EXECUTORY CONTRACTS (IN ITALIAN LAW)[⊗]

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1. The Reform of the Italian Insolvency Law, implemented with the decree of March 14th 2005 n. 35 and the decree of January 9th 2006, n. 5, contains significant elements of discontinuity compared to the former Insolvency Law of 1942.

The old provisions were profoundly altered to favor the restructuring of distressed but viable entities.

Presently, the most important and widely used procedures are the Bankruptcy Procedure (i.e. *fallimento*) and the Arrangement with Creditors (i.e. *concordato preventivo*).

Both these Procedures contain rules on the treatment of executory contracts. However, because of the different goals pursued by each of these procedures, the relevant rules are substantially dissimilar.

The goal of the Bankruptcy procedure in Italian Law is only the liquidation (*rectius*: Bankruptcy is a liquidation and a compulsory winding-up procedure). Accordingly, while the latest re-

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forms have given greater importance to the destiny of the corporate structure or its divisions, the focus remains on conceiving mechanisms to maximize the assets of the company for the benefit of its creditors.

On the other hand, the primary goal of the Arrangement with Creditors is the preservation of the company or the business. This satisfactory and preservation procedure can achieve either the restructuring or the liquidation of the company; these two objectives can be pursued within the same procedure.

Obviously, the opposite goal affects the treatment of executory contracts. Different rules apply depending on whether a liquidation or reorganization proceeding is commenced. From the debtor's perspective, executory contracts acquire a particular relevance especially in its reorganization.

In this presentation, I will outline the main characteristics of the treatment of executory contracts in the above-mentioned procedures, and I will suggests how current proposal of reform may affect the evolution of these rules in the near future.

In Italian Law the problems are the traditional ones and so principally:

- when must the idea of *pacta sunt servanda* (or "bargains must be kept") yield to the principle of *paritas creditorum* (or "equal treatment of creditors")?
- which parties in the contract deserve additional protection?

Both Bankruptcy and Arrangement with Creditors are judicial procedures that are provided for by the Court, which outlines the general structures of the process and controls its evolution.

It is necessary to point out that the Judicial Authority, when carrying out this function, is not acting, as usual in civil justice, to resolve a contrast between two opposite parties; instead this is a function of a managerial character in a proceeding focused on its specific goals.

In the following speech, I will use the term Bankruptcy to describe a liquidation proceeding, which can be used by a large number of creditors, including companies. This is because under Italian Law this word is used to make reference to proceedings which can be triggered both by individuals and companies (*rectius*: natural persons, legal persons or other entities which may be subject to bankruptcy carrying out commercial activity) while

in other Jurisdiction the term Bankruptcy only makes reference to liquidation proceedings that involve individuals.

In Italy the procedures for the resolution of the crisis and insolvency problems are numerous. These include: Out of Court Compositions with Creditors, Attested Plans for Restructuring, Agreements for the Restructuring of Debts, Agreements for Restructuring of Debts Involving Financially Distressed Entities, Agreements with Tax Authority, Arrangements with Creditors, Extraordinary Administrations for large Undertakings in State of Insolvency, Bankruptcy and Enforced Judicial Liquidations. Some of these procedures can be considered Formal Insolvency Procedures, according to the definition adopted by the European Union.

However, it is impossible for me to translate the word "Fallimento" with the English notions of "Insolvency" or "Insolvency Procedure": the Italian Bankruptcy procedure is based on different premises and peculiar characteristics, that I will now briefly explain.

2. Bankruptcy is a procedure available to entities carrying out commercial activity (under Italian Law small entities are excluded). It is intended to satisfy creditors by the means of the liquidation of the assets of the debtor.

The objective of the Bankruptcy is to grant protection to the rights of the creditors and to maximize their return, especially when compared to the ordinary individual execution proceedings.

Under art. 51 of the Insolvency Law, entitled "Prohibition of individual enforcement and preventive actions", unless provided otherwise by the Law, from the day of the Bankruptcy order no individual enforcement or preventive action (including those for claims becoming due during the Bankruptcy) can be brought or continued against the assets included in the Bankruptcy estate.

With the discipline of the Bankruptcy proceeding, the legislator nevertheless tries to preserve the integrity of the ailing company. As a result, sales of individual assets are permitted only if the sale of the entire company and/or its divisions would not be in the best interests of the creditors.

The primary concern of the Italian Bankruptcy proceeding is to guarantee the rights of the creditors.

The goal is thus to assure to the creditors the maximum realization of their claims in the shortest time possible.

In the Italian Bankruptcy procedure, a Court-appointed Administrator manages the procedure.

The Administrator (Official Receiver / Trustee in Bankruptcy) is responsible for the insolvent assets. He / She performs all the operations of the procedure under the supervision of the Bankruptcy Judge and the Committee on Inspection in the context of their assigned functions (art. 35).

The Administrator personally performs the functions of his position, but he/she may delegate specific operations (art. 32). The Administrator has an ample autonomy in the management of the case.

The Committee of Inspection is the organ representing the creditors.

The Committee of Inspection supervises the work of the Administrator, authorizes actions and expresses opinions in the cases provided by Law or at request of the Court or the Bankruptcy Judge (art. 41).

3. In the discipline of the Bankruptcy procedure, the principal rule that deals with pre-existing legal relationships is art. 72 of the Insolvency Law.

Subsequently, there are in the Law some specific rules on single contracts: these include, among others, rules on real estate contracts where the building is yet to be built or completed (art. 72 bis) or sales with retention of title (art. 73). Also outside of the Insolvency Law specific contracts are subject to peculiar considerations.

The general rule is that, upon filing, the executory contracts remain suspended. This is because the Law requires that the Administrator should have the ability to assume or reject executory contracts.

Indeed the principal rule states that, when one of the parties is declared bankrupt, if a contract is still not performed or not entirely performed by both parties, the performance of the contract remains suspended.

The contract remains suspended until the Administrator, with the authorization of the Committee of Inspection, declares that

he/she is succeeding to the contract on behalf of the Bankrupt entity.

Only if the Administrator declares that he/she is succeeding into the contract, the preliminary authorization of the Committee of Inspection is required. Only in this last case the Administrator assumes all the relevant obligations.

The Administrator is free to decide to dissolve the contract; in this case the authorization of the Committee of Inspection is not necessary.

The decision / choice of the Administrator is not subject to any time limits.

However the other contracting party may bring an action against the Administrator, obliging the Bankruptcy Judge to set a deadline, of not more than sixty days, for the decision of the Administrator, after which (in the absence of any reply from the Administrator) the contract is considered to be dissolved.

On this general rule we can observe that:

(*a*) the Law attributes to one of the parties of the contract, the Bankruptcy entity, the discretionary power to dissolve the contract;

(*b*) the other party of the contract is penalised;

(*c*) the reason for this discipline – which clearly favours the Bankruptcy estate - can be found in the need to preserve and promote the collective interest of creditors;

(*d*) the choice of the Administrator must be determined after having considered the interests of the creditors on a whole.

This discipline reflects the bankruptcy policy that a debtor should have the ability to abandon burdensome contracts while retaining beneficial contracts if this is in the best interest of creditors.

In the Bankruptcy procedure one relevant exception of this rule is the, not really frequent, situation in which the Court establishes the provisional trading of the Bankrupt enterprise.

Indeed with the Bankruptcy order – or at a later time – the Court may order the enterprise to continue all its activities, or those of specific branches, if a suspension of the activities could lead to serious damage to the value of the company or the business, and provided that continued activities does not prejudice creditors.

In this last case, the general rule is substituted by the provisions that outstanding contracts shall continue to be performed by both parties during provisional trading unless the Administrator opts for suspending their performance or rejecting/cancelling/dissolving them.

4. This is a very important proceeding; as I said before, the goals of the Arrangement with Creditors – a satisfactory and preservation procedure - can be either the restructuring or the liquidation of the company or its business; and these two objectives / goals can be pursued within the same procedure.

During this procedure – unlike what happens during Bankruptcy – the debtor retains the administration of his/her assets and continues the activity of the enterprise under the control of the Court–appointed Receiver.

The goals pursued by the Law are in this case carried out without depriving the debtor of the management of his assets and the management of the enterprise.

Indeed, his/her activities and decisions are subject to a series of controls to avoid abusive behaviour.

The Arrangement with Creditors includes four principal steps (the first of which is optional):

(*a*) the proceeding may commence with the filing of an 'incomplete' petition in which the Court is asked to establish a deadline for the presentation of the complete petition. Debtors obtain manifold advantages from submitting an 'incomplete' petition. These include, among others, the temporary protection of the debtor during the phase of preparation of the definitive petition (i.e. automatic stay);

(*b*) the request for access to the procedure, which consists of the presentation of the complete petition with the request to the Court for admission to the procedure. This petition contains: (*b1*) the proposal directed to creditors constituted by quantitative and qualitative proposals, as well as time deadlines for satisfying these same creditors; and (*b2*) the plan. In other words, the complete petition includes all the activities that the debtor intends to implement in the plan, if approved by the creditors. The plan must be accompanied by, among the other things, a report by an Independent Professional attesting the truth of the company records and the feasibility of the proposed plan;

(*c*) the Assembly of the Creditors, called to vote on the proposal. A proposal is considered to be approved if it supported by the majority of the impaired creditors and the classes admitted to the vote;

(*d*) the ratification of the agreement, in other words the moment in which, if there has been no objections, the Court verifies the regularity of the procedure and the result of the vote of creditors. The decision to ratify an agreement cannot be appealed to a higher court.

5. In the discipline of the Arrangement with Creditors the principal rule which regulates the effects on ongoing contracts is art. 169 *bis*.

According to the law, ongoing contracts are contracts in which the obligations are not performed or not fully performed by both parties.

Considering this point of view, therefore the notion of pending contracts in art. 169 *bis* is comparable to that of pending relationships found in art. 72.

The admission to the procedure itself does not change the discipline of the executory contracts.

But with the (incomplete or complete) petition or with a separate request, the debtor may at any time ask the authorization to dissolve the ongoing, executory contracts. This request is addressed to the Court or, once the debtor has been admitted to the procedure, to the Bankruptcy Judge who supervises the arrangement with creditors.

The ongoing contracts are dissolved as of the date of the said specific petition.

Only at the debtor's request, suspension of a contract may be authorized for no longer than sixty days; and the latter period may be extended one time only for the same period.

Obviously the suspension or the dissolution of the contracts might cause prejudice to the other contracting party.

In the above mentioned cases, the other contracting party shall be entitled to a compensation amounting to the damages due for non-performance. The debt in question shall be paid as an old debt existing prior to the Arrangement with Creditors. These claims are then without priority.

6. To facilitate the preservation of viable but distressed companies or businesses, the Italian legislator has introduced a new procedure, called "Arrangement with Creditors on a Going Concern Basis". The model for this procedure is the discipline of the Arrangement with Creditors described previously.

The goal of this special procedure is to maintain the business running while looking for a buyer, or for the approval of a restructuring plan. To reach this target, the Italian Bankruptcy Law grants additional powers and prerogatives to the debtor.

Art. 186 *bis*, §§ 3, 4 and 5 regulates the treatment of executory contracts in the Arrangement with Creditors on a Going Concern Basis.

This article applies without prejudice to art. 169 *bis* and the admission to this sub-procedure does not suspend and / or dissolve the executory contracts even if the counterparty is a Governmental Authority.

Furthermore, according to these rules the debtor (admitted to this type of Arrangement) may continue to perform contracts with Governmental Authorities and participate in public tenders if it complies with specific terms stated in the Law.

7. This speech has shown that, under Italian law, there is no unified treatment of the executory contracts when the debtor enters into a formal insolvency proceeding. Depending on the procedure and its goals, different rules apply.

For instance, in the Arrangement with Creditors on a Going Concern Basis, since the Law focuses, obviously, on the continuation of the business activity more than in the other Procedures, the debtor rather than the creditors is given large discretion to determine the outcome of the executory contracts.

It is necessary to point out, then, that the Italian Insolvency Law is under review from a global viewpoint. The Italian Parliament is currently discussing the "Rordorf Reform". A bill has recently been approved by the House of Deputies on February 1st 2017, and it has successively been transmitted to the Senate.

But we do not know if this Parliament will last long enough to complete the Reform.

This new discipline might foresee corrections and integrations for the rules on executory contracts, in both Bankruptcy and Arrangement with Creditors, but it is possible to say that the structure of the Law / the principles of the Law will, probably, not change on our topic.