FLEMMING ZULACK WILLIAMSON ZAUDERER

John F. Zulack
One Liberty Plaza
New York, NY 10006
(212) 412-9550
jzulack@fzwz.com

MEMORANDUM

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A Win for the World

INTRODUCTION

On July 6, 2014, U.S. District Court Judge Jed S. Rakoff issued the "Extraterritoriality Decision"[1] in which he delivered a crushing blow to the claims of Irving H. Picard (the trustee (the "Trustee") of the business of Bernard L. Madoff Investment Securities LLC ("BLMIS") that seek to recover tens of billions of dollars from non-U.S. banks,[2] their customers and other foreign entities that invested indirectly with Bernard Madoff. Judge Rakoff decided that Section 550(a) of the U.S. Bankruptcy Code "does not apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor. Therefore, the Trustee's recovery claims are dismissed to the extent that they seek to recover purely foreign transfers." *Sec. Investor Prot. Corp. vs. Bernard L. Madoff Inv. Sec. LLC,* 513 B.R. at 232.

This memorandum will describe the historical and legal context of this "show stopping" decision before providing an analysis of the Extraterritoriality Decision.

[1] The citation for the "Extraterritoriality Decision" is *Sec. Investor Prot. Corp. vs. Bernard L. Madoff Inv. Sec. LLC,* 513 B.R.222 (S.D.N.Y. 2014).

[2] A significant number of the foreign bank defendants are Swiss, including UBS AG: Credit Suisse AG; Bank Julius Baer & Co. Ltd.; Pictet & Cie; Banque J. Safra; Banque Syz & Co. S.A.; Barclays Bank Suisse S.A.; Banque Privée Espírito Santo S.A; Merrill Lynch Bank (Suisse) S.A.; AIG Privat Bank AG; Credit Agricole (Suisse) S.A.; Vontobel AG; BSI AG; Schroder & Co. Bank AG; Bank Hapoalim (Switzerland) Ltd.; Dresdner Bank (Schweiz) AG; Société Générale Private Banking (Suisse) S.A.; EFG Bank S.A.; Banque Lombard Odier (Suisse) S.A.; Banque Cantonale Vaudoise; Bordier & Cie ; Banque Internationale à Luxembourg (Suisse); Royal Bank of Canada (Suisse) S.A.; Citibank (Switzerland) AG; HBSC Private Banking Holdings (Suisse) S.A.; and HSBC Private Bank (Suisse) S.A.

HISTORICAL CONTEXT

The world became aware that Bernard Madoff was running a Ponzi scheme on 11 December 2008. For more than 20 years prior thereto, Madoff had issued account statements to his customers showing remarkably consistent and profitable returns on their investments. Madoff's office had fabricated the account statements. Madoff never invested one penny of the cash that his customers had entrusted to him. Instead of investing in securities, as the account statements falsely showed, Madoff used the cash coming in as the source of the cash going out. When customers closed their accounts, Madoff promptly paid the customers the amount of their principal investment, plus the accumulated earnings shown on the fabricated account statements. As Madoff's reputation grew, the cash coming in exceeded the cash going out. In the fall of 2008, when the U.S. securities markets were suffering their greatest crisis since the Great Depression, the demand for withdrawals far exceeded the cash infusions. Overwhelmed by the demands that he could no longer meet, Madoff confessed and was arrested on 11 December 2008.

The Madoff Ponzi scheme was the largest Ponzi scheme in history. The court-appointed Trustee had many years of experience overseeing the unwinding of prior financial frauds. He believed that the legal procedures that applied to past Ponzi schemes should be applicable to the Madoff Ponzi scheme.[3]

The Trustee had two main jobs: his first job was to set up a claims process by which investors who had lost the principal amount of their cash investments could recover a portion (or perhaps all) of the principal amount of their investment. His second job was to "avoid" transfers that BLMIS made to its investors and then to recover the amount of those "avoided" transfers from the investors that had received them. The amounts thus recovered would become "customer property" of the estate of BLMIS, which the Trustee could then use to pay the claims that he "allowed."

THE CLAIMS PROCESS

From the outset, the Trustee also had a narrow view of the investors who were entitled to recover the amount of their principal investment (or at least a portion of it) in the bankruptcy of BLMIS. The Trustee decided, and the Second Circuit Court of Appeals

[3] Judge Rakoff saw the Madoff fraud differently because BLMIS was a broker-dealer. In Judge Rakoff's view, the rights of customers of broker-dealers had to be balanced with the avoidance and recovery powers of a trustee in bankruptcy. According to the Trustee, Judge Rakoff's rulings "altered the legal landscape." On numerous occasions, Judge Rakoff admonished the Trustee about looking at the Madoff fraud as a pure Ponzi scheme. A discussion of Judge Rakoff's several ground-breaking rulings other than the Extraterritoriality Decision is beyond the scope of this paper.

affirmed his legal position, that the only victims of the Madoff Ponzi scheme that were entitled to recover their principal investment through the means of a SIPA[4] bankruptcy were the direct customers of BLMIS. *See In re Bernard L. Madoff Inv. Sec. LLC,* 708 F.3d 422, 427 (2d Cir. 2013).

Like other Ponzi schemes, Madoff started with an "affinity group" of investors and then extended his fraud to other investors. For Madoff, the "affinity group" consisted of friends, acquaintances and business contacts who resided primarily in New York, Florida and California. This community of investors considered it to be a privilege to invest their money with the great financial wizard, Bernard Madoff. The great majority of the direct customers of BLMIS were U.S. residents and citizens.

The Trustee received 16,519 claims from victims of the Madoff fraud who sought to recover some of their lost investment from the estate of BLMIS. The Trustee allowed 2,551 of those claims and denied approximately 13,000 of the claims.

Most of the denied claims were made by indirect investors. Many of these victims were non-U.S. persons who had invested money in shares of off-shore feeder funds. The feeder funds then invested almost all of their assets in Madoff. Madoff expanded his fraud throughout the world primarily through his relationship with the feeder funds. Although the foreign investors in feeder funds lost far more money in the Madoff fraud than the direct customers (excluding the feeder funds themselves, which were direct customers of BLMIS), all of the claims of the indirect foreign investors were rejected.

Over the past approximately six years, the Trustee has recovered $10.551 billion in "customer property" with which to pay the direct customer victims of the Madoff Ponzi scheme. While the Trustee has distributed a significant amount of the $10.551 billion to direct customers, little of the distribution has trickled down to the foreign investors in the feeder funds, such as Fairfield Sentry, Ltd. and Kingate Global Ltd., two BVI funds.

THE AVOIDANCE AND RECOVERY PROCESS

The process by which the Trustee recovers funds transferred from BLMIS prior to 11 December 2008 has two steps. First, he must "avoid" the transfer from BLMIS to the initial transferee; and second, he must recover the amount of the transfer that was avoided.

Prior to 11 December 2010, the Trustee filed over 1,000 proceedings in the U.S. Bankruptcy Court against initial transferees to avoid and recover transfers. Among the

[4] The Securities Investor Protection Act of 1970 ("SIPA") (15 U.S.C. §§ 78aaa, *et seq.*), regulates the bankruptcies of broker-dealers in conjunction with the U.S. Bankruptcy Code.

1,000 proceedings were complaints to avoid the transfers made by BLMIS to the Madoff feeder funds.[5]

Prior to 30 June 2012, the Trustee brought approximately 80 proceedings against "subsequent transferees" of the feeder funds.[6] Under the Bankruptcy Code, if the Trustee cannot recover the amount of an avoided transfer from the initial transferee, he can attempt to recover that amount from any subsequent transferees from the initial transferee. The Trustee can recover the total amount of the transfer from several parties in the chain of subsequent transferees, but he can only recover the amount of the original transfer.

For example, during the 90 days prior to 11 December 2008, BLMIS transferred $1.13 billion to the Fairfield Sentry. Many shareholders of Fairfield Sentry wanted to redeem their holdings in Fairfield Sentry and related funds and receive the value of their investments in cash the financial crisis in U.S. markets erupted in September 2008. The Trustee has alleged that when Fairfield Sentry received the funds from BLMIS, Fairfield Sentry transferred the $1.13 billion to the shareholders of Fairfield Sentry and related funds. Most shareholders acted through nominees – generally non-U.S. banks at which the shareholders maintained their cash and securities accounts.

The Trustee entered into a settlement agreement with the liquidators of Fairfield Sentry in June 2011, and the US Bankruptcy Court approved that settlement in July 2011. Under the terms of the settlement agreement, the $1.13 billion in transfers to Fairfield Sentry were "avoided." In the recovery phase, the Trustee could not recover the $1.13 billion from Fairfield Sentry because Fairfield Sentry had already transferred that amount to non-U.S. banks and the non-U.S. banks transferred the $1.13 billion to the accounts of their customers.

In suing the subsequent transferees prior to 30 June 2012, the Trustee was pursuing the well-paved road of trustees in prior bankruptcies. Under Section 550(a) of the Bankruptcy Code:

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[5] Among the feeder funds that the Trustee sued were Kingate Global Ltd. (BVI); Kingate Euro Ltd. (BVI); Fairfield Sentry Ltd. (BVI); Fairfield Sigma Ltd. (BVI); Fairfield Lambda Ltd. (BVI); Chester Global Strategy Fund Ltd. (C.I.); Herald Fund SPC (C.I.); Primeo Fund (C.I.); Herald Lux (Lux); Lagoon Investment Limited (BVI); Hermes International Fund Ltd. (BVI); Thema Wise Investments Limited (BVI); Thema Fund Limited (BVI); Thema International Fund plc (Ireland); Plaza Investments International Ltd. (BVI); Luxalpha SICAV (Lux); Oreades SICAV (Lux); Luxembourg Investment Fund U.S. Equity Plus (Lux); Harley (C.I.); Rye Select Broad Market Portfolio Ltd. (C.I.); Rye Select Broad Market XL Portfolio L.P. (C.I.); Elite–Stability Fund SICAV (Lux); and Elite-Stability Fund SICAV Stablerock Compartment (Lux).

[6] The Trustee intends to bring many more subsequent transferee proceedings. He voluntarily stopped bringing additional subsequent transferee proceedings while Judge Rakoff was hearing and deciding a number of pivotal legal issues, including the issue of the territorial limits of the Trustee's power to recover "foreign transfers."

> ...to the extent that a transfer is avoided....the trustee may recover, for the benefit of the estate, the property transferred or, if the court so orders, the value of such property from
>
> (1) the initial transferee of such transfer of the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee.

Defendants (including the foreign subsequent transferee defendants) made a motion to the U.S. District Court to withdraw the reference to U.S. Bankruptcy Court to determine certain pivotal legal issues, including the issue of the extraterritorial application of SIPA and the Bankruptcy Code. Judge Rakoff granted the motion on 7 June 2012. He then proceeded to hear argument on each of the issues. He heard argument on the motion on extraterritoriality on 21 September 2012.

Prior to 7 June 2012, a motion was pending in the U.S. Bankruptcy Court to dismiss the claims of the Trustee on the grounds that he lacked the power to recover extraterritorial transfers. On 11 October 2012, U.S. Bankruptcy Court Judge Burton Lifland decided *Picard v. Bureau of Labor Ins.*, 480 B.R. 501 (Bankr. S.D.N.Y. 2012), in which he held that the Trustee did have power under the Bankruptcy Code to recover subsequent transfers made by Fairfield Sentry to a Taiwanese public agency. Judge Lifland squarely rejected the argument that the Bankruptcy Code did not authorize the recovery of a transfer from a foreign transferor to a foreign transferee.

ANALYSIS OF THE EXTRATERRITORIALITY DECISION[7]

Judge Rakoff's Extraterritoriality Decision of 6 July 2014 reached the opposite conclusion. The Extraterritoriality Decision did not discuss, refer to or mention the decision in the *Bureau of Labor Ins.* case.

Judge Rakoff first determined that "Section 550(a) does not apply extraterritorially to allow for the recovery of subsequent transfers received abroad by a foreign transferee from a foreign transferor." He next determined that the "Trustee's recovery claims are dismissed to the extent that they seek to recover purely foreign transfers. *Sec. Investor Prot. Corp. vs. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. at 232.

[7] This analysis is based substantially on the Consolidated Supplemental Memorandum of Law in Support of the Transferees Defendants' Motion to Dismiss Based Upon Extraterritoriality dated 31 December 2014 (the "Consolidated Memorandum"). Although the author of this paper is a signatory to the Consolidated Memorandum on behalf of six different Swiss bank defendants and on behalf of banks in France, Luxembourg and the United Kingdom, the principal author of the Consolidated Memorandum was Robinson B. Lacy of Sullivan & Cromwell LLP.

A typical complaint against a Swiss bank alleges as follows: "With this Complaint, the Trustee seeks to recover approximately $xxxxxxxxxxx in subsequent transfers of Customer Property made to Defendant [Swiss Bank]. The subsequent transfers were derived from investments with BLMIS made by Fairfield Sentry Limited … and Kingate Global Fund Ltd., which were Madoff Feeder Funds (collectively the 'Feeder Funds'). The Feeder Funds are British Virgin Islands ('BVI') companies that are in liquidation in the BVI."

A later paragraph in the typical complaint states that "Defendant xxx is a Swiss [entity] that maintains a place of business of [street address] Geneva, Switzerland."

Judge Rakoff rejected the Trustee's arguments that dismissal was inappropriate because the Trustee needed to do additional "fact-gathering" to determine where the transfers took place. Judge Rakoff stated:

> …to the extent that the Trustee's complaints allege that both the transferor and the transferee reside outside the United States, there is no plausible inference that the transfer occurred domestically. Therefore, unless the Trustee can put forth specific facts suggesting a domestic transfer, his recovery actions seeking foreign transfers should be dismissed.

Id. at 232.

THE EXTRATERRITORIAL DECISION FOLLOWS THE MORRISON CASE

The Extraterritoriality Decision follows the U.S. Supreme Court's decision in *Morrison v. Nati'l Australia Bank Ltd*, 561 U.S. 247 (2010). In *Morrison*, Supreme Court Justice Scalia stated, "It is a 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." *Id*. at 255. *Morrison* also emphasized that '[w]hen a statute gives no clear indication of an extraterritorial application, it has none. *Id*. at 255.

In applying *Morrison* in the Extraterritoriality Decision, Judge Rakoff considered (1) "whether the factual circumstances at issue require an extraterritorial application of the relevant statutory provision" and (2) "if so, whether Congress intended for the statute to apply extraterritorially." 513 B.R. at 226.

What was the focus of Congress's concern in enacting Section 550(a)(2) of the Bankruptcy Code?

To show that the recovery of the foreign transfers was essentially a permissible domestic extension of the applicable statutes, the Trustee argued that "the 'focus' of

congressional concern in a SIPA liquidation is the regulation of the SIPC-member U.S. broker-dealer, so that the application of any of the incorporated provisions of the Bankruptcy Code is inherently domestic." *See Id.* at 227.

Judge Rakoff disagreed. He held that the focus is "the transfer of property to a subsequent transferee, not the relationship of that property to a perhaps-distant debtor. *Id.* at 227. Judge Rakoff then held that the relevant transfers and transferees are "predominantly foreign: foreign feeder funds transferring assets abroad to their foreign customers and other foreign transferees." *Id.* at 227-228.

Does Section 550(a) have an extraterritorial application?

Judge Rakoff answered "no": "Nothing in [the language of Section 550(a)] suggests that Congress intended for this section to apply to foreign transfers..." *Id.* at 228.

WHAT ARE THE NEXT STEPS?

Judge Rakoff did not dismiss any individual claims. Instead, he remanded the adversary proceedings to the U.S. Bankruptcy Court for further proceedings consistent with his opinion and order in the Extraterritoriality Decision.

On 28 August 2014, the Trustee brought an Omnibus Motion for leave to replead his complaints and to take additional discovery. In his memorandum of law in support of the Omnibus Motion, the Trustee contended that the Extraterritoriality Decision and another decision on an issue that Judge Rakoff made in the consolidated briefing phase "substantially altered the legal landscape..."

On 10 December 2014, U.S. Bankruptcy Judge Stuart Bernstein signed a Scheduling Order that sets forth deadlines for the implementation of the Extraterritoriality Decision. In accordance with the Scheduling Order, the foreign subsequent transferee defendants filed a "Consolidated Memorandum of Law in Support of the Transferee Defendants' Motion to Dismiss Based on Extraterritoriality" on 31 December 2014.

On 2 April 2015 (adjourned from the original date of 2 March 2015) the Trustee is scheduled to file a consolidated memorandum of law opposing the dismissal of his claims to recover foreign transfers and to file up to five pages of additional addenda detailing the reasons why claims against each specific foreign subsequent transferee defendant should not be dismissed. According to the Scheduling Order, the Trustee must also file "proffered allegations relevant to the Extraterritoriality Issue that would be included in a proposed amended complaint. The "proffered allegations will be set forth with enough specificity to permit the Court to determine whether the proposed amendment ... would be futile."

The defendants are to respond to the Trustee's papers on 1 June 2015 (adjourned from 30 April 2015). Thereafter, Judge Bernstein will hold a hearing and decide whether to dismiss the recovery claims against the Swiss banks and their clients and other foreign defendants.

AN UPHILL ROAD FOR THE TRUSTEE

Most defense counsel believe that Judge Bernstein will dismiss the Trustee's claims to recover foreign transfers. To avoid dismissal, the Trustee's complaints must affirmatively allege facts giving rise to a plausible inference that the transfers occurred in the United States. As discussed above, each complaint identifies the transferee entity as organized under the law of a foreign jurisdiction. Each complaint also identifies each transferor as an entity organized in a foreign jurisdiction. Judge Rakoff stated expressly that "to the extent that the Trustee's complaints allege that both the transferor and the transferee reside outside of the United States, there is no plausible inference that the transfer occurred domestically." 513 B.R. at 232 n.4.

Judge Rakoff anticipated some of the facts that the Trustee may assert in an attempt to meet his burden of showing that the transfers occurred in the United States. Judge Rakoff used the Trustee's complaint against CACEIS Bank Luxembourg and CAECEIS Bank (France)[8] as an example of "foreign transfers" that are outside the territorial scope of section 550(a) of the Bankruptcy Code. He concluded that some contacts with the United States are insufficient to create a plausible inference that the transfer occurred domestically.

In footnote 1. Judge Rakoff expressly held that "...the fact that some of the defendants here allegedly used correspondent banks in the United States to process dollar-denominated transfers" is not sufficient to make the foreign transfers domestic. 513 B.R. at 228 n.1

The CACEIS complaint alleged that CAECIS entered into subscription agreements with Fairfield Sentry in which CAECIS submitted to New York jurisdiction. Many foreign banks entered into subscription agreement with Fairfield Sentry that contained a provision consenting to New York jurisdiction.

The CACEIS complaint also alleged that CACEIS "sent copies of the [subscription] agreements to FGG's [i.e. Fairfield Greenwich Group's] New York City office and wired funds to Fairfield Sentry through a bank in New York."

[8] *Picard v. Caceis Bank Luxembourg et al.,* Adv. Proc. No. 11-2758 (Bankr. S.D.N.Y.).

The CACEIS complaint also alleges that "CACEIS Bank Luxembourg and CACEIS Bank (France) are part of the CACEIS Group, which maintains an office in New York City."

After analyzing these contacts with New York, Judge Rakoff concluded that some contacts with the United States are insufficient to create a plausible inference that the transfer to be avoided occurred within the U.S.

IS THE EXTRATERRITORIALITY DECISION JUST?[9]

The Trustee believes that the Extraterritoriality Decision undermines the policy considerations of the Bankruptcy Code and of SIPA. Is he correct? Not according to Judge Rakoff:

> Furthermore, although the Trustee argues that finding no extraterritorial application would undermine the primary policy objective of SIPA— the equitable distribution of customer funds to customers of the debtor—the Trustee has long insisted that indirect customers of Madoff Securities, like many of the defendants here, are not themselves creditors of the customer-property estate. *See In re Bernard L. Madoff Inv. Sec. LLC,* 708 F.3d 422, 427 (2d Cir. 2013) (adopting this position). Therefore, the Trustee's claim that the defendants here are being treated somehow more favorably than customer-beneficiaries of the SIPA estate — who are not similarly situated to these non-beneficiaries — is disingenuous, especially since the defendants here stand to benefit little, if at all, from the customer-property estate through their now-defunct feeder funds.

Id. at 231.

Moreover, the Extraterritoriality Decision is the latest and most important step toward ameliorating the discriminatory and disparate treatment directed toward non-U.S. Madoff investors. Over the past six years, the press and the Trustee's public communications posted on the Trustee's website (http://www.madofftrustee.com) have praised the efforts that the Trustee has made to recover customer property and distribute money to victims of the Madoff fraud. However, these efforts have been exclusively for the benefit of the direct - largely U.S.-based investors. Until late 2013,

[9] The Trustee has indicated that he may bring claw-back proceedings in the home countries of foreign subsequent transferees. We are unaware of any proceedings that he has commenced in Switzerland. The merits of any of the Trustee's claims in Switzerland or in other countries outside the United States is beyond the scope of this memorandum

little was said about the fate of the feeder fund investors, who were predominantly foreign investors.

That began to change when, in November 2013, the U.S. Attorney for the Southern District of New York successfully retained $2.2 billion of the $7.2 billion that was recovered in a December 2010 settlement with the estate of deceased Madoff investor Jeffrey Picower. The Trustee had wanted the entire $7.2 billion to go to direct customers of BLMIS. Picard stated: "Every penny of the $7.2 billion recovered through these two settlements will be distributed to BLMIS customers with valid claims." *See* http://www.madofftrustee.com/statements-07.html.

The U.S. Attorney for the Southern District of New York, Preet Bharara, had other plans, however. In his 18 November 2013 announcement of the establishment of the Madoff Victim Fund, U.S. Attorney Bharara specifically noted that:

> This was an epic fraud and the process of compensating victims has been complex, but significant steps have been taken, and the Government is continuing its investigation to ensure that assets are recovered for the benefit of Madoff's victims. With today's announcement, we take a great step forward in returning the $2.35 billion collected so far to Madoff's victims, and we hope to return even more. The process we have put in place opens the door for thousands of defrauded victims who otherwise might never have recovered anything. We have made eligibility to recover far more inclusive, and more equitable, than ever before.

See http://www.madoffvictimfund.com/Madoff_Remission_Announcement_PR.pdf.

Over the next several months, the Madoff Victim Fund received claims from many victims of the Madoff Ponzi scheme, including direct customers and indirect customers (such as the investors in the Madoff feeder funds). The Madoff Victim Fund received 63,553 claims from investors in 119 countries. The total amount of losses claimed was $76.654 billion. The Madoff Victim Fund has approximately $4 billion in assets. The administrators of the Madoff Victim Fund are still reviewing the voluminous claims that they received. However, it is anticipated that the total amount of principal cash investment lost will be less than the $76.654 billion claimed. Conversely, it will almost certainly be far greater than the approximately $20 billion of cash investment that the Trustee was seeking to recover and distribute. Thus, how much the investors in the feeder funds will be able to recover through the Madoff Victim Fund is unclear, but there is now at least some possibility of a partial recovery of their losses.

In addition, the Extraterritoriality Decision also potentially eliminates another way in which the feeder fund investors have been treated unfairly in the Madoff liquidation process. One of the reasons that the Madoff Ponzi scheme was so enormous is that a substantial part of the money invested in feeder funds never was transferred from the feeder funds to BLMIS. Instead, for extended periods, the feeder funds funded their redemptions from the proceeds of new subscriptions. Then, much of the excess of the proceeds of the new subscriptions over the redemptions would be invested with BLMIS. However, in years of growth, many feeder funds did not need transfers from BLMIS in order to fund their redemptions.

The Trustee's complaints do not acknowledge this capital point. The Trustee has sued to recover 100% of the transfers from the feeder funds to their investors. He has not limited his claims to recover "profits." He has sued to recover principal as well. He also has not limited his claims to periods when the feeder funds obtained transfers from BLMIS. For example, Kingate Global did not receive any transfers from BLMIS between 12 May 2000 and 28 November 2005. However, the Trustee's complaints seek to recover redemptions made to Kingate Global's shareholders in 2003 and 2004.

From the viewpoint of the foreign investor and their nominee foreign banks that face the claims that the Trustee has already filed and those billions of dollars of additional claims that he is waiting to file, the Extraterritoriality Decision is a great interim victory. It, together with the establishment of the Madoff Victim Fund, has brought some equitable treatment and justice to those victims of Madoff who were not direct customers of BLMIS.