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Global investors beware: Second Circuit gives green light to extraterritorial Madoff clawback claims

By Jonathan Sablone and Lizl Leonardo

On February 26, the United States Court of Appeals for the Second Circuit vacated and remanded for further proceedings a previous decision of the United States Bankruptcy Court for the Southern District of New York dismissing lawsuits brought by Irving H. Picard (the "Trustee"), the trustee for the liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS"), against foreign transferees from foreign feeder funds for billions of dollars.

Background

The issue presented at the trial court level was whether the Trustee could file suit directly against non-U.S. transferees who received transfers from foreign funds and entities that had been direct investors into BLMIS. There were many so-called "feeder funds" into BLMIS. These, usually offshore, funds would pool capital from foreign investors and then invest that money with BLMIS. After the collapse of BLMIS, the Trustee brought clawback claims against many of these feeder funds. While there were substantial personal jurisdiction issues that had to be addressed in those cases, there was no doubt that the Trustee had subject matter jurisdiction over the transfers from BLMIS to direct investors, foreign or domestic. Faced with the reality that most feeder funds were insolvent, due to the fact that the only substantial underlying asset of those funds was the now worthless investment in BLMIS, the Trustee filed lawsuits against the mostly foreign investors in the mostly foreign feeder funds. For example, if a British Virgin Islands ("BVI") feeder fund had invested in BLMIS, and was subject to a clawback claim, the Trustee might file litigation directly against a U.K. investor in the BVI feeder fund. Not surprisingly, the U.K. target of such a case would challenge the extraterritorial reach of the U.S. legal system to bring U.S.-based claims against a U.K. entity that invested in a BVI fund. While many foreign targets of the Trustee raised these types of defenses, many simply ignored the lawsuits, resulting in default judgments in the U.S.

Lower court proceedings

In the district court, Judge Rakoff held that the Trustee could not proceed with the various suits against non-U.S. investors of non-U.S. funds because of (1) the presumption against extraterritoriality limits and (2) international comity principles, both under § 550(a)(2) of the U.S. Bankruptcy Code ("Code"). The bankruptcy court, per Judge Bernstein, agreed with the district court's reasoning and dismissed the claims against the subsequent transferees. Applying the

presumption against extraterritoriality principle, he concluded that the most relevant factors to determine whether or not U.S. law could apply are the location from which the transfers were made and the location of both the initial and subsequent transferee. Using these criteria, Judge Bernstein held that the Trustee failed to allege facts to satisfy the requirements. With regard to international comity principles, he found that the United States "has no interest in regulating the relationship between [these funds] and their investors or the liquidation of [these funds] and the payment of their investors' claims," and that foreign nations have a greater interest in adjudicating the disputes, as they relate to the validity of transfers made from the feeder funds to the subsequent transferees.

Second Circuit decision

The Second Circuit ("Court") disagreed with the lower court's conclusions as to the application of the principles of presumption against extraterritoriality and international comity.

After conducting an in-depth analysis of § 550(a) and § 548(a)(1)(A), the Court overturned the lower court's ruling and held that the Code regulates the "fraudulent transfer of property depleting the estate." Specifically, it found that the debtor's act of transferring property from the United States triggered application of the statute, and that the subsequent extraterritorial transfer fell within the penumbra of the initial fraudulent transfer. Moreover, the Court rejected the lower court's use of a balancing test and criteria to determine whether alleged fraudulent transfers involved a domestic application of the Code. It held that a transfer made by a domestic debtor in the United States is a "domestic activity," regardless of where the initial or subsequent transferee is located.

As to international comity concerns, the Court applied a choice-of-law analysis to determine whether or not the United States or another foreign state has a compelling interest in disputes such as the case at hand. Ultimately, because the initial transfer to the feeder funds and not the relationship between the subsequent transferees and the feeder funds is in question, the Court held that the United States has a compelling interest in regulating the subsequent transfers between foreign entities.

Conclusion

The Second Circuit's opinion just reversed what many in the business and legal community had thought was clear, namely that purely foreign subsequent transfers are outside the reach of U.S. Bankruptcy Courts. In light of this recent decision, global investors who had any exposure to Madoff clawback claims need to immediately re-assess their strategy. Investors who had ignored the lawsuits, and defaulted, should retain U.S. counsel to address the defaults and assert substantive defenses. Investors who had responded to the lawsuits, and whose cases were dismissed by the lower court, or effectively stayed, need to gear-up for a prolonged legal fight with the Trustee and should reassess their litigation team, needs and strategy.

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