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But Only From Sea to Shining Sea: U.S. Court Limits the Reach of U.S. Bankruptcy Code

International businesses involved in transactions associated in some way with U.S. citizens received a measure of relief over the 4th of July holiday weekend.

A decision by Judge Jed S. Rakoff of the United States District Court for the Southern District of New York (the "Court") addressed whether the provisions of section 550(a)(2) of the U.S. Bankruptcy Code (the "Code") apply to transfers which take place wholly outside the United States. The Court held that the Securities Investor Protection Act ("SIPA") trustee could not recover transfers originating with Bernard L. Madoff Investment Securities LLC ("BLMIS") that were subsequently transferred between foreign entities. Judge Rakoff's decision marks a significant victory for international creditors, as it establishes that a trustee may not rely on the U.S. Bankruptcy Code to claw back transfers between purely foreign entities, but must instead seek recoveries in foreign jurisdictions applying foreign law. The ruling came on the heels of a June 30, 2014 Supreme Court decision denying the SIPA trustee's petition to appeal the dismissal of his claims against several large banks and constitutes a new and significant setback for the trustee.¹

Section 550(a)(2) and the Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC Decision

Section 550(a)(2) of the Code has received increased attention recently, particularly as the SIPA trustee for the BLMIS estate, Irving Picard, seeks to claw back tens of billions of dollars from several offshore transferees.

Section 550(a)(2) empowers a trustee to recover, for the benefit of the estate, transfers made to "any immediate or mediate transferee," if those transfers are avoidable under the Code. In *Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities LLC*, the trustee sought to recover transfers made by BLMIS to foreign customers that were subsequently transferred to foreign entities and individuals.

¹ *Picard v. HSBC Bank PLC*, 13-448, 2014 WL 2921722 (U.S. June 30, 2014). Our firm played an instrumental role in obtaining both this Supreme Court decision and Judge Rakoff's decision. Our partner Frank B. Velie acted as lead counsel at oral argument in the case before Judge Rakoff.

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In determining whether section 550(a)(2) applied to allow recovery of wholly foreign transfers from the defendant funds, Judge Rakoff largely based his decision on the Supreme Court's 2010 decision in *Morrison v. National Australia Bank Ltd.*² In that case, the Supreme Court held that, unless Congress clearly intended otherwise, U.S. laws do not apply extraterritorially. The Supreme Court explained that this presumption exists to prevent "unintended clashes" between U.S. and foreign law.

Under the analysis set forth in *Morrison*, Judge Rakoff first addressed whether the circumstances required extraterritorial application of section 550(a)(2). Picard argued that the transfers were sufficiently domestic in nature such that extraterritorial application was not required. Judge Rakoff disagreed, noting that a mere indirect connection to a U.S. debtor does not render an application of the Code domestic. Judge Rakoff looked to the plain language of section 550 and found that the statute focuses on the property at issue and its transfer, not on the debtor. Notably, the transfers at issue were subsequent transfers: BLMIS made transfers to foreign feeder funds, which subsequently transferred the property to other foreign transferees. Judge Rakoff held that such transfers from one foreign entity to another – notwithstanding that they originated with a U.S. debtor – are not sufficiently tied to the United States to warrant a domestic application of the Code.

Under the second prong articulated in *Morrison*, the Court addressed whether Congress intended section 550 to apply extraterritorially. Again, looking at the plain language of the statute, Judge Rakoff found no indication that Congress intended the provision to apply to foreign transfers.

Picard attempted to rebut the presumption against extraterritorial application by turning to section 541 of the Code, which defines "property of the estate" as property "wherever located and by whomever held." Judge Rakoff, while noting that Picard's argument was "clever," was not persuaded, reasoning that, under prevailing Second Circuit precedent,³ allegedly fraudulently transferred property does not become "property of the estate" until it has successfully been recovered by a trustee,

which had not happened in this case. Furthermore, the Court noted that the inclusion of the "wherever located" language in section 541 – but its absence in section 550 – undermined the trustee's argument that section 550 was intended to apply extraterritorially. Thus, section 541 did not aid the trustee in convincing the Court that the property was subject to recovery under section 550.

Having dismissed the trustee's claims on a statutory reading of section 550, Judge Rakoff further dismissed the trustee's claims on the alternative grounds that extraterritorial application of section 550 would violate the principles of international comity. Noting that various foreign feeder funds already were in liquidation proceedings in their home jurisdictions, Judge Rakoff concluded that the trustee was using SIPA to "reach around" such foreign liquidations, in violation of comity principles. The Court found that those foreign jurisdictions "have a greater interest in applying their own laws than does the United States." While noting the potential risk of a U.S. debtor fraudulently transferring its assets offshore to avoid U.S. bankruptcy law, the Court stated that such a risk was outweighed by the danger of "international discord."

Conclusion

Although the Court's decision provides some comfort to foreign businesses who have received property that originated with U.S. debtors, the decision is not without its limits, as the individual circumstances of a particular transfer may warrant application of the statute. If the Court's decision is left intact, it will undoubtedly have a widespread impact, as U.S. debtors increasingly have international ties. Non-U.S. creditors should be on watch for the next move, as the trustee determines whether to appeal Judge Rakoff's decision.

² 130 S. Ct. 2869 (2010).

³ *In re Colonial Realty Co.*, 980 F.2d 125, 131 (2d Cir. 1992).