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The changes of the Italian insolvency and foreclosure regulation adopted in 2015

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Summary

Last August the Italian Government passed important amendments to the Bankruptcy Law and the Civil Procedure Code, with the aim to increase the speed and efficiency of insolvency procedures and property foreclosures, and to promote higher recovery rates for creditors. Preliminary estimates suggest that the average duration of bankruptcy procedures could be halved in a favorable scenario. The average duration of foreclosures might also be significantly shortened. As the length of judiciary procedures is among the root causes of the large stock of non-performing loans (NPLs) in Italian banks' balance sheet, the reform is expected to help address the problem. It should boost the value of NPLs and foster the development of a private market for these assets.

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Introduction and main conclusions

New legislation amending the procedures for firms' restructuring and for the foreclosure of assets was approved by the Italian Government on June 23, 2015, and finally enacted by the Parliament in August.[1)]

The main amendments to the Bankruptcy Law seek to improve the efficiency of the available restructuring tools (such as the so-called *concordato preventivo*[2)] or "composition with creditors" and the out-of-court "restructuring agreements") with the aim of promoting a prompt solution of a firm's crisis and preventing irreversible insolvency. A new kind of "restructuring agreement", inspired by the UK "scheme of arrangement", aims at facilitating a more prompt agreement among creditors. Other measures affect the liquidation of the debtor's estate and aim at reducing the length of the process and improving the efficiency of the sale; time limits have been established for the insolvency administrators to prepare the liquidation plan and to complete it; the violation of such deadlines may constitute ground for administrators' dismissal. An increase of the recovery rate for creditors should ensue, with ultimate beneficial effects on lenders and borrowers.

The reform is expected to have important effects for NPLs. Better chances of success for restructuring and turnaround operations will reduce the inflow of positions into the worst quality category of NPLs (the bad loans or "*sofferenze*"). Faster and more efficient insolvency and foreclosure procedures will have a twofold effect on the stock of NPLs. In the short term, they should reduce the discount required by NPL buyers, with positive effects on NPL prices and on the perspective of development of a market for these assets. In the long term, they should bring about a fall in the equilibrium value of the NPL/total loans ratio of Italian banks.

1. The amendments to the Bankruptcy Law [3)]

The new restructuring agreement addresses the "holdout problem"

1.1 A new scheme of restructuring agreement

A first piece of legislation, aimed at distressed but potentially viable firms that wish to conclude out-of-court restructuring agreements with creditors, introduces a mechanism to fend off potential problems generated by opportunistic behavior by minorities of creditors (the so-called "holdout problem"). Companies whose financial debt (debt towards banks and other financial intermediaries) amounts to at least 50%

1) Law Decree No. 83/2015 published in *Gazzetta Ufficiale* No. 147 of 27 June 2015, turned into Law No. 132/2015 published in *Gazzetta Ufficiale* No. 192 of 20 August 2015.

2) The '*concordato preventivo*' is a court-supervised procedure with restructuring purposes, based on a restructuring plan and proposal to be approved by a majority of the value of the debt (and, if the restructuring proposal divides creditors into different classes, also by a majority of classes). Once approved, the proposal has to be confirmed by the court.

3) The new provisions enact changes to the general Bankruptcy Law and do not affect the Insolvency regime applicable to consumers and small enterprises as laid down in Law No. 3/2012 on the over-indebtedness of individuals and small businesses. The latter regime has however a very limited scope of application, as all enterprises with net assets amounting to more than € 300,000 or either yearly gross earnings higher than € 200,000 or a total amount of debts higher than € 500,000 are subject to the general Bankruptcy Law.

of their overall liabilities are entitled to sign restructuring agreements with financial creditors holding at least 75% of total financial liabilities, and to request the Court to make such agreements binding over dissenting financial creditors. In the previous framework dissenting creditors kept their right to be paid in full. Therefore, even if a strong majority favored the debtor's proposal, the objection of a single creditor could delay the process and end up blocking the rescue of a still viable company.[4] Thanks to the new scheme, inspired by UK law scheme of arrangement, banks and other financial creditors can take a more proactive role in the design and implementation of rescue projects of distressed companies. Safeguards for minority creditors have been established.[5]

Competition among turnaround plans is created ...

1.2 Competing plans and competing bids in the concordato

The new rules enable creditors of a firm that has filed for "*concordato preventivo*" to submit to the court restructuring plans in competition with the one presented by the firm. To do so, two conditions must be met. First, the plan submitted by the debtor fails to ensure the repayment of at least 40% of the unsecured claims (or at least 30% if the restructuring plan aims at the continuation of the business). Second, creditors entitled to submit a competitive plan must represent at least 10% of the ailing company's financial debt. The 10% threshold can be reached by creditors through debt purchases made after the firm has filed for *concordato*. Thus, investors can get involved in the rescue of a company even if they had no previous lending relationship with it.

Prior to the reform, a firm filing for *concordato* had the exclusive power to submit a restructuring plan. Creditors therefore could only approve or reject a debtor's plan, without any possibility to influence its substance, or propose alternatives. Therefore, they were often forced to approve suboptimal plans that did not necessarily reflect the real enterprise value and allowed the debtor to adopt opportunistic behavior, extracting value at his/her exclusive benefit.

Competition is also promoted within the sale process which may take place within a *concordato preventivo*. To maximize the recovery rates for creditors of a firm under *concordato*, the reform allows any interested party to make alternative offers to purchase assets whose disposal is foreseen in the plan submitted by the debtor [6].

4) In the previous framework the agreement had to be signed with (financial and non-financial) creditors holding at least 60% of overall liabilities.

5) They will be informed of the negotiations, and will have the opportunity to take part in them. They will have 30 days to challenge the decision of the Court. Furthermore, the Court, in approving the agreement, must be satisfied that: negotiations took place in good faith; proper criteria were applied in the formation of the classes of financial creditors; dissenting creditors will receive an amount which is not less than the amount that they would receive under any feasible alternative solution (the "no creditor worse off" principle).

6) Specifically, when the plan already includes an offer by a third party, the Court shall open a competitive auction process for the collection of other offers. For these offers to be admissible, they need to be improved and fully comparable with each other, without altering the substance of the debtor's plan.

... with benefits for firms' stakeholders and for the NPL market

The new rule should yield several benefits. First, it gives creditors more options to pursue their interests, resulting in higher recovery rates; in perspective, other things equal, this should translate into lower capital absorption for banks and lower cost of credit for all firms. Second, allowing competing restructuring plans should promote the contestability of distressed firms, enhancing the likelihood of a successful turnaround. This may go against the interest of the owner, but it increases the chances of the firm's survival, and is therefore advantageous for all the other firm stakeholders. Third, since investing in distressed debts becomes a tool to take-over distressed but viable firms, the new rule may contribute to the development of private equity and of a market for NPLs in Italy.

1.3 A new regime for insolvency administrators

Transparency and better performance by insolvency administrators are promoted

The reform sets new requirements for the insolvency administrators appointed by the court (the "curatore" or the "commissario giudiziale"), and for the management of assets' liquidation. In detail: (i) for each insolvency procedure an online registry will be established containing all relevant data concerning the administrators and liquidators (including data on the length of previous assignments and on performance). The registry shall be open for consultation by the public free of charge; (ii) the administrator is requested to deliver the liquidation plan within 180 days from the date of the insolvency declaration, and to terminate the liquidation of the assets within 2 years from that date. Failure to comply with such deadlines may constitute ground for the administrator's dismissal by the court. In the old regime no such deadlines were present.

The new rule should increase transparency in the appointment process and influence the administrators' incentives, ultimately improving the efficiency and speed of sales proceedings.

2. Improvements to procedures for the sale of collateral

The efficiency of insolvency proceedings is improved ...

The main changes to the procedural rules governing the foreclosure of collateral seek to simplify and reduce the length of court proceedings. The new rules apply not only to new proceedings, but also to those already initiated at the time of the entry into force of the reform.

... by imposing best practices on courts and interested parties

It is now mandatory for the judge to resort to professional experts (such as notaries, lawyers, accountants) to carry out the activities related to the disposal of the collateral, in order to streamline court proceedings and increase their efficiency.[7] Also, shorter time-limits are set for certain procedural activities. Creditors cannot take more than: 45 days for filing a request to order the sale (down from 90 days in the previous regime); 60 days for filing, prior to the auction sale, the documentation concerning the foreclosed asset (down from 120 days). The court cannot take more than 90 days for conducting

7) In the previous regime resorting to experts was discretionary, and there was little recourse to this option.

the hearing of creditors and other interested parties in view of the auction (down from 120 days).

The likelihood of multiple auctions is reduced

Multiple auctions for real estate collaterals were a feature of the previous regime. The first and the second auction went almost invariably deserted. It typically took a third, and sometimes a fourth auction, to assign the collateral. This caused significant delays in the liquidation process. This was partly due to rigidities in the process. In particular, at the first auction bids could be accepted only if the offer was 20% higher than a reference price estimated by an expert appointed by the court. In case of an unsuccessful auction the reference price for the following auction was obtained by discounting the old one by a maximum of 25 per cent.

The new rules try to address this problem. If the court assesses that there is no serious prospect to get a better price through a second auction, bids can now be accepted even at a price up to 25% lower than the reference price.

The assignment of collateral to creditors is made easier

The reform reduces some hurdles that made it unprofitable for creditors to get collateral assigned to them. Creditors can now offer a price equal to that of the last unsuccessful auction, thereby benefitting from discounts like any other bidder. In the old regime interested creditors had to offer the initial estimated price of the collateral even if this price had been revised downwards as a result of several unsuccessful auctions. This mechanism made the direct assignment of the foreclosed asset to creditors extremely rare.

Deferred payments are now possible

It is now possible for the winning bidder to pay the price in monthly installments, whereas before a lump sum payment for the entire amount was required. Where a guarantee from banks or by insurance policies is provided, the buyer can now get immediate possession of the awarded property.

The market for foreclosed assets goes online

The new provisions introduce mandatory use of internet websites to advertise forced sales, marking a radical move from previous mainly paper-based methods.[8] Moreover, they mandate the creation of a single national on-line platform, managed by the Ministry of Justice, for the publication of all notices regarding sales ordered by courts.

These changes should improve the efficiency of forced sale procedures and increase the probability of early bids to be accepted. The move to online platforms will reduce the costs for the perspective bidders of accessing information, increasing the transparency and efficiency of auction sales. This should result in faster procedures, less time wasted and value lost due to multiple auctions, yielding on average higher sale prices for collaterals, to the benefit of both creditors and debtors, to the benefit of all stakeholders.

8) In the previous regime, forced sales were advertised by posting a notice of sale on the notice board of the Court responsible for the proceedings. The notice of sale had also to be published in daily newspapers (this is now optional and can be ordered by the Court where requested by creditors). Only for certain properties (immovable properties and movable properties whose value exceeded EUR 25.000) the notice had to be also published on dedicated internet websites.

3. Preliminary assessment of the reform

Bankruptcy and foreclosure proceedings should be significantly shortened

As a whole, the reform has substantially improved the legal framework for early intervention in cases of firms in distress, promoting early action in case of crisis and making restructuring more likely. It should also provide better protection to creditors in case of difficulties of the borrowers, as foreclosure procedures are expected to become speedier and less costly, with forced sales improved by extra-judicial and more market-oriented mechanisms.

Only in the coming years will it be possible to gauge the effectiveness of the amendments. A preliminary assessment relying on a series of assumptions indicates that once the new rules display their full effect:

- the average length of the bankruptcy process, from the declaration of insolvency to the final distribution of the proceeds resulting from liquidation, should drop from more than 6 to around 3 years in a favorable scenario of effective implementation (around 4-5 in a less favorable one);

- the overall average length of the judicial foreclosures should drop from more than 4 to around 3 years.

Important beneficial effects on banks' NPLs should ensue

The new norms are expected to have important beneficial effects on banks' NPLs. The IMF has repeatedly insisted that a strategy for developing a market for NPL in Italy should look to remove regulatory impediments to debt restructuring, to improve further the insolvency framework and encourage out-of-court workouts. In addition, further steps to reduce the legal burden and speed up collateral foreclosure would also be helpful, for example by reducing the role of the court; by empowering notaries to determine the values and oversee collateral auctions, using standardized procedures and online tools; by introducing stricter time-limits to expedite liquidation.[9] These aspects have been addressed by the new legislative framework.

9) Shekhar Aiyar, Wolfgang Bergthaler, Jose M. Garrido, Anna Ilyina, Andreas (Andy) Jobst, Kenneth Kang, Dmitriy Kovtun, Yan Liu, Dermot Monaghan, and Marina Moretti, "A Strategy for Resolving Europe's Problem Loans", IMF Staff Discussion Note SDN/15/19, September 2015.