

Second Circuit Backs Foreign Clawback Claims in Madoff Bankruptcy Action

The Second Circuit holds that the presumption against extraterritoriality and international comity do not bar recovery of purely foreign transfers.

Key Points:

- The Second Circuit focused on the initial transfer from Madoff to foreign funds to determine whether subsequent transfers from the foreign funds to other foreign entities could be recovered under Section 550(a) of the Bankruptcy Code.
- The Second Circuit ruled that since the initial transfers were from New York-based Madoff Securities, the presumption against extraterritoriality and the principles of international comity did not bar the Madoff trustee's attempts to recover these foreign subsequent transfers.

In *In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Sec. LLC*,¹ the Second Circuit ruled that the trustee administering Bernie Madoff's insolvent estate could use the US Bankruptcy Code to claw back purely foreign transactions between foreign entities. In doing so, the Second Circuit reversed the Southern District of New York's prior ruling that such foreign transfers could not be recovered, and removed a 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 Ponzi scheme in part through investments from so-called “feeder-funds” — investment vehicles that pooled investments from outside investors, and in turn invested those monies in Madoff's investment company, Bernard L. Madoff Investment Securities LLC (BLMIS). Many of these feeder funds were organized outside the United States. For example, the Fairfield Greenwich Group's funds were organized in the British Virgin Islands. Unsurprisingly, many of the foreign feeder funds' investors were foreign persons or entities.

After Madoff's fraud was revealed 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 a way that maximizes the recovery for the broker-dealer's investors. The statute gives the trustee the power 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, Picard 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. In other words, he seeks to recover transfers made from the feeder funds to their investors. Certain foreign investors in foreign feeder funds moved to dismiss these claims on the grounds that:

- Picard’s use of Section 550(a) was extraterritorial, and thus limited by the presumption against extraterritorial application of statutes.
- The scope of Section 550(a) was limited by the principle of international comity.

In July 2014, Judge Rakoff of the Southern District of New York agreed.² In November 2016, Judge Bernstein of the Bankruptcy Court for the Southern District of New York applied Judge Rakoff’s ruling, and dismissed certain cases that applied Section 550(a) to transfers between foreign feeder funds and foreign investors.³ Picard appealed the dismissals to the Second Circuit, which disagreed with Judge Rakoff and Judge Bernstein, and ordered the dismissals vacated.

The Court’s Analysis

Extraterritoriality

The first question at issue was whether Picard’s claims under Section 550(a) were limited by the presumption against extraterritoriality, which provides that absent clearly expressed congressional intent to the contrary, federal laws are construed to have only domestic application.

To determine whether the presumption applied, the Second Circuit analyzed whether the case involved a domestic or foreign application of Section 550(a) by looking at whether the statute’s “focus” was on domestic or foreign conduct. Quoting the Supreme Court’s recent decision in *WesternGeco LLC v. ION Geophysical Corp.*,⁴ the Second Circuit recognized that “the focus of a statute is the object of its solicitude, which can include the conduct it seeks to regulate as well as the parties and interests it seeks to protect or vindicate.” The Second Circuit further noted that if the “statutory provision at issue works in tandem with other provisions, it must be assessed in concert with those other provisions.”

Given that Section 550(a) applies only to the extent that a transfer is avoided under the avoidance provisions of the Bankruptcy Code, the Second Circuit ruled that Section 550(a) worked “in tandem” with the avoidance provisions. This included Section 548(a)(1)(A), which allowed Picard to avoid the initial transfers from BLMIS to the feeder funds. Stating that “recovery is the business end of avoidance,” the Second Circuit held that if a trustee alleges a debtor’s transfers are avoidable as fraudulent under Section 548(a)(1)(A), Section 550(a) regulates the fraudulent transfer of property leaving the estate. In other words, even when the trustee seeks to recover a subsequent transfer (such as from a feeder fund to its investor), the focus of the statute is on the *initial transfer* from the debtor’s estate (such as from BLMIS to the feeder fund).

Thus, to determine whether the presumption against extraterritoriality applied to these cases, the Second Circuit looked at whether BLMIS’ transfers to the feeder funds constituted domestic or foreign conduct. The court held that a domestic debtor’s allegedly fraudulent transfer of property from the United States is domestic activity for the purposes of Sections 548(a)(1)(A) and 550(a). Since BLMIS was based in New York, the transfers were domestic, and Picard’s claims for recovery under Section 550(a) against foreign defendants who received transfers from foreign feeder funds were not barred by the presumption against extraterritoriality.

Comity

The second question was whether the cases remain dismissed under the principles of international comity. At particular issue was the principle of prescriptive comity, which provides that if a foreign sovereign has a compelling interest in a matter, and the United States does not, application of domestic law to foreign entities may be limited out of respect for that foreign sovereign.

To determine whether prescriptive comity barred Picard's claims, the Second Circuit looked at the test from *In re Maxwell*,⁵ which "takes into account the interests of the United States, the interests of the foreign state, and those mutual interests the family of nations have in just and efficiently functioning rules of international law." Applying that test, the Second Circuit noted that the United States has a compelling interest in allowing domestic estates to recover fraudulently transferred property. The Second Circuit then recognized that the only foreign jurisdictions potentially interested in these cases are those in which a feeder fund that served as an initial transferee is in liquidation. However, the Second Circuit ruled that those particular interests were not compelling because Picard is not a creditor to those funds, Picard's claims are not the subject of a foreign liquidation, and his claims are not duplicating the liquidations of the feeder funds. Given the compelling interest of the United States and lack of foreign compelling interests, the Second Circuit held that Picard's claims were not barred by the principles of international comity.

Notably, the Second Circuit referred back to the idea that Section 548(a)(1)(A) informs the focus of Section 550(a) when discussing international comity. The district court had ruled that the United States did not have a compelling interest because it focused on the subsequent transfers between the foreign feeder funds and the foreign investors. To the contrary, the Second Circuit ruled that since Section 550(a)'s focus was on regulating and remedying the debtor's initial fraudulent transfer of property, the domestic nature of those initial transfers from BLMIS in this case meant that the United States *does* have a compelling interest.

Implications

With the Second Circuit's decision, non-US investors in non-US entities now face a greater risk of clawback under US law in bankruptcy and SIPA cases, and potentially even multiple claims for clawback of the same transfer by insolvent estates in the US and other nations. The Second Circuit's decision will be binding within the Second Circuit (including New York), and the decision is likely to be used as persuasive precedent by debtors in cases nationwide.

Given that the Madoff cases involve billions of dollars of claims and assets, and that these cases involve thorny questions of statutory interpretation and the intersection of insolvency law among multiple nations, the defendants in these actions may seek review by the US Supreme Court. If the US Supreme Court accepts the case, global financial institutions and investors may have interests in participating in the arguments. This matter should continue to be closely followed.

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Endnotes

¹ *In re Picard, Tr. for Liquidation of Bernard L. Madoff Inv. Sec. LLC*, No. 17-2992(L), 2019 WL 903978 (2d Cir. Feb. 25, 2019).

² *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 516 B.R. 19 (S.D.N.Y. 2014).

³ *Sec. Inv'r Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, No. AP 08-01789 (SMB), 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016).

⁴ *WesternGeco LLC v. ION Geophysical Corp.*, 138 S. Ct. 2129 (2018).

⁵ *In re Maxwell*, 93 F.3d 1036 (2d Cir. 1996).