Repaying creditors without imprisoning debtors

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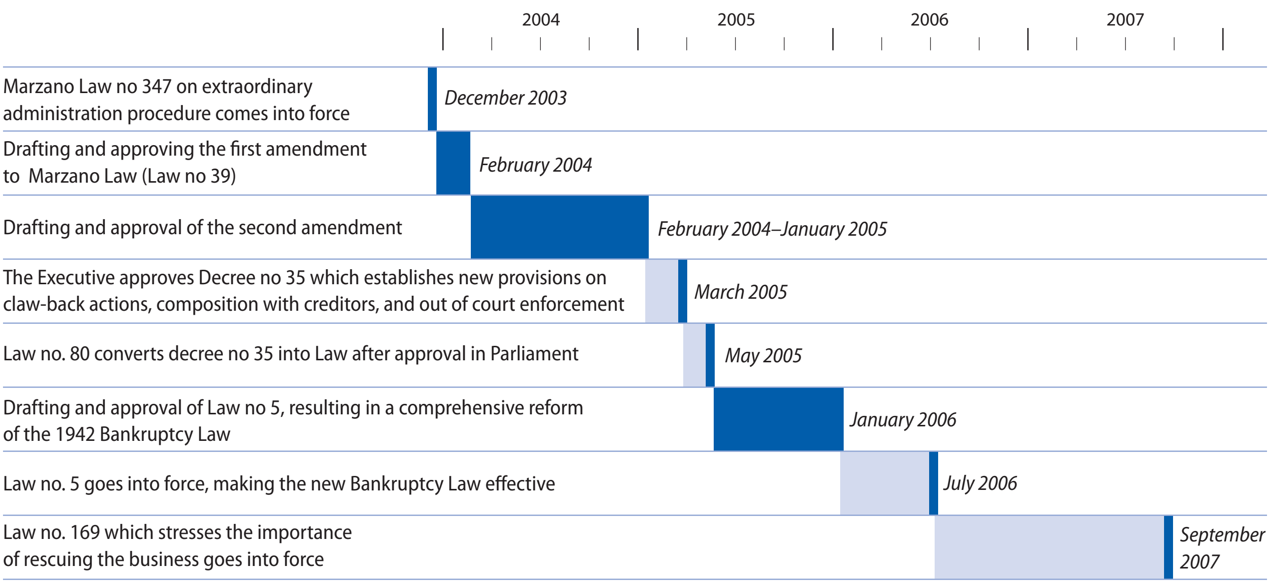
In 2003 Italy's bankruptcy law was over 60 years old—not ideal to keep up with economic transformation. Judges, lawyers, businesses, and creditors all knew that the law needed change. But the process was slow, requiring a jumpstart from major financial crises, like Parmalat's 2003 demise. In the wake of the crisis the Italian government, Parliament, and anyone up for reelection shifted their focus to implementing structural reforms to enhance Italy's competitiveness, especially internationally.

The new law aimed at creating a process similar to Chapter 11 in the United States, transferring the focus of proceedings from liquidation to corporate reorganization and restructuring. This framework strengthened creditors' rights, stimulating the flow of credit to small and medium-size firms.

With the new laws the process no longer takes up 7 years, as before, and it preserves the value of the company. *Doing Business* estimates that creditors are repaid in less than 2 years, with the recovery rate at €0.62 cents per Euro owed—almost double the €0.38 in 2002, according to the Italian Bankers Association. Although the new law provided Italy with an efficient insolvency system, more can be done to implement the law effectively.

FIGURE 1
Timeline of bankruptcy reform in Italy

Source: Doing Business database.



The first step—don't view debtors as criminals

Italy's old bankruptcy procedures were 1-dimensional and inflexible, with major hurdles to successful reorganization. The high costs and expenses of insolvency procedures used up much of the asset value. And the process was long—7–8 years.[1] So, unsecured creditors did not usually recover their claims, with negative spillovers to the whole economy, especially to the reallocation of resources.

Before the reform Italian bankruptcy laws were harsh, treating the debtor as a wrongdoer or a criminal—deprived of the right to vote in elections and disallowed from reentering the market as an entrepreneur or a consumer. To adapt to the modern economy, Italy had to change not only laws and procedures but legal culture and mindsets. The law succeeded in this, imparting a new attitude toward insolvency and bankruptcy. The emphasis shifted to debt restructuring agreements that rescue the business instead of liquidating the debtor's assets. Out-of-court restructuring agreements are the most likely proceeding, taking less time to complete and preserving the business.

Reform came progressively by slowly adopting various laws and decrees in piecemeal. On 1 December 2003 Marzano Law 347 on extraordinary administration was enacted. Law 39 passed on 18 February 2004, amending the Marzano Law. On 14 May 2005 Law 80 on judicial composition with creditors converted into law Decree 35, passed in March 2005. On 9 January 2006 the comprehensive reform Law 5 was passed, going into force on 6 July 2006. The latest reform, Law 169, passed on 12 September 2007 and took effect on 1 January 2008.

Scandals to jumpstart reform

The scandals that struck Italy's market and the demise of Parmalat, Volare Airline, Cirio, and Giacomelli drove the first installments of the bankruptcy law reform. Emergency measures created the political space to negotiate deeper changes in the system. The Italian Constitution (Article 77) allows the government to issue provisional decrees having the force of law, but these decrees must be ratified by Parliament within 60 days. This legislative flexibility allowed the government to start the reform process.

Introducing extraordinary administration

On the heels of Parmalat's failure came the Marzano Law (called the "Parmalat Decree"), set out in Decree Law 347/2003 and amended by Law 39/2004. The Marzano Law tried to streamline the standard procedure of "extraordinary administration" in Decree Law 270/1999 by reducing the administrative burden and extending the time limits of recovery plans. The law brought faster admission to the special insolvency regime for companies meeting its requirements. Insolvent companies of more than 1,000 employees, at least a year since the insolvency, and debt of €1 billion or more could apply to the minister of production for immediate admission to extraordinary administration and for the appointment of an administrator to manage the business.

The Marzano Law was again amended by Law Marzano Bis on 28 January 2005, which eased the requirements to at least 500 employees, at least 1 year in insolvency, and indebtedness of €300 million.

The main advantage of the extraordinary procedure is that the claims of secured and unsecured creditors are automatically stayed. If the reorganization plan fails in 2 years, it converts into a sale plan or a bankruptcy proceeding. The law allows for the sale of the assets through private companies without administrative and judicial intervention and approval.

The sense of urgency from Parmalat's crisis carried reform forward, in 2 stages. The first, in March 2005, dealt with rescue procedures and claw-back provisions—the cancellation of transactions that preceded the declaration of bankruptcy. The second, in January 2006, simplified and shortened bankruptcy proceedings and clearly defined the roles and responsibilities of the key players.

Tackling obstacles to successful reorganization

The next installment of reform was an urgent measure, enacted in March 2005 as Decree 35/2005. It gave distressed firms tools to overcome the crisis, either through out-of-court agreements or through a formal rescue procedure (concordato preventivo, a settlement between the debtor and creditors requiring court approval). Claw-back provisions, perceived as creating an obstacle to out-of-court restructurings, were also made less severe. The administrator can no longer annul transactions essential to continuing operations that occurred between 6 months and a year before the company declared bankruptcy. On 14 May 2005 Law 80 converted Decree 35/2005 into law and mandated the government to overhaul the 1942 Bankruptcy Act.

For the first time in Italy, Law 80/2005 allowed the debtor to file a debt restructuring agreement before the court—already agreed with creditors and without any prerequisites. Before, the debtor could file a petition for composition only when it could guarantee payment of 100% of the secured claims and 40% of the unsecured claims.

Now, debt restructuring procedures are concluded within the framework of composition with creditors, complemented by an expert report on the feasibility of the agreement. The creditors then vote on the composition. Secured creditors do not participate because they are expected to be paid in full. The composition needs the approval of the majority of claims admitted to vote. When there are several classes of creditors, all classes vote separately and each approves the composition by majority. The court approves the proposal if the majority of classes approve and if the court believes that the nonconforming classes will be no worse off than in any alternative—similar to the "cram-down deal" in United States law.

Law 80/2005 tackled many impediments to successful reorganization under the old regime. Under the old laws the 40 different creditor priorities and their privileges delayed the process. The new law divided creditors into classes whose interests are homogeneous. The law also introduced the concept of discharge—that is, giving debtors the ability to restart as consumers and entrepreneurs. Informal, out-of-court debt restructuring agreements are now possible, similar to the pre-packaged reorganization procedure in the United States. And under Law 80/2005 a debtor in crisis but not yet in insolvency is entitled to request composition with creditors.

Law 80/2005 also reduced the "look back" period (suspect period) to a year where it was 2 years and to 6 months where it was a year. But the most significant change was providing a detailed list of transactions that cannot be subject to claw-back actions. For example, payments for goods or services rendered and payments of debts incurred to carry on ordinary company business are enforceable. That gives the company the chance to continue operating

Simplifying and shortening proceedings

After the first installments of reform, the Ministry of Justice and the Ministry of Economy and Finance established a joint commission to prepare a comprehensive reform proposal for the bankruptcy law. The commission included 2 working groups, a group with the Ministry of Justice and a group with the Ministry of Economy and Finance. Although both groups agreed on the need to modernize the law, they had different views on what the reform should do. The Ministry of Economy and Finance working group believed it essential to give more power to creditors, accelerate procedures, and ensure the survival of viable companies. But the Ministry of Justice group wanted to preserve Italy's judicial culture, with the power of the court remaining central.

It was thus essential that the Ministry of Economy and Finance build coalitions to ensure its agenda took the lead. With the vigorous support of the Italian Bankers Association, Assonime, and Confindustria, the largest industrial and commercial associations in the country, the 2 working groups' proposals were merged. The principle was greater creditor involvement in the proceedings. The final proposal, after being made public for comments, became law in January 2006. After 64 years Italy finally had a new bankruptcy law.

The creditors' meeting was put in charge of authorizing and supervising the bankruptcy trustee. The trustee's responsibilities included, to name a few, carrying on ordinary business, liquidating assets, and motioning the judge to substitute the trustee. The judge maintained the power to authorize the trustee to undertake judicial actions when required.

After the general elections in 2006 the government further amended and improved the new law. The purpose was to reaffirm the importance of rescuing a company in financial trouble. The amendments were enacted by Legislative Decree 169 on 12 September 2007 and took effect on 1 January 2008.

Italy's bankruptcy law had to wait a long time for change. The crisis-driven approach meant that some provisions of the old law remained intact and others changed—until January 2006 the criminal provisions remained in force. The result: a slow, piecemeal reform, weakened by economic and political obstacles.

A more effective bankruptcy regime

Italy's comprehensive bankruptcy reform had 6 main aspects. First, it redefined the scope of bankruptcy proceedings from punishing the debtor to satisfying creditors. Second, it expanded the role and scope of the creditors' committee. Third, it modified the rules on executory contracts in bankruptcy. Fourth, it allowed the bankrupt business' operations to continue. Fifth, it introduced discharge from unpaid debt for natural persons. Sixth, it simplified the liquidation of the assets and the distribution of the proceeds among the creditors.

The new regime provided for 3 types of proceedings to implement the changes, aimed at saving troubled companies by preserving the business:

Controlled administration A 2-year moratorium granted to the debtor, with business activities under the supervision of the court and the court-appointed receiver. The controlled administration of companies was later abolished by law no 5/2006.

Composition with creditors (concordato preventivo) A settlement between the debtor and creditors that requires court approval.

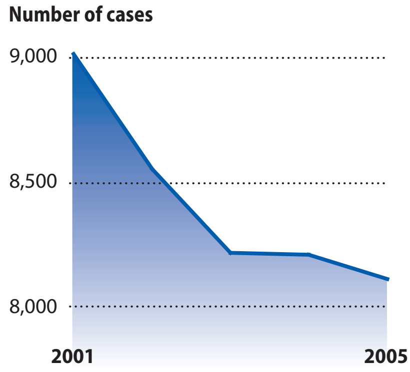
Extraordinary administration An administratively driven restructuring procedure that aims to satisfy creditors' claims while safeguarding the business.

The results—doubling the rate of recovery

Reforming the whole bankruptcy system requires a tough balancing act. If banks cannot protect their credit, they lend less—and at a higher rate. But if entrepreneurs believe that the law empowers creditors to push a company into insolvency, they will be reluctant to start new businesses. The January 2006 law struck the balance by following a new approach that focuses on corporate reorganization and restructuring, not liquidation through bankruptcy. The reform spurred creditors to cooperate with debtors in restructuring companies in crisis.

These provisions are working well on the ground. Most important, the number of bankruptcy cases is down (figure 2). About 85–90% of companies in financial distress now enter an informal workout with creditors, without court involvement.[2] The out-of-court restructuring agreements must be achieved within 6 months from filing—shortening the proceedings and preserving operations. If the debtor is declared insolvent, out-of-court restructuring agreements are resistant to any avoidance action—the agreement is exempted from being revoked by the administrator—as long as an expert assesses the restructuring plan as feasible.

FIGURE 2
Cutting the backlog of insolvency cases



Source: www.guitizia.it

The bankruptcy reform, long overdue, was the result of political choices—what was feasible in Parliament at the time. According to Michele Vietti, chairman of the Commission for the Reform of the Bankruptcy Law, "Those who govern have a responsibility to reform and cannot always wait for the best possible reform. In reality the perfect reform does not exist."

Although not perfect, the new law introduces many innovations. But more must be done for the law to live up to its principles of flexibility, lack of stigma, and direct bargaining between debtor and creditor.

Notes

1. Italian's Bankers Association (ABI).
2. From the newspaper "Il sole24 ore", www.ilsole24ore.com.