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An Update on the Manifestly Contrary to Public Policy Exception

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Chapter 15 is based on the Model Law on Cross Border Insolvency (the "Model Law"), which had been prepared by the United Nations Commission on International Trade Law ("UNCITRAL"), with significant input from insolvency practitioners all over the world.[1] It was designed to create procedures for cooperation among foreign courts where insolvency proceedings are pending in more than one country and establish guidelines for the protection of assets internationally, while being sensitive to the political issues and differing legal systems of the countries involved. Any determination of a request for assistance under Chapter 15 must be "consistent with the principles of comity."[2]

> "Comity," in the legal sense, is neither a matter of absolute obligation, on the one hand, nor of mere courtesy and good will, upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.[3]

The grant of comity is not discretionary; however, the determination of whether a court should grant comity is balanced by the language of § 1506, which provides that "[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States."[4] Whether a request for relief or assistance is "manifestly contrary" to United States public policy is within the discretion of the bankruptcy court to determine.[5] The following are summaries of cases that have directly addressed the issues that surround § 1506 and its public policy exception. The summaries begin with those cases that have found certain relief would be manifestly contrary to public policy, followed by cases where the requested relief would not be manifestly contrary to public policy, and lastly a case where the issue may arise fairly soon.

In re Qimonda AG

In re Qimonda AG is probably the most prominent case to delve into the issue of whether relief requested of the court was manifestly contrary to public policy. On October 28, 2011, the Bankruptcy Court for the Eastern District of Virginia issued an opinion in the Chapter 15 case of Qimonda AG ("Qimonda").[6] The bankruptcy court held that the application of § 365(n)[7] to

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[1] U.S. v. J.A. Jones Constr. Grp., LLC, 333 B.R. 637, 638 (E.D.N.Y. 2005).

[2] 11 U.S.C. § 1507; see J.A. Jones, 333 B.R. at 638.

[3] Hilton v. Guyot, 159 U.S. 113, 163-64 (1895).

[4] 11 U.S.C. § 1506.

[5] Micron Tech., Inc. v. Qimonda AG. (*In re* Qimonda AG Bankr. Litig.), 433 B.R. 547, 565 (E.D. Va. 2010) [Hereinafter *Qimonda I*].

[6] *In re* Qimonda AG, Case No. 09-14766-SSM, 2011 Bankr. LEXIS 4191 (Bankr. E.D. Va. Oct. 28, 2011, *mem. op.*) [Docket No. 635].

[7] Bankruptcy Code § 365(n) provides that if a trustee or debtor-in-possession rejects an intellectual property contract between a debtor/licensor and a licensee, the licensee may elect to either treat the contract as terminated or retain its rights under the contract (including the right to enforce any exclusivity provision of the contract, but excluding any rights to specific performance) for the duration of the contract and any extension period available to the licensee under nonbankruptcy law.

executory licenses to U.S. patents was required to sufficiently protect the interests of U.S. patent licensees under Chapter 15 of the Bankruptcy Code and that the failure of German insolvency law to protect patent licensees was "manifestly contrary" to United States public policy.

Factual Background

Qimonda, a manufacturer of semiconductor memory devices headquartered in Munich, Germany, filed an insolvency proceeding in Munich (the "Munich Proceeding"), and Dr. Michael Jaffé ("Jaffé") was appointed as the insolvency administrator. Jaffé then filed a petition for recognition under Chapter 15 of the Bankruptcy Code in the United States Bankruptcy Court for the Eastern District of Virginia. The bankruptcy court recognized the Munich Proceeding as a foreign main proceeding.[8]

Qimonda owned thousands of patents, including U.S. patents. After being unable to sell small packages of the patents, Jaffé decided the best way to realize the value of the patent portfolio was to license the patents and renegotiate existing patent agreements to achieve greater royalties. Jaffé provided notice that Qimonda would not perform under their existing patent licenses pursuant to German Insolvency Code § 103, which provides that executory contracts are automatically unenforceable unless the insolvency administrator, in this case Jaffé, affirmatively elects to perform the contracts. German Insolvency Code § 103 does not provide the same type of protection that is available under Bankruptcy Code § 365(n).

Two U.S. patent licensees, Samsung Electronics Co., Ltd. ("Samsung") and Elpida Memory, Inc. ("Elpida") (the "U.S. Licensees"), responded to Jaffé's notice by asserting that they were entitled to the protections of Bankruptcy Code § 365(n). In an effort to convince the bankruptcy court that he did not intend to take advantage of the U.S. Licensees, Jaffé filed pleadings committing to re-license Qimonda's patent portfolio at a reasonable and non-discriminatory royalty to be determined through good faith negotiations or through arbitration.

The Bankruptcy Court's Decision

The court explained that the semiconductor industry is characterized by the existence of a "patent thicket," such that any given semiconductor device may incorporate technologies covered by a multitude of patents not owned by the manufacturer, and it is difficult, if not impossible, to identify all potential patents or design around each and every patented technology. As a result, semiconductor manufacturers must obtain licenses to many different patents prior to developing new technologies to avoid infringement claims.

Congress' included § 365(n) in the Bankruptcy Code to remove what had become an unintended burden on American technological development. The court explained that in the absence of appropriate cross-license agreements in the semiconductor industry, "design freedom" gives way to a "hold-up premium" because manufacturers must attempt to license

[8] The bankruptcy court later entered a supplemental recognition order making Bankruptcy Code § 365 applicable to the Chapter 15 proceeding. The provisions of Bankruptcy Code § 365 do not apply automatically in a Chapter 15 proceeding. Instead, a foreign representative or other party-in-interest must petition the court to apply § 365 pursuant to Bankruptcy Code § 1521.

patented technology after potential infringement has already occurred and after an initial, nonrecoverable investment has been made in anticipation of new production.

Jaffé's expert testified that there was no reason to believe that innovation would be harmed given Jaffé's commitment to re-license the Qimonda patent portfolio on reasonable and non-discriminatory terms. Jaffé's expert also explained that a decision applying § 365(n) would only preserve rights in the licensing of U.S. patents, not the non-U.S. patents, which would have to be renegotiated. Jaffé's expert calculated that Qimonda would lose approximately $47 million dollars in revenues if the U.S. Licensees did not have to pay for the continued right to use the U.S. patents.

The court first addressed whether limiting the applicability of § 365(n) "appropriately balanced" the interests of Qimonda and the U.S. Licensees. The court determined that the application of § 365(n) to the U.S. patents was required to ensure that the interests of the U.S. Licensees were "sufficiently protected" under Bankruptcy Code § 1522(a). While the court recognized that the "hold-up premium" caused by requiring the re-license of the U.S. patents was lessened by Jaffé's promise to re-license the U.S. patents on reasonable and non-discriminatory terms, the risk to the substantial investments that the U.S. Licensees had made in research and manufacturing facilities in reliance on the design freedom provided by the agreements outweighed any loss of revenue to the Qimonda estate.

The court then addressed whether granting comity to German insolvency law would be "manifestly contrary to the public policy of the United States" within the meaning of Bankruptcy Code § 1506. The court explained that the public policy exception to granting comity to applicable foreign law must be limited to the *most fundamental policies* of the United States, and the fact that application of foreign law results in a different outcome than applying U.S. law is insufficient to deny comity. The court explained that in order to be manifestly contrary to public policy, foreign law must either (i) be procedurally unfair or (ii) severely impinge a U.S. statutory or Constitutional right in a way that would offend the most fundamental policies and purposes of such right.

The court acknowledged that no party had claimed, nor was there any reason to find, that German insolvency law or proceedings were procedurally unfair. Instead, the court focused on the second basis for the public policy exception to comity. The court determined that German insolvency law, as it applies to licenses to U.S. patents, implicated the statutory right found in Bankruptcy Code § 365(n). While the bankruptcy court recognized that Congress did not make the protection of § 365(n) automatic upon recognition in a Chapter 15 proceeding, and that the harm discussed in the legislative history of § 365(n) differed from the "hold-up premium" discussed by the U.S. Licensees, the court determined that the uncertainty resulting from not applying § 365(n) would slow the *pace* of innovation to the detriment of the U.S. economy and that under the circumstances of this case and *this industry* the failure to apply § 365(n) would "severely impinge" an important statutory protection accorded licensees of U.S. patents and thereby undermine a fundamental U.S. public policy promoting technological innovation.

There is some question as to whether the bankruptcy court's holdings in *Qimonda* will be affirmed on appeal given the high threshold regarding the meaning of "manifestly contrary." Additionally, questions remain as to whether other courts would reach the same conclusions in other Chapter 15 cases involving intellectual property given the *Qimonda* court's limitation of its holdings to these particular circumstances and the semiconductor industry.[9]

<u>In re Toft</u>

On July 22, 2011, Bankruptcy Judge Allan L. Gropper for the Southern District of New York issued an opinion in the Chapter 15 case of *In re Dr. Jürgen Toft*. The court declined to grant recognition to a German administrator because the "order of recognition on the terms requested would be manifestly contrary to U.S. public policy."[10]

<u>Factual Background</u>

Creditors of Dr. Jürgen Toft ("Toft") filed a bankruptcy petition in a German insolvency court hoping to collect debts owed by Toft. The German court appointed Dr. Martin Prager ("Prager") as insolvency administrator to investigate Toft's affairs and attempt to locate Toft's assets. Toft proved to be uncooperative and evasive and began selling estate assets without the German court's permission, squandering the opportunity for his creditors to receive any sort of recovery. In an effort to prevent further loss of estate assets, Prager obtained orders in Germany and England that allowed Prager to intercept Toft's postal mail and e-mail, providing information for Prager's investigation.

Prager filed a Chapter 15 petition for recognition of a foreign main proceeding with the Bankruptcy Court for the Southern District of New York. Along with the petition, Prager sought *ex parte* interim relief in the form of a court order allowing him access to Toft's two e-mail accounts stored on servers located in the U.S. as well as the redirection of future e-mails from these accounts.

<u>The Bankruptcy Court's Decision</u>

In support of the requested interim relief, Prager appealed to the principle of comity and argued that the court should enter an *ex parte* order similar to the German and English orders already obtained and grant Prager access to Toft's e-mail accounts. The court held that the requested relief would be manifestly contrary to public policy because disclosure of Toft's e-mails would violate the Electronic Communications Privacy Act, a bankruptcy trustee would not be entitled to such relief, and Chapter 15 relief cannot ordinarily be obtained without notice to the debtor.

The court began by addressing the Wiretap Act and the Stored Communications Act, each a sub-part of the Electronic Communications Privacy Act (the "Privacy Act").[11] The Wiretap Act imposes criminal and civil penalties on a person who intentionally intercepts

[9] *But see* Daniel A. Nolan IV, Comment, *A "Fundamental" Problem: The Vulnerability of Intellectual Property Licenses in Chapter 15 and the Meaning of § 1506*, 28 EMORY BANKR. DEV. J. 177, 224 (2011) (advocating for bankruptcy courts to continue to find protection of intellectual property licenses as a fundamental public policy of the United States when foreign courts allow total rejection of licenses).

[10] In re Toft, 453 B.R. 186, 201 (Bankr. SDNY 2011).

[11] 18 U.S.C. § 2511, *et seq.*

electronic communications. The court found that allowing Prager secret access to Toft's e-mail accounts would compromise Toft's privacy rights, which are protected by a comprehensive statutory scheme founded on the fundamental rights protected by the Fourth Amendment and many of the States' constitutions.[12]

The court next looked to the powers typically granted to a representative of an estate under U.S. law. Prager sought the right to inspect Toft's e-mail accounts by pointing to (i) the broad nature of Federal Rule of Bankruptcy Procedure 2004, (ii) case law supporting a bankruptcy trustee's ability to obtain a court order to search an uncooperative debtor's home, and (iii) cases that allowed a bankruptcy trustee to intercept a debtor's postal mail. The court declined to see the parallels in each instance. While Rule 2004 is broad and may be commenced by an *ex parte* motion, the procedures do not remain secret once an order is entered. Additionally, in the context of e-mails, the plain language of the Privacy Act provides procedures that allow for "wiretaps," which are only available to law enforcement officials and, in most instances, are only available to those parties who can obtain a search warrant under Federal Rule of Criminal Procedure 41(a). A bankruptcy trustee is not one of those parties. Finally, the court pointed to differences between each of the cases allowing a trustee to inspect a home or intercept postal mail and the secret nature of the relief Prager requested. In each case, the debtor was either notified prior to the inspection of the home or the mail or other measures were made to maintain privacy interests. Prager's request did not include these safeguards.

The court last addressed Prager's request to refrain from providing notice to Toft. The court noted that Bankruptcy Rule 2002(q) was specifically included to require notice in Chapter 15 cases; thus, presumably only a rare situation would allow for the court to disregard Rule 2002(q). The court decided this was not such a situation.

The court found that under all three principles, privacy, powers of estate representatives, and notice, not only would the requested relief be contrary to United States law, it would be manifestly contrary to public policy to grant such relief. In contrast to the German and English rulings, the United States court denied Prager's motion for *ex parte* relief in its entirety.

<u>In re Ephedra Products Liability Litigation</u>

On July 22, 2011, United States District Judge Jed S. Rakoff for the Southern District of New York issued an opinion relating to the Chapter 15 case of *In re Muscletech Research and Development, Inc.* and in general the *In re Ephedra Products Liability Litigation*.[13] The district court held that the Claims Resolution Procedures negotiated in the Canadian Proceeding and enforced through the Chapter 15 proceeding in the U.S. were not manifestly contrary to United States public policy.

<u>Factual Background</u>

Muscletech Research and Development, Inc. ("Muscletech") marketed products that contained ephedra prior to the FDA banning the substance in 2004. The sometimes harmful

[12] *Toft*, 453 B.R. at 198. The Privacy Act protects both aliens and U.S. citizens. *Id.*

[13] *In re* Ephedra Prods. Liab. Litig., 349 B.R. 333 (S.D.N.Y. 2006).

side-effects of ephedra led more than thirty separate actions for personal injury and wrongful death to be brought against Muscletech in both state and federal court. Assumedly as a means of managing its liability, Muscletech commenced an insolvency proceeding in Canada (the "Canadian Proceeding"). RSM Richter, Inc. was appointed as Monitor (the "Monitor") of Muscletech and eventually sought and was granted recognition of the Canadian proceeding as a foreign main proceeding under Chapter 15. As a result of recognition under Chapter 15, the state and federal civil actions were transferred and consolidated in the district court before Judge Rakoff.

In the Canadian Proceeding, the Monitor negotiated a procedure for speedily assessing and valuing creditors' claims, including those of the U.S. plaintiffs, all of which had filed claims in the Canadian Proceeding. The Monitor then sought enforcement of these procedures in the U.S. through the Chapter 15 by filing a motion under §§ 105(a) and 1521(a) of the Bankruptcy Code. Four parties objected to the motion arguing that enforcement of such an order in the U.S. would be manifestly contrary to public policy because it deprives the objectors of due process and the right to a jury trial.

The Bankruptcy Court's Decision

The district court, due to a few amendments having already been made to the order the objectors were attacking, quickly dismissed any arguments that the procedures would violate due process rights. Regarding the right to trial by a jury, the Monitor argued that the objectors waived their right when they filed claims in the Canadian Proceeding. The district court addressed the issue by reflecting upon the limited nature of the public policy exception provided by § 1506. Referring to *Hilton v. Guyot* and a long line of other cases, the district court explained that not affording the objectors the right to a jury trial does not inherently make the procedures manifestly contrary to U.S. public policy.

Although 28 U.S.C. § 1411 represents the importance the U.S. has placed in retaining the right to jury trials in the context of personal injury cases, the lack of a jury does not prevent a verdict from being fair and impartial. The district court explained that the objectors' main thrust of their argument was that the lack of a right to a jury trial would weaken their bargaining position in settlement negotiations. "Deprivation of such bargaining advantage hardly rises to the level of imposing on plaintiffs some fundamental unfairness." Because the objectors would still retain the right to a fair and impartial proceeding, the district court held that the enforcement of the procedures would not be manifestly contrary to public policy.

In re Gold & Honey, Ltd.

In *In re Gold & Honey, Ltd.* the Bankruptcy Court for the Eastern District of New York issued an opinion that denied the recognition of foreign main proceedings because they were pursued in violation of the automatic stay.[14] Following the seizure of assets and the commencement of an Israeli receivership proceeding in July of 2008, Gold & Honey, Ltd. and Gold & Honey (1995) L.P. (the "Debtors") filed for Chapter 11 relief in the Eastern District of New York in September of 2008. The court entered an order specifying that the automatic stay

[14] *In re* Gold & Honey, Ltd., 410 B.R. 357, 373 (Bankr. E.D.N.Y. 2009).

applied to all assets of the Debtors, wherever they are located. Despite the application of the automatic stay, the Debtor's lender continued to pursue the receivership in Israel, and eventually obtained the appointment of receivers, who subsequently filed Chapter 15 petitions in the United States.

The court refused to recognize the Israeli receivers' petitions because they were appointed in violation of the automatic stay and because the proceedings were not "foreign proceedings" under the Bankruptcy Code because they were not collective in nature. The court explained that acquiescing to a creditor's offensive violation of the automatic stay would "ensue in derogation of fundamental United States policies" and would be manifestly contrary to public policy under § 1506.[15]

<u>In re Petition of Ernst & Young, Inc.</u>

Ernst & Young, Inc. filed a petition for recognition of a foreign main proceeding on behalf of Klytie's Developments, Inc. ("KDI"), a Canadian entity formed by two Israeli citizens for the development of real estate throughout the world.[16] The parties opposing the petition argued that the recognition of KDI's foreign proceeding would be manifestly contrary to public policy because (1) Colorado and American investors would receive less in the foreign proceeding than they would receive in a proceeding run in Colorado or federal court and (2) the costs of running the proceeding outside of the United States would deplete the assets of KDI. The court did not find either argument persuasive and held that there was no evidence to support a finding that recognition of the foreign proceeding would be manifestly contrary to public policy.

<u>In re think3 Inc.</u>

In re think3 Inc. is a Chapter 11 case filed in the Bankruptcy Court for the Western District of Texas. think3 is a Delaware corporation and a global leader in the computer-aided design and product lifecycle management software market. A dispute arose when Italian creditors (including the Italian government) filed an involuntary insolvency against think3 and its Italian subsidiary in Italy and the Italian court appointed a trustee in Italy (the "Italian Trustee"). Shortly after commencement of proceedings in Italy, think3 filed for relief under Chapter 11 in the Western District of Texas. The Italian Trustee sought recognition of the Italian proceeding as the foreign main proceeding under Chapter 15 in the Western District of Texas.

The court ultimately denied the Italian Trustee's petition for recognition, refusing to grant recognition as a foreign main proceeding or a foreign nonmain proceeding. Although the court's decision was not based on whether recognition would be manifestly contrary to public policy, think3 argued that recognition would be manifestly contrary within its objection to the Italian Trustee's petition. think3 raised the argument because (1) the Italian Trustee had refused to comply with discovery requests, (2) the Italian Trustee's unilateral termination of a License Agreement violated 365(n) under the same theory as *Qimonda*, and (3) the Italian Trustee continued to take actions in violation of the automatic stay.

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[15] *Id.* at 371-72.

[16] *In re Pet. of Ernst & Young, Inc.*, 383 B.R. 773, 774 (Bankr. D. Colo. 2008).

In re Vitro, S.A.B. de C.V.

In what context will the next "manifestly contrary" decision arise? One likely candidate is *In re Vitro, S.A.B. de C.V.*, a Chapter 15 proceeding pending in the United States Bankruptcy Court for the Northern District of Texas.[17] Recent developments in the case have raised the question of whether the terms of a Mexican reorganization plan that would not meet the standards for confirmation under the Bankruptcy Code should be implemented under Chapter 15, or whether such a plan is manifestly contrary to U.S. public policy.

Background

The debtor, Vitro S.A.B. de C.V. ("Vitro"), is a Mexican glass-manufacturing company owned by a wealthy Mexican family. Vitro has numerous subsidiaries in the United States and Europe. As of December 2010, Vitro had outstanding aggregate indebtedness to non-affiliates of over $1.7 billion, including over $1.2 billion of unsecured notes. The notes were guaranteed by virtually all of Vitro's subsidiaries. Vitro owed over $2 billion in outstanding intercompany debt to the subsidiaries.

In November 2010, Vitro launched a solicitation of a pre-packaged reorganization plan (the "Concurso plan") in Mexico through a tender offer and an exchange offer. Under the Concurso plan, Vitro's existing debt would be exchanged for new notes over the objections of the original noteholders, who would have no recourse to the guaranties provided by the subsidiaries under the original notes. Four of Vitro's creditors who were unhappy with the offer filed an involuntary petitions against 15 of Vitro's subsidiaries, the court, however, ultimately dismissed the involuntary petitions.

Vitro entered into lock-up voting agreements with its subsidiaries pursuant to which the subsidiaries agreed to support extinguishment of the guaranties and vote in favor of the Concurso plan. If the subsidiaries holding intercompany debt are allowed to vote, they will be able to outvote the noteholders and cram down the Concurso plan.

The Concurso plan would not be confirmable in the U.S. because it would violate the "absolute priority rule" of Bankruptcy Code § 1129(b)(2).[18] Under the Bankruptcy Code, equity cannot retain its interest in the debtor unless all the creditors with higher priority have consented or have been paid in full. Vitro's noteholders have accused it of creating the intercompany debt in order to gerrymander voting on the Concurso plan, allowing Vitro's equity holders to control the reorganization and retain their interest at the expense of its creditors. Vitro, in turn, accuses the noteholders of trying to sabotage its reorganization.

On December 13, 2010, Vitro commenced a voluntary judicial reorganization proceeding in Mexico based on the Concurso plan. Several months later, on April 14, 2011, Vitro filed a petition in the United States Bankruptcy Court for the Southern District of New York seeking recognition of the Mexican reorganization case as a foreign main proceeding under Chapter 15 of

[17] *In re Vitro S.A.B. de C.V.*, No. 11-33335-HDH-15 (Bankr. N.D. Tex. filed Apr. 14, 2011).

[18] *See* 11 U.S.C. § 1129(b)(2).

the Bankruptcy Code. The Chapter 15 case was subsequently transferred to the United States Bankruptcy Court for the Northern District of Texas.

Before ruling on Vitro's Chapter 15 petition, the U.S. bankruptcy court issued a preliminary injunction prohibiting all litigation or attempts to collect against Vitro.[19] The injunction did not extend to noteholders' actions against the subsidiary guarantors, however, who were not in insolvency proceedings in either Mexico or the United States. On July 21, 2011, the U.S. bankruptcy court entered an order recognizing the Mexican case as a foreign main proceeding.

In August 2011, a group of noteholders filed suit in New York state court against the subsidiaries.[20] The noteholders sought a declaratory judgment that Vitro's attempted reorganization in Mexico could not impact the subsidiaries' guaranties. The noteholders argued that the indentures governing the notes prohibit non-consensual modification of the guaranties and explicitly state that an insolvency proceeding for Vitro cannot discharge the obligations of the subsidiaries.

The New York lawsuit prompted Vitro to seek protection from the U.S. bankruptcy court. Vitro moved the U.S. bankruptcy court to enforce the automatic stay and prevent the noteholders from pursuing the subsidiaries. Vitro argued that the automatic stay of Bankruptcy Code § 362 should be broadly construed, and that language prohibiting acts "against the debtor" should be extended to its non-debtor subsidiaries. The U.S. bankruptcy court denied Vitro's motion, concluding that the automatic stay did not apply to the New York lawsuit because the subsidiaries were not debtors and the declaratory judgment did not seek control over property of the estate.

On December 5, 2011, the New York court ruled in favor of the noteholders, finding that the indentures prevent non-consensual modification of the subsidiaries' guaranties. The court rejected the argument that noteholders had implicitly agreed that their rights could be altered by Mexican bankruptcy law and pointed out that, to the contrary, the subsidiaries expressly waived any rights under Mexican law.

On December 18, 2011, as voting on the Concurso plan was beginning, the noteholders obtained a temporary restraining order from the New York court which enjoined the subsidiaries from giving their consent to the Concurso plan.[21] The TRO directed the subsidiaries to withdraw their consent to any plan of reorganization of Vitro that purports to release the guaranties.

Vitro again turned to the U.S. bankruptcy court, asking that the New York lawsuit and TRO be stayed and seeking a determination that the noteholders' New York lawsuit violated the automatic stay incorporated in the Chapter 15 proceeding. Alternatively, Vitro sought the entry

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[19] *In re Vitro S.A.B. de C.V.*, 455 B.R. 571 (Bankr. N.D. Tex. June 24, 2011).

[20] *Wilmington Trust N.A. v. Vitro Automotriz S.A. de C.V.*, No. 652303-2011 (Sup. Ct. N.Y. County filed Aug. 17, 2011)

[21] *Wilmington Trust N.A. v. Vitro Automotriz S.A. de C.V.*, No. 653459-2011 (Sup. Ct. N.Y. County filed Dec. 14, 2011)

of an order implementing the automatic stay in the Chapter 15 proceeding. This time, the U.S. bankruptcy court sided with Vitro.

The U.S. bankruptcy court reasoned that the TRO would cause the subsidiaries to breach the lock-up agreements, which are an asset of the debtor. Such action constitutes an "act . . . to exercise control over property of the estate" in violation of Bankruptcy Code § 362(a)(3).[22] Moreover, even if—as the noteholders argued—§ 362(a)(3) only protects property of the debtor in the United States, the U.S. bankruptcy court determined that the New York lawsuit should be stayed pursuant to Bankruptcy Code § 1521(a)(1). Section 1521(a)(1) provides that, upon recognition of a foreign proceeding, the court may grant any appropriate relief necessary to effectuate the purpose of Chapter 15 and to protect the assets of the debtor or the interests of creditors (including staying actions against the debtor and its assets).[23] The U.S. bankruptcy court considered the TRO as going "right to the heart" of the Mexican bankruptcy proceeding. The New York lawsuit clearly concerned Vitro's assets and rights by directly controlling voting on the Concurso plan, and was an "end run" around the Mexican court that the U.S. bankruptcy court could not countenance. The U.S. bankruptcy court applied the standards applicable to an injunction and determined they had been satisfied. Accordingly, the U.S. bankruptcy court entered an order enforcing the automatic stay and enjoining the TRO.

The noteholders appealed to the District Court for the Northern District of Texas, which affirmed the U.S. bankruptcy court's order and remanded for additional findings and rulings.[24] The Fifth Circuit denied a petition for writ of mandamus filed by the noteholders.[25] Hence, the U.S. bankruptcy court's order staying the TRO remained in effect. The subsidiaries remained free to vote on the Concurso plan in accordance with the lockup agreement, and the noteholders remained free to sue the non-debtor subsidiaries on the guaranties. The noteholders proceeded to obtain judgments against the subsidiaries in the amount of $84 million in the New York lawsuits. The noteholders began serving levies and restraining notices on the subsidiaries and Vitro customers in the United States to garnish accounts payable owed to Vitro.

The Mexican court approved the Concurso plan on February 3, 2012, and Vitro proceeded to consummate the plan, issuing new notes and debentures and funding trusts for the payment of claims. Approval of the Concurso plan discharged Vitro's obligations to the noteholders under the original notes and released claims against the subsidiaries under the guaranties.

Following approval of the Concurso plan in Mexico, the noteholders filed additional lawsuits in New York state court for breach of contract and declaratory judgment against the subsidiaries and continued their efforts to collect the judgments. The New York state court denied a request for a temporary restraining order by Vitro.

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[22] 11 U.S.C. § 362(a)(3).

[23] 11 U.S.C. § 1521(a)(1).

[24] This appeal was later dismissed as moot in light of the Mexican court's approval of the Concurso plan. *See In re Vitro S.A.B. de C.V.*, No. 11-CV-3554-F (N.D. Tex. filed Dec. 23, 2011).

[25] *Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V.*, No. 11-11239 (5th Cir.).

Public Policy Issues

On March 2, 2012, Vitro filed a motion asking the U.S. bankruptcy court to enforce the Concurso plan under Bankruptcy Code section 1507.[26] Vitro also requested that the court enjoin creditors from commencing or continuing litigation and taking actions to collect against Vitro and the subsidiaries related to claims that were restructured or discharged under the Concurso plan.

Applying the *Qimonda* reasoning, the U.S. bankruptcy court could only refuse to implement the Concurso plan as "manifestly contrary to public policy" under Bankruptcy Code section 1506 if it determines that the Mexican court's confirmation of the Concurso plan is either (a) procedurally unfair or (b) severely impinges a U.S. statutory or Constitutional right in a way that offends the most fundamental policies of the United States.[27] As the *Qimonda* court noted, application of foreign law that merely results in a different outcome is insufficient.[28]

Consistent with *Qimonda*, Vitro argues in its motion that enforcement of the Concurso plan does not require that Mexican law be identical to U.S. bankruptcy law, but only that the approval order was obtained under a system with procedures compatible with the requirements of due process. Vitro points out that U.S. courts have routinely concluded that Mexican insolvency law fosters reorganization in a manner consistent with fundamental principles and policies of the U.S., and that this U.S. bankruptcy court would be the first U.S. court to deny recognition of an order approving a concurso plan (even plans that contained provisions similar to Vitro's Concurso plan). Finally, Vitro points out that noteholders had an opportunity to be heard consistent with due process, and in fact participated in the Mexican bankruptcy proceeding, and that the Mexican court considered and rejected the noteholders' arguments.

In its motion, Vitro goes on to argue that the public policy exception of Bankruptcy Code section 1506 is not implicated because the Concurso plan does not contravene fundamental policies of the United States. Allowing equity holders to retain their interests when unsecured creditors are not paid in full is not manifestly contrary to U.S. public policy, Vitro argues: Far from being a fundamental U.S. policy, the absolute priority rule applies to classes rather than individual creditors, and can be disregarded by consent of all impaired classes (which Vitro argues is exactly what occurred in the Mexican proceeding). Similarly, Vitro argues, permitting insiders to vote on a plan of reorganization, releasing claims against non-debtors, and allowing the subsidiaries to novate their obligations under the guaranties are all acceptable under U.S. public policy.

Pending a ruling on its motion to enforce the Concurso plan,[29] Vitro commenced an adversary proceeding seeking a temporary restraining order and preliminary injunction against the commencement or continuation of litigation and collection actions against Vitro and the

[26] *See In re Vitro S.A.B. de C.V.*, 455 B.R. 571 (Bankr. N.D. Tex. June 24, 2011) (Docket No. 327).

[27] *In re Qimonda AG*, No. 09-14766-SSM, 2011 LEXIS 4191 (Bankr. E.D. Va. Oct. 28, 2011).

[28] *Id.*

[29] As of the date of this writing, the trial to be held regarding the motion was set to begin on June 5, 2012.

subsidiaries related to claims that were restructured or discharged under the Concurso plan.[30] In particular, Vitro argued that the New York lawsuits and the noteholders' execution actions would cause Vitro irreparable harm. On March 15, 2012, the U.S. bankruptcy court issued a TRO designed to preserve the status quo until it rules on the enforceability of the Concurso plan. The TRO prohibits creditors from taking action in the United States to collect on judgments or seize assets from Vitro and the subsidiaries.

It remains to be seen whether Vitro's Concurso plan will pass the public policy hurdle of Chapter 15. Comments made by the U.S. bankruptcy court earlier in the case suggest that it may take a dim view of the Concurso plan. In its order staying the TRO, the U.S. bankruptcy court noted that Vitro "may very well win the battle here and yet lose the war."[31] Like the noteholders, the U.S. bankruptcy court has noted that the Concurso plan would not be confirmable under U.S. law, and has expressed concerns that the process and result of the Concurso plan may violate U.S. public policy. It has also pointed out that implementation of the Concurso plan may have a negative effect on credit markets, making it more difficult for companies with Mexican operations to obtain credit in the U.S.[32] This would arguably be contrary to one of Chapter 15's stated objectives: greater certainty for trade and investment.[33]

The *Vitro* case has garnered political attention as well. In October of 2011, two U.S. Representatives wrote a letter calling on the Mexican government to take action in Vitro's Mexican proceeding to prevent subsidiaries from voting on the Concurso plan.[34] Other U.S. Representatives have characterized the Mexican proceeding as a "highly unorthodox reorganization" which will set a "dangerous precedent" that will hurt both investors in the Mexican glass company and future cross-border investment.[35]

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[30] *Vitro S.A.B. de C.V. v. ACP Master, Ltd. et al.*, No. 12-03027 (Bankr. N.D. Tex. filed March 2, 2012).

[31] *In re Vitro S.A.B. de C.V.*, No. 11-33335-HDH-15 (Bankr. N.D. Tex. filed Apr. 14, 2011), Docket No. 253.

[32] *Id.* at Docket No. 252.

[33] *See* 11 U.S.C. § 1501(a)(2).

[34] *Vitro Arbitrator Says Restructuring May Extend Past Dec. 31* (Nov. 29, 2011), available at http://www.bloomberg.com/news/2011-11-29/vitro-arbitrator-says-restructuring-may-extend-past-dec-31-1-.html

[35] *Id.*