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Texas Bankruptcy Court Denies Recognition to Mexican Financial Restructuring Plan; Decision to be Appealed to the Fifth Circuit

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On June 13, 2012, the bankruptcy court for the **Northern District of Texas** in *In re Vitro, S.A.B. de C.V.* ("Vitro SAB") declined to recognize and enforce an order issued by the **Federal District Court for Civil and Labor Matters for the State of León, Mexico**, which approved Vitro SAB's reorganization plan in its Mexican insolvency proceeding (known as a concurso mercantil proceeding). *Vitro S.A.B. v. ACP Master Fund, Ltd., et al.* (In re Vitro S.A.B.), Case No. 11–33335 (HDH), 2012 WL 2138112 (Bankr. N.D. Tex. June 13, 2012). The Texas bankruptcy court's refusal to enforce the Mexican court's order and the Mexican plan of reorganization was based in large part on the Mexican plan's release of non-debtor subsidiaries from U.S.-based indebtedness. Vitro SAB has filed a request to take the decision directly to the Fifth Circuit Court of Appeals for expedited review, and the bankruptcy court has already indicated that it will grant the request.

The final decision in this case will have a significant effect on the negotiation and implementation of cross-border financings and restructurings, especially those involving Mexican issuers and guarantors of U.S. debt instruments.

Vitro SAB is a Mexican holding company that conducts substantially all of its operations through its subsidiaries, and together they are the largest manufacturer of glass containers and flat glass in Mexico, with consolidated net sales in 2010 of US$1.85 billion. Vitro SAB is the issuer of approximately US$1.2 billion in unsecured notes pursuant to indentures governed by U.S. law, and its wholly owned direct and indirect subsidiaries (several of which are U.S. entities) are guarantors of those notes. Vitro SAB has manufacturing facilities in 11 countries and distribution centers throughout the Americas and Europe, and exports its products to more than 50 countries worldwide.

The June 13th decision issued by Judge Halen in the Vitro SAB chapter 15 case is the latest twist in the long Vitro SAB reorganization saga. A group of U.S. bondholders initially filed involuntary petitions against Vitro SAB's U.S. affiliates in November 2010 in the Northern District of Texas. In response, Vitro SAB, but not its guarantor-subsidiaries, initiated a voluntary reorganization in Mexico under the *Ley de Concurso Mercantiles* to deleverage its balance sheet and restructure its US$1.7 billion in debt. The involuntary bankruptcy case was subsequently dismissed, and only Vitro SAB's chapter 15 case in Texas and civil litigation in New York state courts remain pending in the United States.

Under Vitro SAB's restructuring plan, which the Mexican court has already approved, the U.S. bondholders will receive a distribution of substantially less than what they are owed, approximately 40 cents on the dollar, while the shareholders will retain equity valued at approximately US$500 million and the non-debtor subsidiaries will be released from their guarantees.

Through **chapter 15 of the United States Bankruptcy Code**, Vitro SAB was attempting to make its Mexican restructuring plan binding on the U.S. bondholders and other U.S. creditors. Generally speaking, chapter 15 is designed to allow foreign debtors to obtain recognition and enforcement of foreign insolvency proceedings in the U.S. Under chapter 15 and the principles of comity, U.S. bankruptcy courts typically give great deference to the insolvency proceedings of foreign countries. However, over the last several years, U.S. bankruptcy courts have shown an increasing tendency to refuse enforcement of foreign insolvency orders in circumstances where doing so would be "manifestly contrary to U.S. public policy." The June 13th decision from the Texas bankruptcy court is another example of this recent line of cases.

The legal issue before the Texas bankruptcy court was whether the release of Vitro SAB's non-debtor subsidiaries could be enforced in the United States through the principles of comity, or whether such enforcement should be denied on the basis that the release of non-debtor subsidiaries is "manifestly contrary to U.S. public policy."

Specifically, Vitro SAB sought enforcement of its plan under sections 1521 and 1507 of the U.S. Bankruptcy Code, which provide for enforcement of foreign insolvency orders in the United States as long as such enforcement is consistent with the principles of comity. Comity is a form of legal reciprocity where a U.S. court can recognize and enforce the judicial determinations and proceedings of a foreign court. The principle of comity is not unique to bankruptcy and is used frequently to recognize judgments rendered and civil proceedings instituted in foreign countries. U.S. courts generally grant comity to foreign insolvency proceedings and denial of comity is the exception rather than the norm. Under chapter 15, a U.S. court should enforce a foreign order on the basis of comity unless doing so would be manifestly contrary to U.S. public policy. There are no formal definitions of "manifestly contrary" or "U.S. public policy," which causes U.S. courts to engage in extensive factual and legal analysis to reach a decision.

The objecting U.S. bondholders argued on numerous grounds that Vitro SAB's Mexican plan of reorganization is manifestly contrary to U.S. public policy. The bankruptcy court overruled the objections asserted by the bondholders on the grounds that (i) the judicial system in Mexico is corrupt, (ii) the proposed enforcement would have a negative impact on credit markets and cross-border finance, (iii) the Mexican law is unfair, and (iv) Vitro SAB's insolvency proceeding in Mexico violated Mexican law and process. The U.S. bankruptcy court rejected these challenges to enforcement for lack of evidence and persuasiveness.

However, the bankruptcy court did find that the releases of Vitro SAB's non-debtor guarantors were manifestly contrary to U.S. public policy, and as a result refused to enforce the Mexican restructuring plan in the United States. In its analysis, the court stated that under U.S. law such releases are granted only in limited circumstances, such as in mass tort cases. In a case such as this, a chapter 11 plan of reorganization would allow the bondholders to pursue the guarantees made by the subsidiaries that did not file their own bankruptcy petitions.

As stated by the bankruptcy court, "[o]ne could argue that Vitro SAB, as a holding company, is trying to achieve through its Concurso plan, an entrustment of the distribution of assets of its non-debtor U.S. subsidiaries without sufficiently protecting the Objecting Creditors." According to the bankruptcy court, the “protection of third-party claims in a bankruptcy case is a fundamental policy of the United States . . . [and the plan] does not simply modify such claims against non-debtors, they are extinguished.” The court noted that if the Mexican plan was enforced in the United States in its present form and discharged the debts of non-debtor subsidiaries, such enforcement would “create precedent without any seeming bounds.”

The Vitro SAB bankruptcy court declined to analyze the U.S. bondholders’ objection based on the Mexican plan’s violation of the U.S. absolute priority rule because it found that such a decision was unnecessary in light of the court’s decision on the releases of non-debtor guarantors. The U.S. absolute priority rule bars a class of creditors or interest holders from receiving any distribution unless the class senior to it in priority has its claims satisfied in full. If Vitro SAB were a U.S. chapter 11 debtor, then Vitro SAB’s equity holders would be barred from retaining any equity unless the bondholders’ claims were repaid in full. However, the Mexican plan allows equity holders to retain a value of approximately US$500 million even though U.S. bondholders will only receive 40 cents on the dollar.

Under Mexican insolvency law, and under the insolvency regimes in many other Latin American countries, there is no requirement similar to the U.S. absolute priority rule. Therefore, in Latin America it is possible, even quite common, for a debtor’s shareholders to retain equity under a restructuring plan even though creditors are not paid in full.

Following the *Vitro S.A.B.* decision, the looming question that remains in cross-border restructurings is whether a U.S. bankruptcy court would enforce a foreign restructuring plan that violates the U.S. absolute priority rule. The Vitro S.A.B. decision offers more than a hint that this particular court might not enforce such a plan, as the court stated “[b]y allowing the retention of equity, and at the same time not paying the Objecting Parties in full, the Concurso plan arguably runs afoul of § 1507 because the result is demonstrably different than would occur in Chapter 11.”

As it stands, the decision in *Vitro S.A.B.* is significant because it holds that a foreign restructuring plan will not be enforced if the plan provides for the release of claims against non-debtor guarantors. It is still an open question as to whether a foreign restructuring plan that violates the absolute priority rule will be enforced in the United States. At some point, this issue is likely to be decided by a U.S. court. As part of the appeals process, it is possible that the Fifth Circuit Court of Appeals will require the bankruptcy court to decide the absolute priority issue on remand. If U.S. courts decline to enforce a foreign restructuring plan that violates the absolute priority rule, such precedent will have a far-reaching effect on foreign restructurings that involve debt and assets located in the United States.

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