



Italian insolvency law reform

This briefing looks at key aspects of the Italian insolvency law reforms introduced in May 2005, particularly at rules allowing a liquidator to claw back transactions entered into in the run up to an insolvency.

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Italy introduced reforms to its insolvency law on 15 May 2005, including amendments to provisions allowing a liquidator to 'claw back' a wide range of transactions entered into in the period leading up to insolvency. The aim of these changes is to balance the need of companies in financial difficulty to extricate themselves, for example by selling a business or subsidiary or refinancing their debt, and the need of creditors to have adequate protection against certain transactions in the run up to insolvency.

Clawback actions

Some of the most relevant changes are to the so-called 'suspect period' in clawback actions (*azioni revocatorie*). The suspect period is the period before a company's declaration of insolvency. Italian insolvency law provides that certain transactions that took place during this period are liable to challenge by a liquidator of the company. For 'non-gratuitous' transactions, the suspect period has been reduced by half.

Unless the third party is able to prove (note the onus of proof is on the creditor) that it was not aware of the state of insolvency of the debtor at the time of the transaction, a liquidator may revoke:

- any transaction for consideration not on arm's length terms that took place within one year of the declaration of insolvency. A transaction will be deemed not to be on arm's length terms when the value of assets transferred, value given or the obligations assumed by the debtor exceeds by more

than one fourth the value of what the debtor received in exchange;

- any discharge of due and payable obligations made through unusual means of payment (such as, for example, the transfer of goods to a creditor to discharge a payment obligation) that took place within one year of the declaration of insolvency;
- any pledge or mortgage granted as security for pre-existing debts that were not due and payable as at the date of grant of the relevant security that took place within one year of the declaration of insolvency; and
- any pledge or mortgage granted by the debtor as security for pre-existing debts that were due and payable as at the date of grant of the relevant security that took place within six months of the declaration of insolvency.

Additionally, if a liquidator is able to prove that a third party was aware of the debtor's state of insolvency at the time of the transaction, the liquidator may revoke the following transactions if they took place within six months of the declaration of insolvency:

- any debt repayment made through normal means;
- any pledge or mortgage granted by the debtor as security for debts arising simultaneously with the grant of the security; and
- any other transaction for consideration.

Exempt transactions

The amendments to the Italian Insolvency Act exempt certain transactions from being subject to challenge by a liquidator:

- payments for goods and services in the debtor's ordinary course of business;
- remittances to a bank account which do not substantially reduce the bank's exposure;
- a sale of real estate which is used by the purchaser for living purposes;
- deeds, payments and securities carried out or granted in execution of a judicial composition with creditors; and
- payments effected to the employees and other collaborators of the debtor.

Long-term agreements

Where a liquidator seeks to revoke payments or other actions made under an ongoing long-term agreement (eg a lease or supply agreement), the amendments clarify the amount the third party can be required to pay back. The amount will be limited to the difference between the maximum amount that its aggregate claims reached in the period in which it was aware of the debtor's insolvency and the amount of its claims on the date of the debtor's insolvency declaration.

Judicial composition with creditors

Judicial composition with creditors (*concordato preventivo*) is a specific procedure aimed at reorganising the activity of the insolvent company through agreement between the debtor and its creditors.

The debtor is no longer required to be technically 'insolvent' to be admitted to judicial composition with creditors, provided that the debtor is in a state of 'crisis'. The debtor's proposal to creditors may now provide for a wider range of arrangements, including the assignment of assets or the transfer of shares or financial instruments to creditors (as a means to satisfy their claims). The restructuring plan may also provide for creditors to be divided into different classes each of which will receive different treatment.

A majority of creditors, admitted for voting purposes, is required to approve the restructuring plan. Where there are separate classes, a majority of each class must approve the plan. Provided a majority of classes approves the plan, failure by one or more classes of creditors will not prevent court approval of the plan. Secured creditors do

not have the right to vote – it seems as though they must be provided for in full by any restructuring plan.

Out-of-court debt restructurings

The Insolvency Act provides for agreements reflecting out-of-court settlements with creditors (*accordi di ristrutturazione del debito*) representing at least 60 per cent of the debtor's entire debt to receive court approval. The restructuring agreements must be submitted together with an expert's report assessing their feasibility and confirming the debtor's ability to pay in full creditors not a party to such agreements.

Further reform of Italian insolvency law is expected in the next six months. The wide-ranging reform will, among other matters, reduce the persons and entities that can be subject to insolvency proceedings, modify the treatment of pre-insolvency contracts and the rules governing the carrying on of business by the debtor during a reorganisation, further regulate sales of the debtor's assets, and widen and strengthen the powers and role of the creditors' committee.

UK

***Concord Trust v Law Debenture Trust Corporation plc* [2005] All ER (D) 417 (Apr)**

A recent decision of the House of Lords (the UK's highest court) has clarified the rights of bondholders in UK bond issues and confirms that a bond trustee, acting according to its obligations, is not liable to issuers or their guarantors for the commercial consequences of serving a wrongful notice of default/acceleration.

Background

Elektrim Finance BV (the issuer) issued bonds guaranteed by its parent, Elektrim SA (Elektrim). The Law Debenture Trust Corporation was trustee under the terms of the trust deed governing the bond issue (the trustee). Condition 12 of the terms of the trust deed provided that the trustee at its discretion may, and must if required by 30 per cent in value of the bondholders, give notice to the issuer and Elektrim that the bonds are immediately due and payable (an 'acceleration notice') when various events of default occur. However, a proviso to

condition 12 was that there would be no event of default unless the trustee, at its discretion, had certified that the failure was ‘materially prejudicial to the interests of the bondholders’. Furthermore, the giving of an acceleration notice by the trustee was subject to the trustee ‘being indemnified to its satisfaction’. This is conventional language in both secured and unsecured bond issues.

The trustee notified Elektrim, as guarantor, that a breach of one of the conditions of the bonds had occurred. The trustee required this to be remedied within 30 days but Elektrim failed to do so. The trustee was unclear whether such failure was materially prejudicial to the interests of the bondholders.

In *ex parte* proceedings (*Law Debenture Trust Corporation v Acciona SA* [2004] EWHC 270 (Ch)), the trustee obtained guidance that there had been a repudiation of one of the conditions of the bonds and that this was materially prejudicial to the interests of the bondholders. The trustee was then requested by over 30 per cent in value of the bondholders (in due course rising to over 70 per cent in value) to issue an acceleration notice. However, as it was entitled to do so under the terms of the bonds, the trustee required to be ‘indemnified to its satisfaction’ before it would issue the acceleration notice.

Elektrim indicated to the trustee that it would apply for an injunction restraining the trustee from accelerating the bonds and indicated that it may litigate if the trustee did accelerate the bonds. The Trustee rejected as unsatisfactory the various indemnities offered by Concord Trust, who represented a committee of certain bondholders, since such indemnities did not cover any possible liability arising from Elektrim’s threatened proceedings. Concord was unwilling to provide an indemnity against a risk it thought to be grossly exaggerated and sought a declaration that the trustee was obliged to issue an acceleration notice.

Court of Appeal

The Court of Appeal ordered that the trustee should commence proceedings to determine the existence of an event of default and the validity of the proposed acceleration notice, but only after it had received an appropriate indemnity from the bondholders to cover the

litigation costs. Until such time, the trustee would not be obliged to serve an acceleration notice. Concord appealed and the Trustee cross-appealed.

House of Lords

Trustee obliged to issue an acceleration notice

The trustee argued that the mandatory obligation to give notice of acceleration did not arise unless Elektrim/the issuer accepted, or was unable to challenge, the existence of the triggering event of default. Lord Scott, giving judgment on behalf of the House of Lords, held that this was a matter of construction of condition 12 of the terms and conditions of the trust deed. He held that the trustee’s construction would render the indemnity provision otiose, since the indemnity provision was intended to protect the trustee in case Elektrim/the issuer mounted a challenge to the proposed action.

The question as to whether a materially prejudicial event of default had occurred had already been settled between the trustee and the bondholders at an earlier hearing. The bondholders had made the requisite written request. Accordingly, on the true construction of condition 12, the trustee (subject to the indemnity point) came under a mandatory obligation owed to the bondholders to give notice of acceleration to Elektrim/the issuer. The trustee could not argue that anything more needed to happen, or might happen, before it had to give the acceleration notice.

Trustee’s indemnity not to cover merely fanciful risks

Under the terms of the trust deed, the trustee was entitled to be indemnified to its satisfaction before it gave notice of acceleration. There was no dispute that the trustee’s costs of defending a challenge by Elektrim/the issuer to the existence of an event of default would be covered by the indemnity. However, the trustee argued that unless it was certain that a challenge by Elektrim/the issuer to the validity of the notice would fail, it was also entitled to an indemnity to cover its possible exposure to damages should the challenge succeed.

Lord Scott stated that the critical issue was whether the trustee was at risk, not simply of incurring a liability in costs, but also of a liability to Elektrim/the issuer in damages for loss caused by the giving of an invalid

notice. The trustee could not reasonably insist on an indemnity to cover the latter risk unless the risk was more than a 'merely fanciful one'.

No cause of action against trustee for invalid notice

The trustee argued that it was reasonably likely that Elektrim/the issuer might have a cause of action against the trustee for:

- breach of contract;
- negligence;
- conspiring with the bondholders to cause Elektrim/the issuer loss by unlawful means; and/or
- interfering by unlawful means with Elektrim's/the issuer's business.

Lord Scott found that there was no express contractual duty of care owed by the trustee to Elektrim/the issuer not to give an invalid notice of acceleration or unjustly assert an event of default. It was not necessary for business efficacy to imply such a duty. An invalid notice of acceleration would, from a contractual point of view, accelerate nothing and, where no event of default had occurred, would be of no contractual effect. It could not, therefore, constitute the basis of an action for breach of contract against the trustee.

Since the trustee was obliged to give the notice on the fulfilment of certain conditions (which had been satisfied) and it owed no contractual duty of care to Elektrim/the issuer, it was not 'remotely arguable' that the trustee's actions were negligent.

As for a possible conspiracy claim, there was no evidence whatsoever of there being any intention on behalf of the trustee to cause injury to the issuer and it could not be suggested that a bona fide, but invalid, issue of an acceleration notice could constitute 'unlawful means'. The same considerations applied to the tort of interference by unlawful means. Accordingly, it was unarguable that Elektrim/the issuer could bring a conspiracy or tort of interference claim against the trustee.

Accordingly, rejecting each of the trustee's bases of liability, Lord Scott held that it was not reasonably arguable that the trustee would be exposed to liability as a result of an invalid notice of acceleration. The trustee was not entitled to insist on an indemnity to cover such risk.

Comment

The case highlights some differences between UK and New York bond issues. Had the bonds been New York law governed, the bondholders would have had the right to enforce their bonds themselves without the need for indemnifying the trustee. New York law bonds, unlike English law bonds, also do not typically allow trustees the discretion to determine whether an event is materially prejudicial to bondholders' interests so as to constitute an event of default.

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