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In re Toft; Section 1506 Public Policy Exception Trumps General Grant of Comity

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Introduction

Chapter 15 of the Bankruptcy Code allows courts in the United States to recognize the judgments of foreign courts on the basis of comity.[1] Chapter 15's "public policy" exception, however, prevents recognition of such judgments if they are "manifestly contrary to the public policy of the United States."[2] *In re Toft*[3] is one of the few cases to deny relief on the basis of the public policy exception. While courts will continue to apply this exception narrowly, *In re Toft* shows that the public policy exception can be a powerful impediment to requests for aid in foreign insolvency proceedings.

With *In re Toft*,[4] the Bankruptcy Court for the Southern District of New York ("S.D.N.Y. Bankruptcy Court") joined the short list of courts to deny relief on the basis of Chapter 15's public policy exception.[5] The court refused to enforce a German bankruptcy court order that

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[1] 11 U.S.C. § 1509 (2010) (stating that "a court in the United States shall grant comity or cooperation to the foreign representative" once the court grants recognition of the foreign proceeding).
[2] 11 U.S.C. § 1506 (2010).
[3] 453 B.R. 186 (Bankr. S.D.N.Y. 2011).
[4] *Id*.
[5] *See e.g.*, *In re Gold & Honey, Ltd.*, 410 B.R. 357 (Bankr. E.D.N.Y. 2009) (denying recognition of foreign proceedings because Israeli receivership proceeding in underlying foreign case violated automatic stay and adversely affected U.S. public policy). *See also In re Qimonda AG*

would have allowed the foreign representative[6] unfettered access to emails of the chapter 15 debtor that were being stored on internet servers in the United States.[7] The court in the underlying German case had granted the foreign representative a Mail Interception Order ("the German order") on an *ex parte* basis.[8] The German order, which was also recognized by the English High Court of Justice Chancery Division in Bankruptcy ("the English order"),[9] allowed the foreign representative to intercept the debtor's postal and electronic mail without giving any notice to the debtor, Dr. Toft.[10] The S.D.N.Y. Bankruptcy Court held that *ex parte* recognition and enforcement is not normally available to U.S. bankruptcy trustees. "Effectuation of the relief sought might subject the Foreign Representative, or his U.S. agents and possibly an [internet service provider] disclosing the debtor's e-mails, to U.S. criminal liability."[11] Furthermore, the requested relief would also violate the Electronic Communications Privacy Act[12] in disclosing e-mails by internet service providers and the Wiretap Act[13] by constituting an

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Bankr. Litig., 433 B.R. 547 (E.D. Va. 2010) (remanded to determine whether relief granted was manifestly contrary to U.S. public policy). Only two other published decisions have addressed the public policy exception, both of which granted comity. *See In re Metcalfe & Mansfield Alt. Invs.*, 421 B.R. 685 (Bankr. S.D.N.Y. 2010) (upholding validity of third-party releases under Canadian law even though same relief not available under Chapter 11); *In re Ernst & Young, Inc.*, 383 B.R. 773 (Bankr. D. Colo. 2008) (granting comity to Canadian receivership proceedings).

[6] The foreign representative in *In re Toft* is the insolvency administrator for Dr. Toft's bankruptcy proceeding that began in Germany. 453 B.R. 186 at 188. *See* 11 U.S.C. § 1509 (2005) (describing rights of a foreign representative and requirements for recognition).

[7] *In re Toft*, 453 B.R. at 189. Beside the location of these two internet servers, the debtor had no other contacts in the U.S.

[8] *Id.* at 188.

[9] *Id.*

[10] *Id.* at 188-89.

[11] *Id.*

[12] 18 U.S.C. §§ 2701, *et seq*.

[13] 18 U.S.C. §§ 2511, *et seq.*

unlawful interception of electronic communications in transit.[14] Recognition was thus denied as manifestly contrary to U.S. public policy pursuant to § 1506 of the Bankruptcy Code.

Part I of this memorandum discusses the relevant U.S., U.K., German, and other international statutory provisions. Part II discusses and compares application of the public policy exception. Part III contrasts and analyzes the approaches taken by the S.D.N.Y. Bankruptcy Court and the English and German courts. This memorandum concludes that the S.D.N.Y. Bankruptcy Court's ruling, while useful for understanding the limits of comity in U.S. courts, will not expand the reach of the public policy exception.

I. Relevant Statutory Provisions

In the U.S., Chapter 15 of the Bankruptcy Code regulates a federal court's ability to recognize and give effect to foreign insolvency proceedings.[15] Chapter 15 is based on the United Nations Commission on International Trade Law Model Law on Cross-Border Insolvency ("Model law").[16] The Model Law and Chapter 15 "provide[] a comprehensive scheme for recognizing and giving effect to foreign insolvency proceedings."[17] Both contain a public policy exception stating that, "[n]othing in the present Law prevents the court from refusing to take an action governed by the present Law if the action would be manifestly contrary to the public policy of this State."[18] However, in drafting the language of the Model Law, "manifestly" was used "as a qualifier of the expression 'public policy' [] to emphasize that public policy exceptions should be interpreted restrictively and that [the Model Law] is only intended to be invoked under exceptional circumstances concerning matters of fundamental importance for the

[14] *In re Toft*, 453 B.R. at 189.
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] United Nations Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law, A/Res/52/158 (1998).

enacting State."[19] Based on the narrow drafting of the "public policy" exception, courts have applied it sparingly in chapter 15 proceedings.

Also important here are the Electronic Communications Privacy Act[20] and the Wiretap Act.[21] Each of these acts works to protect the U.S. Fourth Amendment "right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures."[22] The Electronic Communications Act prevents the *ex parte* disclosure of internet service providers and the Wiretap Act criminalizes the unlawful interception of electronic communications in transit.

Germany has not enacted the Model Law. [23] Instead, under the *Insolvenzordung* (German insolvency law), interception of a debtor's mail is allowed "[i]f such measure seems necessary in order to investigate or prevent the debtor's transactions disadvantaging the creditors."[24] The German law allows the debtor to be heard unless doing so would endanger the insolvency proceeding because of the particular facts.[25]

Although the U.K. has enacted the Model law,[26] section 371 of the English Insolvency Act of 1986 specifically provides for relief like that granted in Germany.[27] Section 371, titled

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[19] United Nations General Assembly, GUIDE TO ENACTMENT OF THE UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY, ¶ 89, U.N. Doc A/CN.9/442 (1997)
[20] 18 U.S.C. §§ 2701, *et seq*.
[21] 18 U.S.C. §§ 2511, *et seq.*
[22] U.S. CONST. amend. IV.
[23] STATUS - UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY, http://www.uncitral.org/uncitral /en/uncitral _ texts/insolvency/1997Model_status.html (last visited Feb. 12, 2012).
[24] Insolvency Statute of 5 October 1994, § 99, *translated at* http://www.iuscomp.org/gla/statutes/InsO.pdf.
[25] *Id.*
[26] STATUS - UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY, http://www.uncitral.org/uncitral /en/uncitral _ texts/insolvency/1997Model_status.html (last visited Feb. 12, 2012).
[27] English Insolvency Act of 1986 § 371 (U.K.).

"Re-direction of bankrupt's letters, etc." states that a bankruptcy court may, "order a postal operator to re-direct and send or deliver to the official receiver or trustee or otherwise any postal packet which would otherwise be sent or delivered by the operator concerned to the bankrupt."[28] The English statute clearly contemplates redirection of a debtor's letters to expedite the resolution of the bankruptcy proceeding.[29] In addition to § 371, English courts also weigh the fairness of the underlying proceeding and the proportionality of the relief sought against the needs of the bankruptcy proceeding.[30]

Despite the fact that Germany has not enacted the Model law, Germany and the U.K. are also both governed by Article 26(6) of the European Council regulation No 1246/2000 on insolvency proceedings ("EC Regulation") which creates the public policy exception within German law as well as the U.K.. The language of Article 26(6) is very similar to the language of Chapter 15's public policy exception and states that any member state may refuse recognition of an insolvency proceeding "*where the effects of such recognition or enforcement would be manifestly contrary to that State's public policy*, in particular its fundamental principles or the constitutional rights and liberties of the individual."[31]

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[28] Re-direction of bankrupt's letters, etc., Insolvency Act of 1986.

[29] The fact that the English statute is targeted at postal communications and not specifically e-mails was not an issue to the English Court.

> The German order was not only a postal redirection order. It also provided for the redirection of e-mails from two of the bankrupt's e-mail addresses. It seems to me that there can be no reason to decline to exercise the discretion simply because the order extends to e-mails and not post. There is no fundamental difference between the two forms of communication. It can be no more than a matter of legislative chance that the German legislation is ahead of ours.

Prager v. Toft, [2011] (UK), ECF No. 6, p. 10.

[30] *Id.* at p. 9.

[31] Council regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, OFFICIAL JOURNAL L. 160, 30/06/2000 P. 0001-0018 (2000) (emphasis added).

Both Germany and the U.K. are also governed by Article 8 of the European Convention on Human Rights ("ECHR").[32] Although Article 8 of the ECHR protects postal secrecy, it posed no problem to the German and English courts. U.K. caselaw maintains that postal redirection orders do not infringe Article 8 as long as they are proportionate.[33]

II. Significant U.S. Caselaw

"Notwithstanding the direction that a U.S. court grant comity or cooperation to a recognized foreign representative in insolvency matters, it is also beyond question that, 'The principle of comity has never meant categorical deference to foreign proceedings.'"[34] Nevertheless, very few courts have applied § 1506 to deny the extension of comity. *In re Gold & Honey, Ltd.*[35] is one case where a U.S. court refused to recognize an Israeli foreign proceeding because of Chapter 15's public policy exception.[36] There, the foreign representative continued to seek the appointment of a receiver in Israel despite pending chapter 11 proceedings in the Bankruptcy Court of the Eastern District of New York.[37] The debtors asserted that the U.S. automatic stay "applied to the Debtors' property wherever located and by whomever held, and,

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[32] Article 8 of the ECHR provides that:

1. Everyone has the right to respect for his private and family life, his home and his correspondence.
2. There shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others.

European Convention on Human Rights Article 8.

[33] *Prager v. Toft*, [2011] (UK), ECF No. 6, p. 9 (citing *Foxley v. U.K.* [2000] BPIR 1009). In *Foxley*, the English court held that ECHR Article 8 had been breached because the insolvency administrators continued to redirect Foxley's mail well after the court-prescribed window for postal interception.

[34] *In re Toft*, 453 B.R. at 190.

[35] 410 B.R. 357 (Bankr. E.D.N.Y. 2009).

[36] *Id.* at 360.

[37] *Id.*

in particular, to the Israeli Receivership Proceeding."[38] The *Gold & Honey* court agreed with the debtors and held that the automatic stay applied to the Israeli Receivership Proceeding.[39] The Israeli court ignored the decision of the *Gold & Honey* court; the debtors sued for a temporary restraining order against its creditors from proceeding in Israel; and the creditors applied for the Israeli receivership proceeding to be recognized in the *Gold & Honey* court.[40] The *Gold & Honey* court denied recognition pursuant to § 1506 because "such recognition would reward and legitimize [the creditor's] violation of both the automatic stay and this Court's Orders regarding the stay."[41] The court went on to state that allowing the creditor's conduct "would limit a federal court's jurisdiction over all of the debtors' property 'wherever located and by whomever held,' as any future creditor could follow [this creditor's] lead and violate the stay in order to procure assets that were outside the United States, yet still under the United States court's jurisdiction."[42] Because recognition would undercut fundamental protections afforded by the American bankruptcy process, the *Gold & Honey* court refused to recognize the Israeli receivership proceeding.

In re Qimonda AG Bankr. Litig.[43] is another case where issues of comity played a large part in the court's consideration to grant recognition. There, the debtor's foreign representative applied for recognition of a German insolvency proceeding under Chapter 15 and also requested that certain bankruptcy code provisions regarding debtors' abilities to unilaterally reject licensing agreements not apply to the debtor in this case.[44] The bankruptcy court granted recognition and

[38] *Id.* at 363.
[39] *Id.*
[40] *Id.* at 363-65.
[41] *Id.* at 371.
[42] *Id.* at 372.
[43] 433 B.R. 547 (E.D. Va. 2010).
[44] *Id.* at 552.

the requested relief and seven licensees of the debtor's U.S. patents appealed. On appeal, the Eastern District of Virginia Bankruptcy Court ("E.D. Va.") outlined a three-part test to which a court may look in determining whether an action is manifestly contrary to U.S. public policy. First, the mere existence of a conflict between foreign and U.S. law, without other considerations, "is insufficient to support the invocation of the public policy exception."[45] Second, a court should not defer to a foreign proceeding if "the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections."[46] Lastly, [a]n action should not be taken . . . where taking such action would frustrate a U.S. court's ability to administer the Chapter 15 proceeding and/or would impinge severely a U.S. constitutional or statutory right, particularly if a party continues to enjoy the benefits of the Chapter 15 proceeding. "[47] After enumerating this test, the E.D. Va. remanded the case to the bankruptcy court to "determine whether the relief granted violated fundamental U.S. public policies under § 1506."[48] On remand, the E.D. Va. Bankruptcy Court denied the foreign representative's requested relief because it impinged statutory protection given to U.S. patent licensees and undermined fundamental U.S. public policy favoring technological innovation.[49]

III. Analysis of International Courts' Divergence

In the underlying German case, the foreign representative had successfully petitioned the Munich District Insolvency Court to grant a Mail Recognition Order allowing him to access and intercept the debtor's postal and electronic mail.[50] The debtor, after repeatedly failing to work with the German court and insolvency administrator, fled to Great Britain. There, the English

[45] *Id.* at 570.
[46] *Id.* at 570.
[47] *Id.* at 570.
[48] *Id.* at 571.
[49] *In re Qimonda AG*, 462 B.R. 165, 185 (Bankr. E.D. Va. 2011).
[50] *Prager v. Toft*, [2011] (UK), ECF No. 6, p. 5.

High Court of Justice Chancery Division in Bankruptcy recognized and enforced the German order.[51] Afterwards, the debtor continued to obstruct bankruptcy proceedings and allegedly fled to the Philippines. The foreign representative then sought recognition of the German order in the U.S. to intercept the debtor's emails being stored in internet servers located in the U.S.

The English court recognized and enforced the German order. Although English law, like American law, has a public policy exception, English law also has specific statutory provisions allowing for the re-direction of a debtor's letters.[52] After finding § 371 of the English Insolvency Act applicable, the English court considered whether the debtor's personal freedom or postal secrecy would be "unduly fettered" by the German order.[53] The court first found that the debtor's personal freedom was not injured because the debtor had been able to oppose the original German order and his opposition had already been rejected by the German court.[54] The court then held that the debtor's right to postal secrecy had not been infringed because the German order was proportionate to the needs of the bankruptcy proceedings.[55] The court noted a number of factors in favor of recognizing and enforcing the German order, including: (1) the uncooperativeness of the debtor, (2) the effectiveness of postal redirection orders in retrieving information about the debtor, (3) the existence of legal safeguards in German law against undue postal interference, (4) the failure of the debtor to set aside the German order on grounds of proportionality during the underlying German case, and (4) the status of Germany as a fellow

[51] *Id.*
[52] Council regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, OFFICIAL JOURNAL L. 160, 30/06/2000 P. 0001-0018 (2000). *See also* English Insolvency Act of 1986 § 371 (U.K).
[53] *Id.* at p. 8.
[54] *In re Toft*, 453 B.R. at 188-89 n. 1.
[55] *Prager v. Toft*, [2011] (UK), ECF No. 6, p. 9.

ECHR signatory.[56] Thus, the English court, acknowledging the debtor's opportunity to be heard in the German proceeding and noting the debtor's tendency to flee, seemed not to have any qualms about granting *ex parte* relief.

Although "German and English insolvency proceedings are ordinarily entitled to recognition in this country," the S.D.N.Y. Bankruptcy Court did not accept either of these two courts' rationales because of the lack of notice provided to the debtor. [57] Using the three-point test from *In re Qimonda AG Bankr. Litig.*,[58] the court in *In re Toft* found that the requested relief, an *ex parte* email "wiretap," implicated both the second and third parts of the test because the requested relief violated U.S. law and severely impinged a U.S. constitutional right.[59] Not only would the relief sought result in criminal liability under the Electronic Communications Privacy Act and the Wiretap Act, perhaps more importantly, it would "directly compromise privacy rights subject to a comprehensive scheme of statutory protection, available to aliens, built on constitutional safeguards incorporated in the Fourth Amendment as well as the constitutions of many States."[60] The court determined that the requested relief was manifestly contrary to U.S. public policy because it was in direct conflict with fundamental U.S. notice requirements as embodied in state statutory schemes, federal regulations, and the U.S. Constitution. Although the foreign representative argued that the German order merited recognition because of the fairness of the German procedures, the S.D.N.Y. Bankruptcy Court noted that "[t]he sweeping relief requested by the Foreign Representative is not incorporated into U.S. law merely because

[56] *Id.*
[57] *Id.* at 189.
[58] 433 B.R. 547, 570 (E.D. Va. 2010).
[59] *In re Toft*, 453 B.R. at 195, 198.
[60] *Id.* at 198.

of the principle of comity and because it is available in [the debtor's] home country."[61] Although the public policy exception is rarely exercised to deny relief, when it is applied, it poses a formidable obstacle to foreign representatives seeking recognition in the U.S.

Conclusion

In *In re Toft*, the S.D.N.Y. Bankruptcy Court denied relief to a foreign representative based on chapter 15's public policy exception. This ruling falls within a small universe of cases refusing to extend comity because of the public policy exception. Thus, *In re Toft* is a powerful illustration of the public policy exception as an impediment to requests for aid in foreign insolvency proceedings. While this case helps to delimit the extent of comity in U.S. courts when balanced against the fundamental U.S. requirement of notice, courts will continue to apply the public exception narrowly.

[61] *Id.* at 191.