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Bad Facts, Good Law? Important New Circuit-Level Guidance on Chapter 15 Recognition and Enforcement of Foreign Reorganization Orders

Introduction

Recently, in *In re Vitro S.A.B. de C.V.*, Consolidated Case No.'s 12-10542, 12-10689 and 12-10750, 2012 US App. LEXIS 24443 (5th Cir. Nov. 28, 2012) (*Vitro*) the United States Court of Appeals for the Fifth Circuit issued significant new guidance on chapter 15 of the Bankruptcy Code, which governs cross-border insolvencies. The *Vitro* opinion both strengthens the international spirit behind chapter 15 but also illustrates certain hard limits to a foreign debtor's ability to obtain enforcement in the United States of foreign reorganization orders. The Fifth Circuit has strengthened the internationalist spirit of chapter 15 by recognizing "comity is the rule under chapter 15, not the exception" and treating working papers and guidance from chapter 15's roots in an international model law project as crucial interpretive guidance. On the other hand, the *Vitro* opinion firmly demonstrates that plans of reorganization approved in a recognized "foreign proceeding" cannot be enforced in the US if such enforcement would significantly depart from the types of relief available to debtors under US bankruptcy law.

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Background

The *Vitro* opinion itself deals primarily with the technical requirements of recognition and enforcement under chapter 15 of the Bankruptcy Code, but the process whereby Vitro S.A.B. de C.V. (Vitro) won approval of its restructuring plan in Mexico has created a shadow hanging over the entire case. Vitro is the largest glass manufacturer in Mexico. From 2003 until early 2007, Vitro borrowed over more than US$1 billion from primarily US investors through three series of unsecured notes (the Notes). Critically, the Notes were guaranteed by substantially all of Vitro's subsidiaries, including several subsidiaries organized in the United States.

Vitro's performance suffered dramatically during the global financial crisis, and in February of 2009, it stopped making payments on the Notes and entered into restructuring negotiations with creditors. At the same time that it was negotiating (ultimately without success) with its noteholders, Vitro entered into a series of intercompany transactions that radically shifted its intercompany debt. The lynchpin of these transactions was a sale-leaseback between Vitro and Fintech

Investments Ltd. (Fintech). Fintech was a holder of one-third of Vitro's Notes prior to the sale-leaseback and as part of the transaction acquired an option to acquire 24 percent control of a subsidiary holding company owned by Vitro. The sale-leaseback also generated significant intercompany debt and essentially switched Vitro's subsidiaries from *owing* Vitro US$1.2 billion to *being owed* US$1.5 billion by Vitro. This was a critical development because Mexican insolvency law does not distinguish between intercompany debt and general unsecured debt for voting and approval purposes. With a 50 percent (in amount) creditor approval requirement needed to approve a reorganization, the intercompany transactions gave Vitro's subsidiaries the ability to out-vote its noteholders in Mexican insolvency proceedings.

In early 2011, Vitro filed for voluntary reorganization under Mexico's insolvency law — the *Ley de Concursos Mercantiles* (LCM). Later in 2011, Vitro proposed a plan of reorganization (the Plan) substantially similar to previous restructuring proposals that had been rejected by Vitro's noteholders. The Plan provided for a cancelation of Vitro's existing debt and the issuance of significantly haircut replacement notes to creditors who had consented to the Plan (the haircuts included extended maturities and suspended interest payments) and provided no recovery to non-consenting creditors. Importantly for litigation in the US, the Plan also provided that all non-debtor guarantees of Vitro debt (including guarantees issued by non-debtor subsidiaries domiciled in the US) would be extinguished.

While attempting to challenge the Plan in Mexico under the LCM, various creditors simultaneously commenced actions in the United States seeking to enforce the guarantees issued by US-domiciled subsidiaries of Vitro. Lawsuits in New York state courts achieved judgments and orders of attachment, and the trustee under the Notes was able to win a declaratory judgment that the guarantees remained valid under New York law. Finally, certain creditors filed involuntary bankruptcy petitions against various Vitro subsidiaries.[1]

In response to these creditor actions, Vitro commenced a chapter 15 proceeding in April of 2011 in the Southern District of New York (later transferred to the Northern District of Texas). Chapter 15 is the chapter of the Bankruptcy Code under which a "foreign representative" can achieve recognition of a "foreign insolvency proceeding" and is based on the Model Law on Cross Border Insolvency (the Model Law), promulgated by the United Nations Commission on International Trade Law (UNCITRAL). Chapter 15 provides for myriad avenues of relief for foreign representatives, including judicial enforcement in the United States of foreign insolvency orders, an automatic stay preventing transfers of the debtor's property and standing to sue and be sued in US lawsuits.

In its chapter 15 proceeding, Vitro sought to have the bankruptcy court recognize its representatives under chapter 15, a critical first step which is required before any further relief can be obtained. In addition, Vitro separately sought an order providing for the enforcement of the Plan approved under the LCM in Mexico. Among other relief, Vitro sought to enforce the Plan provisions extinguishing the guarantees issued by Vitro's subsidiaries, including its subsidiaries domiciled in the United States.[2]

Earlier this year, the bankruptcy court overseeing Vitro's chapter 15 proceedings granted Vitro's motion to recognize its foreign representatives and, in a separate opinion a month later, denied Vitro's motion to enforce the Plan. Certain of Vitro's noteholders appealed the decision to recognize the foreign representatives. Vitro and Fintech separately appealed the decision not to enforce the Plan. These matters were consolidated and certified for direct appeal to the Fifth Circuit, which late last month affirmed both bankruptcy court decisions.

Recognition of Mexican Proceedings

The Fifth Circuit's highly technical discussion of whether Vitro's foreign representatives were properly recognized is noteworthy in two respects. First, it emphasizes that the purpose of chapter 15 is to facilitate judicial comity between legal systems and that chapter 15 should be interpreted by reference to the UNCITRAL Model Law and related work papers. Second, and more narrowly, the Fifth Circuit held that *concurso* proceedings under Mexico's LCM are sufficiently similar to debtor in possession proceedings in the US to allow Vitro (rather than a Mexican court or tribunal) to appoint its own foreign representative.

A central issue on appeal was whether Vitro had the ability to appoint its foreign representative without explicit approval from the Mexican LCM tribunal. Despite the Bankruptcy Code's definition of "foreign representative" stating that such person must be "authorized in a foreign proceeding," the Fifth Circuit found that Vitro could make the appointment. This decision was based on (i) the plain text of the Bankruptcy Code, which was interpreted to allow "authorized in a foreign proceeding" to be read as "in the context of a foreign proceeding;" (ii) tacit approval of such appointments in prior US case law as well as Vitro's own proceedings under the LCM and (iii) the drafting history of the Model Law. *See Vitro* at 21-24.

In finding Vitro's foreign representatives were properly authorized, the Fifth Circuit used UNICTRAL's drafting history and Enforcement Guide in ways that are closely analogous to courts' use of Congressional legislative history. The Fifth Circuit noted that UNCITRAL specifically rejected a requirement that a foreign representative be "authorized by statute or other order of court" and then used this fact as a basis for not reading such a requirement into chapter 15. *Vitro* at 23-24. This is remarkable because, typically, international organization working papers are not seen as analogous to legislative history (for the simple reason that treaty laws must be codified and ratified by the US Congress).[3] This use of the Model Law appears to be part and parcel of the Fifth Circuit's noting that "comity is the rule under chapter 15, not the exception." *Vitro* at 50.

The spirit of comity also underlies the Fifth Circuit's response to objections to recognition of the foreign representatives based on the representatives' purported inability to satisfy the requirement that they be capable of "administer[ing] the reorganization or liquidation of [Vitro]." The Fifth Circuit noted that the drafters of the Model Law clearly intended that cases with debtors in possession be allowed to send foreign representatives to foreign court systems. *Vitro* at 25. The question thus was whether the Vitro's LCM proceedings established Vitro as a "debtor in possession." Even though Vitro does not have all the powers of a United States chapter 11 debtor in possession, the Fifth Circuit found that this was beside the point and that the real issue was whether Vitro met the definition of "debtor in possession" "originally envisioned by the drafters of the Model Law and incorporated into [the Bankruptcy Code]." *Vitro* at 26. Under this test it was sufficient that the LCM allowed Vitro to retain "broad control over its affairs." *Id.*

In sum, the Fifth Circuit turned to the Model Law and its history for guidance on two critical issues of interpretation of the Bankruptcy Code. This understanding of chapter 15 as crucially informed by the Model Law has its roots in sections 1501(a) and 1508 of the Bankruptcy Code (noting that incorporation of the Model Law is the purpose of chapter 15 and instructing that "in interpreting this chapter, the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions"). By applying and expanding these provisions, Vitro will likely be seen as a boon to proponents of international judicial cooperation.

Enforcement of Vitro's Plan

Despite the Fifth Circuit's broad support for the international spirit of chapter 15, the court said "no" on the fundamental question of whether Vitro's plan of reorganization could be enforced in the United States through chapter 15. In the process, the Fifth Circuit both clarified the proper steps of analysis necessary when evaluating a request for enforcement and also established a hard line beyond which enforcement cannot proceed. In particular, the Fifth Circuit refused to enforce the Vitro Plan's release of guarantee claims against non-debtor subsidiaries.

The bankruptcy court, in its opinion below, rejected enforcement of the non-debtor release based on sections 1507, 1521 and 1506 of the Bankruptcy Code. On appeal, the Fifth Circuit clarified the relationship between sections 1507 and 1521. Section 1521 permits a court to "grant any appropriate relief" and then lists a series of non-exclusive forms of relief that might be undertaken. Section 1507 allows "additional assistance" to the extent certain factors listed in section 1507(b) are met. The Fifth Circuit determined that the relationship between these two statutes is not clear, but that generally "the specific controls the general" and courts must first look to section 1521 before turning to section 1507.[4] *Vitro* at 37.

In reviewing the particular enforcement requested by Vitro, the Fifth Circuit noted that all of the specific forms of relief listed in section 1521 apply to property of a debtor and are therefore not relevant to Vitro's request for enforcement of non-debtor releases. *Vitro* at 41. The Fifth Circuit then determined that such non-debtor releases would not be available as more general "appropriate relief" under section 1521, because this provision only applies to relief that would have been available under the predecessor statute to chapter 15 (the former section 304). Given that the Fifth Circuit has prohibited non-debtor releases in the general chapter 11 context, such relief would also have been unavailable under section 304. *Vitro* at 42 (citing *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009)). Finally, with respect to section 1507, the Fifth Circuit found that even though non-debtor releases are prohibited in the Fifth Circuit, their availability in other circuits means that they are theoretically available to a foreign representative as "additional assistance" under section 1507. *Vitro* at 47. However, even this broad understanding of "additional assistance" is limited by whether the "additional assistance" requested is "substantially in accordance with" relief more generally available under the Bankruptcy Code. *Vitro* at 52. The Fifth Circuit held that the bankruptcy court property determined that Vitro had failed to proffer sufficient evidence to satisfy the extraordinary requirements for a non-debtor release in those jurisdictions where such releases are allowed and that therefore Vitro had failed to show that its requested relief was "substantially in accordance" with general US bankruptcy law. *Vitro* at 58.[5]

Even as it affirmed non-enforcement of the Vitro Plan, the Fifth Circuit stressed: (1) that its review of the bankruptcy court's factual determinations was under a deferential "abuse of discretion" standard; (2) that even though its own ruling in *In re Pac. Lumber Co.* bars non-debtor releases, such releases may be available to a foreign representative under section 1507 because they are still available in some circuits; and (3) that the bankruptcy court likely over-applied section 1506 (a general bar on actions "manifestly contrary to the public policy of the United States") as applicable to the Vitro Plan, because section 1506 is meant as a check for fundamental standards of fairness and not an avenue for ad hoc review of the propriety of individual foreign court decisions. These aspects of the Fifth Circuit's opinion underline the extraordinary breadth and scope of relief available to a foreign representative under chapter 15.

There is an inherent tension between the internationalism avowed by the *Vitro* court and its decision not to enforce the Plan. It is at least plausible that various aspects of Vitro's course of conduct in its LCM proceedings may have influenced the Fifth Circuit's decision not to enforce Vitro's Plan. References to this course of conduct are scattered throughout the *Vitro* opinion and include: direct payments to supporting employee creditors; the Plan's "death-trap" for non-consenting creditors; serial ex-parte meetings between litigants and the LCM tribunal; expressly permitted insider voting; creditor classifications that pooled the votes of creditors with adverse interests; violations of the US absolute priority rule and the multibillion dollar pre-petition intra-company transfers being hidden from creditors. *See e.g. Vitro* at 29-31 and 49-50. The obvious question raised by these "bad" facts is — why did the court mention them at all when they were explicitly not relevant to its holding? The answer may be that the Fifth Circuit wanted to avoid the trap of bad facts making bad law. By repeatedly referring to the broad scope of chapter 15 and its intentional spirit while at the same time rejecting enforcement of the Vitro Plan, the Fifth Circuit allowed the "right" result while at the same time it upheld the breadth and depth of relief available to more deserving foreign representatives in future cases.

Conclusion

The *Vitro* saga continues to unfold, with the bankruptcy court granting involuntary chapter 11 petitions against several Vitro subsidiaries just days after the Fifth Circuit opinion. *See Supra* note 2. Whether the Vitro cases will provide further opportunity for Circuit (or even Supreme) Court guidance remains to be seen. It is certainly fair to assume that a lack of US enforcement of the Plan will have serious implications for Vitro's Mexican proceedings. Nevertheless, the Fifth Circuit's opinion at this juncture is a useful reminder of both the scope and limits of relief under chapter 15, especially in the context of foreign reorganization plans that depend on recognition and enforcement in the United States.

Endnotes

[1] The involuntary petitions were initially rejected, but that decision was overturned on appeal. On remand earlier this month, the bankruptcy court ordered involuntary bankruptcies against the Vitro subsidiaries. Notably, the bankruptcy court found that "special circumstances" under section 303(b) of the Bankruptcy Code favored granting the involuntary petitions, because the Vitro subsidiaries had, during the pendency of the litigation, variously transferred assets out of the United States, reincorporated in the Bahamas, or entered into stock sales — all without adequate notice (even refraining from alerting the court). *See In re Vitro Asset Corp.*, Case No. 11-32600-HDH-11 (Bankr. N.D. Tex. Dec. 4, 2012) [D.I. 1574].

[2] Because chapter 15 proceedings relate only to foreign insolvencies, the only debtor in the chapter 15 proceeding was Vitro; Vitro's subsidiaries in the US were not debtors in the chapter 15 proceeding.

[3] When analyzing issues under chapter 15, courts frequently consult the Model Law, which is explicitly referenced in section 1501(a) of the Bankruptcy Code. What is interesting in *Vitro* is the Fifth Circuit's use of the Model Law's drafting history as a kind of *ersatz* legislative history.

[4] As noted by the Fifth Circuit, this is actually a three-step process: (1) whether the specific enumerated types of relief in section 1521 apply, (2) whether the relief requested qualifies as more general "appropriate relief" under section 1521 and (3) whether section 1507 "additional assistance" is available. The Fifth Circuit's decision to look first to section 1521 and view section 1507 as "extraordinary" relief available only after a "rigorous test" was influenced by two articles by Bankruptcy Judge Leif Clark. *See Vitro* at 37-39 (citing Leif M. Clark, *Chapter 15 Bankruptcy Strategies: Leading Bankruptcy Experts on Understanding the Filing Process and Achieving Successful Outcomes in Cross-Border Insolvency*

Cases—Advice for Handling Cross-Border Bankruptcy Cases Effectively (Aspatore Sept. 2012), *available at* 2012 WL 3279175, at *10 and Leif M. Clark & Karen Goldstein, *Sacred Cows: How to Care for Secured Creditors' Rights in Cross-Border Bankruptcies*, 46 Tex. Int'l L.J. 513, 524 (2011)).

5 The Fifth Circuit's willingness to analyze, in a chapter 15 context, case law that it had rejected in the chapter 11 context is another sign of the court's view that relief under chapter 15 is intended to be flexible.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

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