

International Corporate Rescue



Published by:

Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:

Subscription prices 2017 (6 issues)

Print or electronic access:

EUR 730.00 / USD 890.00 / GBP 520.00

VAT will be charged on online subscriptions.

For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

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Non-US Investors in Non-US Entities Beware: You May Be Subject to Clawback Under US Law if the Investment is Ultimately with a US Entity¹

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Synopsis

In a case stemming from the collapse of the infamous Madoff Ponzi scheme, the United States District Court for the Southern District of New York (the 'Court') ruled in 2014 that foreign entities that indirectly invested in the Madoff fund through foreign feeder funds could not be targeted in avoidance actions brought under the United States Bankruptcy Code ('Bankruptcy Code').² The United States Court of Appeals for the Second Circuit ('Second Circuit'), however, disagreed and held that neither the presumption against extraterritoriality nor international comity limited the ability to recover avoided transfers pursuant to Bankruptcy Code section 550(a).³

Background

The well-known Madoff ponzi scheme affected investors across the globe. Bernard L. Madoff Investment Securities LLC ('Madoff Securities') was partly funded by so-called 'feeder funds', which pooled their own customers' assets and invested them with Madoff Securities. Many of these feeder funds invested all or substantially all of their assets with Madoff Securities.⁴

In 2008, Madoff's ponzi scheme collapsed. A liquidation under the Securities Investor Protection Act ('SIPA') was commenced, and Irving H. Picard was appointed trustee ('Trustee') of the Madoff Securities estate. The Trustee commenced several 'avoidance actions', *i.e.* proceedings under the Bankruptcy Code, SIPA, and other applicable law⁵ seeking the avoidance and recovery of certain transfers, including Madoff Securities'

initial transfers to the feeder funds as fraudulent pursuant to Bankruptcy Code section 548(a)(1)(A).⁶

In October 2011, the Trustee filed adversary proceedings against certain foreign entities to recover, pursuant to Bankruptcy Code section 550(a)(2), subsequent transfers of alleged Madoff Securities customer property to customers of feeder funds.⁷ The paramount issue was whether Bankruptcy Code section 550(a)(2) applied extraterritorially to reach subsequent transfers made abroad between foreign entities.

Legal framework

Bankruptcy Code section 548(a)(1)(A) provides:

The trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted ...⁸

Once a transfer is avoided, a trustee may recover the underlying property pursuant to Bankruptcy Code section 550(a), which provides:

Except as otherwise provided in this section, to the extent that a transfer is avoided under [section 548] of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court

Notes

¹ The views expressed herein are solely those of Ms Zerjal, and not necessarily the views of Proskauer Rose LLP or any of its attorneys.

² *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 222, 226 (S.D.N.Y. 2014).

³ *In re Picard*, 917 F.3d 85, 92 (2d Cir. 2019).

⁴ *Id.* at 93.

⁵ The pertinent provisions include sections 78fff(b), 78fff-1(a) and 78fff-2(c)(3) of SIPA, sections 541, 542, 544, 547, 548, 550, and 551 of the Bankruptcy Code, and sections 273 to 279 of New York Debtor and Creditor Law.

⁶ *In re Picard*, 917 F.3d at 95.

⁷ *Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 225.

⁸ 11 U.S.C. § 548(a)(1)(A).

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.⁹

Neither the Presumption Against Extraterritoriality nor International Comity Limit the Ability to Recover Avoided Transfers

Extraterritoriality

For extraterritoriality purposes, section 548(a)(1)(A) is the relevant section because section 550(a) merely provides for the recovery of what arises from an avoidance under section 548(a)(1)(A). The Second Circuit first considered whether the Trustee's recovery efforts were limited by the presumption against extraterritoriality, which provides that absent clear congressional intent to the contrary, federal laws should be construed to only apply domestically.¹⁰ The Second Circuit first concluded that section 550(a) had to be examined in tandem with the relevant avoidance provision, section 548(a)(1)(A), because section 550(a) was 'a utility provision, helping execute the policy of [section 548(a)(1)(A)]'.¹¹ With that in mind, the Second Circuit held that the focus for its analysis was on the initial transfer, not the subsequent transfer in section 550(a)(2), because the relevant conduct was the transfer of property, not the receipt of property. Indeed, it was the initial transfer that depleted the estate – the subsequent transfer still harmed creditors, but only by making property more remote and difficult to recover.¹²

A transfer of property from a US bank account is 'domestic activity' where the presumption against extraterritoriality does not apply. The Second Circuit next determined that with the focus on the initial transfer, a domestic debtor's alleged fraudulent transfer under Bankruptcy Code section 548(a)(1)(A) was 'domestic activity' because '[w]hen a domestic debtor commits fraud by transferring property from a US bank account, the conduct that [section 550] regulates takes place in the [US]'.¹³

As such, the presumption against extraterritoriality did not prohibit the trustee from recovering such property under section 550(a), regardless of where the transferees (initial or subsequent) were located.¹⁴ The Second Circuit also cautioned that a different reading (the one adopted by the District Court in 2014) would open a loophole allowing 'clever' debtors to transfer property to foreign entity that then transferred such property on to another foreign entity – and even if such entity then transferred the property back to the US, it would still be deemed a non-domestic transfer immune to the recovery powers of section 550(a).¹⁵

Comity

The US's interest in applying its fraudulent transfer and recovery laws outweighs the interest of any foreign state. The Second Circuit then analysed whether prescriptive comity barred the application of section 550(a) to foreign transferees.¹⁶ Here, the question was whether Congress, out of respect for sovereigns, limited the application of the relevant domestic law (*i.e.*, certain Bankruptcy Code provisions) on the given set of facts.¹⁷ The Second Circuit acknowledged comity was especially important in bankruptcy proceedings because it facilitates an equitable, orderly, and systematic distribution of the debtor's assets, and Congress expressly recognised the importance of comity in cross-border insolvency matters.¹⁸ To determine whether comity should apply, the Second Circuit applied the 'choice-of-law test', which takes into account the interests of the US, the foreign state, and the mutual interests in having just and efficiently functioning rules of international law.¹⁹ The Second Circuit concluded that the US had a compelling interest in allowing domestic bankruptcy estate to recover fraudulently transferred property.²⁰ No such parallel interest (or at least not a compelling one, in the Second Circuit's opinion) existed in foreign jurisdiction, because there, the debtors were the feeder funds, not Madoff Securities.²¹ The Second Circuit admitted that the Trustee's recovery efforts may frustrate the efforts of the feeder funds' trustees in recovering

Notes

9 *Id.* § 550(a).

10 *In re Picard*, 917 F.3d at 95.

11 *Id.* at 98 (internal quotations omitted).

12 *Id.*

13 *Id.* at 100.

14 *Id.* at 99-100.

15 *Id.* at 100.

16 The Second Circuit noted that adjudicative comity, which asks whether a court should abstain from exercising jurisdiction in deference to a foreign nation's courts that might by a more appropriate forum, was not at issue in this matter. *Id.* at 101-102.

17 *Id.* at 100.

18 *Id.* at 103.

19 *Id.*, citing *In re Maxwell Commc'n Corp. plc by Homan*, 93 F.3d 1036, 1048 (2d Cir. 1996).

20 *Id.*

21 *Id.* at 103-104.

– and keeping – the same property.²² But that was not a compelling reason to trump the Trustee’s interest in the same property – in fact, section 550(a)(2) envisioned the recovery of property subject to avoided transfers to be recovered from remote subsequent transferees as opposed to requiring the trustees to recover it through piecemeal proceedings around the world.²³

A cautionary tale for foreign investors

The Second Circuit decision should put worldwide investors on notice that if payments on their investments originate in the US, such payments may eventually be subject to clawback under US law in circumstances similar to Madoff. Given its broad-ranging consequences, it came as no surprise that the defendants will seek a writ of certiorari with the Supreme Court in the summer, and the Second Circuit granted a stay of its order pending such petition. Stay tuned.

Notes

²² *Id.* at 104.

²³ *Id.* at 105.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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