Ch. 15 Case Highlights Reach Of Transnational Insolvency

By **Debora de Hoyos, Maria Alevras-Chen and Javier Garibay** (November 16, 2022)

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Financially distressed Crédito Real SAB de CV, a Mexican nonbank lender, has undertaken a corporate liquidation process in Mexico in order to sidestep the protections that Mexican and U.S. bankruptcy laws provide to creditors and minority shareholders.

With declining financial performance due to languishing government utilization of its financing products and the impact of the COVID-19 pandemic, Crédito Real was already vulnerable when investors began to scrutinize its financial statements and reporting practices.

Unable to rationalize not only its depressed profits, cash burn and eroding interest margins, but also the fact that 47% of its loan portfolio was composed of capitalized interest, Crédito Real's meteoric rise came to a screeching halt.

At the end of 2021, Crédito Real announced its intention to find financing sources that would allow it to meet its imminent obligations. However, it failed to attract investor interest in a roadshow organized in Switzerland in November 2021.

Subsequently, its attempts to arrange for the securitization of its payroll loan portfolio and to raise $150 million to refinance its CHF 170 million (about $180 million) bond due Feb. 9 were also thwarted.

Although Crédito Real tried to reassure investors by paying some coupons, each of its attempts to refinance the Swiss bond was a resounding failure, which Crédito Real ended up defaulting on Feb. 9.

The Swiss bond default generated several cross-defaults and forced Crédito Real to try to restructure its debt. All the restructuring attempts failed.

Frustrated with the lack of progress, at the beginning of June, Crédito Real fired its legal and financial advisers, causing the restructuring efforts to grind to a halt. In light of poor restructuring prospects, Crédito Real began to experience growing internal turmoil that further exacerbated the strained dynamic with its creditors.

Eight of the nine members of the board of directors resigned. In addition, its secured creditors demanded additional assets as collateral for their existing loans to mitigate the deterioration of Crédito Real's portfolio.

Faced with the threat that bank creditors would accelerate their loans and enforce their collateral, Crédito Real focused its attention on these secured creditors.

Consequently, on June 22, three unsecured creditors filed an involuntary bankruptcy petition against Crédito Real under Chapter 11 of the U.S. Bankruptcy Code.
These creditors sought to prevent Crédito Real from continuing to grant additional collateral

in favor of its secured creditors and looked for an orderly restructuring involving all interested parties.

Crédito Real responded to this petition by commencing the corporate liquidation process under Mexican legislation, for which it sought recognition under Chapter 15 of the Bankruptcy Code.

Crédito Real filed under Chapter 15 of the Bankruptcy Code in Delaware — the state under which its U.S. subsidiary was organized — to establish the primacy of the Mexican corporate liquidation process.

In addition, Crédito Real argued that the involuntary Chapter 11 case against it pending before U.S. Bankruptcy Judge David S. Jones in the U.S. 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 Crédito 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.

According to some sources, Crédito Real agreed with some of its unsecured creditors to suspend the hearing that was going to take place with the Delaware bankruptcy court on Nov. 3 to recognize or dismiss the company's Chapter 15 filing and the involuntary Chapter 11 petition.

Apparently, the unsecured creditors' advisers are trying to find out from Crédito Real and its liquidator what assets the company still has and which have already been sold.

From the perspective of some creditors, the commencement of the liquidation process by Crédito 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 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 latter group filed in August an appeal against the company's liquidation before the 52nd Civil State Court of 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 Mexico City recently confirmed.

The Problem With the Liquidation Process

Unlike liquidation under Mexican insolvency law, the corporate liquidation process initiated by Crédito Real under the General Law of Commercial Companies does not comply with the basic principles of most modern insolvency laws.

Therefore, it could produce an outcome contrary to U.S. or Mexican public policy.

Among the main differences between the corporate liquidation process regulated by Mexican

corporate law and the commercial bankruptcy process regulated by the Mexican insolvency law are the following.

Asset sale terms are not tested through an arms-length public auction process.

Unlike Mexican insolvency law, under which, as a general rule, the sale of distressed assets must be carried out through a public auction process with certain exceptions, corporate liquidation under the Mexican corporate law is not prescriptive regarding property disposal by the liquidator.

For example, the liquidator under Mexican corporate law may, at its own discretion, in the course of carrying out its duties, choose not to abide by sound commercial practices and customs or take adequate steps to maximize the proceeds from the sale of the company's assets or to consider the convenience of selling the business as an ongoing concern.

Creditor rights are disregarded in favor of shareholder rights.

The liquidation process under Mexican corporate law:

- Does not provide for an orderly liquidation of the debtor's assets;
- Does not provide creditors with an equitable distribution of the debtor's nonexempt assets according to the priorities created under the Mexican insolvency law;
- Does not allow significant creditor participation in the liquidation process;
- Does not enable creditors to be notified efficiently of actions taken by the Mexican court or the liquidator;
- Does not grant creditors sufficient transparency or access to information and documents that allow them to defend their rights; and
- Does not limit or restrict the debtor or liquidator concerning the disposal of the debtor's assets.

All these violations of creditors' rights put into question the collective nature of this procedure.

Both the United Nations Commission on International Trade Law's model law on cross-border insolvency and the Mexican insolvency law provide that recognition of foreign proceedings only applies to collective proceedings — that is, proceedings undertaken for the benefit of all creditors.

Process does not provide for a stay of actions against the debtor.

The corporate liquidation process under Mexican corporate law does not provide for a stay of actions against the debtor or its property.

Therefore, it allows Crédito Real's creditors to continue pursuing both formal and informal actions and remedies against Crédito Real and its property.

It also enables Crédito Real to continue paying local creditors, whether with or without collateral, in violation of the rule of absolute priority and equal treatment that governs

insolvency proceedings.

These differences are due to the very nature of the laws that regulate both procedures. Mexican corporate law is not a law relating to insolvency.

Commercial insolvency proceedings in Mexico are considered a matter of public interest, and are therefore governed by a unique and special law: the Mexican insolvency law.

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 Crédito 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, Crédito 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 Crédito 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 Crédito Real in a Chapter 11 proceeding, the unsecured creditors' chances of collecting their claims and recovering some of their money are almost nonexistent.

It is worth noting that Crédito Real's lawyers have implemented a legally questionable strategy to settle several of the company's debts with its secured creditors. For example, Crédito Real transferred part of its portfolio to its affiliate Crédito Maestro and used collections to pay off some of its creditors without judicial oversight.

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 Crédito 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 Crédito Real in Mexico and with Mexican counterparties, some of them with no presence in the U.S.

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 Lenders in Latin America

Depending on the result for Crédito Real, investors may rethink their appetite for unsecured debt in the region.

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 Crédito Real's.

To adapt, borrowers, and particularly in this climate, nonbank 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 Crédito 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, Crédito Real's strategy has created a crisis similar to that resulting from the Mexican glassmaker Vitro SAB de CV case, where intercompany debt was improperly used to cram down the third-party creditor group.

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