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MODERNIZING ITALY'S BANKRUPTCY LAW

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Reforming bankruptcy laws is difficult for many reasons. First of all, attitudes in Italy toward bankruptcy make it a difficult subject to generate support for. Secondly, bankruptcy reforms are complex and lengthy. They require changes not only to the bankruptcy law but also to other important parts of the legal framework, such as the codes of civil procedures and, in the case of Italy, the penal code. Finally, they require support from those that must implement them. This paper outlines my experience in leading the Commission for the Reform of the Bankruptcy Law and the lessons I learned from it.

Background

According to the Italian Bankers Association (ABI), almost half the bankruptcy proceedings between 1988 and 2002 ended in liquidation, with creditors recovering only 38 percent of their debt. Antonio Auricchio and Rita Gismondi of Gianni, Origoni, Grippo & Partners, one of the most respected law firms in Italy, noted[1] that the high costs and expenses related to bankruptcy procedures exhausted a substantial proportion of the assets, leaving very little for secured creditors and nothing for unsecured creditors. They also noted, along with the ABI, that Italy had one of the longest bankruptcy proceedings in the European Union, lasting up to seven years. Furthermore, in many cases, controlled administration and reorganization do not save the company.

In the wake of Parmalat's financial crisis in December 2003, the reform of the 1942 Bankruptcy Act gathered pace after being on the agenda for almost five years with little results. Despite previous attempts to reform the law, the crisis of 2003 heightened the political pressure to complete the structural reforms which would have enhanced Italy's competitiveness. Before the Parmalat scandal, the center-right government elected in 2001 had introduced encouraging structural reforms in order to spur growth, increase productivity, and improve the public administration, plus a wide-ranging company law reform, implemented in 2003. The successful reform of company law gave us momentum, credibility, and a solid group of allies within the Parliament and the private sector to conduct further reforms like the one concerning the bankruptcy law.

The reform was carried out in two stages: the first in March 2005, dealing with rescue procedures and voidable transactions as part of an emergency package aiming at increasing the

[1] Restructuring and Insolvency in Italy, Gianni, Origoni, Grippo & Partners, PricewaterhouseCoopers Advisory Srl, The European Restructuring and Insolvency Guide 2005/2006, published by Globe White Page, www.europeanrestructuring.com

competitiveness of Italian economy as a whole, and the second in January 2006, more comprehensive and dealing with a number of issues.

The result is that, on the whole, Italy has enacted a comprehensive reform of the Bankruptcy Act which: (a) redefines the scope of bankruptcy proceedings in general (not punishing the debtor but satisfying the creditors); (b) expands the role and scope of the creditors' committee; (c) modifies the rules on executory contracts in bankruptcy; (d) allows the continuation of the bankrupt's business operations; (e) introduces the discharge from unpaid debt for natural persons; and (f) simplifies the liquidation of the assets and the distribution of the proceeds among the creditors. Although it may be too early to tell, there is an overwelming agreement among the practioners and actors of the insolvency saga that these reforms are heading in the right direction.

This overhaul of the Bankruptcy Act of 1942 is the conclusion of a reform attempt that started at the end of the past century but did not produce substantial results before the Parmalat crisis. In a country where political coalitions are often unstable, many observers felt it would be difficult to overhaul the bankruptcy law, especially with general elections scheduled for April 2006. However, the reality was that a strong coalition, the ability to adapt to the political and economic environment, and a focus on the substance of the reform helped us move mountains.

Lesson 1: Build on a strong coalition

After the first installment in March 2005, the Parliament mandated the government to implement a comprehensive reform of the bankruptcy law. A commission, jointly appointed by Minister of Justice Castelli and Minister of Economy and Finance Tremonti, was then set up to prepare a proposal. The commission was composed of several eminent lawyers, judges, economists, and academics. This vast range of expertise was supposed to guarantee a full overview of the law and provide Italy with a modern and complete new bankruptcy law.

The commission was then divided into two working groups, one with the Ministry of Justice and the other with the Ministry of Economy and Finance, which were due to merge their respective propositions into a single text. The two groups had different views on several aspects of the reform. One was sensitive in particular: the role and extent of judicial oversight on bankruptcy proceedings. Here, we had two competing views on the role of market forces and of creditor control in bankruptcy proceedings. One of the two working groups, believing that creditor control can be ineffective and to some extent even dangerous for small creditors, favored a more active judicial involvement in the proceedings. The other group, which I led, believed that in principle the control of the proceedings should lie in the hands of the creditors, with the judge having the nonetheless important task of ensuring the fairness of the whole proceeding and resolving conflicts among the parties involved

With the vigorous support of the ABI, Assonime and Confindustria, the largest industrial and commercial associations in the country, the two proposals were merged into one, written along the principles of higher creditor involvement in proceedings. The proposal, after being made public and commented on, became law in January 2006. After 64 years, Italy finally had a new bankruptcy law.

Lesson 2: Pragmatism is your best friend

Before the reform, the Italian bankruptcy law contained a number of unusually harsh measures. Indeed, the whole Bankruptcy Act of 1942 was conceived around the concept of the insolvent debtor being a wrongdoer, if not a criminal altogether. Debtors were deprived of the right to vote in elections, and their mail was read by the trustee.

This “stigma” culture explains the challenges faced by the reformers. Italy not only had to change the laws and procedures to adapt them to the modern Italian economy, but it also needed to spark a deep cultural change in the perception of bankruptcy proceedings and insolvency in general.

The economic crisis and a number of scandals, such as the bankruptcy of Parmalat, Volare Airline, Cirio, Giacomelli, and the near insolvency at Alitalia and Fiat, left the Italian business community shaken, and created a sense of urgency for the government and the Parliament to amend the insolvency system. That was the driver behind the first installment of the bankruptcy law reform, enacted as an urgent measure in March 2005 as Decree-Law of March 14, 2005, No. 35. It provided distressed firms a set of tools to overcome the crisis, either through out-of-court agreements or through a formal rescue procedure (“concordato preventivo”). Claw-back provisions were also mitigated, as they were perceived as creating an obstacle to out-of-court restructurings.

By introducing these elements as emergency measures, the government created the political space to negotiate deeper changes in the system. The Italian Constitution (article 77) allows the government to issue provisional decrees having the same force of law, but such decrees must be ratified by a law of the Parliament within 60 days of their publication. The first emergency decree of March, therefore, forcibly created a parliamentary discussion on the scope of a possible wider reform of the bankruptcy law. This resulted in the enactment of the law of delegation of May 14, 2005, No. 80, which on the one hand ratified the March decree and, on the other hand, mandated the government with enacting a full overhaul of the Bankruptcy Act of 1942. The mandate was fulfilled with the Legislative Decree of January 9, 2006, No. 5, which completed the picture.

Lesson 3: Reforms can’t wait, or they will never get done!

A reform as broad as the one affecting the entire bankruptcy system is difficult to achieve, and is difficult to do it without making compromises. Most laws are the result of political choices largely connected with what is feasible in Parliament at a given time. In the case of Italy, with a coalition that was weakened by political and economic troubles and a general election less than a year away, the pressure to show results led to a more aggressive course of action, but less time to do a “perfect” job. The criminal provisions accompanying the law were left intact, and also a streamlining of a few alternative procedures designed for particular firms (large firms, financial intermediaries) was scrapped from the agenda.

I assume full responsibility for having chosen to carry out a partial – and not a complete – reform, which certainly has some defects; I believe, however, that those who rule have the responsibility of making reforms and cannot always wait to make the best possible reform. I don’t have this enlightening perspective by which you wait for the legislators to make the perfect reform; in reality, that does not exist.

Convincing judges to relinquish some of their power while maintaining their relevance to the process, as well as reviewing the role of the trustee, were contentious areas which required a great deal of tradeoffs. The analyses carried out by several governmental bodies concerning the inefficiency of the judicial approach of the 1942 system were strong arguments for change for the government during the negotiations with the constituencies involved, but a compromise was still inevitable. It has therefore been agreed to maintain a role of the judge as guarantor of the fairness of the proceedings not only in the liquidation procedure, where the creditors may be less interested, but also in the reorganization procedure, where the debtor and the creditors bargain directly.

To relieve the courts from the burden of supervising thousands of small bankruptcies (often without any assets), it has been decided to exempt small enterprises from bankruptcy. In theory, this will allow judges to focus on bigger cases and have more time to dig deeper into the cases that have most at stake.

The second, and final, part of the reform took effect on July 16, 2006. The center-left government elected in 2006 made some amendments and improvements to the new law, and on the whole confirmed the structure of the reform as done by the previous center-right government. Such amendments have been enacted by the Legislative Decree of September 12, 2007, No. 169, and will take effect on January 1, 2008.

Although not perfect, the new law introduces a lot of innovations. More must be done for its implementation to live up to the spirit of the new principles of flexibility, lack of stigma, and direct bargaining between the debtor and the creditors.

I believe an appropriate expression of this experience is Spinoza's motto: "You don't cry over your own story; you change course." The reform of a bankruptcy law as old as the one in Italy and in many other places is as much about changing attitudes as it is about changing laws and procedures. The battle to give creditors a greater say and a better chance to recover their loans, to give entrepreneurs a second chance, and to save jobs has been won with a large enough coalition and, in the end, with general support.

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