

# Madoff: Insolvency laws without borders

David Conaway reports on the recent US Court of Appeals ruling that the US Bankruptcy Code applies to transfers between foreign entities



DAVID H. CONAWAY  
Attorney at Law, Shumaker,  
Loop & Kendrick, LLP

**O**n February 25, 2019, the US Court of Appeals (2nd Circuit) ruled that the trustee in the Chapter 11 case for Madoff Investment Securities, LLC could use the US Bankruptcy Code to recover payments made between foreign entities.

Previously, the Bankruptcy Court for the SDNY and the US District Court for the SDNY ruled that the trustee could NOT sue the foreign entities based on principles of international comity and the presumption against extraterritoriality of US Laws, including the US Bankruptcy Code. The ruling revitalises 88 avoidance actions against foreign entities.

Bernard Madoff orchestrated the largest Ponzi scheme in history. He solicited investors to buy into “investment funds” that were to generate well above market returns. However, he commingled the investors’ funds into a JP Morgan Chase checking account. When investors sought to withdraw their money, Madoff used this checking account, essentially “robbing Peter to pay Paul”. The scheme worked until 2008 when the markets collapsed.

On December 15, 2008, Bernard Madoff Investment Securities LLC became a Chapter 11 debtor, and a trustee was appointed to administer the estate. The trustee sought to avoid payments to investors as “fraudulent conveyances” under US Bankruptcy Code Section 548(a)(1)(A). Regarding the 88 lawsuits at issue, Madoff made initial transfers to “feeder funds” (which pooled investors’ money), which subsequently transferred the funds to investors. In this case, the



feeder funds were foreign entities, as were the investors. While Section 548(a)(1)(A) allows the estate to avoid payments made, Section 550(a) allows the estate to recover payments from both “initial” transferees (the feeder funds) and “subsequent” transferees (the investors), all of which in this case were foreign entities.

In effect, the Madoff trustee seeks to recover payments made by one foreign entity to another foreign entity, which payments arose from initial transfers from Madoff’s Chapter 11 estate to the feeder funds.

The lower courts dismissed the trustee’s claims on two bases: (1) international comity, and (2) the presumption against the extraterritorial application of US laws, particularly in this case the US Bankruptcy Code. The lower courts ruled that foreign nations had a greater interest in transactions between foreign entities, which interests should be respected by the US. The courts further ruled that because the parties who both made and received the transfers were foreign entities, there was not a sufficient basis to apply US law abroad.

In “unpacking” the US Bankruptcy Code fraudulent conveyance statutes, the Court of Appeals noted that the transfers are avoidable under Section 548(a)(1)(A) which 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 ....”*

Once a transfer is avoidable, it is recoverable, under Section 550(a), which provides:

*“Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such*



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*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.”*

The Court first addressed the presumption against extraterritoriality, noting that absent a clear congressional expression to the contrary, federal laws should have only domestic application. This presumption avoids international discord that can occur when US law is applied to conduct in foreign countries.

There is clear congressional intent that Sections 548(a)(1)(A) and 550(a) allow for avoidance and recovery of the initial transfer made by Madoff Securities to the foreign feeder funds. The lower courts concluded that there was no congressional intent to allow for avoidance and recovery of the subsequent transfer from the foreign feeder funds to the foreign investors. However, the Court of Appeals concluded that Sections

548(a)(1)(A) and 550(a) operate in tandem. The Court noted that Section 550(a) clearly regulates the debtor’s initial transfer, which was the operative transfer that depleted the estate. Thus, recovery of subsequent transfers from one foreign entity to another does not eliminate the connection to and interest of the US arising from the initial transfer. The Court reasoned that any other outcome would “open a loophole” to allow parties to “recovery-proof” transfers by utilising a two-step transfer using foreign entities.

The Court next noted that international comity takes into account the interests of the US, the interest of the foreign state, and the mutual interests of the family of nations. While the US has a vested interest in domestic debtors’ ability to recover funds for the benefit of their estates, there are circumstances where foreign proceedings create interests that trump US interests. However, in this case, there were no foreign parallel proceedings regarding

Madoff Securities. Moreover, the foreign insolvency proceedings of certain of the feeder funds were not duplicative of the actions in the Madoff Chapter 11 proceeding.

As a result of the Court of Appeals’ ruling, the 88 lawsuits against foreign entities have new life. However, the investors have indicated their intent to appeal the Court of Appeals ruling to the US Supreme Court, and have obtained a stay pending appeal such that the litigation is on hold until SCOTUS rules. Should SCOTUS affirm the Court of Appeals ruling, foreign entities will be more at risk for actions under the US Bankruptcy Code. The ruling dealt with Section 548, but the same logic would apply to Section 547 for transfers made to creditors within 90 days prior to a Chapter 11 filing.

*Parting thought: In the event that the Madoff trustee is able to obtain judgments against any of the foreign defendants, can the judgments be enforced abroad? ■*



**THERE ARE CIRCUMSTANCES WHERE FOREIGN PROCEEDINGS CREATE INTERESTS THAT TRUMP U.S. INTERESTS**



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