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Madoff Bankruptcy Decision Offers Protection for Foreign Investors

In re Madoff Securities *Extends Morrison Framework to Prevent Avoidance of Purely Foreign Transfers under SIPA and the Bankruptcy Code*

Applying the U.S. Supreme Court's landmark decision in *Morrison v. National Australian Bank Ltd.*, 130 S. Ct. 2869 (2010), to the highest profile and widest-ranging securities fraud case in decades, Judge Jed S. Rakoff of United States District Court for the Southern District of New York ruled Monday, July 7, 2014, that the trustee administering Bernie Madoff's insolvent estate may not use the U.S. Bankruptcy Code to claw back "purely foreign" transactions between foreign entities. By applying *Morrison* to such a visible case with a number of foreign defendants, the court recognized an important protection for foreign investors who may not have anticipated that their investments — and their returns — could otherwise be subject to clawback under US law.

Background

Madoff funded his now-famous Ponzi scheme partly through the investments from so-called "feeder funds" — investment vehicles that pooled investments from outside investors and in turn invested those monies in Madoff's putative investment company, Bernard L. Madoff Investment Securities LLC (BLMIS). Many of these feeder funds were organized and operated outside of the United States and, not surprisingly, many of their investors were foreign persons or entities.

After Madoff declared his fraud in 2008, the Southern District of New York appointed Irving H. Picard as trustee of the BLMIS estate pursuant to the Securities Investor Protection Act (SIPA). SIPA is a statute specifically designed to facilitate the unwinding of insolvent securities broker-dealers in such a way as to maximize the recovery for the broker-dealer's investors. The statute gives the trustee the powers to recover (or avoid) certain transfers, including those that are fraudulent or preferential, by incorporating the powers of a trustee under the Bankruptcy Code. Accordingly, the trustee has sought to recover so-called "subsequent transfers" pursuant to section 550(a) of the Bankruptcy Code (11 U.S.C. § 550(a)), which allows trustees to recover avoidable transfers, even if that property has since been transferred to another person or entity.

The Court's Analysis

At issue in *Securities Inv. Protection Corp. v. Bernard L. Madoff Investment Secs., LLC (In re Madoff Securities)*, 12-mc-115, Dkt. No. 36 (July 7, 2014), was whether the trustee's ability to avoid subsequent transfers could be extended extraterritorially to reach transfers in foreign jurisdictions from foreign customers to other foreign persons and entities. Certain foreign defendants had asked Judge Rakoff to withdraw the reference to the bankruptcy court in order to consider the issue. The court granted this motion, and after briefing and argument on the issue, ruled that § 550(a) could not be applied to avoid such foreign transactions.

In *Morrison*, the Supreme Court had reaffirmed the presumption that a federal statute, absent clear Congressional intent, does not extend to extraterritorial conduct, and set forth a two-step analysis to determine whether a statute may be applied to conduct occurring outside of the United States. First, a court must determine whether the application of the statute is truly extraterritorial; second, whether Congress intended that the statute be used to reach extraterritorial conduct.

On the first question, Judge Rakoff reasoned that the conduct in question did not qualify as "domestic" merely because SIPA was intended to benefit the estate of a debtor based in the United States, such as BLMIS. Instead, the court held that "a mere connection to a U.S. debtor, be it tangential or remote, is insufficient on its own to make every application of the Bankruptcy Code domestic." Judge Rakoff reasoned that the focus of § 550(a) was not the debtor, but the subsequent transfer itself. To the extent that the transfers took place in a foreign jurisdiction, solely between two foreign entities, the transfers were "foreign transfers" and recovery thereof constituted an extraterritorial application of § 550(a).

The court then turned to the question of whether Congress intended for § 550(a) to apply to extraterritorial conduct. The court first noted that nothing in the language of § 550(a) indicated a Congressional intent to reach extraterritorial conduct. Analyzing different definitions of "property" located within the Bankruptcy Code, the court determined as a matter of statutory interpretation that Congress did not intend § 550 to reach property "wherever located and by whomever held," a formulation that, under applicable precedent, would have included foreign transactions.

Finally, the court held that neither SIPA itself nor policy concerns weighed in favor of rebutting the presumption against extraterritoriality. In fact, the court ruled that concerns of international comity, including the potential for conflict with foreign liquidation proceedings — such as those which many feeder funds are currently undergoing — weighed against rebutting that presumption. Respecting these foreign proceedings was especially important, the court found, because "investors in these foreign funds had no reason to expect that U.S. law would apply to their relationships with the feeder funds."

Conclusion

On one hand, Judge Rakoff's opinion in *In re Madoff Securities* constitutes a fairly straightforward and logical application of the Supreme Court's decision in *Morrison* to the Madoff trustee's attempt to use SIPA and the Bankruptcy Code to avoid purely foreign transactions. On the other, the court — in applying that reasoning to such a closely watched case — has visibly recognized an important protection to foreign investors who may not have anticipated that their foreign transfers could be subject to clawback under US law.

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