PRACTICE NOTE

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Risks for Transactions and Directors in Financially Distressed Businesses (Italy)

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A Practice Note addressing the legal and practical considerations in Italy for a company director where that company is in financial distress and may subsequently enter insolvency proceedings. This Note also outlines the types of claims that an official appointed to oversee the insolvency proceedings or represent the creditors' interests, or both, may bring against the company's former directors, or to unwind transactions that took place before any insolvency proceedings.

When a company is in financial distress and enters into insolvency proceedings, there are a variety of legal and practical issues to consider. Before the distressed company commences insolvency proceedings, the directors may need advice on what they need to do to fulfil their duties to the company, its creditors, and shareholders, and will need to consider the status of any ongoing transactions in which the company may be engaged. Once the company has commenced insolvency proceedings, the pre-insolvency actions of the directors will be scrutinised by insolvency officials attempting to achieve the greatest return for the company's creditors.

This Note considers the legal and practical issues involved in the law of Italy and addresses:

- The duties that directors owe to their company, its shareholders and its creditors, and how these duties may change according to the company's financial situation.
- The investigation of the pre-insolvency actions of the directors by insolvency officials.
- The powers of the insolvency officials to unwind any ongoing transactions and general powers of recovery in their aim to achieve the greatest possible return for the company's creditors and other applicable aims.
- The potential for any claims against the company's directors, and whether the directors can be personally pursued because of certain conduct even if ordinarily they would not be liable for the insolvent company's debts.

Directors' Duties

Royal Decree no 262 of 16 March 1942 (Civil Code) expressly includes the general duties of a company's directors. However, the company's articles of association and applicable contracts can impose other specific duties on its directors (for example, specific articles of association provisions or any kind of agreement whereby a specific duty is charged upon the director, such as sale and purchase contracts or tender contracts).

Under the Civil Code, general directors have the following duties to their company, its shareholders, and creditors:

- To act with the care required by the nature of the office and the specific competence of the individual director. (That is, a director should apply the usual care of a professional who has the capabilities for which the director has been appointed) (Article 2,392, Paragraph 1, Civil Code).
- To act in an informed manner. (That is, before taking any decision related to the management of the company, a director must follow a reasonable assessment of the information relevant to that decision) (Article 2,381, Paragraph 6, Civil Code).
- To refrain from acting where a director has a conflict of interest with the company. (That is, a director must not carry out any transaction in which the director has an interest adverse to the interests of the company) (Article 2,391, Paragraph 1, Civil Code).

In addition to these general provisions, Italian law imposes specific duties on a company's directors:

- Duties when responding to corporate losses.
- Duties when the company is in financial crisis (for more on this see How Directors' Duties Change in the Pre-Insolvency Period).

For a practice note outlining the general and specific duties of directors of a public limited company (*societa' per azioni* (SPA)) and a private limited company (*societa'*

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a responsabilita limitata (SRL)), see Practice Note, Directors' Duties in an SPA and an SRL (Italy).

Where an SPA suffers corporate losses, Articles 2,446 and 2,447 of the Civil Code set out the actions directors must take. These actions depend on the thresholds of the corporate losses. These thresholds include:

- Corporate losses affecting less than one third of the company's share capital do not constitute serious unreasonable losses, and the directors are not required to perform any specific actions other than:
  - duly monitoring the company's financial and economic situation under the Civil Code; and
  - taking any necessary actions immediately.
- Corporate losses affecting more than one third of the company's share capital, that do not reduce the overall share capital below the statutory minimum amount prescribed by the Civil Code, are considered more serious. Still, they still do not trigger any mandatory duty on the directors to recapitalise the company. However, under the Civil Code, the directors must:
  - perform certain reporting obligations; and
  - promptly call a shareholders' meeting for an SPA (Article 2,446, Civil Code) or a quotaholders' meeting for an SRL (Article 2,482-*bis,* Civil Code) to pass resolutions on the next steps to be taken.
- Corporate losses affecting more than one third of the company's share capital, that reduce the overall share capital below the statutory minimum amount prescribed by the Civil Code (Articles 2447 and 2,482-*ter,* Civil Code) constitute serious losses and trigger a duty on the directors to immediately call a shareholders'/quotaholders' meeting to recapitalise the company (otherwise, the company can be wound-up under the liquidation rules set forth under Article 2,484 of the Civil Code).

Because the Civil Code does not specify the frequency with which directors must inspect corporate losses, directors should assess any losses in accordance with the general duty of care provided for by the Civil Code.

Where a shareholders'/quotaholders' meeting is called, as stated above, the directors must provide the attending shareholders/quotaholders with a report explaining the company's financial situation. The board of directors, any statutory auditors' board, or the company's audit firm must also provide an opinion on that financial situation.

At the meeting, the shareholders/quotaholders can resolve to take appropriate action.

If there are corporate losses affecting more than one third of the company's share capital, and the loss does not reduce the overall share capital below the statutory minimum amount prescribed by the Italian Civil Code, the shareholders/quotaholders can resolve to do one of the following:

- Cover the corporate losses with shareholders'/quotaholders' contributions.
- Reduce the share capital.
- Impose an annual moratorium to reduce the corporate losses. If the corporate losses are not reduced to less than one third of the company's share capital during the following year, shareholders or quotaholders must meet and determine a share capital reduction proportional to the ascertained corporate losses.

If there are corporate losses affecting more than one third of the company's share capital, and the loss reduces the overall share capital below the statutory minimum amount prescribed by the Civil Code, the shareholders/quotaholders can resolve to do one of the following:

- Reduce the share capital to no less than the statutory minimum.
- Wind up the company.
- Transform the nature of the company.

For a note explaining the Civil Code provisions that govern how to reduce the quota capital of an Italian SRL, see Reducing the Capital of a Private Company (Italy).

However, under Articles 64 and 89 of Legislative Decree no 14 of 12 January 2019 (Insolvency Code), the shareholders/quotaholders cannot take any of the above actions where the company has filed an application for the approval of either:

- An agreement with creditors (*concordato preventivo*).
- A debt restructuring agreement (*accordo di ristrutturazione dei debiti*).

Furthermore, under Article 20 of the Insolvency Code, a company involved in a negotiated settlement (*composizione negoziata*) can make a declaration that it is suspending its duties concerning recapitalisation. Ordinarily, these duties would be imposed on the company under the Civil Code in the event of certain capital losses. This declaration must be filed with the relevant Companies House (*Registro delle Imprese*) electronic platform either with the petition for the appointment of an expert (*esperto*) or as a separate petition. The declaration allows the company to benefit from the suspension of the duties concerning recapitalisation until either:

- The conclusion of the successfully negotiated settlement.
- The termination of the unsuccessfully negotiated settlement.

How Directors' Duties Change in the Pre-Insolvency Period

The Insolvency Code became effective on 15 July 2022 and replaced former Royal Decree no 267 of 16 March 1942 (the Bankruptcy Law). Article 2 of the Insolvency Code specifically defines "insolvency" and "crisis."

Insolvency was originally defined in Article 5 of the Bankruptcy Law, under which a company was deemed insolvent when it was unable to regularly meet its obligations as they came due – the same definition of "insolvency" provided in the Bankruptcy Law has been used in the Insolvency Code. Neither the Bankruptcy Law nor the Insolvency Code specifies which facts and circumstances constitute signs of insolvency. Consequently, various matters have been substantially considered to constitute signs of insolvency by case law.

However, although a company's inability to regularly meet its obligations is often linked to a liquidity shortfall, and the shortfall can be an important sign that the company may be insolvent, that shortfall alone is not *per se* sufficient to assess that the company is insolvent. Conversely, the absence of a liquidity shortfall is not sufficient to exclude the possibility that the company is insolvent. In fact, the assessment of whether a company is insolvent (or not) will also depend, among other things, on whether:

- The liquidity shortfall can be removed in a reasonable timeframe.
- The company is capable of meeting its payment obligations by ordinary means (that is, without resorting to harmful or fraudulent acts).

To assist in determining if a company is insolvent, Article 2 of the Insolvency Code introduced a new concept, and the relevant definition, of "crisis." A company is in crisis if its financial situation makes insolvency likely, as evidenced by the company's expected cash flows not being sufficient to repay debts owed within a 12-month period.

Where a company is in crisis, the Insolvency Code and the Civil Code impose specific duties on the company's directors. Article 375(2) of the Insolvency Code introduces a new paragraph into Article 2,086 of the Italian Civil Code. Article 2,086 now states that a business owner (that is, the directors) has a legal obligation to establish:

> "an organisational, administrative, and accounting structure adequate to the nature and size of the business, also with a view to the timely detection of a company crisis and the loss of its status as a going concern, and to act without delay in such cases, implementing the appropriate legal tools to overcome the crisis and recover the status of a going concern."

Article 2,086 therefore provides a reference standard of general scope for companies to effectively assess the functional organisation of the business and to detect a company crisis at the earliest opportunity. Under Articles 2,380-*bis* and 2,475 of the Civil Code, Article 2086 of the Italian Civil Code specifically applies to company directors.

If a company is in crisis, the directors must promptly act without delay and implement the appropriate legal tools to overcome the crisis and recover the company's status as a going concern. In particular, the directors must promptly and without delay carry out an assessment of the potential solutions and the tools required to overcome the crisis, therefore avoiding the company's insolvency and it entering into judicial liquidation proceedings (*liquidazione giudiziale*) (formerly called bankruptcy proceedings (*fallimento*)). Under the Insolvency Code, the directors can assess the situation and enter into:

- A negotiated settlement under Articles 12 to 25 of the Insolvency Code.
- An agreement in execution of a certified recovery plan (*accordo in esecuzione di piano attestato di risanamento*) under Article 56 of the Insolvency Code.
- A debt restructuring agreement under Article 57 of the Insolvency Code.
- A moratorium agreement (*convenzione di moratoria*) under Article 62 of the Insolvency Code.
- An agreement with creditors (*concordato preventivo*) under Articles 84 to 120 of the Insolvency Code.

Where there is no opportunity to overcome the crisis, the directors can file a petition to commence judicial liquidation proceedings. However, where the directors have failed to act promptly to either assess the potential solutions or implement the necessary tools to overcome the crisis, resulting in the company seeking judicial liquidation, the directors can be liable to the company, the shareholders and the creditors for their (mis) conduct. The (mis)conduct shall be factually established according to the meeting of the following:

- The unlawful (mis)conduct of the director.
- The damage caused to the company's assets.
- The connection (that is, "*nesso causale*") between the conduct and the damage.

Examination of Directors' Pre-Insolvency Actions During Insolvency Proceedings

Under Article 341(2) of the Insolvency Code, in cases where a company is subject to judicial liquidation or is involved in an agreement with creditors, the directors may be subject to certain criminal sanctions for any fraudulent acts or misconduct committed at the pre-insolvency stage. The directors can be liable for causing:

- The company's fraudulent bankruptcy (*bancarotta fraudolenta*), where the directors' fraudulent acts caused or contributed to the company's bankruptcy (Articles 322 and 329, Insolvency Code).
- The company's simple bankruptcy (*bancarotta semplice*), where the directors delayed the filing of the petition for bankruptcy (Articles 323 and 330, Insolvency Code).

The examination of the directors' conduct is typically carried out by the public prosecutor (*pubblico ministero*). However, where a company is involved in an agreement with creditors or is subject to judicial liquidation, the examination of the directors' activities is also by:

- The judicial commissioner (*commissario giudiziale*), in cases where the company is involved in an agreement with creditors.
- The court-appointed receiver (*curatore*), in cases of judicial liquidation.

Where a company is involved in an agreement with creditors and the judicial commissioner's examination detects that certain fraudulent acts have been committed, the judicial commissioner can apply to revoke the agreement with creditors. However, directors' fraudulent acts or misconduct are more often detected in cases of judicial liquidation, which is subject to a more stringent investigation, subject to criminal liability.

In a judicial liquidation, the directors are effectively replaced by the court-appointed receiver, who then manages the company and enforces its rights (including those against the directors) under the court's supervision. The court-appointed receiver, among other things, carries out any necessary activities required to assess potential misconduct or fraudulent activity by the directors in the period before the commencement of the judicial liquidation proceedings. In particular, Article 255 of the Insolvency Code grants the court-appointed receiver the power to file any liability action available under the Civil Code against the directors for the actions they took when managing the company, including the action for directors' liabilities towards the company (*azione sociale di responsabilità nei confronti degli amministratori*) (see Potential Claims Against Former Directors). An action for directors' liabilities towards the company is subject to a statute of limitations of 5 years from the date on which the director's (or directors') appointment was terminated. However, according to a legal presumption, in case of judicial liquidation the statute of limitations starts from the date of the judicial liquidation declaration.

Under Article 130(1) of the Insolvency Code, no more than 30 days from the commencement of the judicial liquidation, the court-appointed receiver must issue to the delegated judge (*giudice delegato*) a first preliminary report (*informativa*), highlighting the reasons for the insolvency and setting out the receiver's evaluations of the diligence of the directors and any of their potential liabilities. This preliminary report provides the delegated judge with an initial description (even if only in summary form) of the causes of, and circumstances surrounding, the insolvency and of any potential liability of the persons involved in the management and control of the company, including the directors.

Under Article 130(4) of the Insolvency Code, no more than 60 days from the date of filing the decree of enforceability of the statement of liabilities, formerly known as the opening of the insolvency proceedings under the Bankruptcy Law), the court-appointed receiver will file a second detailed report (*relazione particolareggiata*) with the delegated judge containing further details about:

- The time and causes of the occurrence of the crisis.
- The time and causes of the occurrence of the insolvency.
- The diligence exercised by the debtor-company in the conduct of its business.
- Any potential liabilities of the debtor or others (including directors).
- Any other matter that may also be of interest for the purposes of preliminary criminal investigations.

Additionally, under Article 130(5) of the Insolvency Code, where the entity subject to judicial liquidation is a company, the second report must also describe the facts ascertained and the information gathered concerning the potential liability of:

- The company's directors.
- The company's supervisory board.
- The company's shareholders who, under Article 2,476(7) of the Civil Code, intentionally decided on or authorised the performance of acts detrimental to the company.
- Any other persons of interest who are not directly related to the company.

These details must be included to ascertain the appropriateness of commencing any liability actions against the above persons/bodies.

The second report must also set out the facts ascertained, and the information gathered, concerning the potential liability of any:

- General managers (Article 2,396 of the Civil Code).
- Shadow directors – shadow directors are not expressly contemplated by Italian law, however according to Italian case law (see Supreme Court of Cassation, Decision no 23151 (31 July 2023)), a shadow director is not formally appointed as a director. Rather, the shadow director exerts the powers of a director, in facts directly and continuously, with freedom of decision and in relation to material aspects of the company's business. It is not necessary for the shadow director to exercise all the powers of the directors of the company, but it is sufficient that these powers (and the transactions carried out by virtue of the same) refer to certain areas or functions of the company's business. Should a shadow director exist, they would be liable (under contract, in tort, and from a criminal law perspective) the same as a formally appointed director. The determination that a shadow director does or does not exist is fact sensitive.

The court-appointed receiver's final reporting duty is the issuance and filing with the delegated judge of periodic summary reports (*obblighi informativi periodici*), in the following timeframe:

- The first periodic summary report must be filed no more than four months after the date of filing the decree of enforceability of the statement of liabilities.
- Other periodic summary reports must be filed once every six months, after the date of filing the first periodic summary report.

The first preliminary report and the second detailed report issued by the court-appointed receiver focus on the causes of the insolvency and the activities and responsibilities of the debtor/company. The periodic summary reports essentially summarise the activities carried out by court-appointed receivers in the course of their duties.

Potential Claims Against Former Directors

Under Article 255 of the Insolvency Code, if a company is subject to judicial liquidation, the court-appointed receiver, with the approval of the delegated judge, can bring any liability action available under the Civil Code against the directors for the actions they took when managing the company. The primary action available under Article 255 is for the directors' liabilities to the company (*azione sociale di responsabilità nei confronti degli amministratori*).

When considering the duties owed by directors to the company, the court-appointed receiver considers both:

- The general duties imposed by the Civil Code (see Directors' Duties).
- Any other specific duties imposed by the company's by-laws and any applicable contracts (for example, a director's service contract).

Generally, the directors will be held liable to the company if a breach of any of the above duties caused damage to the company. The delegated judge must assess whether or not a breach of duty occurred, and whether that breach in fact caused damage to the company, on a case-by-case basis. If a breach of duty occurred and caused damage to the company, either the company, in cases where the company is involved in an agreement with creditors, or the court-appointed receiver, where the company is subject to judicial liquidation, can file an action for directors' liabilities to the company. The claimant must bring this action no more than five years from the date on which the director's (or directors') appointment was terminated. However, presumptively, in a judicial liquidation, the statute of limitations starts from the date of the judicial liquidation declaration. The claimant has the burden of proof.

Company Transactions That Can Be Challenged and Unwound If the Company Becomes Insolvent

In judicial liquidation proceedings, the court-appointed receiver is permitted to restore the economic and financial substance of the judicial liquidation estate to its pre-insolvency state:

- By setting aside transactions.
- Through claw-back.

The court-appointed receiver can take these actions for certain transactions or agreements entered into in the six-month, one-year or two-year period before the commencement of the judicial liquidation proceedings (respectively, the six-month suspect period, the one-year suspect period, and the two-year suspect period).

Under Article 166(1) of the Insolvency Code, other than when the creditor can provide evidence that it was unaware of the company's state of insolvency, the court-appointed receiver can ask the court to claw back certain transactions involving:

- Any under-valued transactions made for consideration during the one-year suspect period if the obligations of the insolvent company were greater than the value of the counter-obligations of the relevant creditor by at least 25 per cent.
- Payments of monetary debts due and payable during the one-year suspect period that were not made with cash or any other ordinary means of payment.
- Pledges, security interests, and voluntary mortgages granted during the one-year suspect period by the

insolvent company in respect of pre-existing debts, where the pre-existing debts were not yet due.

- Pledges, security interests, and voluntary or judiciary mortgages granted during the six-month suspect period in respect of due and payable debts.

Under Article 166(2) of the Insolvency Code, the court-appointed receiver can ask a court of competent jurisdiction to set aside or claw-back certain transactions, if both:

- The transactions were conducted or carried out during the six-month suspect period.
- The court-appointed receiver provides evidence that the relevant creditor was aware at the time of the transaction of the company's state of insolvency.

Subject to these conditions, transactions that can be set aside are:

- The payment of debts that are due and payable.
- Any transactions entered into for consideration.
- Any security interests granted simultaneously with the creation of secured obligations including if the security interests were granted to a third party.

The court-appointed receiver cannot exercise a claw-back action under Article 166 of the Insolvency Code for certain transactions including:

- Payments for goods and services made in the ordinary course of business and on standard market terms (*termini d'uso*).
- Remittances made on bank accounts, to the extent they did not have the effect of significantly reducing, in the long term, the debt of the insolvent company to the bank.
- Sale and purchase agreements and, subject to certain conditions, preliminary sale and purchase agreements of houses for fair consideration, which were to be used as main residence for either:
  - the purchaser; or
  - certain relatives of the purchaser.
- Acts, payments, and security interests made or granted over the company's assets, to the extent these were made or granted in execution of an agreement that is subject to a certified recovery plan.
- Acts, payments, and security interests made or granted in the framework of agreements made in the execution of:
  - a certified recovery plan;
  - debt restructuring agreements; or
  - an agreement with creditors.

Under Article 163 of the Insolvency Code, subject to a limited number of exceptions, any gratuitous acts conducted by the insolvent debtor company in the two-year suspect period are ineffective (*inefficaci*). In these cases, the court-appointed receiver is entitled to obtain a declaration of the ineffectiveness of these acts without bearing any burden of proof. In the context of intra-group transactions, some courts have held that transactions carried out in the two-year suspect period by the insolvent company without any corporate benefit to that company are gratuitous acts, and therefore are ineffective under Article 163 of the Insolvency Code (see Supreme Court of Cassation, Decisions no 18,815 (28 July 2017) and no 17,200 (9 October 2012)).

Under Article 165 of the Insolvency Code and Article 2,901 of the Civil Code addressing ordinary revocation (*revocatoria ordinaria*), either the court-appointed receiver (in the course of judicial insolvency proceedings), or the creditor (in the absence of any such proceedings), can apply to have acts by which the company improperly disposes of its assets to the prejudice of its creditors declared ineffective. This is possible if:

- The company was aware of the prejudice the act would cause to the creditor's rights, or if the act was conducted prior to the existence of the creditor's claim, and the act was designed to fraudulently prejudice the satisfaction of a future creditor's claim.
- In the case of a non-gratuitous act, the third party involved in the act was aware the act would cause prejudice to the creditor's claim, or if the act was made prior to the existence of the creditor's claim, that third party participated in the fraudulent scheme.

Payments of amounts due and payable cannot be subject to claw-back under Article 2,901 of the Civil Code and Article 165 of the Insolvency Code. Those actions will not prejudice rights purchased for consideration by third parties in good faith.

Duties of Insolvency Officials and Other Authorities to Investigate Pre-Insolvency Transactions and Director Conduct

Under Italian law, the court-appointed receiver's duties are slightly different from those of similar officials in other jurisdictions. The court-appointed receiver is bound by the provisions set out in Article 38 of the Insolvency Code. In particular, the court-appointed receiver must fulfil the duties of their office, whether imposed by law or arising from an approved liquidation plan with the same diligence required by the nature of the appointment. This is similar to the duty to act with care required by the directors to their company under Article 2,392 of the Civil Code (see Directors' Duties).

The diligence required of a court-appointed receiver is not merely a generic standard of diligence. Instead, it is categorised as the high degree of professionalism required to perform the role, given its complexity and the technical skills required. Additionally, Article 38 of the Insolvency Code specifically provides that a court-appointed receiver has certain obligations, including the issuance of an electronic register that:

- Can be accessed by:
  - the delegated judge; and
  - each member of the creditors' committee.
- Is used by the court-appointed receiver to record, daily, their actions and operations that relate to the administration of company.

The Insolvency Code does not impose any other duties or obligations on the court-appointed receiver other than those outlined above. There is no specific duty or obligation imposed by legislation on a court-appointed receiver to investigate pre-insolvency transactions or the directors' previous conduct. However, according to the general principles of Italian law, the activities conducted by the court-appointed receiver must intend to:

- Respect the rule that the same treatment will be provided to all creditors of the same ranking (*par condicio creditorum*).
- Maximise the returns for all creditors.

As a result, while no express duty or obligation is imposed by specific legislation, the court-appointed receiver can still, in practice, rely on any remedy or action provided for in Italian law to achieve the purposes outlined above.

Powers of Insolvency Officials and Office Holders to Require the Production of Information, Documents, or Assets When Investigating

Italian law grants no specific powers to the court-appointed receiver to order or require the production of information, documents, or assets during an investigation. However, under Article 194 of the Insolvency Code, the debtor company involved in judicial liquidation proceedings must provide the court-appointed receiver with:

- Details of any cash amounts available to the company.
- Details of any promissory notes or other credit titles provided to the company even if overdue.
- The accounting records of the company.
- Any other documentation required by the court-appointed receiver if such documentation has not already been filed with the clerk of the appropriate court.