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Two Decisions Address the Extraterritoriality of Avoidance Provisions under Morrison

by Weston T. Eguchi
Willkie Farr & Gallagher LLP
New York

The "presumption against extraterritoriality" is a statutory canon of construction that embodies the "longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[1] Stated simply, it provides that "[w]hen a statute gives no clear indication of an extraterritorial application, it has none."

Four years ago, the U.S. Supreme Court decided *Morrison v. National Australia Bank Ltd*,[2] which elevated the presumption against extraterritoriality in a far-reaching and decisive securities fraud case that upended four decades of circuit-level jurisprudence. Courts have since taken the Supreme Court's direction to "apply the presumption in all cases" to heart.[3] Nevertheless, its impact was rarely felt in bankruptcy jurisprudence until recently.

This summer, two decisions — rendered within days of one another — examined the extraterritoriality of the Bankruptcy Code's avoidance statutes, reaching opposing conclusions regarding prepetition, as opposed to postpetition, transfers.

In re Icenhower

In *Kismet Acquisition LLC v. Diaz-Barba (In re Icenhower)*,[4] the Ninth Circuit Court of Appeals concluded, among other things, that §§ 549 and 550 could be applied extraterritoriality in an action to avoid the postpetition transfer of Mexican real estate. Prior to the petition date, the debtors had purchased coastal property in Mexico, which they transferred to a nondebtor shell company (H&G) that was controlled by the debtors. During the bankruptcy case, H&G sold its interests in the Mexican property to the defendants in a sale transaction that was controlled by the debtors.

In the course of the debtors' bankruptcy case, the trustee challenged the postpetition sale from H&G to the defendants. Following a trial, the bankruptcy court ruled for the plaintiff. The court concluded that H&G should be substantively consolidated with the debtors' estate and the sale of the Mexican property to the defendants was avoidable under § 549(a), thereby requiring the defendants, as initial transferees, to return their interest in the Mexican property or its value to the estate pursuant to § 550(a)(1).[5]

On appeal, the appellants/defendants argued that the bankruptcy court's order should be reversed because, among other grounds,[6] its extraterritorial application of U.S. law was improper. Guided by *Morrison*, the Ninth Circuit summarily rejected the defendants' arguments.

The Ninth Circuit articulated the "two-part test" established in *Morrison* for deciding extraterritoriality issues: (1) the court must determine whether "Congress clearly expressed its intent to apply a statute extraterritoriality" and if not, the court "must presume the statue is primarily concerned with domestic conditions"; and (2) if a statute applies only domestically, the court must examine the domestic acts that the statute seeks to regulate in order to determine whether the defendants' conduct "implicate[s] the focus of congressional concern."[7] The Ninth Circuit reiterated the position, articulated in earlier precedent, that "Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate" because 28 U.S.C. § 1334(e) grants the bankruptcy court exclusive jurisdiction over "all the property, wherever located, of the debtor," and § 541(a) defines "property of the estate" to include all legal and equitable interests of the debtor in property "wherever located and by whomever held."[8] The Ninth Circuit then concluded that extraterritorial application was appropriate given that as a result of the substantive consolidation of the debtors and H&G, the Mexican property had been property of the estate as of the petition date.

Madoff Securities

A few days after the *In re Icenhower* decision, Hon. Jed S. Rakoff entered his decision in *SIPC v. Bernard L. Madoff Investment Securities LLC.*[9] The district court concluded that § 550(a)(2) of the Bankruptcy Code did not apply extraterritorially to allow the trustee of Madoff Investment Securities LLC to recover funds that — following their initial transfer to certain foreign feeder funds (which were customers of Madoff Securities) — were subsequently transferred to the defendants, who were the foreign customers of such feeder funds.[10]

The district court noted that the presumption against the extraterritorial application of federal statutes "serves to protect against unintended clashes between our laws and those of other nations, which could result in international discord."[11] Turning to *Morrison's* two-step analysis for determining whether the presumption against extraterritoriality should apply, the district court first addressed the question of whether the factual circumstances at issue required the extraterritorial application of § 550(a).

Toward that end, the district court rejected the trustee and SIPC's argument that the "focus of congressional concern" under SIPA was the regulation of the U.S. broker/dealer, such that application of the incorporated Bankruptcy Code provisions would be inherently domestic. The district court reasoned 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." Rather, the district court noted that a straightforward reading of § 550(a) indicated that the transaction being regulated is "the transfer of property to a subsequent transferee" and "not the relationship of the property to a perhaps-distant debtor."[12] The court then determined that the relevant transfers and parties to the transfer were foreign, even though the chain of transfers had originated with Madoff Securities in New York.[13]

The district court then turned to the second prong of the extraterritoriality inquiry: whether Congress intended for the statute to apply extraterritorially. After first noting that nothing in the language of § 550(a) itself suggested that Congress intended for it to apply to foreign transfers, the district court next turned to surrounding Code provisions for "context." The trustee argued that the avoidance provisions — which refer to "an interest of the debtor in property" — should be read in light of the definition of "property of the estate" which, pursuant to § 541, includes property "wherever located and by whomever held." Describing this argument as "clever," the district court ultimately rejected the argument as "neither logical nor persuasive," relying on the Second Circuit precedent in *In re Colonial Realty* that fraudulently transferred property is not considered property of the estate until such property has been recovered.[14]

Further, the district court rejected the trustee's policy argument that restricting § 550(a)'s application domestically would allow a U.S. debtor to fraudulently transfer all of its assets offshore, then retransfer such assets to avoid the reach of U.S. bankruptcy laws.[15] Balancing the risk of such abuse against the protections afforded by the presumption against extraterritoriality, the district court concluded that a trustee might "be able to utilize the laws of the countries where such transfers occurred to avoid such an evasion while at the same time avoiding international discord."[16]

The district court concluded that even if the presumption against extraterritoriality were rebutted, concerns about international comity would preclude the application of § 550(a). Since the feeder funds were themselves involved in local liquidation proceedings with their own disgorgement proceedings, the district court concluded that comity would not permit the trustee to circumvent such proceedings in order to augment an estate with which the defendants had no direct relationship, as well as apply U.S. law when the defendants had no expectation such law would apply.

Takeaways

Although, on its face, *Madoff Securities* is limited to § 550(a)(2), Judge Rakoff's reasoning would appear to apply equally to many of the Bankruptcy Code's other avoidance provisions, including §§ 547 and 548 where no extraterritorial reach is expressed and the Second Circuit's precedent in *In re Colonial Realty* would apply. Judge Rakoff relied heavily on pre-*Morrison* cases — such as *In re Maxwell Commc'n Corp.*[17] and *In re Midland Euro Exch. Inc.*[18] — that declined to apply §§ 547 and 548 extraterritorially.

At first blush, Judge Rakoff's conclusion that § 550 did not apply extraterritorially after rejecting the trustee's "property of the estate" argument would appear to conflict with the Ninth Circuit's articulation of the "property of the estate" reasoning in concluding that the transfers there could be avoided. However, the fact that postpetition — as opposed to prepetition — transfers were at issue in *In re Icenhower* is significant, since prior to this transfer, such property was property of the estate, a fact recognized expressly in § 549 itself.[19] Moreover, the extraterritorial regulation of postpetition transfers, after a U.S. bankruptcy case has been commenced with respect to the debtors, is unlikely to run afoul of the policy concerns, such as clashing with foreign law and permitting the circumvention of foreign insolvency proceedings, that animated *Madoff Securities*.[20] Nevertheless, the full extent of the *In re Icenhower* decision in the Ninth Circuit is an open question, at least until the issue of whether property transferred prepetition would be considered property of the estate (an issue not addressed in the Ninth Circuit's decision) has been resolved.

Moreover, it remains to be seen whether the ripples created by *Morrison* in other areas of the law will upend a bankruptcy practitioner's longstanding conviction that the Bankruptcy Code's reach (such as, in respect of the automatic stay and discharge) extend beyond our borders.

1. *Morrison v. National Australia Bank Ltd,* 561 U.S. 247, 255, 130 S.Ct. 2869 (2010).

2. *Id.*

3. *See, e.g.,* Todd G. Cosenza, *'Morrison's' Impact on Claims Under the Commodity Exchange Act*, New York Law Journal, April 24, 2013; Marin Weinstein, Robert Meyer & Jeffrey Clark, *Second Circuit Issues Key Decision on the Extraterritorial Applicability of the Dodd-Frank Whistleblower Protection Provisions*, Willkie Farr & Gallagher Client Memorandum, Aug. 25, 2014 (both articles are available at www.willkie.com/publications).

4. --- F.3d ---, 2014 WL 2978491 (9th Cir. July 3, 2014).

5. Alternatively, the bankruptcy court concluded that the debtors' prepetition transfer of the Mexican property to H&G was avoidable pursuant to § 544(b)(1) and California law, and that the interest in such a property could be recovered from the defendants under § 550(a)(2) as a transfer made to subsequent transferees not in good faith. However, the Ninth Circuit's decision appears to address only the § 549/550 argument.

6. The Ninth Circuit also addressed other arguments and reached the following conclusions:

   1. the bankruptcy court's order did not violate the "local action doctrine," a federal common law rule barring courts from exercising jurisdiction over actions directly affecting land in a different state, because the rule was preempted by 28 U.S.C. §1334(e) and § 541 of the Bankruptcy Code;
   2. the bankruptcy court properly declined to enforce Mexican forum selection clauses based on the strong public policy underlying the Bankruptcy Code in favor of centralizing disputes concerning the debtors' obligations;
   3. the doctrine of comity, which the defendants argued required application of Mexican law, was not implicated as there was no true conflict between U.S. and Mexican law where the bankruptcy court's order structured relief in such a way as to account for Mexican law (which prohibited foreign nationals from owning border or coastal properties; instead permitting title to be held by a bank in trust for the benefit of the foreign national subject to the Mexican government's permission);
   4. the Mexican government was not a necessary and indispensable party because the bankruptcy could, alternatively, provide the estate with monetary relief if the Mexican government did not permit the trust structure;
   5. defendants had failed to establish that Mexican law would apply to the issue of whether the defendants were good-faith purchasers.

   Id. at *4-6.

7. *Id.* at *4 (quoting *Morrison*, 130 S. Ct. at 2877, 2884 (internal citations and quotations omitted)).

8. *Id.* at *4 (citing *In re Simon*, 153 F.3d 991, 996 (9th Cir. 1998)).

9. 513 B.R. 222 (S.D.N.Y. 2014), *supp'd by* 2014 WL 3778155 (S.D.N.Y. July 28, 2014).

10. The *Madoff Securities* decision appears to reach precisely the opposite conclusion that the late Hon. **Burton R. Lifland** had earlier reached in *Picard v. Bureau of Labor Insurance (In re Madoff)*, 480 B.R. 501 (Bankr. S.D.N.Y. 2012) ("*Picard v. BLI*"). In that case, the bankruptcy court, applying *Morrison*, concluded that the presumption against extraterritoriality did not prevent the trustee from recovering under § 550(a) from the defendant, the Taiwanese Bureau of Insurance, as a subsequent transferee that received funds outside of the U.S. from one of the foreign feeder funds.

11. 513 B.R. at 226 (quoting *EEOC v. Arabian American Oil Co.*, 499 U.S. 244, 248, 111 S. Ct. 1227 (1991))

12. 513 B.R. at 227.

13. In contrast, in *Picard v. BLI*, Judge Lifland concluded that the focus of the Bankruptcy Code's avoidance and recovery sections was on the "improper depletion of the bankruptcy estate's assets" and in particular, "on the initial transfers that deplete the bankruptcy estate and not on the recipient of the transfers or the subsequent transfers." 480 B.R. at 524. As such, the court concluded that the trustee's application of § 550 was domestic because the depletion of the estate occurred in the U.S., where the Ponzi scheme had operated and the funds were initially dispersed; unlike Judge Rakoff, Judge Lifland was not persuaded by the fact that the foreign defendant received the transferred property in a foreign country from a foreign feeder fund. *Id.* at 524-25.

14. 513 B.R. at 229 (citing *In re Colonial Realty Co.*, 980 F.2d 125, 131 (2d Cir. 1992)). In contrast, Judge Lifland concluded that *In re Colonial Realty* did not militate limiting the application of § 550 because § 548 expressed Congress's intent that all transfers that — except for the fraudulent transfer — would have been property of the estate. *Picard v. BLI*, 480 B.R. at 528

15. In contrast, Judge Lifland cited the risk that "a debtor could end-run the Code by simply arranging to have the transfer made overseas" in support of applying § 550 extraterritorially. *Id.* at 525.

16. 513 B.R. at 231.

17. 186 B.R. 807 (S.D.N.Y. 1995) ("[N]othing in the language or legislative history of § 547 expresses Congress's intent to apply the statute to foreign transfers.") *aff'd*, 93 F.3d 1036 (2d Cir. 1996).

18. 347 B.R. 708, 717 (Bankr. C.D. Cal. 2006) ("Nothing in the text of § 548 indicates congressional intent to apply it extraterritorially.").

19. *See* 11 U.S.C. § 549(a) ("[T]he trustee may avoid a transfer of *property of the estate* ... that occurs after the commencement of the case....") (emphasis added).

20. This distinction between the enforcement of prepetition and postpetition transfers seems consistent with chapter 15, as to avoidance actions with respect to property within the territorial U.S. Section 1520(a)(2) provides that upon recognition of a foreign main proceeding, section 549 will apply to transfers of the debtor's property within U.S. However, section 1521(a)(7) limits a foreign representative's ability to employ U.S.-law avoidance powers under §§ 544, 547, 548 and 550 (among others) in a chapter 15 case, requiring the foreign representative to commence a plenary U.S. bankruptcy case under chapter 7 or 11 pursuant to §§ 1523(a) and 1528. *See In re Fairfield Sentry Ltd.*, 458 B.R. 665, 678 (S.D.N.Y. 2011).

66 Canal Center Plaza, Suite 600, Alexandria, VA 22314
www.abi.org | support@abiworld.org
Tel. (703)-739-0800