SQUARE THE CIRCLE
by iLS

September 2021
Issue No. 5

RESTRUCTURING UPDATE: A NEW SIMPLE TOOL IS SET TO RESHAPE THE UTP MARKET

Murphy's law has struck again. The reform of the Italian insolvency law, which was approved just a couple of years ago after a decade-long process, has been put on hold. The usual suspect for this is Covid-19. The pandemic has reshaped the economic landscape so dramatically that the new tools are likely to prove already obsolete and unable to catch up with the current scenario.

To counteract the risk of a tsunami of insolvencies upon withdrawal of the payment moratorium, the government of Super Mario has introduced, by law decree[1] and along with other measures[2], a brand-new restructuring procedure titled "crisis negotiated composition" (*composizione negoziata della crisi*) to streamline the management process of the corporate crisis from an early stage.

In this Square The Circle we will:

- describe certain key features of the new "negotiated" composition procedure (the "CNC Procedure"); and
- provide a high-level analysis of the impact of the new regime on the position of certain stakeholders (namely, financial creditors, UTP investors, and potential buyers of the underlying business).

Key Features of the CNC Procedure

The CNC Procedure may be activated on a voluntary basis by any company (the "Company") which is likely to become insolvent due to imbalance in its economic, financial or assets and liabilities metrics.

This "early warning" tool is two-pronged as it may result in either a full-scale arrangement with the creditors capable of relaunching the underlying business or, should such arrangement not be reached within a given timeframe, a liquidation procedure in which the creditors will have a limited say.

The key role is played by a third-party expert appointed following submission of the Company's application to access the CNC Procedure[3]. The expert will, in consultation with the Company and its creditors, try to facilitate consensus-building around a credible recovery strategy, including

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[1] Namely Law Decree No. 118 of 25 August 2021 (the "Law Decree"). Under the Italian Constitution, the Law Decree will become ineffective retrospectively unless converted into law by the Parliament within 60 days of its promulgation.

[2] The Law Decree has, *inter alia*:

- postponed the date on which the new Insolvency and Corporate Crisis Code (or "ICC Code") will enter into force;
- provided for a simplified procedure of composition with creditors (*concordato liquidatorio semplificato*) aimed at the liquidation of the debtor;
- make certain tools contemplated by the ICC Code (*e.g.*, "*accordi di ristrutturazione agevolati*" and "*accordi di ristrutturazione ad efficacia estesa*") immediately available;
- set out specific provisions for a group of companies involved in a CNC Procedure.

[3] The expert will be appointed by an *ad-hoc* public body (to be created in the next few months) and will be selected among professionals enrolled in a special register (also to be created in the next few months).

through the disposal of the going concern or specific lines of business.[4] Pending negotiations, the Company will retain the power to manage its business, with no involvement of the expert. However, the expert will have to be notified of certain types of courses of action planned by the Company[5] and, in case of disagreement, may file a formal objection. The objection will not prevent the Company from implementing its decision, but it is likely to affect the Company's credibility and, therefore, the chances of success of the procedure.[6]

Such a soft approach, however, coupled with certain tools available to the Company and the expert, intended to strengthen the CNC Procedure's probability of success. In particular:

a) **Stay and Interim Measures:** to avoid disruptions during negotiations, the Company may seek:

   i) stay measures (*misure protettive*) that prevent creditors from obtaining, without the Company's consent, rights of priority (*diritti di prelazione*) over the rights and assets of the Company which are instrumental to the business, and commencing enforcement on such rights and assets;[7] and

   ii) interim measures (*misure cautelari*) which may be necessary to carry out the negotiations;

b) **Renegotiation of Agreements:** for contracts that are performed on a continued, periodical or deferred basis (*contratti ad esecuzione continuata, periodica o differita*),[8] the expert may identify those which need to be renegotiated by the parties to rebalance their respective positions in light of the consequences of the pandemic. Should the Company and its counterparty fail to agree on such renegotiated terms, the court may, upon the request of the Company, unilaterally redetermine, on equitable grounds, the terms of the contract for the time and to the extent necessary to ensure continuation of the business;[9]

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[4] The expert will have no active involvement in the management of the Company and, therefore, will play a quite different role compared to the trustee (*curatore fallimentare*) in bankruptcy procedures or the judicial commissioner (*commissario giudiziale*) in pre-bankruptcy compositions with creditors procedures . The Italian legislator seems to have learned a lesson from the day-to-day practice over the last few years, that for a successful outcome of debt restructuring a more flexible approach and professionals with long standing experience and specialized skills are needed. This is quite a significant development in the Italian insolvency legislation, which has traditionally followed a more bureaucratic and formalistic approach.

[5] This is the case of management activities falling outside the ordinary course of business, and of payments that are not consistent with the negotiations in the context of the CNC Procedure or with the recovery prospects of the Company.

[6] Please note that, as discussed below, the expert's objection will also prevent the relevant management activity from benefitting from the insolvency claw-back exemption, and, as such, may trigger some resistance by the counterparty of the Company to proceed with the relevant transaction.

[7] In addition, the creditors to whom the stay measures (*misure protettive*) are directed cannot refuse performance of ongoing agreements nor cause their termination or early expiry, nor amend the aforementioned agreements at terms less favourable to the Company due only to the failure of the Company to pay its existing debt. Prior to the end of the CNC Procedure, the Company cannot be declared bankrupt or insolvent.

[8] These are typically tenancy agreements and supply agreements. However, certain types of financing agreements (*e.g.*, overdraft facilities (*aperture di credito in conto corrente*)) may fall within the scope of this definition and there may be room for this new tool to be used by the Company also in its dealings with banks and lenders in general.

[9] The ability of the court to unilaterally redetermine the contents of agreements in certain extreme scenarios (like a pandemic) has been discussed and supported by the Italian Supreme Court in a recent internal paper (Rel. No. 56 of the *Ufficio del Massimario e del Ruolo* of 8 July 2020, pp. 20-25). In this paper, the Italian Supreme Court has maintained, based on an evolutionary interpretation of the Italian contractual law, that the refusal by a party to agree on a fair

c) **Preferred Financings:** subject to an *ad-hoc* authorisation from the court, the Company may obtain (from the market and/or its shareholders) preferred financing (*finanziamenti prededucibili / finanziamenti soci prededucibili*) (which, in a bankruptcy scenario, will be repaid in super-priority);

d) **Disposal of Business:** subject to an *ad-hoc* authorisation from the court, the Company may dispose of its business or one or more lines of business (in which case, the disposal will not be subject to insolvency claw-back (*revocatoria fallimentare*));

e) **Other Exemptions from Claw-Back:** payments made and security granted by the Company to its creditors during the CNC Procedure are not subject to insolvency claw-back (*revocatoria fallimentare*) if they are consistent with the ongoing negotiations and/or the turnaround prospects of the Company and no formal objection is raised by the expert.

Although creditors engaged in the negotiations of the CNC Procedure are required by law to act in good faith and actively, and opportunistic behaviours may lead to liabilities (*i.e.*, claims for damages), it is the mechanics of the CNC Procedure itself that provides the strongest incentive for creditors to be compliant. Should the CNC Procedure not be successfully completed within the given timeframe[10] (due, for example, to a passive behaviours of the creditors), the Company may resort to the simplified pre-bankruptcy composition with creditors procedure (*procedura di concordato preventivo liquidatorio semplificato*), which offers far less protection for the creditors compared to the standard pre-bankruptcy composition with creditors (*concordato preventivo liquidatorio*). In this new type of pre-bankruptcy composition with creditors:

- the composition proposal (*proposta concordataria*) does not require the approval of the creditors (which, in case of disagreement, are only left with the remedy of filing a judicial opposition);
- no minimum percentage of satisfaction of the relevant classes of creditors is required (however the court will verify that: i) the composition proposal is compliant with the classes of creditors' ranking order established by the law; ii) there is "a benefit" for each creditor; and iii) the creditors are no worse off than they would be in case of bankruptcy (*fallimento*));
- subject to authorisation from the court, the Company may immediately[11] dispose of its business or specific lines of business, to allow for a faster "fresh start", with better chances of recovery of the business operations.

rebalancing of the terms of the agreement proposed by the other party in the context of a changed economic environment due to the pandemic, would amount to a breach of his or her duty to act in good faith in the performance of the contract.

[10] The standard length of the CNC Procedure is 180 days. However, extensions may be agreed by the parties involved in the negotiation or be granted if the Company has requested stay measures (*misure protettive*) or interim measures (*misure cautelari*) or the renegotiation of one or more agreements.

[11] That is, with no need for the procedure to be finally approved (as it would normally happens, instead, in case of a standard pre-bankruptcy composition with creditors (*concordato preventivo*)).

The Impact of the New Regime on Banks, UTP Investors and PE funds

The CNC Procedure is likely to put pressure on banks. A passive attitude on their part may well result in a failure of the CNC Procedure and, in turn, the opening of a simplified pre-bankruptcy composition with creditors (*concordato preventivo liquidatorio semplificato*). This may lead to a faster-than-expected liquidation at values which are far from those in the banks' books. Banks will, therefore, find themselves at a crossroad: they will have to either step up their capability to manage UTPs and take a more active role in the CNC Procedures, or offload their increasing stocks of UTPs on the market to avoid their balance sheet getting hurt even more.

Conversely, the new legislation appears to offer obvious opportunities to investors in UTPs, but not only to them. There may be room for PE funds specialising in turnaround to use the CNC Procedure as an effective tool to ease access to the business of the target. In particular:

- financial players active in the UTP space may acquire exposures to the Company and use the CNC Procedure to help sustain its business with a view to reperforming;
- PE funds may acquire the debt of the target in order to support the preservation and continuation of the business of the target by leveraging the benefits of the CNC Procedure (*e.g.*, renegotiation of contracts), and eventually converting that debt it in a sort of currency for the acquisition of the business in a safer environment (without claw-back risk).

Considering the impact of the calendar provisioning regulation on the ability of banks to carry out investment activity on non-performing exposures, and the traditional lack of lending infrastructure by PE funds, securitisation is expected to be the main financial technique to be used by investors to acquire the UTPs disposed by banks.

Any UTP investment strategy to be implemented via a securitisation platform is likely to revolve around the ability of the securitisation vehicle to provide additional funding to the debtors. As things currently stand, this ability is subject, depending on the situation, to compliance with a 5% retention requirement,[12] a requirement that the new financing is part of a "restructuring agreement or procedure",[13] or a condition that a third-party bank or financial intermediary assumes (acting as a sort of fronting bank on behalf of the securitisation vehicle) the obligation to make the residual advances under the original financing agreement.[14]

There should be little doubt that the CNC Procedure constitutes a "restructuring agreement or procedure" for the purpose of article 7.1(3) of Law 130 and that the securitisation vehicle should be capable of granting preferred financing to the Company with no need for a third-party bank or financial intermediary to act as sponsor.

However, when dealing with UTPs, to unlock the full potential of the securitisation maybe it is time to reconsider the scope of the securitisation vehicles' direct lending capability and allow

[12] See article 7.1(2) of Law no. 130 of 30 April 1999 (the "Law 130").
[13] See article 7.1(3) of Law 130.
[14] See article 4(4-ter) of Law 130.

them to step in directly in the originator's obligation to make further advances under the original financing agreement with no involvement of a third-party bank or financial intermediary as sponsor[15] or a fronting bank.

A more radical approach is probably needed to handle the issues associated with the sale of UTPs originating from financings in the form of overdrafts or revolving facilities on a current account. The mechanism currently devised by the law contemplates a convoluted scheme whereby the securitisation vehicle acquires the UTP, a bank or financial intermediary steps in the originator's obligation to make the further advances, and the originator continues to hold the relevant bank account. Leaving aside the operational complexity of this arrangement, the solution offered by the law seems incapable of achieving two key objectives, *i.e.*, on the one hand, the practical release of the originator from the obligations to make further advances[16] and, on the other hand, an effective protection of the securitisation vehicle's claims to the funds received by the originator/depositary bank in the event of insolvency of the latter.[17] It should not come as a surprise that this tool has seldom been used, if at all.

[15] This proposal seems sensible considering that the originator itself had already selected the borrower and, therefore, an objection that, by making the advances, the securitisation vehicle would carry out banking activity, seems far-fetched.
[16] This is because the bank account is, in legal terms, a relationship between the borrower/account holder and the originator/depositary bank. Therefore, any withdrawal from the bank account is likely to be construed as an advance by the originator/depositary bank to its counterparty.
[17] According to the law, the funds received by the originator on the bank account opened by the originator with itself will be segregated in favour of the securitisation vehicle. It is quite difficult to understand how such segregation is supposed to operate considering that the aforementioned funds will be commingled with the other funds of the originator (and, therefore, cannot be identified and isolated).

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