

Pratt's Journal of Bankruptcy Law

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EDITOR'S NOTE: BRAZIL, MEXICO AND THE UNITED STATES

Victoria Prussen Spears

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The Mexican Non-Bank Lending Sector Crisis: A Bankruptcy Perspective

*By Francisco Javier Garibay Guemez, Francisco Garcia-Naranjo and
Juan Pablo Garibay**

In this article, the authors analyze recent challenges faced by select entities within the Mexican non-bank lending sector.

This article presents a comprehensive analysis of recent challenges faced by select entities within the Mexican non-bank lending (NBL) sector, highlighting the legal complexities involved in their bankruptcy and restructuring processes. This article focuses on the cases of UNIFIN, Crédito Real, Alpha Credit, and Tangelo (formerly Mexarrend) as cautionary examples, exploring the risks associated with rapid expansion, aggressive credit underpricing, asset-liability mismatches, weak corporate governance practices, and lack of transparency. The goal of this article is to provide an in-depth understanding of these events and their implications for the broader Mexican financial system, as well as to identify lessons that can help prevent similar crises in the future.

INTRODUCTION

The Mexican NBL sector has played a vital role in promoting financial inclusion and fostering economic growth. Nevertheless, a series of setbacks have resulted in financial distress for certain NBLs. This article delves into the vulnerabilities of selected Mexican NBLs, the catalysts for the crisis, the impact of bankruptcy and restructuring on the sector, and the legal nuances involved in these cases.

In addition to the aforementioned factors, accounting inconsistencies and shortcomings in both internal and external accounting controls significantly contributed to the insolvency of these NBLs. The situation was exacerbated by inadequate reporting and accounting standards, as some companies failed to comply with proper financial reporting guidelines. This noncompliance has severely affected the sector's stability.

It is essential to note that this issue is not necessarily pervasive among all companies in the NBL sector. Several NBLs have not engaged in such practices

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but have, unfortunately, faced the repercussions of diminished investor confidence and industry uncertainty. As a result, these well-managed NBLs have had to confront the challenges posed by the broader crisis within the sector.

This article's analysis of the Mexican NBL sector underscores the importance of addressing accounting inconsistencies, strengthening accounting controls, and improving compliance with financial reporting standards. By doing so, the sector can work towards restoring investor confidence and ensuring the stability and resilience of NBLs that have not engaged in these malpractices. In the long run, learning from these cautionary examples and implementing necessary reforms can help prevent similar crises in the future and guarantee the continued growth and success of the Mexican NBL sector.

By examining these cases, this article aims to provide valuable insights into the bankruptcy and restructuring processes from a legal standpoint while taking into account the broader context and the role of NBLs in fostering financial inclusion and economic growth.

OVERVIEW OF THE MEXICAN NBL SECTOR AND FACTORS CONTRIBUTING TO THE CRISIS

The Mexican NBL sector has played a crucial role in providing credit to underserved segments of the population, fostering financial inclusion, and promoting economic growth. However, a combination of factors has led to financial distress for certain NBLs, such as UNIFIN, Crédito Real, Alpha Credit and Tangelo. This article now offers a brief overview of the sector and discusses some of the main factors contributing to the crisis experienced by these specific NBLs.

Rapid Expansion and Compression of Net Interest Margins

Over the past decade, the Mexican NBL sector has experienced rapid growth, driven by increasing demand for credit and the development of innovative lending products. This growth has enabled NBLs to access underserved markets, providing much-needed capital to borrowers who might not have qualified for traditional banking services. However, this expansion has also intensified competition among NBLs, as they strive to gain market share and capitalize on the lucrative opportunities within the sector.

To attract more borrowers in this competitive environment, some NBLs have resorted to underpricing credit, disregarding the inherent risks associated with lending to subprime borrowers. This aggressive underpricing has had a direct impact on net interest margins (NIMs), which is the difference between the

interest income generated by NBLs and the amount of interest paid out to their lenders, relative to the amount of their interest-earning assets. As NBLs lower interest rates on loans to gain market share, coupled with rising funding costs, it results in a squeeze on their NIMs, consequently diminishing the profitability of their lending operations.

The decline in NIMs can lead to a vicious cycle, where NBLs may feel compelled to take on even riskier loans to offset the reduced profitability, further exposing them to credit risk. As a result, NBLs with compressed NIMs become increasingly vulnerable to financial distress, particularly during economic downturns or increases in loan defaults. In some cases, aggressive credit underpricing and the resulting decline in NIMs have contributed significantly to the financial difficulties faced by certain Mexican NBLs.

In addition to competitive pressures and aggressive credit underpricing, some NBLs (such as UNIFIN and Crédito Real), began diversifying and growing excessively. After experiencing significant growth, they shifted their focus to lending to subprime borrowers in an effort to further expand their loan portfolios. Consequently, these NBLs deprioritized the origination and quality of their credit portfolios and failed to implement necessary protective measures against the risks associated with lending to subprime borrowers.

This excessive growth and diversification led to a deterioration in the overall quality of these NBLs' credit portfolios. As they increasingly took on riskier loans, they became more susceptible to financial distress during economic downturns or spikes in loan defaults.

Given this backdrop, it becomes increasingly critical for NBLs to manage their balance sheets prudently, particularly in the face of heightened risks and rising funding costs. Rigorous credit analysis and robust risk management procedures need to be at the forefront of their operational strategies. This includes not only appropriately pricing their loans to reflect the underlying risks, but also establishing limits on exposure to subprime borrowers to maintain a well-diversified and quality credit portfolio.

Asset-Liability Mismatches

Asset-liability mismatches occur when the maturity of an institution's assets and liabilities are not properly aligned, resulting in potential liquidity risks. In the case of some Mexican NBLs, mismatches have arisen due to funding strategies that heavily rely on short-term funding to finance long-term loans.

By relying on short-term funding, these NBLs accessed cheaper financing costs compared to long-term funding sources. However, this approach left them vulnerable to refinancing risks, as they constantly needed to roll over their

short-term debt to sustain their operations. This funding strategy worked well during periods of favorable market conditions (or low interest rates) when NBLs could easily access new funding to replace maturing debt.

However, when market conditions deteriorated – such as during the COVID-19 pandemic or due to company-specific issues – these NBLs faced significant challenges in refinancing their short-term debt. As investors and lenders became more risk-averse, they were less willing to provide new funding to institutions with perceived higher credit risks, such as those with substantial asset-liability mismatches.

This situation led to liquidity pressures for NBLs like UNIFIN and Crédito Real, as they struggled to meet their debt obligations and maintain their operations.

While some NBLs (like Tangelo) experienced problems in their operations, these issues were exacerbated by the lack of financing once banks and investors lost confidence in the sector. It is difficult to determine what percentage of the negative impact on these NBLs was a direct consequence of their own operations and what percentage can be attributed to the lack of investor confidence in the sector and the uncertainty in the industry. However, it is clear that both factors played a significant role in the challenges faced by these NBLs.

As market conditions deteriorated and investor confidence waned, NBLs relying on short-term funding to finance long-term loans found it increasingly difficult to secure the necessary financing to maintain their operations. This led to liquidity pressures for NBLs such as UNIFIN and Crédito Real, which only served to intensify the problems they were already facing due to their own operational shortcomings.

Hence, it is important to underscore the imperative for NBLs to adopt robust risk management strategies and harness the power of new technologies. With the rise of Open Banking and its ability to integrate with third-party sources like Sistema de Administración Tributaria (SAT), institutional debt investors can now verify and scrutinize loan data from NBLs in real-time. This not only empowers them but also mandates NBLs to invest in technologies offering increased transparency into the duration of both their assets (loans) and liabilities (funding sources). Regrettably, NBLs often rely on outdated, manual processes, including spreadsheet data analysis, to identify potential liquidity issues. It's high time these practices are replaced with more efficient, automated solutions to ensure greater financial stability and resilience.

Corporate Governance and Transparency Issues

In the cases of Alpha Credit, UNIFIN, and Crédito Real, issues related to corporate governance and transparency have played a significant role in their

financial struggles. Allegations of financial misconduct and accounting irregularities have eroded investor confidence, leading to a decline in stock prices and a loss of access to funding markets. These issues highlight the importance of robust corporate governance and transparent financial reporting in maintaining trust and confidence among investors and creditors.

A notable absence of transparency became apparent when external auditors and rating agencies did not detect or question these practices and aggressive lending strategies in a timely manner. It is important to recognize that the inability of external auditors and rating agencies to identify or express concerns about these potentially problematic practices promptly may have unintentionally compounded the challenges faced by the affected NBLs. In some instances, the delayed detection and intervention might have inadvertently permitted these NBLs to persist in adopting high-risk lending strategies, ultimately contributing to their financial distress and exacerbating the broader issues within the sector.

To address these concerns and restore investor confidence, NBLs must implement stronger corporate governance frameworks and enhance transparency in their financial reporting. This may involve the adoption of more stringent internal controls, greater board oversight, and increased disclosure requirements. In addition, NBLs should foster a culture of ethical conduct and ensure that all employees adhere to the highest standards of professionalism and integrity.

Challenges in Managing Illiquid Assets in the Leasing Industry

Leasing companies, such as UNIFIN, confront the formidable challenge of effectively managing and recouping specialized and illiquid assets used as collateral in instances of lessee default. The intricate process of recovering and liquidating these assets is influenced by factors including limited market demand, regulatory limitations, and the specialized knowledge necessary for accurate valuation. Moreover, the time-consuming and costly undertaking of identifying potential buyers serves to exacerbate this challenge. This issue also hampers leasing companies' ability to accelerate or early terminate agreements following lessee default, ultimately affecting their capacity to recover investments and minimize risks associated with non-payment.

To address this problem, leasing companies often establish low residual values – the price at which the lessee can purchase the asset at the end of the contract if they choose to do so – and raise initial fees and/or rent payments as a means of maintaining profitability and transferring the risk of non-payment to clients. However, these measures may inadvertently weaken clients' payment capabilities, as increased rent payments or initial fees can impose a greater financial

burden on them. As a result, the risk of default persists with the leasing company, since these strategies do not ensure clients' ability to fulfill their financial obligations. In addition, such tactics can lead to unfavorable tax implications and adversely affect market competitiveness.

The challenge of managing illiquid assets can result in suboptimal risk management, hinder the growth and development of leasing companies, and limit the range of assets they can offer to clients. Consequently, it is crucial for leasing companies to carefully balance their risk management approaches with their clients' needs and capabilities in order to secure financial stability and maintain competitiveness within the market.

CRISIS TRIGGERS AND THEIR IMPACT ON MEXICAN NBLs

As previously outlined, the crisis encountered by select NBLs in the Mexican sector can be attributed to a confluence of factors, such as rapid expansion, inadequate credit pricing, asset-liability mismatches, and corporate governance and transparency concerns.

Additionally, leasing companies like UNIFIN faced the challenge of effectively managing and recovering specialized and illiquid assets utilized as collateral in cases of lessee default. This article will now delve into the ramifications of some of these contributing factors on the aforementioned NBLs and discuss their implications for the broader sector.¹

Alpha Credit

Alpha Latam Management and its affiliates, including the prominent Mexican NBL AlphaCredit, confronted a series of financial and legal challenges during their bankruptcy proceedings. These issues originated from accounting irregularities that required the restatement of three years of financial statements and revealed severe inconsistencies in Alpha Credit's credit portfolios and extensive undisclosed liabilities. This led to a substantial erosion of public confidence in the company's accounting controls. In the aftermath of the

¹ The authors have not served as legal counsel for any entities mentioned and have conducted an independent investigation to gather facts, primarily relying on media sources and public legal records. While every effort has been made to ensure the accuracy and authenticity of the information presented, the authors cannot guarantee its complete accuracy without full access to all court documents and up-to-date financial records. The information provided here has been obtained in good faith and with a commitment to professional integrity. Readers are encouraged to exercise their own judgment and consult additional sources to gain a thorough understanding of the subject matter.

scandal, Alpha Credit faced liquidity challenges, ultimately defaulting on its payment obligations and initiating insolvency proceedings in both the United States and Mexico.

Throughout the bankruptcy process, Alpha Credit faced numerous hurdles, such as unexpected asset impairments, weak loan performance, and delays in legal proceedings. Despite these setbacks, creditors agreed to provide \$45 million in debtor-in-possession financing, and the company sold its Colombian assets for \$149 million to repay creditors. In January 2022, Alpha submitted the initial version of their Chapter 11 plan, which underwent several amendments and modifications before the U.S. bankruptcy court approved it in May 2022.

However, the legal process in Mexico experienced delays, with Alpha's Mexican subsidiaries not being admitted into Concurso proceedings until April 2022. The Mexican court eventually accepted the voluntary bankruptcy proceedings of Alpha Latam Management's Mexican units, AlphaCredit Capital, Alpha Holding, and Acercandonos. This pre-pack voluntary filing had the support of more than 50% of the company's unsecured claims from various members of the ad hoc group of creditors.

Crédito Real

Crédito Real, grappling with financial difficulties arising from allegations of financial reporting inadequacies and worsening market conditions, opted for a corporate liquidation process under Mexican law instead of a judicially supervised restructuring.² Having already paid most of its secured creditors (including BBVA Mexico, Scotiabank, Grupo Financiero Banorte, and Banco Santander Mexico), Crédito Real is now immersed in a complex bankruptcy process involving both Mexican and U.S. courts. The company is negotiating a prepackaged Concurso with its ad hoc unsecured creditor group, which represents the majority of its \$2.1 billion outstanding bonds.

Crédito Real's restructuring plan involves negotiating a prepackaged bankruptcy with its unsecured creditors, with nearly half of them agreeing to the settlement. The negotiations also involve the ad hoc unsecured creditor group dropping the involuntary Chapter 11 filing and accepting the transfer of collateral to secured creditors that occurred in 2022. In an effort to improve its financial position, Crédito Real has sold subsidiaries such as CRUSAFin for \$60.5 million and settled debts with various financial institutions.

² The Delaware bankruptcy court faces a critical decision: recognizing the Mexican corporate liquidation process under Chapter 15 or granting an order for relief based on creditors' involuntary Chapter 11 petition. This outcome could significantly impact cross-border investments in the Mexican market.

Nevertheless, the restructuring process has encountered challenges, including concerns over weak recovery prospects from a prepackaged Concurso and potential contestation in court by creditors or minority shareholders. Additionally, Crédito Real's loan book and assets have significantly shrunk, raising questions about the true value of the remaining assets and recovery prospects for creditors.

Impact on UNIFIN

The Alpha Credit scandal had a significant impact on UNIFIN, a major Mexican leasing company and NBL, leading to a halt in new lease and loan originations. UNIFIN's liquidity pressures emerged from a sharp decline in stock price and loss of investor confidence, hindering its ability to raise debt or equity. Consequently, the company was unable to renew credit lines with banks due to unfavorable economic conditions, leading to challenges in meeting its existing payment obligations and ultimately resulting in insolvency proceedings under Mexican law.

UNIFIN filed for Concurso under the Mexican Bankruptcy Law (Ley de Concursos Mercantiles) in January 2023 and is currently undergoing an in-court restructuring process in the conciliatory stage. The company is restructuring its \$7.87 billion debt, which includes senior unsecured bonds, unsecured junior bank debt, secured bank debt, and securitizations.

To alleviate its financial challenges, UNIFIN has taken proactive steps such as the sale of its Frida oil rig, which is believed to have netted between \$55m and \$60m. Although this sale provides crucial liquidity for the ongoing restructuring process, it will only slightly ease the company's substantial debt burden. Simultaneously, the company has reached out to specific firms like Apollo Global Management, Fintech Advisory, and investors from the United States and Asia to secure exit financing.

Moreover, the company is aware of the fluidity of the restructuring timeline, acknowledging that the conciliatory stage could be subject to extensions if they manage to secure approval from 50% of their creditors. This proactive approach shows that the company is actively navigating through the challenges.

Investors, however, have raised concerns about the actual status of the company's loan portfolio due to discrepancies between the reported non-performing loan (NPL) ratio and the actual level of delinquencies. The ongoing crisis at UNIFIN has raised questions about the company's ability to rebuild enough investor confidence to meet demand in the leasing and lending market. The impact of UNIFIN's financial troubles has resonated throughout the Mexican financial system, adversely affecting the reputation of NBLs in the

country. Consequently, other lenders may face heightened scrutiny and encounter difficulties securing financing or maintaining investor trust, potentially affecting the broader economy and access to credit for small and medium-sized enterprises (SMEs).

UNIFIN is also undertaking the sale of additional unspecified assets. Negotiations are ongoing between UNIFIN and an ad hoc group of bondholders, who are demanding changes to the company's restructuring proposal. The group seeks a reduction in the nominal haircut for local debt holders and an increase in the haircut for bondholders and unsecured bank debt.

Tangelo (formerly Mexarrend)

Tangelo, formerly known as Mexarrend, is facing a crisis similar to other Mexican NBLs. The company recently received an acceleration notice from bondholders with over 25% of its USD-denominated 10.25% senior notes due in 2024. Consequently, Tangelo has engaged in talks with its creditors to allow business continuity during the restructuring process. To explore available options and continue as a going concern, the company has engaged restructuring litigation counsel and advisors. Tangelo has decided not to release financial statements until the completion of a forensic review.

The company's liquidity has been strained due to near-term debt maturities, increasing refinancing risk, and adverse economic conditions in the industry. In September 2022, both Fitch and S&P Global Ratings downgraded Tangelo's credit rating, citing its weakened liquidity profile and the impact of market events that undermined investor confidence in the Mexican NBL sector. This downgrade led to difficulties in accessing financing, resulting in Tangelo defaulting on its short-term bonds in January 2023.

As Tangelo navigates its restructuring process, the company's ability to restore investor confidence and stabilize its financial position will be crucial for its long-term survival.

CROSS-BORDER LEGAL CONSIDERATIONS

The bankruptcy and restructuring processes of some of the NBLs have involved both Mexican and U.S. courts, highlighting the importance of understanding the different jurisdictions and legal frameworks involved in insolvency proceedings. When considering restructuring options, Mexican NBLs must weigh the benefits and drawbacks of Chapter 11 bankruptcy and Concurso.

Chapter 11, while effective for some organizations, may be unsuitable for others due to its high costs and stringent requirements. It provides advantages

such as debtor-in-possession financing and an organized reorganization process and often results in more predictable and transparent outcomes than Concurso. However, it also entails significant expenses, labor, and tax compliance obligations.

On the other hand, Concurso may seem like a more attractive option for local businesses, but it has shown substantial unreliability and unpredictability in its outcomes. This alternative frequently poses risks for large corporations, leading to considerable value loss for stakeholders, particularly bondholder creditors. In addition, Mexican courts often exhibit slow acceptance of filings, causing cases to stagnate due to procedural formalities and unconventional delaying tactics. Consequently, the time frames outlined in the Mexican Bankruptcy Law (*Ley de Concursos Mercantiles*) are regularly disregarded.

Mexican NBLs must thoroughly evaluate each approach, and legal professionals need to be well-versed in cross-border insolvency and restructuring cases to effectively guide clients through these challenging processes. Additionally, it is important to note that Mexican courts will not recognize a foreign proceeding involving a debtor with a permanent establishment in Mexico without undergoing the exhaustive process of a full *Concurso*. This highlights the critical need for legal professionals to navigate the complexities of cross-border insolvency.

CONCLUSION

The crisis within Mexico's NBL sector has profoundly impacted companies such as UNIFIN, Crédito Real, Alpha Credit, and Tangelo, providing a crucial case study to evaluate the potential risks and consequences related to rapid expansion, inaccurate credit pricing, asset-liability mismatches, and insufficient transparency and corporate governance. This crisis has significantly eroded investor confidence and heightened uncertainty within the industry, consequently affecting funding accessibility and posing challenges for numerous NBLs. However, the current environment also presents considerable opportunities for well-capitalized and well-managed companies to distinguish themselves and gain a competitive edge.

As a result of the crisis, industry consolidation is anticipated as stronger players absorb or merge with struggling entities, ultimately creating a more stable and concentrated market. Despite recent setbacks, the NBL sector's future remains promising due to the persistent market demand for alternative lending options. This demand, coupled with the lessons learned from the crisis, has the potential to drive enhancements in risk management practices.

The future success of NBLs hinges on their capacity to rebuild trust with investors and lenders, which can be accomplished through increased transpar-

ency, improved reporting, and robust corporate governance. By streamlining operations and refocusing on core business objectives, these institutions can create valuable opportunities for investors and secure the necessary funding for their continued existence.

It is imperative for all stakeholders to learn from the Mexican NBL sector crisis in order to foster a more stable and resilient financial system while simultaneously promoting financial inclusion and stimulating economic growth. As the sector overcomes its challenges and reestablishes trust with stakeholders, the Mexican NBL market will present promising opportunities for both institutions and investors.