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Self-administration proceedings: creditor support determines success

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Introduction

The Insolvency Code allows for 'self-administration' proceedings, wherein a debtor retains possession and control of its assets while undergoing reorganisation. Self-administration proceedings are designed to maintain the trustworthy and capable management of the operating company while minimising outside interference. A debtor may apply for self-administration proceedings in order to maintain its ability to manage an insolvent company through the insolvency process, under the supervision of a court-appointed trustee. Self-administration proceedings can be used to liquidate an enterprise; however, they are normally used for a restructuring in connection with a court-driven insolvency process. In these situations, the management stays in place in order to maintain relationships of trust with customers, suppliers and employees – an essential factor for a successful restructuring.

In March 2012 the legislature introduced several changes to the Insolvency Code to facilitate insolvent debtors' access to self-administration proceedings. Under the new legislation, self-administration proceedings can also be combined with protective shield proceedings, which are specific preliminary insolvency proceedings for a period of up to three months which should be used to prepare an insolvency plan in order to restructure the crisis shaken business of the German enterprise.

Legal background

The support of creditors plays an important role in an insolvency court's decision as to whether to accept an application for self-administration proceedings. The court will order self-administration proceedings on the basis of the unanimous support of the preliminary creditors' committee, without requiring further assessment. The court may also repeal self-administration proceedings at any time at the request of a creditor, if and to the extent that such creditor demonstrates that its position is at risk of being adversely affected during the restructuring process. If a substantial impairment of creditor interests is imminent from the outset, the court will refuse self-administration proceedings.

Case law has developed the interpretation of the statutory provisions for self-administration; however, uncertainty remains as to the scope and content of a 'substantial impairment of interests', which will lead the court to refuse an application for self-administration and, where alleged by creditors, will trigger severe consequences for the restructuring process. In a recent decision the Cologne Local Court further clarified the definition of a substantial impairment of interests.

Decision

The insolvent debtor prepared an insolvency plan which included a *pro rata* satisfaction of the insolvency creditors as well as a so-called 'better fortune clause' for the benefit of the creditors. While the insolvency plan was accepted by the creditors and confirmed by the insolvency court, the debtor failed to pay the debt when due under the insolvency plan. Such failure caused a delay in the implementation of the plan and indicated further payment difficulties of the debtor.

The court held that the delay in the implementation of the insolvency plan caused substantial disadvantages for the creditors. The temporary nature of the payment difficulties and the ability to rectify the failure were not taken into account, as the mere delay was considered as an impairment of creditor interests (factoring in the costs of the insolvency proceedings). In addition, the management had failed to disclose certain information to the court-appointed insolvency trustee. The court held that such omission would hinder the trustee's capacity to fulfil the relevant supervisory duties, which further disadvantaged the creditors.

Comment

The decision demonstrates that the initiation of self-administration proceedings requires timely and thorough preparation of the restructuring process. Further, all efforts and achievements of the management will depend on the support of the main creditors. Apart from the points highlighted above, the following aspects should also be considered in the preparation phase.

Management suitability
An insolvent debtor seeking to enter into self-administration proceedings must first demonstrate the suitability of the management to manage the insolvency process and meet the procedural requirements; management unsuitability can also be used by creditors to challenge the debtor's application. Managing directors do not usually have such skills; however, they may appoint specialised legal advisers to guide the management through the proceedings or appoint an experienced restructuring officer as part of the management. Further, shareholders may decide to install new management and engage experts to manoeuvre an insolvent corporation through the restructuring process.

Economic advantage
The second basis for a successful self-administration process is economic advantage to creditors, as compared to regular insolvency proceedings. This factor also becomes relevant with regards to the costs of the self-administration proceedings (eg, the costs for the restructuring officer, legal advisers and court-appointed insolvency trustee).

Restructuring concept
There is a predominant view among German legal authors which asks for a rough restructuring and reorganisation concept to be presented to the court together with the application for self-administration proceedings. This is against the background that an unstructured application for self-administration, which has not been prepared thoroughly or validated in advance, is typically considered detrimental to creditors. According to the statutory provisions, there is a requirement to present a rough restructuring concept in the context of protective shield proceedings in order to demonstrate that such proceedings have prospects of success. However, such a requirement has not been established for simple self-administration proceedings without the protective shield. It could be argued that this view reflects the most promising approach to successfully restructuring a business in insolvency proceedings. Restructuring in self-administration should therefore be preceded by a restructuring concept which has been set up in advance and pre-agreed with at least certain major stakeholders, thereby mitigating the risk of being subsequently challenged in the insolvency process.

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