ALERT MEMORANDUM

Italy's New Insolvency Code

January 28, 2019

On January 10, 2019, the Italian Government enacted a new bankruptcy code (the "Code") which replaces large swaths of Italy's insolvency legislation dating back to 1942 (though subject to significant amendment in recent years), in accordance with certain principles that had been set out by the Italian Parliament in 2017, also taking into account the recommendation of the EU Commission of March 12, 2014 on business failure and insolvency, which in turn formed the basis for the draft EU directive on preventive restructuring frameworks currently under discussion (the "Proposed Directive"). Although the Code appears to incorporate a number or principles embodied in the Proposed Directive, it is likely that further amendments will be necessary to conform the Italian bankruptcy laws to its final text.

The Code will enter into force after 18 months of its publication on Italy's official journal (which is expected to occur imminently).

The Code will entail a major overhaul of Italy's bankruptcy and restructuring framework, including by (*i*) introducing alert measures that seek to identify and address distress situations at an early stage, (*ii*) providing mechanisms designed to facilitate the restructuring of corporate groups, (*iii*) limiting the use of judicial compositions with creditors (*concordato preventivo*) to going-concern restructurings (as opposed to liquidations), and (*iv*) re-defining the requirements of debtor-in-possession financings.

The Code also amends certain important aspects of Italian corporate law.

This is the first of a series of alert memoranda and is intended to provide a general overview of the key features of the reform introduced by the Code. More focused alert memoranda will follow to describe in greater detail specific topics arising from the Code.

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I. General Principles

The Code sets forth certain general principles applicable throughout the reformed framework. These include:

- a statutory definition of "distress" (*crisi*),[1] equated to probable future insolvency, in turn defined as the determination that prospective cash-flows will be insufficient to meet the debtor's expected obligations over the next 6 months;
- the establishment of a single judicial process to ascertain the insolvency, applicable to all debtors irrespective of the nature of the ensuing insolvency proceedings;
- ensuring that restructuring proceedings seeking to maintain the debtor's a going concern are treated by the courts as a matter of priority; and
- while the rules applicable to bankruptcy liquidation proceedings are not substantially affected, the term "bankruptcy" (*fallimento*) is abandoned and the relevant proceedings are renamed "judicial liquidation" (*liquidazione giudiziale*).

II. Alert measures

The Code introduces a system that appears to be inspired by the so-called "alert measures" (contemplated in other jurisdictions, such as France) and imposes an active obligation upon the debtor's corporate bodies to take the necessary actions to address a situation of distress at a time when insolvency could still be avoided.

This system of alert measures will not apply to listed companies, "large enterprises" (as defined under the laws of the EU)[2] and financial institutions.

Each local chamber of commerce will be required to establish certain crisis composition organizations (the "CCO"),[3] which will play a central role in the this context.[4]

The CCO may be involved either voluntarily by the debtor or by the debtor's supervisory bodies, auditors or certain public creditors.

Debtor's initiative

Upon request of the debtor, the CCO will assist the debtor in working out a consensual arrangement with its creditors. Pending the restructuring discussions, the debtor may also apply to the court for the adoption of such protective measures (*e.g.*, a moratorium) as appear appropriate to enable a successful outcome of the negotiations.

In case no agreement is reached within a 6-month term, the CCO will recommend that the debtor file for court-supervised restructuring or insolvency procedures within 30 days and, in case the debtor fails to do so, the CCO is required to notify the court so that it can determine whether to open an involuntary insolvency proceeding.

Supervisory bodies' request

If the supervisory bodies of a company (*i.e.*, the board of statutory auditors (*collegio sindacale*) or the supervisory board) or its auditors believe that the company is in distress, they will be obliged to inform the board of directors promptly of their determination, thereby giving a term of up to 30 days for the board to act. In the event that the directors

[1] Which will be a requisite to trigger the new alert measures (see Section II), be granted access to *concordato preventivo* proceedings (see Section IV) or propose a Court-ratified restructuring agreement (see Section V).

[2] Notably, Article 3, paragraph 4, of Directive 2013/34/EU of June 26, 2013, *i.e.* undertakings meeting at least 2 of the following requirements: total assets, Euro 20 million; net revenues, Euro 40 million; average number of employees, 250.

[3] The introduction of the CCOs appears consistent with the Proposed Directive, Article 1 of which provides that "*Member States shall ensure that debtors have access to one or more clear and transparent early warnings which can detect circumstances that may give rise to the likelihood of insolvency*" and, among such early warning tools, Article 1a(c) includes "*advisory services by public or private organisations.*"

[4] In practice, once the CCOs are involved (whether upon request of the debtor or as a result of a notice from the debtor's control bodies or qualified creditors), the CCO will appoint a committee of at least three experts who will be in charge of assisting the debtor in addressing the situation of distress.

fail to follow up with appropriate initiatives, the supervisory bodies must directly inform the CCO of such situation.

Public creditors' request

Finally, certain public creditors (such as the tax administration, the tax collection agencies and the social security organizations),[5] are required by law to inform the debtor when its exposure towards them has exceeded certain statutory thresholds and that, should the debtor fail to pay its outstanding liabilities or otherwise address the situation of distress (by requesting the assistance of CCO or start restructuring or insolvency proceedings) within 90 days, they will inform the debtor's supervisory bodies and the CCO of such situation.[6]

Debtor's failure to act

Where the CCO is involved upon notice of the debtor's supervisory bodies or the above-mentioned public creditors, the CCO will convene the debtor and grant a term of up to 6 months for the debtor to seek, with the assistance of the CCO, a consensual restructuring solution with its creditors.[7]

In the event that the debtor does not cooperate, the CCO must notify the court so that it can determine whether to open an involuntary insolvency proceeding.

III. Corporate group restructuring

The Code also introduces a long-awaited set of (mainly procedural) rules governing the insolvency of corporate groups applicable to all entities whose center of main interest is in Italy.

In particular, insolvency proceedings with respect to a group of companies may be started through a single petition to the same court (regardless of the location of the registered office of the group members) and will be supervised or managed by the same trustee or judicial commissioner (as the case may be, depending on the type of proceedings).

If the proceeding consists of a composition with creditors (*concordato preventivo*), the entities may submit to the court and offer the creditors a single coordinated plan of reorganization for the group. This single plan, however, will continue to be required to reflect the separate assets and liabilities of each member of the group (*i.e.*, there will be no consolidation).

Creditors of the various group debtors will be convened at the same meeting but will vote as separate classes. The plan will be deemed approved if the required majorities are reached within each group entity (*i.e.*, the majority of claims, by value, and if classes are formed the majority of classes of each group entity).

Finally, intra-group creditors will be excluded from the vote.

IV. Changes to the judicial composition with creditors (*concordato preventivo*)

The Code's stated intention in reforming the judicial composition with creditors (*concordato preventivo*) is to strike a fairer balance between the interests of debtors and creditors, as various recent reforms had been criticized as being too debtor-friendly.

Protection against enforcement actions

One important feature of *concordato* proceedings resulting from prior reforms was that, upon the simple making a 'blank' filing for *concordato* (*i.e.*, one that does not contain a restructuring plan or other substantive information), a debtor could immediately benefit from an automatic stay on enforcement and *interim* actions by its creditors, which stay could continue in practice indefinitely pending the *concordato* proceedings.

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[5] The involvement of "*accountants, tax and social security authorities to flag to the debtor a negative development*" is also contemplated by the Proposed Directive as an example of early warning tool.

[6] However these creditors are not required to flag the debtor's situation of financial distress to the CCO if the debtor shows that it holds receivables towards public administrations in an amount at least equal to 50% of its exposure towards the relevant public creditor.

[7] The CCO however must terminate this process if the debtor shows (and an independent expert certifies) that it holds outstanding significant receivables towards the public administrations.

With a view to addressing frequent perceived abuses by debtors, the Code now provides that, even though such stay will continue to be triggered by a filing by the debtor (provided the filing requests such protection), the court will be called to confirm it or revoke it at its first hearing following the filing (and, if initially confirmed, the court may revoke it later pending the proceedings) in its discretion. In any event, such stay may not last for more than 12 months.[8]

Types of concordato plans

Concordato proceedings contemplating the full liquidation of the debtor's assets (*i.e.*, with no preservation of the business as a going concern) will no longer be permitted, unless the shareholders or other third parties contribute equity funds in an amount sufficient to increase the expected recovery of unsecured creditors by at least 10% (provided that their absolute recovery is at least 20%).

In addition, *concordato* plans envisaging the continuation of the debtor's business as a going concern[9] ("Business Continuity") will be permissible only if they contemplate that at least 50% of the debtor's employees will continue to be employed in the business for a certain period after the court confirmation of the plan.

Rescheduling of secured creditors

Under current law, a Business Continuity *concordato* may provide for a rescheduling of the claims of secured creditors for up to 1 year (from the date of the court confirmation of the plan), in which case these creditors are not entitled to cast their vote on the plan, provided they are paid in full. However, it used to be debated whether a longer rescheduling of the claims of secured creditors was permitted so long as the plan was submitted to their vote (and, if so, which amount of their claim should carry a vote).

In this respect, the Code confirms that the claims of secured creditors may be rescheduled for a longer period, but only up to 2 years, and clarifies that in such case the creditors are admitted to vote on the plan in an amount equal to the excess of (*i*) the face value of their claims (including interest at the statutory rate accrued thereon) over (*ii*) the present value of the payments envisaged under the plan, discounted on the basis of a rate equal to 50% of the interest rate accruing on late payments on commercial transactions under the Italian implementation of Directive 2000/35/EU.[10]

Formation of classes of creditors

Finally, the Code provides that separate voting classes must (as opposed to may, under current law) be formed in respect of: (*i*) tax or social security claims (unless these are contemplated to be paid in full); (*ii*) claims guaranteed by third parties or secured on their assets; (*iii*) claims proposed to be satisfied other than in cash; and (*iv*) in the event that a creditor-proposed plan is to be voted on, the creditors that submitted such plan.

Also, in the event that a single creditor holds more than 50% of the aggregate debt of the debtor, the approval of the plan requires the favorable vote of the majority of creditors in number (in addition to the majority of claims).

V. Court-ratified Restructuring Agreements

Under current law, restructuring agreements entered into between the debtor and creditors holding at least 60% of the aggregate liabilities may – subject to certain conditions – be ratified by the court, in which case, *inter alia*, payments and transactions made thereunder cannot be clawed back by the trustee in case of subsequent bankruptcy liquidation of the debtor.

These agreements are in principle binding only on their participants. However, their effects may, under current law, be extended to dissenting financial creditors[11] of a given class, provided that (*i*) at least

[8] This is consistent with the Proposed Directive, Article 6(7) of which provides that "*the total duration of the stay of individual enforcement actions … shall not exceed twelve months*."

[9] Whether directly by the debtor entity or indirectly by another entity to which the debtor's business has been sold or contributed pending the proceedings or pursuant to the *concordato* plan.

[10] At the date of this memorandum, the interest rate applicable for the first half of 2019 is equal to 0%.

[11] These are defined as the banks and certain other financial intermediaries.

50% of the total debt is owed to financial creditors and (*ii*) consenting creditors hold at least (*a*) 75% of the financial debt in that class and (*b*) 60% of the total debt.

Under the Code, such effects may now be extended to any dissenting creditor in a given class, regardless of its circumstances or the nature of its claims, provided that either the agreement entails the debtor's Business Continuity or at least 50% of the total debt is owed to financial creditors.

Finally, the Code provides that the general requirement that creditors representing 60% of the total debt participate in the agreement can be reduced to 30% if, among other things, the agreement does not extend its effects to non-participating creditors.

VI. Debtor-in-possession Financing

Finally, the Code has reorganized several provisions relating to the ability of the debtor to obtain new financing during a restructuring.

Under the Code, a debtor having filed a *concordato* application (or a petition to have a restructuring agreement ratified by the court) may request court authorization to obtain debt financing, provided that the debtor's plan envisages the Business Continuity. Along with the request, the debtor must file a report from an independent expert certifying that the financing is expected to enhance the recovery of the creditors (which certification may be waived in case of urgency).

As per current law, the claims of the lenders under these financings have super-priority status (*prededucibili*). The Code, however, clarifies that such status can later be set aside in a subsequent judicial liquidation of the debtor if (*i*) the debtor's petition or the third party expert's certification omitted material information or the debtor otherwise used fraud on the court in order to obtain its authorization and (*ii*) the trustee shows that the applicable lender was aware of such omissions or fraud at the time it provided the financing.[12]

VII. Payment of secured financial lenders

Under current law, upon filing of a *concordato* application, the debtor may not, with limited exceptions, repay any of its prepetition creditors until confirmation of the plan.

The Code reiterates this principle, but introduces a peculiar exception: in case of a loan secured on assets of the debtor that are instrumental to the operation of its business, the debtor may request the court to authorize it to pay any overdue amounts or future instalments of the loan, on condition that the debtor's request is supported by an independent expert certifying that (*i*) the liquidation value of the collateral would be sufficient to ensure a repayment of the secured creditor in full; and (*ii*) the repayment which the debtor seeks to authorize does not undermine the rights of the other creditors.[13]

VIII. Impact on corporate law

The Code also touches upon certain rules of Italian corporate law incidental to its subject matter. Chiefly:

- companies and their corporate bodies will be required to adopt appropriate organizational models designed to promptly detect and address a situation of distress;
- the statutory obligation to convene the shareholders' meeting to recapitalize or wind-up the company (which is triggered by losses exceeding 1/3 of the share capital) is suspended in the event that a court grants a

[12] This limitation seems consistent with the EU Commission's initial draft of the Proposed Directive, Article 16(1) of which provides that "*new and interim financing shall not be declared void, voidable or unenforceable … unless such transactions have been carried out fraudulently or in bad faith*." However, the latest version of the Proposed Directive published on December 17, 2018, no longer makes reference to fraud or bad faith but simply leaves the Member States to lay down additional grounds.

[13] Arguably because of the priority enjoyed by the lender over the other creditors by virtue of its security over the collateral so that, in any event, the other creditors would not be entitled to share in the liquidation proceeds until full repayment of the secured lender.

protective measure pending the restructuring effort under the auspices of the CCO;[14]

- a broader set of companies will be required to appoint a board of statutory auditors or external auditors than is currently the case.[15]

In contrast to most of the other provisions in the Code, these changes will be effective 30 days after publication of the Code in the official journal.

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[14] Under the existing legal framework, such suspension applies only upon filing a petition to be admitted to *concordato* proceedings or ratify a restructuring agreement.

[15] In particular, for limited liability companies (*società a responsabilità limitata*), the obligation is triggered when two of the following thresholds are exceeded: total assets Euro 2 million (instead of the current 4.4 million); revenues Euro 2 million (instead of the current 8.8 million); average number of employees: 10 (as opposed to the current 50). The obligation becomes no longer applicable if none of the above-mentioned thresholds is exceeded for at least 3 consecutive years (as opposed to the current 2).