

CODE OF BUSINESS CRISIS AND INSOLVENCY LIABILITIES AND PROTECTIONS FOR COMPANY DIRECTORS

1. A new concept of business crisis

The new Code of Business Crisis and Insolvency ("the Code") has become fully applicable in Italy on 15 July 2022 in accordance with Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency (2014/135/EU), through a quite long path started in January 2019.

From one side, the Code replaces Italy's Bankruptcy Law with the aim of greater harmonisation of insolvency proceedings while, from the other side, introduces new specific corporate governance rules and new specific duties for all directors of any kind of business – including non-profit organisations and individual entrepreneurs – with the main purpose of allowing the early detection of the crisis, in order to adopt recovery solutions before the company becomes irreversibly insolvent.

Under the Code, the concept of crisis, traditionally falling under the "pathological" aspects of the business activity, now becomes an integral part of the "physiological processes" of the business organisation, avoidable or that can be overcome under certain conditions.

2. A forward-looking approach

Article 2086 of the Italian Civil Code ("ICC"), as amended by Article 3 of the Code, requires these directors to take a new approach, i.e. a forward-looking approach, instead of a backward-looking approach as was previously the case.

Focusing our analysis here on the collective entities, we may underline that the director *"must (i) adopt organisational, administrative and accounting structures, adequate to the nature and size of the enterprise, also in the light of the timely detection of the business crisis and (ii) take action without delay to adopt and implement one of the legal instruments for overcoming the crisis and restoring business continuity".*

Such structures are considered "adequate" if they are able to verify the sustainability of debts and the prospects of business continuity at least for the following twelve months and to promptly detect possible imbalances of an economic and financial nature (related to the specific characteristics of the enterprise and to the entrepreneurial activity carried out by it).

Article 3, paragraph 4 of the Code, provides for "warning signals" (called "alert indexes" in the first draft) which, in this regard, have to be taken in consideration by the directors, such as:

1) existence of debts (i) for salaries that have fallen due for at least 30 days equal to more than half of the monthly total amount of salaries or (ii) to suppliers that have fallen due for at least 90 days in excess of the debts that have not fallen due;
2) existence of exposures to banks and other financial intermediaries that have fallen due for more than 60 days or have exceeded by at least 60 days the limit of any assignment obtained in any form, provided that they together represent at least 5% of the total of exposures;
3) existence of one or more of the debt exposures provided for in Article 25-*novies*, paragraph 1, of the Code (e.g. exposures to public bodies/ Authorities, such as the National Social Insurance Institute (INPS), the National Institute for Insurance against Incidents at Work (INAIL), the Italian Tax Authority (Agenzia delle Entrate).

3. New duties / new liabilities?

a) The Business Judgement Rule

Consequently, the question arises of whether the imposition of the specific obligation laid down in Article 2086 of the ICC (which supersedes the previous generic duty of care) entails for the directors the exclusion of any discretion with respect to its application, and therefore the exclusion from the protection of the Business Judgement Rule ("BJR"), which indeed is normally granted in the context of the generic duty of care of the Italian directors in relation to their management choices/decisions.

The BJR focuses on the decision-making process (rather than the assessment of the merits of the decision), thereby shielding the directors from the risk to be held liable for any decisions made by them and found to be wrong at a later stage, which entails that the merits of such decisions cannot be subject to judicial review (applying the benefit of hindsight).

The application of the BJR requires that certain conditions are met: the choices/decisions (i) comply with the law and company by-laws, (ii) are not made by the directors in conflict of interests, and (iii) are adopted through a procedure which uses all the information reasonably available at the time, considering the size of the business and the impact on its assets.

Some prominent scholars rightly observe that such new specific duty (without the protection of the BJR) only concerns "whether" to set up the structures, as this is imposed by the Code, but does not concern "how" to set them up, since the choice of adequate organisational structures not only depends on the type and the size of the business (there cannot be one organisational structure which is valid for every business), buy may also be influenced by complex factors which are both endogenous and exogenous to the business – not forgetting geopolitical factors, which are especially at the moment very topical.

Consequently, in terms of liability, should the executive directors fail, without any prior evaluation, to put in place the structures, they will not enjoy the protection of the BJR in any subsequent judicial review.

Conversely, should they decide – with appropriate information – that the existing structures are "adequate", or should they decide to put in place new structures which are deemed to be subsequently "not adequate", they will enjoy the so-called "safe harbour" granted by the BJR and their choice cannot be subsequently assessed applying the benefit of hindsight.

However, it is worth pointing out that even those who deny the applicability of the BJR in the latter two cases, admit that any subsequent judgement should, however, consider the decision-making process of the directors (including the completeness of the information available to them at the time of the decision), as well as the margins of discretion which are, however, inherent in the choice on the adequacy of the structures, by reference not only to the variability in the type, size, and characteristics of the business, but also to the difficulty in assessing the factors external to it.

a) Different directors' liabilities

In this scenario, which is the liability of non-executive directors vis-à-vis that of executive directors?

The specific duty to put in place adequate structures is on the executive directors but the non-executive directors are part of the board making the relevant choice.

According to the provisions of Articles 2392 and 2381 of the ICC and to the Code:

- the duty of care of each director is more specific than that of the "*bonus pater familias*", related to his specific competences and to the nature of his tasks (proxies received);
- each director has to act in an "informed manner" (i.e., make a "conscious decision"), according to a correct system of information flows (the executive directors have a duty to keep non-executive directors regularly informed, and non-executive directors have a duty to ask for information from the executive directors);
- each member of the board must avoid to be a merely passive recipient of the information given by the executive bodies, and, therefore, must promptly express his own written dissent, where he considers such a resolution an act of mismanagement that could cause detrimental consequences for the company (even his absence in the board meeting does not justify his failure to intervene).
- In the light of the above, in case of acts of mismanagement:

a) the non-executive directors are not informed by the executive directors even though they asked them for information: in such a case, the executive directors are not liable for their inactivity or negligence, especially for not intervening to avoid damages to the company, and for not promptly recording their dissent in the book of minutes of the board of directors' meetings and, consequently, for not promptly informing in writing the Corporate audit body;

b) the non-executive directors are informed by the executive directors but do not intervene: they are liable for their inactivity or negligence.

4. Directors' protection under the Italian law

Even prior the entry into force of the Code, but of course much more now, directors should think about how to protect their personal assets, in order to avoid or to limit the prejudicial effects of any liability actions towards them.
The institution of an "internal trust" (under the provisions of the Hague Convention (the "Convention") of 1 July 1985, ratified in Italy by Law no. 364 of 16 October 1989 and applicable as from 1 January 1993) allows, under certain conditions, for the effective protection to real estate, shares/quotas, money, and securities, in a more complete way than other possible solutions, such as, for example, (i) the directors & officers insurance policy (which allows compensation, in whole or in part, for the damage suffered by third parties following the negligent conduct of the director, but which does not exclude a possible recourse to the director's personal assets if the policy is not sufficient to ensure the entire compensation), and/or (ii) the capital fund (Article 167 of the ICC) (which limits enforcement on the director's assets that are not tied up in the fund for family needs).
An "internal trust" is considered as such when its main elements (the place where the assets in trust are located, the purpose of the trust, the place where the purpose must be realised) are linked to the Italian territory, even though it is ruled by a foreign law (the applicable law), chosen by the settlor.
Under Article 2 of the Convention:

- the term "trust" refers to the legal relationships created - *inter vivos* or on death - by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose.
- a trust has the following characteristics:

  a) the assets constitute a separate fund and are not a part of the trustee's own estate;
  b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee;
  c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law.

The settlement of a trust is made by means of two deeds (which could be simultaneous):

1. the "trust deed", where the settlor appoints the trustee and lays down the purpose and the rules under the applicable law that the trustee has to follow during the validity of the trust, and
2. the "deed of segregation" of the assets (*atto di segregazione patrimoniale*), signed in front of an Italian notary public and regulated by the Italian law, under which the settlor transfers certain assets to the trust fund, managed by the trustee according to the trust deed.

According to the Italian case-law, a trust in Italy must not be established for *"purposes repugnant to the legal system, if aimed at derogating from mandatory rules of law"*;

thus, for example, it cannot be instituted aiming at infringing on the rights of the heirs, or at removing the assets from the guarantee of the creditors.
However, if a trust

- is set up for “purposes worthy of protection”, such as “for the benefit of a beneficiary”,
- at a time when the settlor is not subject to executions or insolvency proceedings,
- attributing to the trust fund real estate, equity, money and/or securities
- in order to establish, at the termination of the trust, a plan to direct the distribution of assets among the heirs - the beneficiaries - in order to avoid future disputes between them

is valid and effective and cannot be “attacked” by the creditors of the settlor, since the recognition of the trust (according to Articles 2 and 11 of the Convention) implies that the trust fund forms a "separate patrimony" (i.e. separate assets) from the patrimony of the settlor (as well as that of the trustee and the beneficiaries).
When such conditions are met, setting up a trust could be considered the most appropriate protection tool for a director who wants to “rest easy”.
The fiscal aspects are also worthy of attention; Circular no. 34/2022 of the Italian Tax Authority established that both the trust deed and the deed of segregation of the assets in trust discount the fixed registration tax, which currently amounts to 200 euros, and that any succession and gift tax apply only at the termination of the trust (knowing that the term of the trust can also be up to 90 years from the date of setting up the trust deed).

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Do not hesitate to contact us for any clarification you may need.
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