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New U.S. Second Circuit Court of Appeals ruling in Madoff liquidation extends the long arm of fraudulent transfer law

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In a unanimous 25 February panel decision, the Second Circuit Court of Appeals held that the trustee liquidating Bernard L. Madoff's investment firm can claw back billions in Ponzi scheme proceeds from investors who received the proceeds indirectly through non-U.S. "feeder funds" (funds that aggregate investor capital to invest in funds such as Madoff's).

The ruling is significant because it affirmed the power of U.S. bankruptcy trustees to pursue estate funds to their ultimate destination, even if the paper trail involved transactions between non-U.S. entities. The effect of the ruling is to revive 88 adversary cases against international investors by Irving Pickard, the trustee of Bernard L. Madoff Investment Securities LLC (Madoff Securities) who is seeking to recover roughly US$4 billion in funds on behalf of customers who lost money in the Madoff Ponzi scheme.

The transactions in question involved a process whereby Madoff Securities, a U.S. entity, received requests from feeder fund investors wishing to withdraw their capital. Returning their funds, Madoff Securities transferred the proceeds first to non-U.S. feeder funds (Step 1). Thereafter, the non-U.S. feeder funds further transferred the proceeds to their non-U.S. investors (Step 2). U.S. District Judge Jed S. Radkoff had earlier held in a 2014 decision that the Step 2 transactions involving transfers from non-U.S. entities to other non-U.S. entities were outside the reach of the Bankruptcy Code avoidance (or clawback) actions because application of clawback laws in that context would violate principles of comity and the presumption against extraterritoriality.

The Second Circuit disagreed, holding that the fraudulent transfer provisions of the Bankruptcy Code (sections 548 and 550) may permit a trustee to recover funds from foreign investment entities, even when such entities never transacted directly with a U.S.-based debtor. The court noted that U.S. bankruptcy courts have a compelling interest in allowing domestic U.S. bankruptcy estates to recover fraudulently transferred property, wherever it ends up, and that such interests are not trumped by either principles of comity (whereby each nation respects the laws of other nations) or the presumption that U.S. laws are not meant to take effect beyond U.S. borders (extraterritoriality), at least when the transfers originated in the U.S. and absent the presence of concurrent foreign insolvency proceedings involving the same debtor. The fact that many of the non-U.S. feeder funds were involved in their own foreign insolvency proceedings did not control, as the main issue in the view of the Second Circuit was a fraudulent transfer from a

U.S. debtor, and the subsequent transfer by the foreign recipient to its foreign investors was not unrelated and recovery against such a subsequent transferee was specifically contemplated by the Bankruptcy Code. The Second Circuit held that Congress intended such claims to be resolved in the United States "rather than through piecemeal proceedings around the world."

The Second Circuit showed little sympathy for the investors whose funds can now be clawed back, as it noted that they "knew where their money was going" and chose to place their assets in feeder funds that in turn invested nearly all of their assets in Madoff Securities.

This ruling provides that the Bankruptcy Code's fraudulent transfer provisions have long arms indeed, and that proceeds transferred from a U.S.-based debtor down a chain of non-U.S. entities may not outrun the Bankruptcy Code's reach.

Contacts

Ronald Silverman
Partner, New York
T +1 212 918 3880
ronald.silverman@hoganlovells.com

Hampton Foushee
Senior Associate, New York
T +1 212 918 3078
hampton.foushee@hoganlovells.com