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The Italian Insolvency Code: New Rules on 'Debtor-in-Possession' Financing

The Insolvency Code contains a "debtor-in-possession" financing regulation that reforms the legal framework outlined in the Bankruptcy Law in force until August 2020.

Key Points:

- The newly enacted Insolvency Code grants lenders special protection to ensure full recovery of DIP Financing receivables.
- Several forms of DIP Financing, including guarantees, subscription of notes, and continuation of short-term facilities are available.
- New requirements for the provision and utilization of DIP Financing before the homologation of a *concordato preventivo* and a debt restructuring agreement have been introduced.
- Special protection is granted to DIP Financing receivables provided by shareholders of a debtor.
- New rules on the ineffectiveness of the special protection granted to DIP Financing receivables have been introduced.

The "Business Crisis and Insolvency Code" (the so-called "Insolvency Code") contains several features, including one to reshape the rules governing debtor-in-possession financing (DIP Financing) made in connection with certain insolvency proceedings, namely debt restructuring agreements (formerly the so-called "182-*bis* agreements") and composition with creditors proceedings (*concordato preventivo*).[1]

This *Client Alert* provides an overview of the DIP Financing regulation in the Insolvency Code, highlighting its main points of development from the corresponding regulation under Royal Decree No. 267 of March 16, 1942 (*i.e.*, the Bankruptcy Law, which will be replaced by the Insolvency Code once it comes into full force and effect) and highlighting certain issues that may affect implementation.

The Benefit of *Prededuzione* and the Forms of DIP Financing Contemplated by the Insolvency Code

DIP Financing plays a crucial role in the Italian insolvency framework, as it represents one of the main tools through which a debtor may obtain the financing needed to overcome its state of crisis or insolvency pursuant to — and in performance of — a *concordato preventivo* or a debt restructuring agreement, as the case may be.

Simultaneously, lenders providing DIP Financing are granted special protection for their receivables called *prededuzione*, aimed at ensuring full recovery (such receivables being defined as *prededucibili*). More specifically, by virtue of *prededuzione*, receivables arising from DIP Financing must be satisfied, in the context of a debtor's subsequent insolvency proceedings, with absolute priority over other unsecured and secured receivables the same debtor owes (with the exception of those secured by mortgage or pledge over the debtor's assets).

Notably, *prededuzione* differs from — and operates on a different level than — security interests over assets of the debtor, which may however secure DIP Financing receivables either by operation of law (*e.g.*, general or special privileges) or because the interests have been granted by the same debtor (*e.g.*, mortgage, pledge, or assignment by way of security of receivables). In such cases, those receivables qualify as both *prededucibili* and secured, and the relevant creditors shall be entitled to both:

- Enforce the collateral granted as security in case of non-payment
- Be repaid in the context of subsequent insolvency proceedings of the debtor — not only with absolute priority over other unsecured and secured receivables (other than those secured by mortgage or pledge), as indicated above, but also in accordance with the ranking provided by the relevant security interest (*e.g.*, prior to other *prededucibili* receivables that are either unsecured or secured by lower ranking security interests)

The Insolvency Code contemplates two different types of DIP Financing:

- DIP Financing authorized before the final approval (homologation) of a *concordato preventivo* or a debt restructuring agreement (Article 99 of the Insolvency Code)
- DIP Financing made in performance of a *concordato preventivo* or a debt restructuring agreement (Article 101 of the Insolvency Code)

Certain exceptions to the legal subordination rule of shareholders' loans also apply if DIP Financing is provided by a shareholder of the debtor.

Notably, Article 182-*quarter*, paragraph 2, of the Bankruptcy Law also grants the benefit of *prededuzione* — under certain conditions[2] — to receivables arising from financing made before the filing with the court of a petition for the admission to a *concordato preventivo* or for the homologation of a debt restructuring agreement. This type of DIP Financing has **not** been included in the Insolvency Code (which contemplates only DIP Financing authorized or made, as the case may be, after the filing of the said petition), and is therefore destined to disappear from Italy's insolvency legal framework once the same code comes into full force and effect.

Scope of DIP Financing

One of the first matters to be dealt with in the analysis of DIP Financing is its scope and, specifically, the individuation of the forms of financing (*e.g.*, loans, notes, guarantees, etc.) eligible to *prededuzione* under the relevant Insolvency Code provisions.

The Insolvency Code does not impose any specific requirements as to the type of lender that must provide the financing (*i.e.*, the lender can be either an individual or an entity, although whether the Italian regulatory limits on lending activity should apply is under dispute).[3] The Insolvency Code expressly refers to financing provided "*in any form*" — *e.g.*, the granting of guarantees, the subscription of notes, and the

continuation of the so-called "self-liquidating credit facilities" (*linee di credito autoliquidanti*)[4] in place when the petition for the admission to the insolvency proceedings was filed.

In consideration of the above, DIP Financing includes any form of financial support to the debtor, regardless of the contractual scheme adopted by the parties. However, certain forms of financing, due to their features, might fall outside of the scope of DIP Financing regulation, including namely:

- **The extension of the terms for repayment with respect to term loans:** Although the repayment of term loans could be considered a form of financial support — as it alleviates the cash needs of the debtor — this is actually a form of restructuring the debtor's indebtedness that falls within the scope of a *concordato preventivo* proposal or a debt restructuring agreement.

- **Financing provided to entities other than the debtor:** The application of DIP Financing provisions is limited to financing provided to the debtor who enters a *concordato preventivo* or executes a debt restructuring agreement, and does not extend to financing made available to other entities belonging to the same corporate group (such as a subsidiary or an affiliate of the same debtor). However, according to certain case law,[5] the benefit of *prededuzione* does operate if the financing is provided to a newco incorporated by the debtor in performance of the restructuring plan.

Financing Authorized Before the Homologation of a Concordato Preventivo or a Debt Restructuring Agreement

The first type of DIP Financing regulated by the Insolvency Code is defined by Article 99 as "*financing authorized before the* homologation *of a* concordato preventivo *or a debt restructuring agreement.*"

Receivables arising from such DIP Financing qualify as *prededucibili* if the following requirements are met:

- The *concordato preventivo* or the debt restructuring agreement shall provide for the continuation of the business (*continuità aziendale*), even if temporary (*e.g.*, in cases when the aim is to preserve or increase the value of the assets of the debtor in anticipation of the debtor's liquidation, so as to satisfy creditors through the proceeds arising therefrom).

- The purpose of the financing is to allow one or both of the following: (1) The continuation of the business until the homologation of the *concordato preventivo* or the debt restructuring agreement, as the case may be; (2) "*The access to such insolvency proceedings and their execution* (*svolgimento*)."

Notably, the latter requirement means that:

- As a general rule, the financing cannot be utilized (*per se*) for the repayment of receivables incurred before the *concordato preventivo* proceedings, even if it falls within the ordinary course of business of the debtor. As an exception to this rule, Article 100 of the Insolvency Code provides that the debtor may request the court to authorize the repayment of receivables for goods and services provided before the commencement of the proceedings,[6] if it demonstrates that repayment of those receivables is essential to the continuation of the business and ensures a better return to the creditors, as certified by an independent expert's report[7] to be filed along with the relevant petition.

- The financing must be aligned to the "best return" (*migliore soddisfazione*) for creditors — meaning that the debtor must provide evidence that the financing is purported (and able) to create value for the

benefit of its creditors and increase their recovery ratio, compared to the scenario in which no financing is made available.

- The debtor must provide evidence that: (1) It is unable to obtain the financing through other means; and (2) A severe prejudice to the continuation of the business or the continuation of the insolvency proceedings will occur should the financing not be obtained. Such requirements — which, under the Bankruptcy Law, are provided for only with respect to certain forms of interim urgent financing — could significantly restrict the debtor's ability to access such a type of DIP Financing. This is because it will be very difficult for the debtor to provide evidence of such urgency and foreseeable prejudice, which is ultimately based on projections and forecasts of the company's financial situation.

- Any financing which is intended to be utilized after the homologation of the *concordato preventivo* or the debt restructuring agreement, as the case may be, either (1) for the performance of the obligations provided in the *concordato preventivo* proposal or in the debt restructuring agreement or (2) for other obligations to be performed in contemplation of the underlying restructuring plan, is excluded from this type of DIP Financing.

The debtor, in seeking authorization for DIP Financing, will file with the court an *ad hoc* petition that shall:

- Indicate the purpose of the financing

- Describe the fulfilment of the conditions referred to above, and provide the relevant evidence accompanied by an independent expert's report certifying that the financing:

  - Is essential for the continuation of the business until the homologation of the *concordato preventivo* or the debt restructuring agreement, as the case may be (and/or to access such insolvency proceedings and their execution)

  - Realizes the "best return" for the creditors

Such a report is not required in urgent cases, in order to avoid severe and irreversible damage to the business.

The petition may be filed at any point during the proceedings, either after or at the same time as the filing of a petition to access a *concordato preventivo* or a debt restructuring agreement[8] and before its homologation. The court shall respond to the petition within 10 days of the filing, after having considered the opinion of the judicial commissioner and, if deemed appropriate, of the main creditors.

Financing Provided in Performance of a *Concordato Preventivo* or a Debt Restructuring Agreement

The second type of DIP Financing regulated by the Insolvency Code is defined by Article 101 as "*financing made in performance of a* concordato preventivo *or debt restructuring agreements.*"

Receivables arising from such DIP Financing qualify as *prededucibili* if the following requirements are met:

- The *concordato preventivo* or the debt restructuring agreement provide for the **continuation of the business** (*continuità aziendale*) as a way of overcoming the state of crisis or insolvency, thus excluding all cases in which the relevant plan provides for the liquidation of the business and the

repayment of the creditors though the proceeding arising therefrom (including the case of temporary continuation of the business in the view of a more profitable liquidation).

- The financing will be utilized for the **performance** of a *concordato preventivo* or a debt restructuring agreement. The authors of this *Client Alert* believe — in line with the corresponding provisions contained in the Bankruptcy Law — that this requirement is met when the financing is intended to be utilized for either:
  - The performance of the obligations provided for in the *concordato preventivo* proposal or in the debt restructuring agreement
  - Other obligations to be performed in contemplation of the underlying restructuring plan (*e.g.*, making the investments necessary to increase the profits of the business and generate the cash needed for the repayment of the creditors)
- The court has homologated the *concordato preventivo* or the debt restructuring agreement for which the financing is being provided.
- The financing is expressly contemplated by the restructuring plan, but no specific indication of all the terms and conditions of the financing is imposed on the debtor, who is under no obligation to have fully negotiated the relevant agreements before the homologation.[9]

A key question concerning Article 101 of the Insolvency Code is the meaning of the expression "financing provided (…)" and, more specifically, whether it shall be interpreted as referring to a financing that has been executed, made available, advanced, or utilized in performance of the *concordato preventivo* or the debt restructuring agreement. Thus, a financing shall be deemed as "provided" in performance of such proceedings when the financing is either advanced or utilized after the homologation, regardless of the moment when the same financing has been made available or the relevant agreement executed. It is fairly common in practice that the agreements are entered into before the homologation but become effective subject to the occurrence of the homologation.[10]

Special Provisions for Shareholders' DIP Financing

As a general rule, shareholders' financing made to a company in a situation of over-indebtedness or financial distress is subordinated to the prior repayment of the company's other debts.

Similar to the Bankruptcy Law, the Insolvency Code contains certain exceptions to the aforementioned principle in order to encourage shareholders to provide financing to companies undergoing a situation of crisis or insolvency. More specifically:

- Receivables arising from shareholders' DIP Financing provided by shareholders qualify as *prededucibili* up to **80%** of their amount, while the residual 20% shall remain subordinated (Article 102, paragraph 1.[11]
- As an exception to the above, *prededuzione* will cover **100%** of the amount of the DIP Financing receivables if the lender becomes a shareholder "*in performance of*" the *concordato preventivo* or the debt restructuring agreement (Article 102, paragraph 2). In this scenario, the width of the expressions used in Article 102 of the Insolvency Code could create some uncertainty as to when the lender needs to become a shareholder in order to benefit from a full *prededuzione*. However, there are few indications that the provision would apply to lenders who became shareholders not only after, but also

before the homologation of the *concordato preventivo* or the debt restructuring agreement (but after the filing of the relevant petition with the court).[12]

Ineffectiveness of *Prededuzione*

A new feature of the DIP Financing regulation outlined in the Insolvency Code is the introduction of certain circumstances that will trigger the ineffectiveness of *prededuzione*, namely:

- With respect to DIP Financing authorized before the homologation of a *concordato preventivo* or a debt restructuring agreement, if both:
  - The authorization for the financing was obtained by the debtor with fraud, or if the petition filed by the debtor or the independent expert's report contained false data or omitted relevant information.
  - The lender was provenly aware of such circumstances at the time when the financing was advanced.
- With respect to DIP Financing made in performance of a final approved *concordato preventivo* or debt restructuring agreement, if both:
  - The restructuring plan is based on false data, or omits relevant information or if acts of fraud detrimental to the creditors have been committed by the debtor.
  - The lender was provenly aware of such circumstances at the time when the financing was advanced.

Notably, the majority of academics and certain case law concur that the benefit of *prededuzione* may become ineffective if DIP Financing is provided after a significant discrepancy between the restructuring plan's projected milestones and the actual results — provided that the lender was provenly aware of such a discrepancy at the time when the financing was executed or advanced, and notwithstanding the absence of any such provisions in the Bankruptcy Law. However, since the Insolvency Code does not contemplate any provision of this kind, it is uncertain whether this rule applies — or will be applied by case law — once the same code comes in full force and effect.

Lastly, whether or not the benefit of *prededuzione* becomes ineffective if the rights and obligations arising from DIP Financing are transferred or assigned to a third party remains unclear. However, based on case law and many academics' interpretation of the Bankruptcy Law, the correct solution will likely distinguish between the following:

- The assignment or transfer of DIP Financing receivables, in which case the assignee/transferee should benefit from the *prededuzione* to the same extent as the assignor[13]
- The assumption or transfer of the corresponding debts and liability incurred in connection with DIP Financing, in which case *prededuzione* would operate exclusively towards the original debtor to whom DIP Financing was originally provided (rather than towards the new debtor)

Conclusion

The Insolvency Code has significantly simplified the relevant legal framework by introducing a new set of provisions on DIP Financing in connection with *concordato preventivo* and debt restructuring agreements.

Although certain new provisions have helped create a more comprehensive and advanced framework for DIP Financing, the legislator could have gone further by solving certain controversial issues that frequently occur. The long interim period before the Insolvency Code will come into force should allow the legislator and professionals to identify some amendments that frequently draw skepticism concerning their effectiveness and ability to streamline the relevant proceedings.

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Endnotes

[1] The relevant provisions will come into force 18 months after the publication of the Insolvency Code in the Official Journal of the Republic of Italy (*Gazzetta Ufficiale*), which occurred on 14 February 2019.

[2] Pursuant to Article 182-*quater*, paragraph 2, of the Italian Bankruptcy Law, receivables arising from financing made for the purpose of allowing the debtor to access a *concordato preventivo* or debt restructuring agreement are *prededucibili*, under the condition that *prededuzione* is envisaged by the relevant plan and is expressly confirmed by the court in the homologation decree.

[3] In accordance with Italian banking law mandatory provisions, whoever carries out lending activity on a professional basis in Italy must be authorized as a bank or a financial intermediary pursuant to Legislative Decree No. 385 of 1 September 1993 (the so-called "Italian Consolidated Banking Act"). Hence, entities that intend to provide financing to an Italian entity must be either (1) EU financial institutions, (2) EU branches or Italian branches of non-EU financial institutions, or (3) non-EU financial institutions which have been duly authorized by the competent Italian authority.

[4] These are bilateral operating facilities for the anticipation of invoices. Once the invoices are presented to the bank, the bank loans a percentage of the relevant amount to the debtor. The proceeds are then collected by the same bank, credited to the bank account of the debtor and eventually applied for the repayment of the bank's receivables towards the debtor arising from the anticipations originally made.

[5] Court of Milan, 5 October 2017, in *www.ilfallimentarista.it*, which refers to a DIP Financing directly provided to a newco incorporated by the debtor; on the contrary, the benefit of *prededuzione* was denied in a similar case by the Court of Pisa, 29 June 2018, in *www.ilfallimentarista.it*, which refers to a DIP Financing originally made to the debtor and subsequently transferred to a newco (incorporated by the debtor) along with the entire business of the debtor.

[6] The same rules apply to the authorization for the repayments of salaries of employees of the debtor that accrued during the month preceding the filing of the petition with the court.

[7] The report is not required if the amount of the payments is equal to — or lower than — the amount of the financial resources provided to the debtor (1) without any repayment obligations on the same debtor or (2) the repayment of which is subordinated to the prior satisfaction of other debtor's liabilities.

[8] The same authorization may be requested by the debtor at an earlier stage, together with — or after — the filing of the pre-petition aimed at obtaining protection from, *inter alia*, potential interim actions (*azioni cautelari*) and enforcement actions from the creditors for the time needed to prepare and file (within the timeframe to be determined by the same court) the documentation needed for the admission to a *concordato preventivo* or the homologation of a debt restructuring agreement.

[9] This solution has been offered with respect to the corresponding DIP Financing provisions under the Italian Bankruptcy Law by the so-called "*Guidelines for the Financing of Distressed Businesses*" (*Linee Guida per il Finanziamento delle Imprese in Crisi*) approved by, *inter alios*, the National Board of Chartered Accountants and Accounting Experts (*Ordine Nazionale dei Dottori Commercialisti ed Esperti Contabili*) (p. 62).

[10] Regarding the corresponding provisions of the Italian Bankruptcy Law, it is debated whether *prededuzione* could also apply if the financing is advanced before the homologation of the *concordato preventivo* or the debt restructuring agreement.

[11] The subordination of the remaining 20% is not expressly provided under the Insolvency Code, but it is mentioned by the explanatory memorandum published with the last draft of the Insolvency Code that was circulated before the Insolvency Code's publication in the Official Journal of the Republic of Italy (*Gazzetta Ufficiale*).

[12] Namely:

- The fact that Article 102, paragraph 2, of the Insolvency Code refers to all forms of DIP Financing, including those authorized before the homologation; in doing so, such provision implicitly contemplates the case in which the lender has become a shareholder during the period preceding the same homologation
- The fact that — unlike Article 101 of the Insolvency Code (which expressly refers to financing made "in performance of an homologated c*oncordato preventivo* or debt restructuring agreement") — Article 102, paragraph 2, of the Insolvency Code merely requires that the shareholding is acquired in performance of such proceedings, without any reference to the homologation requirement

[13] This principle was stated by Tribunale di Mantova, 21 April 2005, in *www.ilcaso.it*.