Freshfields Bruckhaus Deringer

# Investing in Italy

## Top 10 things a private equity investor should know

## 1. Family-owned businesses

Traditionally, family-owned businesses represent an important part of the Italian economy. These kinds of businesses may have adopted corporate governance structures that are not always in line with the business standards a sophisticated investor would expect and often key positions are held by the founder(s) and family members. The reaction of the family members to the deal may vary and be more complex to manage when the family does not exit completely. Understanding the impact of the deal on the family members at an early stage can save time and money.

## 2. Pre-contractual liability

When engaging in discussions on a deal, it should be kept in mind that Italian law provides for a principle of good faith in the carrying out of negotiations. The breach of this may result in a so-called pre-contractual liability. In particular, when negotiations are stopped without reason, a party may incur in such liability whenever its behaviour has given rise to the other party's reliance on the positive conclusion of a contract. This should be kept in mind both in drafting the relevant pre-contractual documentation and in conducting the negotiations.

## 3. Management incentive plans

When entering into negotiations of management incentive plans with Italian executives, it must be borne in mind that managers in Italy are often employed by (as opposed to being just directors, or consultants, of) the companies they provide services to and that Italian employment law and case law regulate in great detail several aspects of such employment relationships, including when (and on which terms) the employing company may (or may not) terminate their employment. Such law (and case law) provisions often come into play during discussions regarding management incentive plans (and, in particular, bad and good leaver clauses), whose negotiations quite often end up taking longer than originally planned.

## 4. Regulatory approvals

The regulatory approval procedure to acquire Italian regulated financial institutions (such as banks and insurance companies) may be quite burdensome in terms of both paperwork (the investor must provide, among other things, detailed information and documentation on its investment, acquisition and financing structure, all the way up to topco and the funds) and timing (as getting the approval may take up to several months). Among other things, the approval procedure is aimed at evaluating whether the investor would ensure the sound and prudent management of the target over a medium- to long-term investment horizon. In such respect, the Italian regulators have historically shown a sort restrictive attitude towards applications involving foreign private equity firms (which are generally perceived as short-term investors). While this attitude has recently changed and the authorities are showing a more co-operative attitude vis-à-vis this type of investor, a PE investor should anticipate that the relevant regulator will carefully look at the target's envisaged post-closing corporate governance and business plan (with a view to assessing that the regulatory capital could not be affected/endangered by the acquisition); it must be also considered that, based on what is the structure of the acquisition financing, a risk may exist that the debt used to finance the acquisition structure could be included in the calculation of the regulatory capital requirements of the target business.

## 5. Litigation process

Litigation is still a lengthy process in Italy. Lawsuits can continue for several years and the decisions of the first instance courts are usually appealed by the interested parties. Such a lengthy litigation process should be taken into account both during the due diligence phase and when selecting the more advantageous dispute resolution mechanism (ie court vs arbitration). In such respect, arbitration is usually the preferred choice among foreign investors, in consideration of the fact that arbitrators are typically experienced commercial/corporate lawyers who are better positioned than ordinary judges to deal with the provisions of an international, English language M&A agreement.

## 6. Golden share rules

Italian legislation does not provide for general restrictions in respect of foreign investments. There are, however, some investment restrictions if the target operates or holds assets in key industries in Italy, such as, inter alia, defence and national security, energy and transportation. In this connection, in 2012 the Italian legislator finalised new 'golden share' rules applicable to a wide range of M&A transactions relating to Italy-based companies or assets in said key industries. Such rules grant to the Italian government the power to impose vetoes, restrictions and/or other conditions on deals involving strategic assets. These rules also impose strict filing obligations on the parties to such transactions.

## 7. Warranties protection

As opposed to what is the case in other jurisdictions, Italy does not have a consolidated approach on management warranties. This is usually balanced by the fact that industrial sellers are usually quite prepared to give comprehensive sets of warranties, including business warranties. Secondary buyouts may be trickier, given the general reluctance of PE sellers to give business warranties: in such case, to balance the fact that, in Italy, even in secondary buyouts (and/or when the management is rolling over) the management's warranties would have a very limited scope and be subject to a very low cap (as management warranties are not really seen as financial recourse/risk allocation warranties), we have seen PE sellers being sometimes more flexible in terms of seller's warranties they are available to give.

## 8. Warranties insurance

When considering what level of warranties protection a purchaser would usually get in the context of an acquisition in Italy, it is also important to note, among other things, that while still quite uncommon, warranties insurance is increasingly being discussed (although still rarely implemented) in Italy. Insurance is not generally seen pre-packed but is usually arranged by the purchaser (there is really no clear trend on coverage/premiums payable but it is fair to say that insurance solutions in Italy are still more costly than in other jurisdictions (eg UK) due to a proper market not having developed yet).

## 9. Financial assistance prohibition

The structuring of acquisitions financed by a significant debt component needs to be assessed at an early stage as a consequence of the financial assistance prohibition provided by Italian law, which may conflict with the lenders' need to be granted security interest at a group level which is as close as possible to the target/operating companies of the group. While a debt push-down to the target's level is usually achievable through a statutory merger between investco and target (or other solutions, such as dividend upstreams or bond issues), due to the limited scope of whitewash procedures in Italy, the implementation (and timing) of such solutions usually requires careful and advanced planning.

## 10. Tax

When considering the acquisition structure, it must always be considered what is the degree of risk of the tax authorities possibly reviewing (and challenging) such structure. This is particularly true in respect of leveraged buyouts, where, in the recent years, the Italian tax authorities:

- have often challenged (on the basis of various Italian tax principles such as the transfer pricing rules, the 'business purpose test' and general anti-abuse principles) the tax deductibility of interest expenses and costs incurred by Italian investment vehicles established by foreign investors. The matter is subject to a certain degree of subjective judgment and conflicting decisions have been issued by the Italian tax courts so far on this matter; and
- have disputed the beneficial withholding treatment applied to interest and dividends paid by Italian acquisition vehicles (and/or targets) to intermediate subholding companies (often incorporated in Luxembourg), generally in situations where the same beneficial withholding treatment would have not been available to the ultimate investors. Such challenges are often based on the alleged lack of substance or beneficial ownership of such subholdings or on general anti-abuse principles.

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