ct. at 2877).
40 *Id.*
41 980 F.2d 125 (2d Cir. 1992).
42 *Madoff* Extraterritorial Decision, at *5 (citing *Maxwell I*, 186 B.R. at 816, and *Colonial Realty*, 980 F.2d at 131) (emphasis added).
43 *Id.* at *8.