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Alert and Prevention Measures in the New Italian Crisis Code

The New Legal Framework and Its Philosophy

On 12 January 2019, Legislative Decree No 14, the new Crisis and Insolvency Code (the Code), was introduced into the Italian legal system. The Code consists of a multifaceted regulatory framework, intended to replace the 1942 Bankruptcy Act, which was unanimously considered outdated and, therefore, devoid of the tools needed to manage today's business crises.

The new rules aim to promptly detect an incoming crisis, to provide adequate tools to turn around businesses which show promise of survival, and – prospectively – to build a new entrepreneurial culture.

An overall examination of the new provisions highlights the legislators' ambition to push forward a real cultural change in the management of crises and insolvencies, which will hopefully end up spreading to contiguous areas of the law.

The new law intends to:

- eliminate the negative implications which have traditionally accompanied the concept of *fallimento* (Italian for "bankruptcy"), which is clearly semantically close to "failure" and has been deleted from the Code, making room for the new idea that crisis and insolvency – especially in a complex world like the present – are just phases during the life of a company; and
- ensure that all those involved in the business crisis effectively and responsibly perform their duties, in the widely shared assumption that while a terminally ill company must be removed from the market, because its "disease" may spread into the community, a healthy company (or one with a noticeable residual vitality) should be preserved and helped to overcome its crisis, since its preservation benefits the community.

In pursuance of the above, among the general principles at the beginning of the Code, some obligations have been set out. These obligations include:

- the duty of the debtor to "adopt appropriate measures to promptly detect the crisis and take immediate action in order to deal with it", by equipping themselves with adequate organisational structures (Article 3 of the Code);
- the duty of the debtor – and of those with whom the debtor is dealing in the management of the crisis – is to behave fairly (Article 4 of the Code); and
- the duties of the competent authorities (Article 5 of the Code).

In addition, the Code requires that the corporate bodies of the debtor and certain categories of creditors, called "qualified creditors", report the crisis in order for it to be promptly detected and dealt with. Rewards or penalties are respectively applied in the event of compliance or non-compliance with such obligations.

It is noteworthy that an "early warning" procedure has also been set up by EU Directive No 1023/2019 on preventative restructuring frameworks. This directive aims to strengthen, by means of soon-to-be-enforced national legislation, the culture of crisis prevention and recovery in the European Union.

One essential clarification needs to be made: although the Code will come into force within 18 months from its publication in the official journal (*Gazzetta Ufficiale*), therefore on 20 August 2020, some of its provisions – including those affecting corporate governance – already came into force on 16 March 2019 because of their function, which is "somehow preparatory to the entry into force of alert tools" (see the government's Explanatory Report to the Code).

Alert Procedures and Crisis Composition: General Notes

The Code deals with alert procedures immediately after the general provisions. This location has been strategically selected, since these procedures are functional in both the detection and the management of a crisis, hopefully at such an early stage as to exclude the need for the adoption of jurisdictional remedies.

The Code defines crisis in a new way (Article 2, letter "a"), clearly describing it as "a state of economic and/or financial difficulty that makes the debtor likely to become insolvent, and which, for companies, consists of the inadequacy of prospective cash flow to regularly meet obligations". Crisis is therefore codified in terms of prospective – and not current – insolvency.

In a nutshell, the set of rules in question aims to ensure that the entrepreneur promptly becomes aware of the crisis, and is induced to deal with it in a confidential and professionally qualified out-of-court context that should allow for an assessment of the opposing, but not necessarily divergent, interests of the debtor (and any corporate control bodies) as well as the creditors. This discipline allows for the crisis to be managed in a more efficient way.

In general, the rules governing alert and crisis composition procedures are divided into two essential phases:

- an alert phase, which the legislators define as "instruments of alert" (Articles 12–18 of the Code); and
- a procedural phase, a so-called "procedure of assisted composition of the crisis" (Articles 19–23 of the Code) before the Composition Board of the Enterprise Crisis (*Organismo di Composizione della Crisi* or the OCRI), "whose task is to receive the reports and to manage the

alert phase and, for enterprises other than the small ones, the OCRI manages the phase of the assisted composition of the crisis" (Article 2, letter "u" of the Code).

The framework is completed by the so-called "bonus measures" (Articles 24–25 of the Code) which the legislators intend should encourage companies to use assisted composition procedures.

In such a system, the formulation of the indicators or indexes of the crisis is very important (Article 13 of the Code): the identification of such indicators has therefore been delegated to the National Council of Chartered Accountants (CNDCEC).

These indicators are legal means which allow the entrepreneur to promptly become aware of the crisis in the company, allowing them to adopt the necessary measures: thus, straight after the promulgation of the Code, a lively debate arose on the identification of such indicators, which eventually led to the diffusion, by the CNDCEC, of extremely detailed operative guidelines.

A fundamental prerequisite for the reliable functioning of the warning system designed by the Code is the adoption, by the entrepreneur, of adequate organisational structures aimed at promptly recognising the crisis.

Having outlined the general picture, we can now analyse the alert phase, which precedes the activation of the OCRI procedure.

The Alert Phase

General rules and scope of application

The alert phase is a complex structural mechanism aimed at making the internal organisation of the business aware of the existence of a crisis, thereby activating a series of steps which, even if the company or the entrepreneur is inactive, will still trigger the alert procedure before the OCRI.

Article 12 of the Code, paragraphs 4 and 7, identifies all debtors who carry out entrepreneurial activities, along with agricultural enterprises and minor enterprises (Article 2, paragraph 1, letter "d" of the Code), as the subjects to whom the discipline is applicable.

At the same time, however, the same Article 12, paragraph 4, excludes from the list of companies subject to the alert: large companies (Article 2, paragraph 1, letter "g" of the Code), groups of companies of significant size (Article 2, paragraph 1, letter "i" of the Code), companies with shares in regulated markets and those with shares held to a significant extent by the general public, according to the criteria established by the Companies and Exchange Commission (*Commissione Nazionale per le Società e la Borsa* or the Consob).

Finally, paragraph 5 contains a long list of excluded companies: large companies operating in the banking, finance, insurance and trust sector, usually subject to compulsory administrative liquidation (*liquidazione coatta amministrativa*).

The crisis indicators

The activation of the alert depends on the occurrence of certain indicators, which the legislators have assumed to be highly relevant alarm signals to detect the existence of a crisis: therefore, such indicators are the keystone to the whole prevention system.

Such indicators are income, equity or financial imbalances which – in relation to the characteristics of the company and of its area of activity, and based on the date of its incorporation – show "the sustainability of the debts for at least the following six months, and the prospects of continuity for the current financial year or, when the residual duration of the financial year at the time of the evaluation is less than six months, for the following six months" (Article 13, paragraph 1 of the Code).

There are two kinds of indicators: those using the cash flow that the company can generate to measure the sustainability of debt charges; and those that measure the adequacy of the company's funds with respect to those of third parties.

According to the same Article 13, paragraph 1, crisis indicators also include repeated and significant payment delays (eg, salary debts and supplier non-payments).

The norm is completed by one more provision, stating that:

- every three years, pursuant to the first paragraph of Article 13 of the Code, in accordance with both national and international best practices, the CNDCEC must draw up the relevant indicators which, cumulatively assessed, suggest the existence of a crisis; such specific indicators must be separately formulated for innovative start-ups, innovative SMEs, companies in liquidation, and companies incorporated for less than two years; and
- the entrepreneur who considers the national indicators inadequate in relation to the specific characteristics of their company, may indicate the reason for this inadequacy in the financial statements, thus adopting their own crisis indicators; the effectiveness of this derogation is, however, subject to the existence of a specific attestation, issued by an independent professional, which must be attached to the explanatory notes of the financial statements and which forms a substantial part of them. These "tailor-made" indicators will be in force from the financial year following the one in which they were approved and adopted.

Reporting obligations
Introduction:

The alert system is aimed at providing not only the entrepreneur with all the tools needed for a more accurate forecast of the performance of the company, but also for the internal control bodies of the company to report the onset of a crisis, in the first instance, to the entrepreneur and then, if required, to third parties.

The Italian legislators have, therefore, also built in a system of reporting obligations that aim to make this instrument effective.

The structure of the system is very simple:

- the corporate control bodies, the auditor and the auditing company are required to report "internally"; and
- the Italian Tax Authority, the National Social Security Institution (INPS) and the Tax Collection Agent are required to report "externally".

The paths through which the internal and external reporting are reached are inevitably different, even if their rationale is the same.

The control bodies:

Pursuant to Article 14 of the Code, the corporate control bodies, the auditor and the auditing company must take certain actions when the existence of crisis indicators is detected.

Despite the fact that the wording of the law seems to place the above-mentioned three bodies in the same position, their functions and duties are, in fact, extremely different. The activities of the auditor are limited to the delivery of a professional opinion on the correctness of the financial statements; therefore, they are in no way similar to the supervisory duties entrusted to the corporate control bodies by the Italian Civil Code. In particular, the auditor does not take part in the board of directors' meetings, does not supervise either the management or the adequacy of organisational structures, and cannot express opinions on the interim financial statements. In other words, the auditor carries out an ex-post control on the final documents drawn up by the company, which is very different from the ex-ante supervision carried out, from a prospective and forward-looking perspective, by the statutory auditors.

In any case, as to the report by the internal corporate bodies:

- if they detect the existence of well-grounded indicators of crisis (and in this sense, as mentioned, the indexes elaborated according to Article 13 of the Code will be fundamental) pursuant to Article 14, paragraph 1, they must immediately report their existence to the management body, in written form and with adequate explanations, through electronic certified email (or equivalent means), with contextual granting of a term not exceeding 30 days within which the management body must report on the steps taken to overcome the crisis; and
- in the event of inactivity in the 60 days following the expiry of the assigned term, the entity that has detected the crisis must report it to the OCRI, in detailed form, for the purpose of activating the related procedure.

The provision according to which, timely reporting to the management body results in an exemption of the reporting body from liability for events subsequent to the date of the report that do not arise from prior behaviours (provided, however, that the possible inactivity of the management body is also followed by the report to the OCRI) is of primary importance, due to the dynamics it can activate between corporate bodies.

The reporting discipline is completed by provisions that somehow further strengthen and make the supervisory body responsible, since:

- banks are required to notify changes, revisions and revocation of credit lines to the internal control bodies, together with the communication they make to the client (Article 14, paragraph 4 of the Code), with the consequence that the control body will have direct access to this particular kind of information; and
- the fact that a report was sent to the OCRI cannot be cause for the revocation of the assignment conferred to the reporting body (Article 14, paragraph 3 of the Code).

Qualified creditors:

It is well known that, in the Italian economic system, an entrepreneur in crisis often finances themselves through indebtedness with the Tax Authority and social security institutions, which are generally much slower to protect their claims and to commence recovery actions. An increase in debt exposure in relation to these subjects is, therefore, quite a significant indicator that an illiquidity issue exists, at the very least.

With that being said, from the perspective of a systemic empowerment of all subjects dealing with the entrepreneur in crisis, the Code provides that so-called qualified public creditors (the Tax Authority, INPS and the Tax Collection Agent) are also required to activate a reporting mechanism.

Therefore, upon certain debt thresholds being exceeded, as indicated in Article 15, paragraph 2 of the Code (clearly differentiated for each qualified creditor):

- the three above-mentioned entities shall give the entrepreneur/debtor formal notice by electronic certified email, informing them that, in the event of non-compliance or non-regularisation (also by payment of instalments, where allowed) or in the event of lack of spontaneous activation of the assisted composition of the crisis proceeding within 90 days from receipt of the report, a report will be sent to the OCRI; and
- upon unsuccessful expiration of the term of 90 days assigned to the debtor with the notice, the public creditors shall make the relative report to the OCRI in electronic form; and
- if the debtor, after having remedied its position by negotiating the payment of the debt in instalments, is in default, the creditor must give notice to the OCRI without delay as soon as the debt exceeds the thresholds indicated by Article 15, paragraph 2 of the Code.

As for the control body, failure to comply with the requirement to activate the alert mechanism bears adverse consequences; more precisely, failure to report to the debtor and/or the OCRI (as the case may be) will result in: the loss of the preferential nature of the claims held by the Italian Tax Authority and INPS; and the unenforceability of the claim for collection costs and charges of the Collection Agent.

Critical remarks:

In terms of critical assessments, there is clearly little to note about the reporting obligation of public entities: in relation to this obligation and its functionality there is a problem of adequacy of reporting thresholds, which can probably only be tested and verified with practical experience. There is indeed an actual risk, as noted by several commentators, that the introduction of these thresholds may lead to a massive phenomenon of reports, with a consequent foreseeable impasse of the alert system and the achievement of entirely different results from those pursued by the law.

The implications relating to the reporting obligations of internal corporate bodies may appear more complex and burdensome.

First of all, in the future, the internal and audit bodies will have a far more widespread distribution than they currently have, given the modification of the mandatory thresholds for the appointment of the internal control and audit bodies in limited liability companies, which will be implemented (before the Code as a whole comes into force) with the amendment of Article 2477 of the Italian Civil Code, set forth in Article 339 of the Code. There is a wide debate around this subject. Only a few months after the Code came into force, with the introduction by Law No 55/2019 of Article 2-bis in Legislative Decree No 32/2019, it is quite significant that the legislator has already completely amended, and increased, the dimensional thresholds that need to be overcome by the appointment of control bodies (today the control body is mandatory if at least one of the following parameters is exceeded for two consecutive financial years: assets in the balance sheet equal to EUR4 million; revenues in the income statement equal to EUR4 million; average employees equal to 20 units).

Secondly, and most importantly, the reporting obligation (with the related liability exemption of the reporting body) could create a real rush to report, in a context in which the indicators referred to in Article 14 of the Code can always be assessed with margins of discretion. As a result, in the long run, this could cause a functional deadlock concerning the relationships between management bodies and control and auditing bodies, on the one hand, and, on the other hand, the risk of reporting based on excessively prudent assessments which could perhaps cause greater damage than a failure to report in the presence of a crisis.

Final considerations

The legislative innovation is certainly of epochal importance: it is up to the sensitivity of all operators (entrepreneurs, stakeholders and professionals), in their respective operational fields, to do their best to produce the desired results and not – as many fear – a stalemate in the Italian economic system.

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