

# ***Latinvex***

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## **Credito Real Strategy Tests US Court**

**Credito Real body-checks Mexican and US insolvency laws. Will US court strike back?**

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Credito Real is attempting to bypass Mexican and US insolvency laws and deploy a corporate liquidation statute with almost no protections for creditors. Whether Credito Real's strategy can be successful is about to be tested in a US bankruptcy court.

Facing financial difficulties arising from allegations of financial reporting shortcomings and deteriorating market conditions, and in the wake of crumbling discussions with its creditor group, Credito Real has bypassed a judicially supervised restructuring under either US or Mexican law, instead choosing to pursue a corporate liquidation process under Mexican law.

### **Background**

Credito Real's suspension of restructuring discussions with its creditors had resulted in certain unsecured creditors filing an involuntary bankruptcy petition against Credito Real under Chapter 11 of the US Bankruptcy Code. Credito Real responded to this petition by commencing the corporate liquidation process under Mexican legislation, for which it sought recognition under Chapter 15 of the US Bankruptcy Code.

Credito Real filed under Chapter 15 of the Bankruptcy Code in Delaware (the state under which its US subsidiary was organized) to establish the primacy of the Mexican corporate liquidation process. In addition, Credito Real argued that the involuntary Chapter 11 case against it pending before Judge David S. Jones in the US Bankruptcy Court for the Southern District of New York should be dismissed for lack of jurisdiction and because a court-supervised liquidation process already was pending in Mexico (where the majority of Credito Real's assets are located). While the involuntary Chapter 11 case has been transferred to the Delaware bankruptcy court, the hearing to dismiss the involuntary petition is still pending.

From the perspective of some creditors, the commencement of the liquidation process by Credito Real appears to be a fraudulent strategy to avoid the imminent criminal

prosecution of its principal shareholders and directors, as well as an improper tactic to avoid paying its unsecured creditors (mainly the bondholders). From the perspective of minority shareholders, it is a perverse scheme deployed by the controlling shareholders to distribute assets without considering the minority shareholders' views or interests in a shareholders' meeting. For that reason, this last group filed in August an appeal against the company's liquidation before the 52nd Civil Court of the State in Mexico City, requesting the suspension of the liquidation process. The local court granted the request, which the Third Chamber of Appeals of the Supreme Court of Justice of Mexico City recently confirmed.

### **The Problem with the Liquidation Process**

Unlike liquidation under the Mexican Insolvency Law (Ley de Concursos Mercantiles), the corporate liquidation process initiated by Credito Real under the General Law of Commercial Companies (Ley General de Sociedades Mercantiles, the "Mexican Corporate Law") does not comply with the basic principles of most modern insolvency laws. Therefore, it could produce an outcome contrary to US public policy. Additionally, the corporate liquidation process regulated by Mexican Corporate Law lacks the judicial oversight necessary to ensure fair treatment of creditors, including permitting the preferential payment of unsecured, local creditors. It also restricts information flow to creditors and their participation in the process, providing an opportunity for flagrant violations of the rule of absolute priority and equal treatment that governs most insolvency proceedings.

### **What the Delaware Bankruptcy Court's Decision Could Mean**

At the moment, the issue for decision is whether the Delaware bankruptcy court should grant recognition under Chapter 15 of the corporate liquidation process initiated by Credito Real under the Mexican Corporate Law or instead deny this recognition request and enter an order for relief on the creditors' involuntary Chapter 11 petition. To do the latter, the Delaware bankruptcy court must consider whether it believes that the interests of all the parties are better served in a Chapter 11 proceeding than in a Mexican corporate liquidation process. This resolution may well have important implications for cross-border investment in the Mexican market.

If the Delaware bankruptcy court decides to recognize the corporate liquidation process under Chapter 15, not only will the involuntary Chapter 11 petition filed by the ad hoc group be dismissed, but this unsecured group of creditors will be left in an unfavorable procedural position vis-à-vis the local creditors. For example, without a court order prohibiting it, Credito Real can be expected to continue paying its local creditors in the amounts and order of priority of its choice according to the terms that the liquidator agrees to with each of those creditors. Additionally, the liquidator can be expected to continue acting according to the controlling shareholder's instructions without regard to sound commercial practices and customs to maximize the proceeds from selling the company's assets. Moreover, the corporate liquidation process does not provide for a

look-back period that allows certain transfers that occurred before the bankruptcy declaration to be challenged as fraudulent conveyances; there is no process to review whether transactions that Credito Real has already implemented were to the detriment of unsecured creditors.

Even if the Delaware bankruptcy court denies recognition of the corporate liquidation process under Chapter 15 and puts Credito Real in a Chapter 11 proceeding, the unsecured creditors' chances of collecting their claims and recovering some of their money are almost non-existent. It is worth noting that Credito Real's lawyers have implemented a complex but efficient strategy to settle several of the company's debts with its secured creditors. For example, Credito Real paid its debt with Banorte by transferring part of its loan portfolio to the bank, which Banorte then sold to Crédito Maestro (an affiliate of Credito Real). The problem is that by the time the Delaware bankruptcy court rules, it may already be too late to recover the assets disposed of by Credito Real. It is true that under Chapter 11, unsecured creditors or their representatives may be able to initiate actual or constructive fraudulent conveyance actions against certain of Credito Real's transferees to bring the transferred property back into the estate. However, some of the transactions that could be subject to such measures were executed by Credito Real in Mexico and with Mexican counterparties (some of them with no presence in the United States). This situation could preclude the unsecured creditors' or a bankruptcy trustee's ability to set aside these transactions and bring back the transferred property into the bankruptcy estate to be distributed to all creditors under the priority scheme of the Bankruptcy Code.

### **Takeaways for Non-bank Lenders in Latin America**

Depending on the result for Credito Real, investors may rethink their debt strategy in Mexico and perhaps elsewhere in Latin America, particularly their appetite for unsecured debt. Although Credito Real's strategy could be deployed by a company in any industry, because Credito Real is a non-bank lender, like Alpha Credit and UNIFIN, that sector may be subjected to greater risk aversion. In addition, investors considering taking a minority equity position in a Mexican company may wish to try to protect themselves against the controlling shareholders pursuing a course of action similar to Credito Real's. To adapt, non-bank lenders must fortify their accounting practices and corporate governance; only by doing so will they be able to take advantage of the new opportunities that will undoubtedly open up for those lenders that learn to navigate this new and stormy climate of investor suspicion and financial uncertainty.

The Credito Real case underscores the reach and implications of transnational insolvency proceedings in Latin America, highlighting lingering unresolved Chapter 15 questions related to the narrow construction of public policy exemptions to recognition of foreign proceedings. Fraught with controversy, Credito Real's strategy has created a crisis similar to that resulting from the Vitro case, where intercompany debt was improperly used to cram down the third-party creditor group.

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