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The Continued Growth of the Presumption Against Extraterritoriality and its Impact on the Bankruptcy Code's Avoidance Provisions

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Introduction

Over the past several years, ever since the United States Supreme Court's seminal decision in *Morrison v. National Australia Bank Limited*,[1] the presumption against extraterritoriality has steadily expanded across much of the legal field. In doing so, the presumption has again become the dominant standard in deciding whether Congressional legislation may be used on an extraterritorial basis.[2] This expansion has recently encompassed portions of the Bankruptcy Code, specifically, its avoidance provisions.

The presumption, as noted in detail below, relies on the premise that although the legislature has the authority to regulate beyond the borders of the United States, there is a general presumption against extraterritorial application of U.S. law.[3] The presumption can only be overcome if Congress intended to apply the statute abroad.[4]

Part I of this article will discuss the presumption against extraterritoriality generally; Part II will give a brief overview of the standards used prior to the Supreme Court's decision in

[1] 561 U.S. 247 (2010).
[2] *See* Franklin A. Guvurtz, Article, *Determining Extraterritoriality*, 56 WM. & MARY L REV. 341, 349–50 (2014) (observing that although Federal courts, at one point in time, were reluctant to impose the presumption against extraterritoriality, the United States Supreme Court has, in recent years, invoked the presumption far more often).
[3] *See Morrison*, 561 U.S. at 261.
[4] *Id.*

Morrison and will then discuss the Court's holding in *Morrison* and it's reasons for rejecting the prior standards adopted by the Circuit Courts; and finally, Part III will discuss the expansion of the presumption against extraterritoriality to the Bankruptcy Code's avoidance provisions and some of the current sources of friction between the Circuit Courts over which avoidance provisions were intended by Congress to be used extraterritorially.

I. The Presumption Against Extraterritoriality

Considered "[o]ne of the long-settled precepts" the definition of extraterritorially has remained virtually universal by both courts and commentators alike.[5] Both have defined extraterritorial jurisdiction simply as "domestic law that regulates conduct abroad."[6] Or more precisely, extraterritorial jurisdiction enables a court "to exercise power beyond its territorial limits."[7]

However, even though Congressional authority to legislate extraterritorially is extensive, courts are reluctant to attribute any extraterritorial effect to a statutory provision without express Congressional authorization.[8] Notably, the presumption is not a creature of statute, but is instead a judicial product of statutory construction and interpretation regarding the territorial reach of federal statutes.[9] The courts have reasoned that such a cautious construction helps to guard against inadvertent clashes between United States law and the laws of other nations.[10] A court will often look to three broad categories of construction that form the basis for applying the presumption: (1) a federal statute that is silent on its extraterritorial applicability will be

[5] Austin L. Parrish, *Evading Legislative Jurisdiction*, 87 NOTRE DAME L. REV. 1673, 1678 (2012).
[6] *Id.*
[7] *Id.* at 1678–79.
[8] *See* Patrick M. Birney, *Revisiting Presumption Against Extraterritoriality in Avoidance Actions*, 33 AM. BANK. INST. J. 28 (2014) [hereinafter *Revisiting Presumption Against Extraterritoriality*].
[9] *Id.*
[10] Foley Bros., Inc. v. Filardo, 336 U.S. 281, 285 (1949).

interpreted to have only domestic reach, absent a "clear indication of some broader intent"[11]; (2) the "nature and purpose of a statute may provide an indication of whether Congress intended a statute to apply beyond the confines of the United States"[12]; and (3) Congress is presumed to have enacted legislation that does not conflict with international law.[13]

Furthermore, courts have noted several reasons, other than international comity, to have the presumption. First, the courts have observed that the presumption makes sense because "Congress ordinarily legislates with respect to domestic, not foreign matters . . . [and] . . . it knows how to give extraterritorial effect to its statutes when it wants to."[14] Second, there are concerns of inconsistency when courts apply relevant federal provisions to similar factual situations only to have multiple outcomes.[15] The third and final principle in support of the presumption is the acknowledgement of the Congress's "role in the law-making process and limit[ing] activist judicial interpretations."[16]

II. The Cause and Effects Tests and its End Under Morrison

The Second Circuit, in formulating its own standard for deciding when Congressional legislation was intended to apply extraterritorially, initially had two separate tests: one for conduct[17] and one for effect.[18] Eventually however, the Second Circuit combined both tests and created the "conduct and effects test."[19] This test was subsequently struck down by the Supreme Court in *Morrison*.[20] In accordance with the test, a court determining whether it had jurisdiction over an action with extraterritorial concerns, had to ascertain whether: (1) the "wrongful conduct

[11] *Revisiting Presumption Against Extraterritoriality*, 33 AM. BANK. INST. J. at 28.
[12] *Id.* at 28–29.
[13] *Id.* at 29.
[14] *Id.*
[15] *Id.*
[16] *Id.*; *see Morrison*, 561 U.S. at 261.
[17] *See* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (1972).
[18] *See* Schoenbaum v. Fistbrook, 268 F. Supp. 385 (1967).
[19] *See* Itoba Ltd. v. Lep Group PLC, 54 F.3d 118, 122 (1995).
[20] 561 U.S. at 261.

occurred in the United States" and (2) did such conduct "have a substantial effect in the United States or upon United States citizens."[21] The vague standards of the test soon led to unpredictable and inconsistent applications of law.[22]

Although several Circuit Court of Appeals eventually adopted the cause and effects test, this only resulted in a "proliferation of vaguely related variations" which only created further inconsistencies.[23] These continued inconsistencies became one of several reasons why the U.S. Supreme Court rejected the cause and effects test in *Morrison*.[24]

In *Morrison*,[25] three Australian plaintiffs sued an Australian bank for alleged fraud in U.S. Federal court.[26] The claims revolved around common stock traded on the Australian Stock Exchange and other non-U.S. securities exchanges.[27] There, the foreign plaintiffs attempted to argue that the alleged fraudulent conduct actually occurred in the United States which thus satisfied the then used conduct and effects test implemented by the Second Circuit.[28] The Supreme Court flatly rejected the conduct and effects test and instead held that the presumption against extraterritorial application applies in cases of deciding whether to apply domestic law abroad.[29]

The Court noted that the "criticisms [of the conduct and effects test] seem to us justified. The results of judicial-speculation-made-law—divining what Congress would have wanted . . .

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[21] *Itoba Ltd.*, 54 F.3d at 122.
[22] *Morrison*, 561 U.S. at 257–58 ("Th[is] became the north star of the Second Circuit's . . . jurisprudence, pointing the way to what Congress would have wished.").
[23] *Id.* at 259–60; *see* Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 665–67 (C.A.7 1998) (describing the approaches of the various Circuit Courts and adopting another variance of the conduct and effects tests).
[24] *Morrison*, 561 U.S. at 261.
[25] 561 U.S. 247.
[26] *Id.* at 251.
[27] *Id.* at 252–53.
[28] *Id.* at 258.
[29] *Id.* at 261 ("Rather then guess anew in each case, this Court applies the presumption in all cases, preserving a stable background against which Congress can legislature with predictable effects.).

—demonstrate the wisdom of the presumption against extraterritoriality."[30] In reasserting the presumption as the dominant line of thought, the Supreme Court crafted a two-step analysis to determine whether the presumption against extraterritoriality applies. First, "whether the factual circumstances at issue require an extraterritorial application of the relevant statutory provision" and second, "if so, whether Congress intended for the statute to apply extraterritorially."[31] Furthermore, the Court noted that "it is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States" and that the focus should "not [be] upon the place where the deception originated, but upon purchases and sales of securities in the United States."[32]

Applying the test in *Morrison*, the Court, focusing on the second prong, rejected the petitioners' argument that the definition of interstate commerce, which explicitly mentions trade "between any foreign country and any State," rebuts the presumption against extraterritorially.[33] Instead, the Court held that even when statutes contain such broad language in their definitions of commerce, these general references do not defeat the presumption.[34] Similarly, the Court rejected the argument that sections of the Exchange Act pointed to by the plaintiffs were never intended to apply abroad.[35]

III. Morrison's Impact on the Bankruptcy Code's Avoidance Provisions

As noted earlier, the Supreme Court's two-part test laid out in *Morrison* has recently expanded to the avoidance provisions of the Bankruptcy Code. Though there is little dispute over whether the presumption against extraterritorially is the appropriate standard to apply in cases

[30] *Id.*
[31] *In re Madoff Securities*, 513 B.R. 222, 232 (S.D.N.Y. 2014) (citing *Morrison*, 561 U.S. at 255).
[32] *Morrison*, 561 U.S. at 249, 266.
[33] *Id.* at 262–63.
[34] *Id.*
[35] *Id.* at 265 (the Court holding that because section 10(b) lacks "a clear statement of extraterritorial effect" from Congress, the Court has no power to give this section (or any other) such effect).

involving international exchanges, the question, at least as far as the Bankruptcy Code is concerned, is exactly which of the avoidance provisions are subject to the presumption? Indeed, at least one commentator has noted difficulty is finding "any affirmative evidence of congressional intent to apply the avoidance mechanisms of the Code extraterritorially."[36] That being said, several federal courts have held that certain avoidance provisions were intended to be used overseas, thus allowing a domestic trustee to use domestic law to secure foreign based funds.

For example, in *In re Elcoteq*,[37] the court there held that a chapter 7 trustee who brought an adversary proceeding against the purchaser seeking to recover the value of the debtor-corporations assets in Mexico that had been foreclosed as a result of a decisions of a local labor board in Mexico was not entitled to void the improper transactions made as they failed to state a cause of action.[38]

More importantly however, was the court's analysis of whether sections 541 and 550 of the Bankruptcy Code's avoidance provisions could be applied on an extraterritorial basis. For each provision the court held that because of the "tight connection" between these claims and their effects domestically, "federal courts have a 'virtually unflagging obligation' to exercise their jurisdiction."[39]

This line of reasoning is continued in *In re Icenhower*,[40] where the Ninth Circuit upheld a bankruptcy court's extraterritorial application of section 541 and section 550.[41] In sum, prior to filing bankruptcy, the debtor in question created a fraudulent corporation and transferred his

[36] T. Brandon Welch, *The Territorial Avoidance Power of the Bankruptcy Code*, 24 EMORY BANKR. DEV. J. 553, 561 (2008).
[37] 521 B.R. 189 (Bankr. N.D. Tex. 2014).
[38] *Id.* at 193.
[39] *Id.* at 199 (internal citations omitted).
[40] Kismet Acquisition, LLC v. Icenhower (*In re* Icenhower), 757 F.3d 1044 (9th Cir. 2014).
[41] *Id.*

interest in a costal villa in Mexico to that corporation.[42] Then after filing bankruptcy, the fraud corporation sold the villa to a Mexican national, who was aware of the bankruptcy.[43]

After the bankruptcy, the trustee attempted to undue the transactions even though they involved a subsequent foreign transferee.[44] The Ninth Circuit agreed that section 541's definition of property allowed a trustee to avoid a transaction extraterritorially.[45] The court reasoned that because '"Congress intended extraterritorial application of the Bankruptcy Code as it applies to property of the estate"' it naturally followed that section 541's definition be allowed extraterritorial basis as well.[46] Finally, the court held that as result, a trustee could recover under section 550 on an extraterritorial basis as well.[47]

On the other hand however, the United States District Court for the Southern District of New York recently held in *In re Madoff Securities*,[48] that the avoidance and recovery provisions in section 550 of the Bankruptcy Code could not be used extraterritorially to permit a SIPA trustee to recover funds disbursed abroad which were allegedly fraudulently obtained during the fall-out from the Madoff Ponzi scheme.[49]

Applying the first prong of the *Morrison* test, the court held that the trustee's use of the section would require the statute to be applied extraterritorially.[50] In making its determination, the court, examined the regulatory focus of section 550.[51] The court held that because the

[42] *Id.* at 1048.
[43] *Id.*
[44] *Id.* at 1048–49.
[45] *Id.* at 1050.
[46] Id. (quoting *In re* Simon, 153 F.3d 991, 996 (9th Cir. 1998)).
[47] Id. 1049–50.
[48] *In re Madoff Securities*, 513 B.R. 222.
[49] *Id.* at 228.
[50] *Id.*
[51] *Id.* at 227.

transfers in question were "predominantly foreign"[52] the trustee's use of section 550 would require it to be used extraterritorially.[53]

Turning to the second prong of the extraterritoriality inquiry, the court found that Congress never intended section 550 of the Code to be used extraterritorially.[54] Looking first to the text of section 550 itself,[55] the court found that nothing in the statutory language suggested that Congress expressly intended that the provision to apply to foreign transfers.[56] In an attempt to rebut the presumption against extraterritoriality, the trustee argued that section 541 of the Bankruptcy Code, which defines property of the estate to include property of the debtor "wherever located and by whomever held,"[57] is indirectly incorporated into section 550, thus indicating Congressional authority for section 550's use extraterritorially.[58] The trustee attempted to further link sections 541 and 550 of the Bankruptcy Code by using the avoidance and recovery provisions use of the phrase "an interest of the debtor in property" to define the transfer that may be avoided, which is repeated in section 541's definition of "property of the estate."[59] The court, however, rejected that argument, determining that although section 541's definition of "property of the estate" may be relevant to interpreting the avoidance provisions "property of the debtor," such property is not considered "property of the estate" under section 541 until the property is first recovered by the trustee.[60] Thus, the court concluded that section

[52] *Id.*
[53] *Id.* at 227–28.
[54] *Id.* at 231.
[55] 11 U.S.C. § 550(a) (2012) reads that a: "trustee may recover, for the benefit of the estate, the property transferred . . . the value of such 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."
[56] *In re Madoff Securities*, 513 B.R. at 228.
[57] 11 U.S.C. § 541(a) (2012).
[58] *In re Madoff Securities*, 513 B.R. at 228–29.
[59] *Id.* at 229.
[60] *Id.* (citing Federal Deposit Ins. Corp. v. Hirsch (*In re* Colonial Realty Co.), 980 F.2d 125, 131 (2d Cir.1992)).

541 cannot supply section 550 with "any extraterritorial authority that the avoidance and recovery provisions lack on their own."[61]

Implications

The expansion of the presumption against extraterritoriality to the Bankruptcy Code's avoidance provisions is significant because it may limit a trustee's or debtor in possession's ability to avoid cross-border transactions between foreign entities under the Bankruptcy Code depending on the court the action is brought in.[62] Such a limitation may force a trustee or debtor in possession to commence an ancillary proceeding in a foreign court in order to avoid the transfer under foreign law.[63] Seeking to avoid transactions in foreign courts may increase the trustee or debtor in possession's costs in connection with bringing such actions because the trustee or debtor in possession may have to retain local counsel in multiple jurisdictions to bring multiple actions instead of consolidating all of the actions into a single forum.

Additionally, there is a possibility for conflicting decisions if the trustee or debtor in possession is seeking to recover from the subsequent transferees of the same initial transaction in multiple jurisdictions, especially if each jurisdiction applies its own law. Finally, there are concerns that a debtor could shield his assets by transferring his assets to a jurisdiction that does not permit a trustee to avoid or makes it difficult to avoid fraudulent transfers, thus allowing a debtor to escape his creditors.

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[61] *Id.*

[62] This split among several different courts over exactly what avoidance provisions can be used extraterritorially is somewhat ironic given the fact that the U.S. Supreme Court's goal in *Morrison* was to institute a test that would avoid such inconsistent rulings.

[63] It is still not clear however, whether a U.S. court could apply foreign law to decide the case or whether the trustee or debtor in possession would need to go to the foreign court in question. *See* Condor Ins. Ltd., v. Condor Guaranty, Inc., (*In re* Condor Ins. Ltd.), 601 F.3d 319 (5th Cir. 2010).

Conclusion

The last few years have seen quite the resurgence of the presumption against extraterritoriality. Indeed, with the U.S. Supreme Court's rejection of the conduct and effects test, the test laid down by the Court in *Morrison* has grown to become the dominant standard throughout the legal field. Though it would appear that many courts have accepted the standard laid down by the Supreme Court in *Morrison*, the struggle now appears to be revolving around the question of exactly which statutes are limited to domestic application.