Virtual secondary insolvency proceedings under the Recast EIR

Professor Dr. Dominik Skauradszun outlines the first steps in their preparation according to Article 36 EIR

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> SINCE THE PROVISIONS BECAME APPLICABLE FROM THE END OF JUNE, IPs HAVE ADDED VIRTUAL (SYNTHETIC) SECONDARY INSOLVENCY PROCEEDINGS TO THEIR TOOLBOX

The 6th European Insolvency & Restructuring Congress (German Bar Association in cooperation with INSOL Europe) provided the opportunity to further analyse the issue of dealing with the new virtual secondary insolvency proceedings according to Article 36 EIR.

Currently, it appears that the most urgent question for insolvency practitioners is the preparation of such virtual proceedings. As this task requires comprehensive preparation, pursuant to Article 36 (10) EIR, also including avoiding personal liability, the article outlines the first steps to take.

Since the provisions became applicable from the end of June this year, insolvency practitioners (IP) throughout Europe have added virtual (synthetic) secondary insolvency proceedings to their toolbox. The background is easily explained: real secondary insolvency proceedings may hamper efficient administration (recital 41) and jeopardise overall restructuring. Hence, the IP is now entitled to give a promise – called *undertaking* – in order to avoid the opening of real secondary insolvency proceedings. Pursuant to Article 36(1, 3, 4) EIR the IP makes a unilateral declaration in writing and must use the official language of the state in which the virtual secondary proceedings takes place. It is also clear that the *undertaking* concerns the assets in the state of the virtual secondary proceedings and respects the state's distribution and priority rights.

Preparation of the "factual assumptions"

The far more difficult part is that the undertaking shall specify the "factual assumptions" on which it is based, particularly in respect to the value of the assets located in the Member State in question and the available options to realise such assets (Article 36(1) sentence 2 EIR).

The preparation of the virtual secondary proceedings commences with the assessment of the mandatory factual assumptions, which are the local creditors' basis for approving or disapproving the undertaking pursuant to Article 36(5) EIR. Certainly, the approval procedure itself is worth examining in detail.[1] However, Art. 36(5) EIR stipulates that the national rules on restructuring plans are to apply. The approval procedure therefore will differ between the Member States. Furthermore, a wrong presentation of the factual assumptions may cause a claim for damages pursuant to Article 36(10) EIR. Hence, the IP must take this requirement very seriously.

Options to extend the narrow time frame

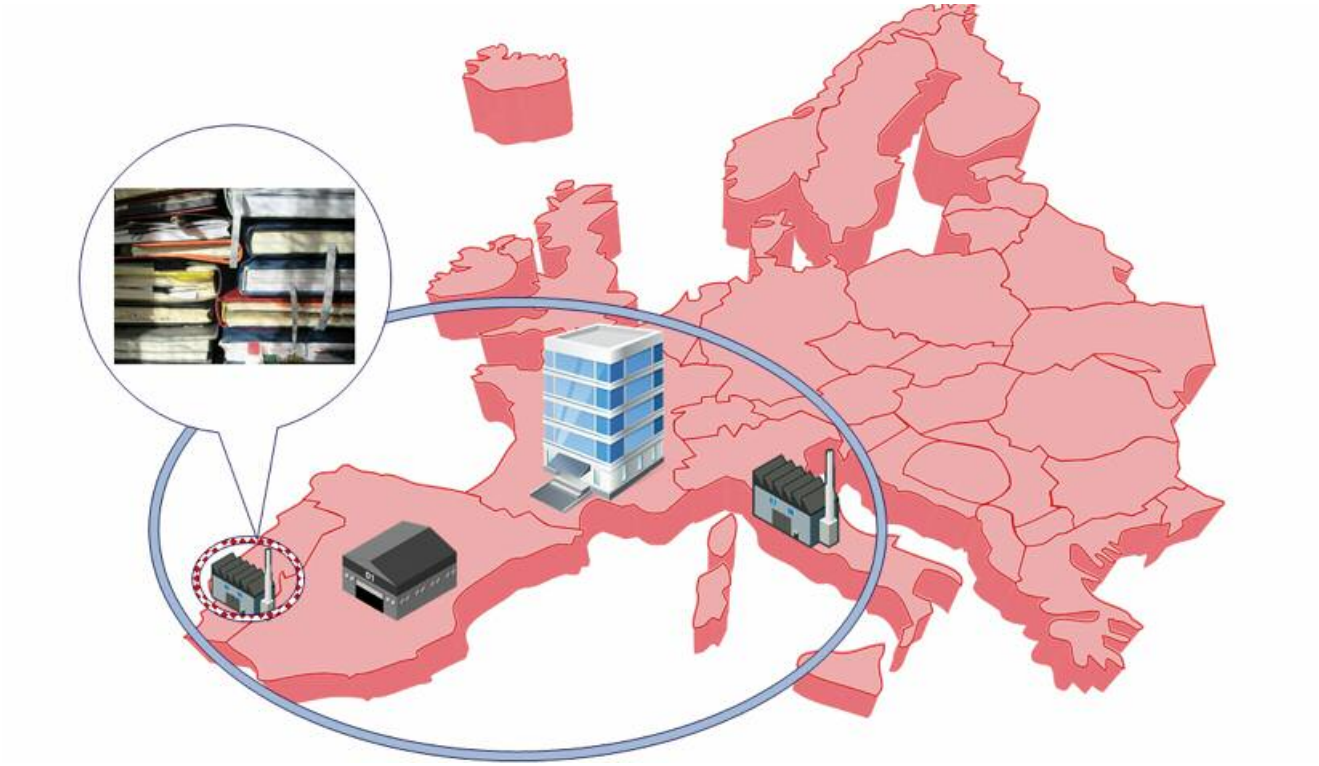
The measurement of factual assumptions is usually time consuming. As cross-border insolvency proceedings in particular have a very narrow time frame, the IP's assessment of the factual assumptions will consequently be of a prognostic nature, which may be incomplete or incorrect. Avoiding a real secondary insolvency proceedings becomes increasingly unlikely the longer this process lasts.

Currently, there are no directly applicable statutory provisions based on which the IP could effect a temporary stay of a request to open secondary insolvency proceedings. However, it may be an option referring to Article 38(3) EIR *mutatis mutandis*. Pursuant to this provision the IP may request a stay of the opening of secondary insolvency proceedings for a period not exceeding 3 months. Literally taken, this provision is only applicable in the event of a temporary stay of individual enforcement proceedings which has been granted in order to allow for negotiations between the debtor and the creditors.

On the other hand, Article 38(3) EIR is the provision most related to the problem in question. Both situations are comparable (ongoing negotiation on the one hand, undertaking as a compromise on the other), hence they shall be treated equally. Without a temporary stay of secondary insolvency proceedings, the new instrument of the undertaking cannot be used effectively, undermining the *effet utile* principle. Therefore, it is to be recommended to request a stay pursuant to Article 38(3) EIR *mutatis mutandis* in order to prepare the factual assumptions.[2]

Time and place specifications of the assets concerned

Art. 36(1) sentence 2 EIR demands that "the undertaking shall specify the factual assumptions on which it is based, particularly in respect to the value of the assets located in the



Symbolised here is a company with headquarters in France and three establishments in Europe. The IP wants to give an undertaking regarding the assets located in Portugal because he wants to restructure the company as a whole. Firstly, he has to figure out the value of the assets situated in Portugal and the options to realise.

Member State" in which the secondary proceeding could be opened. Determining the assets located in that Member State allows for two possible interpretations: either assets are those *which belong* to the establishment situated in the Member State, or the assets do *not need to belong* to the establishment. Following the wording of Art. 36(1) sentence 1 EIR, the second interpretation is more convincing. Hence, all assets which are physically located in the Member State are comprised.

Furthermore, the time of affiliation of the assets must be clarified. Basically, this is the point in time in which the undertaking is expressed, yet the risk remains that once a secondary insolvency proceedings is looming, assets are moved to the Member State in which the main insolvency proceedings is taking place. Should this occur, the approval of the undertaking by the local creditors is in jeopardy.

Data base for factual assumptions

The EIR does not mention how the IP should determine the correct data base for the value of the assets. Depending on whether the establishment is obliged to keep its own trading books (e.g. a foreign company's establishment in Germany), or if the headquarters' books include the assets in question, the data base changes. Since it is not regulated otherwise, the IP can choose from either. In many cases it will be easier for the IP to access the trading books of the headquarters.

Are national or international accounting standards relevant?

The obligor's trading books are kept in accordance with national or international accounting standards, often even both at the same time. Due to different underlying accounting principles, the valuation of the same asset may vary.[3] It may be assumed that the local creditors will argue for the higher valuation. The EIR does not regulate the relevant accounting standard.

A solution approach may be to consider the *prime* accounting standards of the debtor's headquarters as binding, as the IP of the main insolvency proceedings will be familiar with the local prime accounting standards. Additionally, undertakings may be given in different Member States. Following this method of resolution would allow the IP to maintain the same accounting standard in all Member States.[4]

Are the book values or market values of the assets relevant?

Aside from possible differences in the book value, the achievable selling price on the free market could be higher or lower than the value in the books. Some national

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accounting standards, like the German Commercial Code, only allow companies to activate assets up to their initial cost (purchase and production costs). However, revaluation models of international standards, like IFRS, enable companies to activate higher values in case an impairment loss is recovered.

A first step solution could be to take the book value, but to mandatorily use the market value of an asset if the IP gets the information that the values differ. This understanding would be in line with the wording of Article 36(1) sentence 2 EIR which explicitly mentions the "factual" assumptions and not the former situation.[5] Additionally, Article 36(1) sentence 2 EIR requires the IP to explain the options available to realise the assets. The free market will only pay the market value. This is why the IP has to choose the market values if they differ from the book values.

Are liquidation values or continuation values relevant?

There is no provision or recital dealing with the question whether the IP shall work with continuation or liquidation values. It is obvious that the local creditors will claim for the continuation values, since these values are generally higher than the liquidation values. This is at least true for most of the machinery, furniture, vehicle fleet and other used goods. The IP might also be interested in using the continuation values since he/she can take them easily from the trading books whereas the liquidation values are to be evaluated, often with the assistance of further experts.

According to the view expressed here, the focus shall lie on the (virtual) *secondary* insolvency proceedings. This is exactly what Article 36(1) EIR does. The creditors' legal position should be equal to a real secondary proceedings, but not better. Hence, continuation values seem to be the right choice only if the establishment has an economic viability in the case of a real secondary insolvency proceedings. If the establishment lacks economic viability (e.g. if it is merely a warehouse that is not economically independent and therefore cannot survive), then liquidation values shall be used. In order to determine which value is the right one to use, the truly relevant question is whether the establishment is economically viable or not.[6]

Applicable law for the realisation of assets

The applicable law for the realisation of assets is the law of the Member State in which the main insolvency proceedings are opened. This complies with the basic principle pursuant to Article 7(2)(i) EIR and the principle of universality according to recital 23 and the IP's powers (Art. 21(1) sentence 1 EIR). The IP therefore explains the options available to realise the assets under the law of the state in which the main proceedings were opened.

Other factual assumptions

Other factual assumptions exceeding the information required by law may include information about the debtor's liabilities, the number of known creditors or the overall amount of liabilities. Providing information about lodged claims, pending actions and challenged transactions and if assets have been moved out of the Member State in which the secondary insolvency proceedings could have been opened, is also possible.[7]

Consequences of non-compliance with the assumed facts

In the event that the assumed facts do not comply with the true situation, the local creditors may apply court proceedings according to Article 36(7, 8, 9) EIR.[8] Furthermore, the basis for a claim for damages pursuant to Article 36(10) EIR, whose eligibility criteria are not finally examined, could be applicable.

However, the IP only undertakes to comply with the distribution and priority rights, which is a *legal* position.[9] Even if the underlying factual assumptions of the undertaking are incorrect from the outset (e.g. an asset cannot be realised since there is no potential buyer), the local creditors' position is secured. Therefore, the European legislator's decision to refrain from ruling in Article 36 EIR that the IP undertakes concrete amounts was wise.

Conclusion

The preparation of all virtual secondary insolvency proceedings starts with the specification of the factual assumptions. If this first step fails, the undertaking does not even reach the next step: the proposal and approval. Hence, on the one hand the IP must take the preparation seriously; on the other hand, the court should grant appropriate time for the preparation if requested by the IP, pursuant to Article 38(3) EIR *mutatis mutandis*. ■

Footnotes:

1 See *Mangano*, in: Bork/v. Zwieten, EIR, Oxford 2016, Article 36 at 36.16 et seq.
2 *Skauradszun*, "The 'factual assumptions' of the undertaking according to Art. 36 para. 1 s. 2 EIR recast", ZIP 2016, p. 1563.
3 *Schmid*, DStR 2005, p. 80.
4 See footnote 2 at p. 1568.
5 See footnote 2 at p. 1569.
6 See footnote 2 at p. 1570.
7 *Mankowski*, "Undertaking in order to avoid secondary insolvency proceedings pursuant to Article 36 EIR – Synthetic secondary proceedings", NZI 2015, p. 961, 964.
8 *Skauradszun*, "Provisional and protective measures according to Art. 36 para. 9 EIR recast", KTS 2016, p. 419 et seq.
9 See footnote 2 at p. 1573.

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