

Bankruptcy

COMMENTARY

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A Loophole in the Bankruptcy Code? Are International Fraudulent Transfers Immune From Domestic Attack?

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Does a U.S. bankruptcy judge have the power to avoid and recover an "international fraudulent transfer"?

A decision by the U.S. Court of Appeals for the 4th Circuit issued Feb. 14, 2006, in *In re French*, 440 F.3d 145 (4th Cir. 2006), cert. denied, 127 S. Ct. 72 (Oct. 2, 2006), said yes. However, an August 2006 decision by the U.S. Bankruptcy Court for the Central District of California, in *In re Midland Euro Exchange Inc.*, 347 B.R. 708 (Bankr. C.D. Cal. 2006), disagreed with the 4th Circuit's analysis and concluded that a U.S. bankruptcy judge was, in fact, powerless to avoid and recover an international fraudulent transfer.

The judge's decision in *Midland Euro* follows an older decision from the U.S. Bankruptcy Court for the Southern District of New York in *In re Maxwell Communication Corp.*, 170 B.R. 800 (Bankr. S.D.N.Y. 1994), *aff'd on other grounds*, 93 F.3d 1036 (2d Cir. 1996), which held that a U.S. bankruptcy judge was powerless to avoid and recover an international preferential transfer. In reaching their decisions, the *Midland Euro* and *Maxwell* courts both relied on the "presumption against extraterritoriality," which says:

It is a long-settled 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

Whether a U.S. bankruptcy judge has the power to avoid and recover an international fraudulent transfer is important, as the court in *Midland Euro* recognized: "The efficacy of the bankruptcy proceeding depends on the court's ability to control and marshal the assets of the debtor wherever located. Failure to extend application of

[Bankruptcy Code] Section 548 to transfers outside the territorial borders of the United States creates a loophole for unscrupulous debtors to freely transfer their assets to shell entities and avoid the reach of the Bankruptcy Code."²

The desire to close any "loophole" in the bankruptcy process was clearly on the mind of the 4th Circuit when it ruled in *French*. The court was faced with a debtor who had fraudulently transferred real property in the Bahamas to the debtor's children, who lived in the United States.

The Chapter 7 trustee had filed a complaint to avoid the transfer and recover the real property, or its fair market value, for the benefit of the bankruptcy estate.³ The defendants filed a motion to dismiss the case based upon, among other things, the "presumption against extraterritoriality."⁴ The defendants argued that the Bankruptcy Code and its fraudulent-transfer provision, Section 548, should not apply to transfers of foreign property.⁵

The bankruptcy judge denied the defendants' motion to dismiss and granted the Chapter 7 trustee's motion for summary judgment, finding the transfer to be constructively fraudulent.⁶ The U.S. District Court for the District of Maryland affirmed the decision.⁷ The 4th Circuit affirmed the lower courts' decisions and held that the Chapter 7 bankruptcy trustee could avoid and recover the fraudulently transferred Bahamian real property.

The court in *French* focused on the interplay between Bankruptcy Code Section 541, which defines "property of the estate" to include domestic or foreign property, and Section 548, which permits a debtor in bankruptcy to recover transfers of "interests of the debtor in property."

The court noted, "By incorporating the language of Section 541 to define what property a trustee may recover under his avoidance powers, Section 548 plainly allows a trustee to avoid any transfer of property that *would have been* 'property of the estate' prior to the transfer in question — as defined by Section 541 — even if that property is not 'property of the estate' now."⁸

The 4th Circuit acknowledged that the Bankruptcy Code, and specifically Section 548, is an act of Congress and as such is subject to the presumption against extraterritoriality.⁹ However, the 4th Circuit analyzed several sections of the code and concluded that Congress intended to allow the code to be used to avoid transfers of foreign property:

Congress thus demonstrated an affirmative intention to allow avoidance of transfers of foreign property that, but for a fraudulent transfer, would have been property of the debtor's estate. Therefore, the presumption against extraterritoriality does not prevent application of Section 548 here.¹⁰

The 4th Circuit's ruling in *French* was the first appellate court decision expressly analyzing and permitting extraterritorial application of Section 548. Shortly thereafter, on Aug. 15, 2006, the U.S. Bankruptcy Court for the Central District of California, in *Midland Euro*, explicitly disagreed with the 4th Circuit's analysis and concluded that a U.S. bankruptcy judge could not avoid and recover an "international fraudulent transfer." In support of its decision, the *Midland Euro* court relied on a 1994 decision out of the Bankruptcy Court for the Southern District of New York in *Maxwell*, which barred the extraterritorial application of Section 547 of the Bankruptcy Code.¹¹

The court in *Maxwell* was faced with a debtor, English corporation Maxwell Communication Corp., that filed a Chapter 11 petition in the Southern District of New York and a nearly simultaneous (next day) petition for administration in the High Court of Justice in London. The English and American cases were essentially co-administered.

Prior to the filing of the bankruptcy cases, Maxwell made large transfers to Barclays Bank and National Westminster Bank, both English banks, and Societe Generale, a French bank. After the bankruptcy cases were commenced, Maxwell sought to recover those transfers from the banks as preferential transfers. The banks moved to dismiss the preference actions "on the theory that U.S. preference law does not apply extraterritorially."¹² The bankruptcy judge agreed that Maxwell was seeking to apply Section 547 extraterritorially:

Here, no one suggests that, under our facts, the use of Section 547 would be anything other than extraterritorial. After all, the debtor is an English corporation, the antecedent debts were incurred overseas, the transfers on account of those debts were made overseas and the recipients, although subject to my personal jurisdiction, are nonetheless foreigners.¹³

After analyzing the presumption against extraterritoriality at length, the Bankruptcy Court held, "Where a foreign debtor makes a preferential transfer to a foreign transferee and the center of gravity of that transfer is overseas, the presumption against extraterritoriality prevents utilization of Section 547 to avoid the transfer."¹⁴

The court in *Midland Euro* relied on *Maxwell* to support its decision that Section 548 does not apply extraterritorially. The *Midland Euro* court was dealing with a "massive Ponzi scheme run in Southern California between 1999 and 2003."¹⁵ The Chapter 7 trustee filed a complaint to recover fraudulent transfers of \$897,000 in fees, commissions and/or profits paid by the debtors to Swiss Financial Corp., a foreign exchange brokerage formed under the laws of England and headquartered in London.¹⁶

The Chapter 7 trustee alleged that one of the debtors, Midland Group Inc., a Barbados corporation, opened a foreign-exchange trading account with Swiss Financial in May 2002. The debtor then made a wire transfer of \$1 million from its bank account in London to Swiss Financial's bank account in New York.¹⁷ From there, Swiss Financial transferred the deposit to one of its accounts in London.¹⁸ Thereafter, over the next year the debtors proceeded to transfer \$897,000 to Swiss Financial for fees, commissions and/or profits.¹⁹ The Chapter 7 trustee alleged that these transfers were fraudulent and sought to avoid them under Section 548 of the Bankruptcy Code.²⁰

Swiss Financial filed a motion to dismiss the Chapter 7 trustee's complaint, arguing that Congress did not intend Section 548, the fraudulent-transfer provision, to apply extraterritorially.²¹ The court noted, and the parties agreed, that the application of Section 548 would be extraterritorial because:

The transferor was a Barbados corporation, the transferee was an English corporation, the funds originated from a bank account in London and, although transferred through a bank account in New York, eventually ended up in another bank account in England.²²

Moreover, the court noted that the issue of whether Section 548 could be applied extraterritorially “is a matter of great practical concern for the parties”:

If the extraterritorial application of Section 548 is upheld, the trustee would be able to recover from [Swiss Financial] by merely proving the existence of a Ponzi scheme and the fact that the transfers actually occurred. Otherwise, the trustee will not only face the logistical difficulties of bringing the suit in England, but he will also have to prove, under British law, that [Swiss Financial] had actual knowledge of the Midland entities’ [the debtors’] scheme to defraud its creditors.²³

The *Midland Euro* court noted that “it is undeniable” that policy considerations favor the extraterritorial application of Section 548.²⁴ However, it held that the policy considerations “must be balanced against the presumption against extraterritoriality, which serves to protect against unintended clashes between our laws and those of other nations which could result in international discord.”²⁵

The *Midland Euro* court relied on precedent in the 9th Circuit for the proposition that “policy considerations alone are insufficient to overcome the presumption against extraterritoriality”²⁶ and granted Swiss Financial’s motion to dismiss the Chapter 7 trustee’s complaint. The court held that neither the plain language Section 548 nor its reading in conjunction with other parts of the Bankruptcy Code establish congressional intent to apply Section 548 extraterritorially.²⁷

In so holding, the bankruptcy judge criticized the 4th Circuit’s decision in *French*: “*In re French* totally ignores Section 541(a)(3) and uses an unclear and convoluted method to reach its conclusion. I have a great deal of trouble following the 4th Circuit’s reasoning and am not persuaded that it leads to the proper conclusion. Thus I find no basis for holding that Congress intended the trustee’s avoiding powers to apply extraterritorially.”²⁸

The *Midland Euro* court did note that “[p]erhaps the true reason the 4th Circuit extended the application of Section 548 extraterritorially lies in the next paragraph, which acknowledges that such ‘interpretation fully accords with the purposes of the Bankruptcy Code’s avoidance provisions, which is to prevent debtors from illegitimately disposing of property that should be available to their creditors.’”²⁹

Using not so subtle language, the *Midland Euro* court expressed its opinion that the 4th Circuit’s ruling in *French* was nothing more than a policy decision arrived at through an “unclear and convoluted method.”³⁰ The *Midland Euro* judge, on the other hand, concluded that the 9th Circuit “does not view policy considerations alone as valid grounds for overcoming the presumption against extraterritoriality. ... Therefore, since I can find no evidence of congressional intent to extend the application of Section 548 extraterritorially, the trustee may not pursue his claim against [Swiss Financial] under this statute.”³¹

The *Midland Euro* court recognized the implications of its ruling: “The decision does nothing to close the loophole in the Bankruptcy Code that allows dishonest debtors to avoid the reach of the U.S. bankruptcy system by hiding assets abroad.”³²

However, the judge believed that the loophole could only be closed by Congress, not the courts. The judge invited Congress to amend the Bankruptcy Code to extend the application of Section 548 extraterritorially: “Congress is the ultimate arbiter of the laws it enacts and has the power to alter the language of the statute to clearly manifest its intent.”³³

In light of the Bankruptcy Court’s decision in *Midland Euro*, outside the 4th Circuit, there appears to be a potential loophole in the Bankruptcy Code. The loophole would allow “dishonest” and “unscrupulous debtors”³⁴ to conceal their assets abroad³⁵ by engaging in international fraudulent transfers. The additional time, costs and complexities involved in forcing Chapter 7 trustees to pursue international fraudulent transfers in “unfriendly” jurisdictions abroad with different laws regarding fraudulent transfer liability may result in decreased recoveries for innocent creditors harmed by debtors who make international fraudulent transfers in an effort to “protect” their assets.

To the extent that such extraterritorial application could, in certain cases, result in conflicts between the laws of the United States and those of other nations, doctrines such as international comity and the bankruptcy courts’ statutory power to abstain from hearing certain cases would more than adequately resolve those conflicts.³⁶

Congress needs to affirmatively act to evince its intent for the avoidance provisions of the Bankruptcy Code to apply extraterritorially. There is no legitimate reason to restrict the ability of U.S. bankruptcy judges to avoid and recover international fraudulent transfers by debtors who use this nation’s bankruptcy court system.

Notes

¹ *In re Midland Euro Exchange Inc. et al.*, 347 B.R. 708, 715 (Bankr. C.D. Cal. 2006); *In re Maxwell Commc'n Corp.*, 170 B.R. 800, 809 (Bankr. S.D.N.Y. 1994).

² *Midland Euro* at 718.

³ *In re French*, 440 F.3d 145 (4th Cir. 2006), at 148.

⁴ *Id.* at 149.

⁵ *Id.*

⁶ *Id.*

⁷ *French*, 320 B.R. 78 (D. Md. 2004).

⁸ *Id.* at 151 (emphasis in original). The *French* court notes that there is a split among the circuits as to whether "property of the estate" includes property that a debtor has fraudulently transferred. *Id.* Compare *Cullen Ctr. Bank & Trust v. Hensley (In re Criswell)*, 102 F.3d 1411, 1417 (5th Cir. 1997) (property of the estate includes property fraudulently transferred by debtor); *Am. Nat'l Bank v. Mortgage America Corp. (In re MortgageAmerica Corp.)*, 714 F.2d 1266, 1275 (5th Cir. 1983); with *In re Saunders*, 101 B.R. 303, 304-305 (Bankr. N.D. Fla. 1989) (property held by third-party transferees only becomes property of the estate after transfers have been avoided and recovered); *FDIC v. Hirsch (In re Colonial Realty Co.)*, 980 F.2d 125, 131 (2d Cir. 1992); *Dunes Hotel Assocs. v. Hyatt Corp.*, 245 B.R. 492, 504-505 (D.S.C. 2000). Consideration of whether a fraudulent transfer should be deemed property of the estate before it is avoided and recovered is beyond the scope of this article.

⁹ *In re French*, 440 F.3d at 149.

¹⁰ *Id.* at 152.

¹¹ Section 547 of the Bankruptcy Code permits debtors to recover preferential transfers by debtors to creditors. See 11 U.S.C. § 547 (2007).

¹² *Maxwell* at 807.

¹³ *Id.* at 809.

¹⁴ *Id.* at 814.

¹⁵ *Midland Euro* at 710.

¹⁶ *Id.* at 712.

¹⁷ *Id.* at 713.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 714. Swiss Financial also argued that the Chapter 7 trustee's complaint should be dismissed based on the doctrine of international comity. This issue was also raised in the decision in *Maxwell* and was the primary grounds under which the 2nd Circuit affirmed the bankruptcy judge's decision in *Maxwell*. A discussion of the doctrine of international comity is beyond the scope of this article.

²² *Id.* at 715.

²³ *Id.*

²⁴ *Id.* at 718.

²⁵ *Id.* (internal citations omitted).

²⁶ *Id.*, citing *Subafilms Ltd. v. MGM-Pathe Commc'ns Co.*, 24 F.3d 1088 (9th Cir. 1994).

²⁷ *Id.* at 718.

²⁸ *Id.* at 719.

²⁹ *Id.* at 719, citing *French*, 440 F.3d at 152.

³⁰ *Id.* at 719

³¹ *Id.* at 719.

³² *Midland Euro* at 720.

³³ *Id.*

³⁴ *Id.* at 711.

³⁵ *Id.*

³⁶ 28 U.S.C. § 1334. See also note 21 above.

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