Reform of insolvency procedures: pre-bankruptcy composition agreement

July 22 2016 | Contributed by Lombardi Molinari Segni

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Introduction

By a decree of January 28 2015 the minister of justice set up the Rordorf Commission, a ministerial commission to develop and submit draft legislation designed to reform, review and reorganise the rules governing insolvency procedures in Italy (for further details please see "Draft statutory instrument for reform of insolvency procedures: alert procedures"). On December 29 2015 the Rordorf Commission completed its proceedings and submitted a draft statutory instrument delegating powers to the government "for a comprehensive reform of the existing rules on business crises and insolvency".

Following the Council of Ministers' approval on February 10 2016, the draft statutory instrument was laid before the Chamber of Deputies and the Senate for parliamentary discussion and approval. If approved, the new statutory instrument will be published in the *Official Journal*, and will then finally come into force.

The purpose of the Rordorf Commission was to provide a more comprehensive set of legal provisions in insolvency matters than those currently in force, in addition to emphasising the significance of crisis prevention and the safeguarding of business values. Within this context, special emphasis has been given to all those tools – including negotiated crisis composition – that can ensure the early identification and emergence of any signs of a firm's financial distress. Among these, the pre-bankruptcy composition agreement procedure is believed to be the most effective tool to solve business crises favourably. Indeed, if correctly applied, it can protect a debtor company's business potentials in potentially reversible insolvency situations and ensure the best possible satisfaction of creditors' claims.

For this reason the pre-bankruptcy composition agreement procedure was considered closely by the Rordorf Commission, which, in its proposed statutory instrument, submitted some amendments for effective action with a view to:

- stimulate and simplify the use of this procedure by businesses; and
- reinforce its capability to solve business crises successfully.

This update illustrates the most significant amendments.

Pre-bankruptcy composition agreement in business continuity

By its draft statutory instrument the Rordorf Commission intended to restrict the use of pre-bankruptcy agreements to cases where the proposal for a pre-bankruptcy agreement envisages business continuity, while asset liquidation arrangements are limited to those cases in which pre-

bankruptcy sale of asset is found to be more convenient than liquidation in bankruptcy.

In this respect, the amendments made to the provisions governing insolvency over the past decade have made the pre-bankruptcy composition agreement highly flexible. In fact, for the time being, both the plan and the proposal for agreement can have any content. Yet most proposals for pre-bankruptcy composition arrangements have developed into a form of sale of individual assets (a so-called 'agreement in liquidation'). Unlike a liquidation in bankruptcy, a pre-bankruptcy composition agreement envisaging the sale of assets:

- only seldom is a more beneficial solution for the creditors; and
- can hardly protect the debtor business's residual value, if any, more effectively.

On the contrary, a pre-bankruptcy composition agreement that secures business continuity (a so-called 'agreement in business continuity') has a high "salvage content" because (at least in principle) the debtor firm's permanence in the market helps to sustain the preservation of business worth and provides for better satisfaction of the firm's creditors.

Precisely on the basis of these considerations and past experience, the Rordorf Commission deemed it appropriate to encourage market players to choose a solution that envisages business continuity – that is, one that tends to restrict the use of pre-bankruptcy composition agreements to arrangements envisaging business continuity (as currently governed by Article 186*bis* of the Insolvency Act).

Pre-bankruptcy composition agreements in liquidation

Within the framework of the new provisions of law on pre-bankruptcy composition agreements, the Rordorf Commission also made room for pre-bankruptcy composition agreements envisaging the liquidation of assets, provided that they are structured so as to allow for third-party contributions suitable to satisfy the creditors' claims to an appreciably larger extent than the alternative bankruptcy solution.

Thus, the pre-bankruptcy composition agreement in liquidation has been conceived as an exception to the standard approach, allowed when the pre-bankruptcy liquidation procedure is offering the creditors something more than the proceeds from the sale of the whole of the insolvent debtor's assets. The Rordorf Commission's choice is clearly supported on the possibility that, in this case, a pre-bankruptcy composition agreement in liquidation may still offer creditors a more attractive approach than liquidation in bankruptcy.

Obviously, the additional offer should make the pre-bankruptcy composition agreement worthwhile for the creditors in more than negligible terms, and its extent can be determined on a case-by-case basis, or possibly specified by the delegated legislature at a later date.

Third-party initiatives

The draft statutory instrument requires that any third party has standing to submit an autonomous application for the admission to the pre-bankruptcy composition agreement. Indeed, pursuant to the provisions of law in force, the only party with standing to apply for admission to the pre-bankruptcy agreement procedure is the debtor. Third parties may only submit concurring proposals, subject to certain conditions, within the scope of the proceedings initiated by the debtor.

By increasing the number of parties with standing to file an application for admission to the procedure, the Rordorf Commission clearly intends to achieve a specific purpose: to encourage the debtor to trigger the pre-bankruptcy composition agreement procedure at an early stage in the crisis management process, before its slide into insolvency could open the door to third-party actions.

A third party may apply to open a pre-bankruptcy composition agreement procedure only where the debtor is already in a state of insolvency. This is because, in a crisis, a mechanism likely to lead to the firm being taken away from its original owner, on the basis of a plan prepared by third parties on their own initiative, would hardly be justified. Conversely, in the case of insolvency, it can be assumed that the crisis is so serious as to result in the belief that the firm no longer belongs to the person that only formally appears still to be its owner.

Additional changes

More proposed changes to the provisions governing pre-bankruptcy composition agreement are intended to simplify the main steps in the procedure and to foster the resolution of major interpretational issues that have been encountered in actual application in the past.

First, the Rordorf Commission has proposed a better specification of Article 169*bis* of the Insolvency Act, which governs "existing legal relationships". The article allows the debtor, after applying for a pre-bankruptcy composition agreement, to request that the court seized – after hearing the other party to the relevant contract, and collecting summary information, if need be – authorise the debtor to withdraw from, or suspend, any contracts not yet performed, whether in full or in part, as at the filing date of the application.

In particular, the commission recommends that the grounds for suspension of, and/or withdrawal from, contracts be more closely specified (Article 6.1(j)). As Article 169*bis* merely provides for an unspecified, just contingent authorisation by the court seized to terminate or suspend existing contracts, it fails properly and furtherly to regulate the matter. This has resulted in controversial views in case law as to the necessary grounds on which such authorisation can be sought. Thus, if the commission's proposed amendment is adopted, it would put an end to many uncertainties about the matter arisen in court proceedings.

Second, the draft statutory instrument in question requires that, with due respect to proceedings opened by or against a limited company, the delegated legislature should introduce a set of rules expressly providing for the specific grounds for, entitlements to, and effects of, any legal actions that can be brought by the company's shareholders for directors' liability or by the company's creditors against its governing bodies. In doing so, the legislature should comply with the principles laid down in the Civil Code in respect of such legal actions (Article 6.2(b)).

In this case, the proposed supplemental provisions are appropriate, because, as things stand now, there are no *ad hoc* provisions to regulate the shareholders' or creditors' actions against the debtor company's officers and governing bodies in pre-bankruptcy composition agreement proceedings. This has led to the doubts raised in literature and case law, not only about the pre-conditions and effects, but also about the admissibility of such actions. By its proposed amendments, the Rordorf Commission has:

- implicitly – and once and for all – recognised that any such action can be brought in pre-bankruptcy composition agreement proceedings; and
- attempted to fill a regulatory gap, and to put an end to the far-reaching debate that has developed in case law and scholarly writings in this area.

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