DE BERTI ■ JACCHIA

De Berti Jacchia Franchini Forlani
studio legale

Insolvency: the Italian legislator swings to and fro

Cristina Fussi

A common experience of most European insolvency law systems is the legislators' constant swinging backwards and forwards in their attempts to find a balance between the interests of the creditors (which inspired the legislator when insolvency laws were enacted for the first time in1942 in Italy) with those of the debtor and its owners, as well as the need to protect jobs and rescue viable businesses for the benefit of the economy as a whole.

The first Italian insolvency law was enacted in 1942, and was modelled on the German Konkursordnung. It had the goal of regulating the insolvency of individual entrepreneurs in such a way as to ensure liquidation of their assets and satisfy their creditors, on a *par condicio* basis.

No second chances, or rescue provisions were contemplated.

In fact, by tradition, insolvency was considered as one of the worst breaches of the law so penalties could involve limitations to personal freedom.

After the war and for many years during the booming economy, the structure of insolvency legislation did not change. The idea was that bankruptcy is a way for the economy to defend itself: the weaker and less efficient enterprises are destined to fail and disappear.

The first changes to Italian insolvency law came at the end of the seventies in order to address the insolvency of large companies, for which the 1942 law did not provide the necessary tools. These introduced the ideas of safeguarding the continuity of the business and protecting jobs for the first time, but during the following decade the legislator swung back to strengthening protection of the interests of the creditors, focusing on an extensive use of avoidance actions and an increase in the number of claims classed as having priority.

The first comprehensive reform of Italian insolvency law took place in 2005 and was aimed in the first place at speeding up the liquidation process and making it more efficient, but contained a set of provisions inspired by the principle of giving the entrepreneur a second chance.

This reform, and the subsequent amendments up to 2012 transformed the previous structure into a Chapter 11-like preventive restructuring framework with a view to the rescue of the business (*concordato preventivo* or arrangement with creditors). That was sought to be achieved *inter alia* through (i) reducing powers of the judge and increasing the role of the committee of creditors and the receivers, in a sort of privatization of the process that nevertheless still provides for the involvement of the court for the stay of enforcement actions and cram-down of creditors; (ii) abolishing declarations of bankruptcy *ex officio* and automatic declarations of bankruptcy in the event of failure to reach a composition with creditors; (iii) abolishing those provisions, which treated the bankrupt entrepreneur as an outcast.

The new provisions did not even consider payment of the debt in a certain percentage and referred instead to debt restructuring and any form of satisfaction (including without limitation "… *the assignment of receivables, assumption of debts, other extraordinary operations, transfers to creditors or their subsidiaries of shares or financial instruments, as well as restructuring agreements and assessed plans*…") that, if accepted by (the majority of) the creditors, could lead to the solution of the crisis and the continuation of the business.

So conceived, the restructuring option became the preferred one as compared to liquidation options, also due to new restrictions on receivers to taking avoidance actions (by limiting the duration of the suspicious period and increasing the number of unavoidable transactions). While liquidation of the existing assets is the only way to satisfy the creditors in a judicial liquidation (bankruptcy), the restructuring option should inevitably be focused on the preservation and continuation of the business. Otherwise, it would become a duplication of the judicial liquidation (bankruptcy) option.

The *concordato preventivo* was indeed shaped as a "contract" between debtor and creditors, with the latter having to evaluate the viability of the proposed *concordato* plan from an economic/financial perspective, while only the assessment on the formal/legal viability of the plan was left to the court.

In 2012, a second reform added new elements in favor of the restructuring option:

- the automatic temporary stay of individual enforcement actions upon filing by the debtor of a pre-restructuring proposal and for a maximum term of 180 days until filing of the plan; initially, the debtor was allowed full control over the business during this period, but a year later a further amendment introduced the possibility for the court to appoint a commissioner to supervise the debtor's activity;
- new tools to facilitate the continuation of the business (with rules on executory contracts, including with public entities, the possibility of postponing payment of privileged creditors until one year after court approval of the *concordato*, introduction of deemed consent);
- exception to the absolute priority rule (cram-down of dissenting creditors) with banking institutions;
- rules on interim financing.

Some of the above tools have been used extensively, even abused, such as in the case of the so call *pre-concordato* proposal. This tool was introduced in order to favor a timely attempt to find a restructuring agreement insofar as it gives the possibility to the debtor to apply for a preventive restructuring, enjoy for a few months the stay of individual enforcement actions, and remain in possession and control of the business while preparing the restructuring plan and proposal to be submitted to the creditors' vote. It has however been often used as a way to delay an unavoidable judicial liquidation/bankruptcy and enjoy the stay of enforcement actions.

This, as well as other elements, led the legislator in 2015 to listen to the requests of industrial associations taking the part of creditors and re-introduce restrictions and limits to the *concordato* procedure, such as the abolishing of deemed consent to the *concordato* proposal and the introduction of a minimum 20% satisfaction of the creditors.

The idea that the *concordato* could be a good deal for the debtor is indeed still in the mind of practitioners and creditors, and has often been behind the "to-ing and fro-ing" of legislation.

More in general, the new trend brought an increasing mistrust of the *concordato* procedure, the main arguments being that the *concordato*, even when it is not a means of delaying judicial liquidation, is too expensive, and brings low satisfaction to the creditors. The *concordato*'s detractors deem that the judicial liquidation of the debtor's assets is a more appropriate option, but they do not take into account the fact that the lengthy procedure necessary to liquidate the assets and the low price thereof certainly do not concur to give better satisfaction to the creditors.

In this respect, i.e. in order to ensure more effective security, the legislator introduced in 2016 for the first time tools such as the floating charge, which go in the direction of allowing secured creditors to obtain out-of-court satisfaction.

Yet another reform is now underway, the guiding principles of which have been approved by the Senate on October 19 after the approval of the Chamber of Deputies back in February. The law containing the guiding principles of the reform enters into force today, November 14, 2017 and the decrees that will implement these principles will be passed in the coming twelve months.

In general, the new reform is aimed at ensuring effective and speedy procedures, including liquidation procedures.
In an effort towards harmonization with EU legislation, the term bankruptcy will be abandoned: insolvency and judicial liquidation will replace it.

In the same direction, the term state of crisis will be defined and an early warning system will be introduced (by means of incentives for debtors, early warning obligations for tax agencies with penalties for failure to alert, such as the loss of priority status) as a way to overcome the “my baby cannot fail” attitude of Italian entrepreneurs.

A mediation scheme will also be introduced, aimed at favoring restructuring options.

The new reform will impact in various ways on existing restructuring options.

1. In out-of court restructuring agreements (which have been used infrequently, and very rarely with success), enforcement actions can at present be stayed by the court if the proposal has the consent of at least 60% of the creditors and the dissenting creditors are paid in full (absolute priority rule).
   In line with the EU Directive’s principles, the reform will reduce the required quota of consenting creditors to below 60%, provided the dissenting creditors are paid in full, <u>and no stay of enforcement actions is demanded by the debtor.</u>
2. When creditors are banks or financial institutions, currently, with the agreement of 75% of the creditors, the restructuring proposal and/or moratorium can be imposed on the dissenting creditors of the same category (cram-down of dissenting creditors).
   With the reform, the same provision will be applied to other classes of creditors.
3. The aim is to make the c*oncordato preventivo* the preventive restructuring option for the rescuing of the business because so far only 4,5% did not eventually end in a liquidation. So the initial text of the reform provided that it could <u>only</u> be aimed at rescuing the business (no possibility of liquidation). During the discussion of the bill, this has been changed and it now provides that the procedure can also be aimed at liquidation (in particular, of a going concern), provided a third party contributes finance that brings benefit to the creditors. This is not bad news, since the sale of the going concern to a third party will remain as an important rescue option.
   Limits to the duration of the *concordato* will be provided, as well as more a more effective control on the implementation of the receivership proposal. The court will again have powers to evaluate the merits of the plan, and this will make practitioners very unhappy. New rules will be provided with regard to executory contracts.
   Stricter rules will be applied to select the best trained practitioners and to determine their compensation.
4. Specific provisions address the insolvency/restructuring of companies belonging to the same group. It is envisaged that one single procedure is opened, but this will not be judicial. If more than one procedure is opened, they must be coordinated.

5. There will be improvements in the liquidation process (less obstacles and more certain timing). In an attempt to provide more effective security and enforcement proceedings, the legal provisions on floating charges will be further detailed.

This ongoing reform is certainly aimed at making the financial crisis of a business emerge and being resolved earlier and in a safer way, in the interests of the creditors.

It contains however important elements that should favour debt restructurings, including the possibility – so far granted only when creditors are banking institutions and now extended to other classes – to impose the cram-down of dissenting creditors with the agreement of 75% of the creditors.

Finally, it may be interesting to note that the “step backwards” of the legislator, from an initial version of the bill where the *concordato* could not contemplate the liquidation of the business to the current version where it can (provided the purchaser makes available the funds necessary to satisfy creditors to greater advantage than if the business continued) will, at first sight, favor the distressed M&A market.

A doubt remains: why has the EU legislator, in the draft Directive that will in the next few years hopefully harmonize legislation on the subject throughout the EU, deemed by default as being more favorable to the creditors the enterprise value, which is the value attributed to the business when it continues (with the same shareholders who led to the distress), than the going concern value, which is the value attributed to the business when it is transferred to third parties?