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New Rules on Restructurings: Italian Bankruptcy Law Increasingly Aligned to US Chapter 11

Italian Bankruptcy Law has been extensively reformed in recent years in order to focus on the reorganization of distressed and failing businesses rather than on their liquidation. The Law Decree adopted by the Italian Council of Ministers, dated June 22, 2012, contains new provisions which aim at facilitating the reorganization of distressed businesses and increasing the efficiency of the Italian bankruptcy system.

Italian Bankruptcy Law[1] has been extensively reformed in recent years. Until 2005, the Italian bankruptcy system was centered around the idea that failing businesses should be liquidated[2] and insolvent debtors expelled from the market. Therefore, the typical outcome of an insolvency proceeding was the liquidation of the debtor's assets.

Based on the assumptions that liquidations are inefficient and costly to society, and that reorganizations of failing businesses are a better option so long as there is a going-concern value to be preserved, the Italian Bankruptcy Law has been modified to reflect this new approach to dealing with distressed and failing businesses.

Between 2005 and 2010, the Italian legislature enacted several amendments in order to, among other things: (i) introduce new restructuring proceedings (the "recovery plans"[3] and the "Article 182-*bis* restructuring agreements"[4]), (ii)

1 Royal Decree No. 267 of March 16, 1942, as amended.

2 The extraordinary administration proceedings set forth by the Legislative Decree No. 270 of July 8, 1999, as amended (the so called "*Prodi Law*") and of the Law Decree No. 347 of December 23, 2003, converted into Law No. 39 of February 18, 2004, as amended (the so called "*Marzano Law*") represent exceptions to this general approach.

3 A recovery plan pursuant to Article 67, paragraph 3, letter d) of the Italian Bankruptcy Law is an instrument setting forth certain actions (which may include debt reschedulings, payments, granting of collateral, etc.) to be carried out by the debtor (and typically one or more of its creditors) to restructure the debtor's indebtedness and rebalance its financial structure. The feasibility of the recovery plan must be certified by an independent third-party expert. Actions carried out pursuant to a duly certified recovery plan are shielded from claw-back actions and certain criminal liabilities in case of subsequent bankruptcy of the debtor.

4 Restructuring agreements pursuant to Article 182-*bis* of the Italian Bankruptcy Law are prepackaged reorganization plans that can achieve the debtor's restructuring by any means provided that (i) an independent third-party expert certifies the feasibility of the plan; (ii) creditors holding at least 60% of the total credits vis à vis the debtor approve the plan and (iii) the competent bankruptcy court ratifies the plan. Dissenting creditors must be paid in full and cannot be subject to cram down. Restructuring agreements are filed with the companies' register and, upon publication (or earlier, if certain conditions occur), all individual enforcement or protective actions are stayed for 60 days. Creditors and third-parties in interest may file objections to the restructuring agreement within 30 days from its publication in the companies' register. Actions carried out pursuant to a certified and approved restructuring agreement are shielded from claw-back actions and certain criminal liabilities in case of subsequent bankruptcy of the debtor.

modify the characteristics and scope of the *concordato preventivo*[5] (composition with creditors), which has become a proceeding resembling a traditional Chapter 11 case[6] rather than one aimed at achieving a fast liquidation of the debtor's assets (as it was originally intended) and (iii) establish a first set of rules relating to the granting of financing during the restructuring phase.[7] Such reforms were aimed at providing the tools necessary to preserve a business when its going-concern value is higher than the liquidation value of its assets, so that its restructuring would benefit all the constituencies involved and in particular the creditors.

Legal scholars, commentators and practitioners concurred, however, and experience has shown, that the system needed further refinements in order to, among other things: (i) grant the debtor an earlier relief from enforcement and protective actions carried out by individual creditors and provide incentives for an early emergence of the debtor's crisis; (ii) establish clear rules regarding the management of the business during the restructuring process and (iii) provide an exemption from the application of certain rules regarding companies' minimum capital requirements during the time necessary to carry out the restructuring.

The Law Decree adopted by the Italian Council of Ministers to stimulate the Italian economy, dated June 22, 2012 (the "Decree")[8], contains, among other things, amendments to the Italian Bankruptcy Law which represent a new critical step in the process of reforming the bankruptcy system and is intended to address the above indicated shortcomings.

Section III of the Decree contains provisions that—in addition to amending certain rules pertaining to recovery plans and Article 182-*bis* restructuring agreements[9] and harmonizing the fiscal treatment of debt reductions in the context of restructuring proceedings[10] —are aimed at facilitating the restructuring of distressed entities along the lines of the key principles underlying the US Chapter 11 process.

I. New Procedural Rules

A. Early Automatic Stay

One of the most evident shortcomings of the current system is that distressed debtors cannot obtain immediate relief from individual enforcement and protective actions once their crisis emerges and thus have no incentives to favor an early emergence of the same, since creditors typically start collecting their credits and enforcing their securities as soon

[5] Under the *concordato preventivo* set forth by Article 160 *et seqq.* of the Italian Bankruptcy Law, a distressed debtor may propose to its creditors a plan of reorganization that can achieve the restructuring of the business by any means, provided that such plan is, among other things, (i) certified as to its feasibility by an independent third-party expert; (ii) approved by creditors holding at least the majority of the credits entitled to vote and by the majority of the classes if the plan provides for the establishment of classes of credits; and (iii) ratified by the bankruptcy court. The court may cram down dissenting creditors if the plan is approved by the required majorities and the court finds that dissenting creditors will receive under the plan at least as much as they would potentially receive under any available alternatives. The court's analysis typically entails a comparison between the amount the creditors will receive under the proposed plan and the liquidation value of the business. It cannot be excluded, however, that dissenting creditors propose competing plans for the purpose of showing the court that they would recover a greater amount of their credits under available alternatives.

[6] 11 U.S.C., §§ 101 *et seqq.*

[7] Article 182-*quater* of the Italian Bankruptcy Law.

[8] The Decree has been adopted "*subject to further amendments*" and must be converted into Law within 60 days following its publication in the Italian Official Gazette.

[9] *See*, respectively, Article 33, paragraph 1, letter a) and letter e) of the Decree.

[10] *See* Article 33, paragraph 4 of the Decree.

as knowledge of the debtor's crisis becomes widespread. An early emergence of the debtor's crisis and the protection of its assets, however, are essential to avoid delays and a disorderly rush by individual creditors to seize the debtor's assets, which typically result in irreparable harm to the business and to the restructuring process.

Under a *concordato preventivo* proceeding, a distressed debtor may propose to its creditors a plan that may achieve the debtor's reorganization by any means.[11] The Italian Bankruptcy Law provides, however, that a debtor applying for a *concordato preventivo* must file, together with the relevant petition, among other things: (i) its proposed plan of reorganization, duly certified as to its feasibility by an independent third-party expert; (ii) a report on the financial and economic situation of the business; (iii) a list of all secured creditors; and (iv) an analytic estimate of the value of its assets. The same documentation must be filed together with an Article 182-*bis* restructuring agreement.

This means that during the time necessary to prepare, negotiate and file all such documents (and in particular the certification of the third-party expert, which is typically time consuming), the debtor is exposed to enforcement or protective actions by individual creditors.

By contrast, Chapter 11 provides for the automatic stay of almost all actions to recover pre-petition debts upon the filing of the Chapter 11 petition.[12] Thus, the Chapter 11 solution grants a so called "breathing spell" which allows the debtor to retain property in which creditors have interests for the time necessary to prepare and negotiate its plan of reorganization.

The Decree now adopts the same solution for the *concordato preventivo* (and, indirectly, for Article 182-*bis* restructuring agreements) by providing new rules pursuant to which a debtor may obtain the stay of individual enforcement and protective actions upon the filing of a petition for *concordato preventivo* and its registration in the companies' registry (*See* Section I.D. below). The filing of the plan of reorganization and of the other required documents is then deferred to a term set by the bankruptcy court between 60 and 120 days following the date of the filing of the petition.[13] Within the same term, the debtor may alternatively file an Article 182-*bis* restructuring agreement, together with the same required documents.[14]

The new rules are of paramount importance and will have a deep impact on the way restructurings will be carried out in Italy in the future. Indeed, the new rule provides for much quicker access to bankruptcy protections and maximizes the debtor's leverage vis à vis its creditors. While at present a debtor must prepare its plan of reorganization under the constant threat of the commencement of individual enforcement actions, the new rule will grant the debtor a "breathing spell" of up to 6 months to prepare and negotiate its plan of reorganization without interference.

Moreover, by providing an early stay of individual enforcement and protective actions, the new rule should also favor an early emergence of the debtor's crisis, as the debtor will not have to fear the commencement of creditor actions.

It is quite apparent from the above discussion and the further details throughout this note that the new rules make the role of the independent expert even more central to the procedure than under the prior regime. This is likely the reason

[11] Including debt for equity swaps, contribution in kind of the business and other extraordinary transactions.

[12] *See* Section 362(a) of the Bankruptcy Code.

[13] Such term can be extended by the Court up to 60 additional days for justified reasons.

[14] It is worth noting that a 120-day period is also the default term for a debtor to file a plan of reorganization under Chapter 11 (*See* Section 1121(a) of the Bankruptcy Code).

underlying the new, specific criminal law provisions dealing with possible misconduct by the expert while discharging its duties.[15]

B. Obligations Incurred After the Filing of the Petition for *Concordato Preventivo*

As a logical corollary of the automatic stay commencing at an earlier stage of the restructuring process, the Decree also provides that all actions legally carried out by the debtor between the filing of the petition for *concordato preventivo* and the deposit of all other required documents are shielded from claw-back actions and will enjoy super-priority status as administrative expenses of the process in case of subsequent bankruptcy of the debtor.

C. Avoidance of Certain Attachments

The Decree provides also that judicial attachments of real estate assets obtained by creditors within 90 days prior to the publication of the petition for *concordato preventivo* in the companies' registry are ineffective vis à vis other pre-petition creditors.

The provision aims at avoiding the creation of preferences immediately before the filing of a petition for *concordato preventivo* and thus at maintaining the equality of position and rights among all pre-petition creditors.[16]

D. New Transparent Regime

The Decree provides that the petition for *concordato preventivo* must be filed both with the competent bankruptcy court and with the companies' register and that the automatic stay will become effective upon such publication.[17]

Such new rule, which results in greater publicity than under the current regime, is the logical consequence of, and represents a balance to, the early automatic stay, as it flags the debtor's commencement of a restructuring process in a transparent way to all third parties.

II. New Rules Regarding the Management of the Estate Pending the Restructuring Process

The Decree provides numerous new rules regarding the management of the business during the restructuring process which are clearly intended (as with the rules pertaining to the early automatic stay) to increase the chances of the successful restructuring of businesses showing potential to overcome the crisis and preserve their going-concern value. These include rules allowing easier access to new financial resources, as well as preserving commercial relationships with critical third-party contractors while shedding those that are not essential.

[15] Article 33, paragraph 1, letter l) of the Decree sets forth a new Article 236-bis pursuant to which the independent expert is punished with imprisonment from two to five years and with a fine ranging from 50.000 to 100.000 Euro if its certifications and attestations regarding Recovery Plans, plans of reorganization pursuant to a *concordato preventivo*, Article 182-*bis* restructuring agreements as well as interim financing and payment of critical vendors and suppliers (discussed hereinafter) contain false statements or omit material information. Such punishments (i) may be increased by the court if, through the false statements or the omission of material information, the expert intended to gain an illicit profit, for his own benefit or for the benefit of a third-party and (ii) are increased by up to one half of their original amount if creditors are harmed as a result of the expert's false statements or omissions of material information.

[16] So called *par conditio creditorum*.

[17] Article 33. paragraph 1, letter c) of the Decree.

A. Access to Interim Financing

Interim and bridge financing are essential for a successful reorganization, since distressed companies typically face cash shortfalls as they seek to finalize their plan of reorganization.

The issue was addressed for the first time in 2010 with the introduction in the Italian Bankruptcy Law of provisions whereby financings granted by financial institutions pursuant to an approved Article 182-*bis* restructuring agreement or *concordato preventivo* would enjoy super-priority status and would be exempt from criminal liability in case of subsequent bankruptcy of the debtor.[18] In addition, financing granted "in view of" (i.e., before) the approval of an Article 182-*bis* restructuring agreement or of a *concordato preventivo* would enjoy the same super-priority status if such financing (i) was explicitly mentioned in the reorganization plan certified by the independent third-party expert and (ii) its super-priority status was expressly approved by the bankruptcy court.[19]

The major shortcoming of this regime is that it does not grant to creditors willing to extend financing before the court approval of the Article 182-*bis* restructuring agreement or *concordato preventivo* (i.e., when financing is most critical to keep the debtor in business) enough certainty as to the super-priority status of such financing and the protection of the lender from possible criminal liability in case of subsequent bankruptcy of the debtor.

The Decree takes a step forward by setting forth a new provision pursuant to which a debtor filing a petition for *concordato preventivo* or a proposal for an Article 182-*bis* restructuring agreement may ask the bankruptcy court for authorization to obtain financing with super-priority status to fund its ongoing operations and the restructuring process, provided that a third-party independent expert certifies that such financing is instrumental to enhancing the recovery of all creditors.[20] Such authorization may be requested also for loans identified only by nature and amount and even prior to the commencement of the relevant negotiations. The bankruptcy court may also authorize the debtor to grant mortgages or pledges as collateral for such financing.[21]

While the interplay between the new and the old provisions needs to be assessed, it is evident that the new rule, which is analogous to Section 364 of the Bankruptcy Code with respect to DIP financing,[22] is designed to facilitate the granting of interim and bridge financing immediately after the commencement of the restructuring process and before the restructuring plan is finalized, without exposing the financing creditors to the risk that the court would disallow the super-priority status (as it could happen under the existing regime).

The exemption from criminal liability covering new financing provided under the existing regime does not explicitly apply to financing provided under the new regime. It would appear that debtors and lenders should be able to invoke the bankruptcy court's approval of the new financing (which, in turn, is based on the third-party expert's certification) as a

[18] Articles 182-*quater* and 217 *bis* of the Italian Bankruptcy Law.

[19] Shareholders' loans extended pursuant to a *concordato preventivo* or an Article 182-*bis* restructuring agreement are also exempted from criminal liability and enjoy the same super priority status in respect to 80% of their value.

[20] While the Decree does not set forth the criteria this certification should be based on, it is to be expected that the analysis will hinge on the potential of the new financing to allow the business to overcome the most acute phase of its crisis and, in the context of the restructuring, to allow the debtor to rebalance its financial structure and restart to pay its obligations according to their terms.

[21] The Decree appears restrictive in specifying what type of collateral can be authorized, although a more expansive view to include other forms of securities is not to be excluded.

[22] The term DIP (Debtor In Possession) financing refers to financing granted in the context of a restructuring proceeding to a debtor who has not been dispossessed of its assets, as it would occur in a *concordato preventivo* proceeding or in the context of a restructuring agreement.

defense against criminal liability, but a clarification in this respect upon conversion of the Decree into Law would help dispel any doubt.[23]

B. Executory Contracts

One of the major shortcomings of the current regime on the *concordato preventivo* is that it does not set out rules regarding the pre-petition obligations of the debtor.[24]

The Decree fills this gap by adding a new provision (mirroring Section 365(a) of the Bankruptcy Code) pursuant to which the debtor may ask the court to be released from executory contracts[25] (with the exception of labor contracts) that are not essential for its reorganization.[26]

Analogous to the Chapter 11 rule, the debtor's decision to be released from an executory contract will be considered a pre-petition breach of such contract. Therefore, the non breaching party will only be entitled to a pre-petition claim for damages.

By contrast, if a debtor commences a *concordato preventivo* aimed at preserving its business continuity (so called "*concordato preventivo con continuità aziendale*")[27], creditors cannot terminate executory contracts on the basis of the debtor's insolvency, despite any provision to the contrary contained in the same (the so called "*ipso facto* clauses").[28]

C. Payment of Critical Vendors and Suppliers

Another key issue addressed by the Decree pertains to the payment of the pre-petition credits of critical vendors and suppliers. Critical vendors and suppliers are those whose services are deemed essential for the continuation of the business. The payment of their pre-petition credits is intended to avoid disruptions in the supply of goods and services that could harm the reorganization process.

In a Chapter 11 proceeding, the issue is addressed through the so called first-day motions and orders under Section 105(a) of the Bankruptcy Code, while case law governs the criteria for–and the limits to—such payments.[29]

[23] Absent this exemption, for example, a distressed debtor seeking new financing may incur criminal liability—if it later becomes subject to liquidation in bankruptcy—for having worsened its insolvency and/or for having recklessly delayed the filing for bankruptcy. The lender providing new financing might be found to have conspired with the debtor to commit such crime.

[24] Such rules instead have been provided with respect to extraordinary administration proceedings for large companies.

[25] A contract is executory when the obligations of the parties have not been yet performed, in full or in part.

[26] The debtor may also ask the Court to suspend its duty to perform under such contracts for 60 days (extendable up to 60 additional days for justified reasons) in order to have enough time to decide whether to assume or to reject such contracts.

[27] Pursuant to Article 33, paragraph 1, letter h) of the Decree a *concordato preventivo con continuità aziendale* encompasses plans of reorganization providing for: (a) the continuation of the business by the debtor, or (b) the sale of the business as a going concern, or (c) the contribution in kind of the business as a going concern to one or more entities (including new entities). A *concordato preventivo con continuità aziendale* is governed by special rules. Among other things: (i) an independent third-party expert must certify that preserving the business continuity is instrumental to enhance the creditors' recovery; and (ii) the plan of reorganization must contain an analytic description of the expected proceeds and costs and of the financial resources necessary to fund the business continuity.

[28] The provision has extended to proceedings for *concordato preventivo con continuità aziendale* the principle of ineffectiveness of *ipso facto* clauses that is already established with respect to liquidation proceedings.

[29] *See In re Kmart Corporation*, 359 F.3d 866 (7th Cir. 2004).

The new rule set forth by the Decree provides that a debtor filing a *concordato preventivo con continuità aziendale*, as well as a debtor filing an Article 182-*bis* restructuring agreement, may ask the court for authorization to pay pre-petition credits of its critical vendors and suppliers, provided that an independent third-party expert certifies that the goods and services rendered by such vendors and suppliers are (i) essential to ensure the continuity of the business and (ii) instrumental to enhance the recovery of all creditors.

By contrast, the Decree provides that a debtor filing a *concordato preventivo con continuità aziendale* may defer the payment of secured creditors up to one year after the ratification of the *concordato* by the bankruptcy court.

D. Contracts with Public Entities

The Decree sets forth new rules applicable to contracts entered into by debtors and Public Entities by providing that if the debtor files a petition for *concordato preventivo con continuità aziendale*, such contracts cannot be terminated by the Public Entity if an independent third-party expert certifies that (i) they are instrumental to the debtor's plan of reorganization and (ii) the debtor should reasonably be able to perform its contractual obligations.[30]

Furthermore, a debtor filing for a *concordato preventivo con continuità aziendale* will be able to participate in competitive public contract tenders provided that (i) an independent third-party expert certifies that such participation is instrumental to the debtor's reorganization and that the debtor should reasonably be able to perform its obligations; and (ii) another company satisfying the conditions for participation in the public tender undertakes to assume the debtor's obligations in the event the debtor becomes insolvent.

Similarly, a debtor filing for a *concordato preventivo con continuità aziendale* can present joint offers with other entities in connection with public contract tenders provided that: (i) the debtor does not act as the agent for the group of entities; (ii) none of the other entities in the group is subject to any restructuring or insolvency proceedings and (iii) one entity of the group undertakes to assume the debtor's obligations in the event the debtor becomes insolvent.

III. Exemptions to the Application of the Rules Regarding Companies' Minimum Capital Requirements

The Decree also intervenes in the area of corporate law by providing that from the filing of the petition for c*oncordato preventivo* or a proposal for an Article 182-*bis* restructuring agreement and until the end of the restructuring process, a debtor does not have to comply with the Civil Code rules regarding the minimum capital requirements for companies.

In particular, during the restructuring phase, (i) the company will not be compelled to reduce such capital loss in the following year, reduce its capital in accordance with such loss or change its corporate form to adopt one with lower capital requirements and (ii) the company will not be wound up if its capital falls below the minimum threshold and is not restored.

The new rule aims at keeping the corporate existence of the debtor in place during the restructuring phase despite any fluctuation in its equity and at not forcing shareholders to put in additional equity while a more comprehensive restructuring plan is being contemplated, prepared and implemented.

[30] The same regime applies to companies acquiring the business as a going concern (*See* Footnote 26).

IV. Preliminary Considerations

The new rules contained in the Decree seem to provide the necessary tools to complete the transition of the Italian Bankruptcy Law to a system that focuses on reorganizing failing businesses rather than liquidating them.

Such rules need now pass the test of the Italian Parliament, which must convert the Decree into Law, and can introduce amendments to it, within 60 days following its publication in the Italian Official Gazette.

The new rules would begin to apply to petitions for *concordato preventivo* and proposals for Article 182-*bis* restructuring agreements filed at least 30 days after the publication of the definitive Law. As such, pending proceedings will not be affected.

While the new statute is still subject to change and its effectiveness is yet to be tested, the similarities between the rules introduced by the Decree and Chapter 11 of the US Bankruptcy Code ensure that, if the Decree is not subject to dramatic changes during its conversion into Law, the new Italian bankruptcy system will replicate a legal framework that has been, and still is, deemed to be highly successful in balancing the protection of creditors with the notion that distressed businesses oftentimes retain a going-concern value that exceeds their liquidation value and it is therefore more efficient to preserve them.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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