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Directors' Duties—An Italian Overview: Tough Decisions Amid COVID-19 Emergency Legislation

Italian COVID-19 legislation, with the aim of keeping companies alive by providing them with a short-term alternative to dissolution, provides for the suspension of (i) certain directors' obligations triggered by substantial corporate capital losses, and (ii) the possibility, until June 30, 2020, to file for the opening of new bankruptcy proceedings. However, these exceptional remedies have not been paired with an equally remodeled liabilities regime. As such, directors are left with no clear guidance for managing a distressed company in these times of unprecedented troubles. They are, in fact, confronted with the tough decision whether to take advantage of the COVID-19 measures and carry on the corporate activity even if the company is undoubtedly in distress, or cease the corporate business to avoid future and possibly more severe liabilities for not having taken the necessary remedial measures. The only viable option for directors in lack of both reliable data (not distorted by the current emergency and governmental lockdown measures) and reasonable prospects for the future business of the company is thus adopting a short-term management strategy based on the constant monitoring of the company's conditions and the achievement of close-set objectives.

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INTRODUCTION

In the wake of the COVID-19 pandemic, Italy, as most States, has both provided for exceptional liquidity injections to refinance companies' cash flows and enacted extraordinary provisions aimed at freezing certain obligations that would have inhibited said injections (the "COVID-19 Measures")[1]. The underlying *rationale* of the COVID-19 Measures is to keep companies alive and provide them with a short-term alternative to dissolution. However, these exceptional remedies have not been accompanied with an equally remodeled liabilities regime.

As such, on the one hand directors may choose to take advantage of the COVID-19 Measures and carry on the corporate activity even if the company is undoubtedly in distress, hoping that the underlying *rationale* of said provisions will later shield them from liabilities. On the other hand, however, directors may still choose to cease any corporate activity to avoid future and more severe liabilities for not having taken the necessary remedial measures amid such a distressed situation for a company that had financial difficulties even before the break of the pandemic.

THE COVID-19 MEASURES *RE* CORPORATE AND RESTRUCTURING OBLIGATIONS

In a nutshell, the COVID-19 Measures provide for, *inter alia*:

(1) liquidity injections by means of debt mainly in the form of bank financings assisted by public guarantees;

(2) the suspension, until 31 December 2020, of the obligation to reduce the company's corporate capital or to put the company into voluntary liquidation despite the significant losses that the company may have faced and will face throughout said period (the "Corporate COVID-19 Measures)[2]; and

(3) the freezing of any filing for a bankruptcy declaration *(*i.e., for the *judicial liquidation* of the company) made between 9 March 2020 and 30 June 2020, either filed by the directors of the distressed company themselves or its creditors, provided that the following will still be possible: (a) directors may file for the bankruptcy of the company they manage (so called, *self-bankruptcy*) in case the company was already in serious distress before the break of the pandemic and directors see no other practicable alternative (i.e., the company's insolvency is *not* due to the COVID-19 pandemic); (b) creditors may file for the company's bankruptcy in case other pre-bankruptcy proceedings involving the company (such as a composition with creditors proceeding (*concordato preventivo*)) turned out to be unsuccessful; and (c) the public prosecutor may also file for the company's bankruptcy under certain conditions (the "Restructuring COVID-19 Measures"). These measures were thought as an opportunity for directors to take more time without breaching their fiduciary duties to assess alternative solutions to bankruptcy and regain a clear representation of the company's real condition, not deformed by such a contingent and exceptional situation[3].

However, with the exception of the measures referred to under point (1) above and the minor carve-out provided for by the Restructuring COVID-19 Measures (*see* point (3)(a)), the COVID-19 Measures generally apply also to companies that were already in financial distress before the spread of the virus. In fact, nowhere do the Corporate COVID-19 Measures or the Restructuring COVID-19 Measures specify that the company's difficulties must have been caused by the pandemic itself. This means that even when the company was already facing a serious financial and economic distress, and when extreme measures such as putting the company into liquidation proceedings were already considered as the only viable option even then, directors may benefit from the COVID-19 Measures regardless of the company's "pre-existing conditions."

GENERAL RULES ON DIRECTORS' OBLIGATIONS AND LIABILITIES

Under Italian law, directors have a general duty of care towards the company, which includes, *inter alia*, a duty to preserve its assets, also in order to ensure the satisfaction of the company's creditors. In this respect, when a company is facing significant losses, provided that certain thresholds are exceeded, directors must promptly convene the shareholders' meeting in order to resolve upon (i) the reduction of the company's corporate capital or, if viable, the adoption of other remedial measures[4]; or (ii) if the corporate capital falls under the minimum

legal requirement, and cannot be restored: (i) if applicable, the transformation of the company into a different legal entity, or (ii) the company's voluntary liquidation[5].

In this latter case and in any case of statutory cause for the winding up of the company directors shall manage the company *conservatively*, with the only purpose of preserving the corporate assets' worth and integrity until its liquidation.

Moreover, when the company's condition is so serious that the company becomes unable to settle its payment obligations when due on a regular basis, the company is deemed to be *insolvent* and thus possibly eligible for bankruptcy. Although, under Italian law, there is no statutory deadline within which directors must file for bankruptcy once the company becomes insolvent, directors may still be required to promptly file the company into bankruptcy.

Failure to comply with any of the above mentioned duties may trigger liability allegations for the directors (except those that, under certain circumstances, prove blameless and have officially recorded their dissent). In particular:

(1) from a civil law perspective, directors may face joint and several liability towards the company, its shareholders and creditors for the loss of the corporate assets and damages eventually caused[6];

(2) from a criminal law perspective, should the company be declared bankrupt, directors may face charges for:

   a. ***wrongful bankruptcy*** (*bancarotta semplice*)[7], i.e., for having worsened the company's financial situation by carrying on the corporate activity as opposed to filing for bankruptcy despite the company's unrecoverable conditions and/or for having carried out "*highly imprudent actions*" aimed at delaying a bankruptcy declaration. In both instances, the Court must ascertain the directors' gross negligence (*colpa grave*);

   b. ***preferential bankruptcy*** (*bancarotta preferenziale*)[8], i.e., certain payments may be considered as if aimed at excluding certain assets from the company's (eventually) bankruptcy estate and, thus, at preferring certain creditors over others in spite of the *absolute priority rule*;

   c. ***illegal incurrence of debt*** (*ricorso abusivo al credito*)[9], i.e., recurring, or continuing to recur, to (new) credit disguising the company's insolvency.

DIRECTORS' *NOT-SO-CLEAR* DUTIES IN LIGHT OF THE EMERGENCY LEGISLATION

Impact of the Corporate COVID-19 Measures. Considering at first the Corporate COVID-19 Measures, although the only obligations that are expressly frozen are those to reduce the company's share capital or liquidate it, other equally important obligations, which may open the gate to directors' liabilities, have not been considered at all.

According to most scholars, if the above mentioned directors' obligation to take certain remedial measures are indeed temporarily frozen, so to allow directors not to take hasty decisions but instead keep the company alive and operating; accordingly and even if not clearly stated the corresponding obligation to manage the corporation conservatively should equally be considered frozen for the time being. To this extent directors who choose to take advantage of the Corporate COVID-19 Measures and carry on the corporate activity may be allowed to take certain risks which a conservative management would not allow for, of course, always within the boundaries of their fiduciary duties which remain fully standing and binding. Indeed, directors may choose to undertake significant changes to the corporate activity (e.g., switching to or bolstering e-commerce) with the specific aim of adapting to and recovering from the present dire circumstances. The additional chances given to directors to save the company would otherwise be substantially trimmed. It is important to stress, however, that the Corporate COVID-19 Measures provide for no altered liabilities regime that would actually sanction any such "risky" management.

On the other hand, the Corporate COVID-19 Measures do not affect other provisions providing for the voluntary winding up of the company for other specific statutory causes (e.g., in case the company is no longer able to reach its corporate goal (*oggetto sociale*)), which remain fully applicable. Similarly, the Corporate COVID-19 Measures did not affect the shareholders' choice, as it remains possible for them to resolve upon the liquidation of the company in case the company's corporate capital falls below certain thresholds and cannot be restored, despite the

Corporate COVID-19 Measures which suspended only the *obligation* to do so. Finally, it is also important to stress that in this latter case, and in any case of statutory liquidation, the directors' obligation to manage the company *conservatively* would be fully applicable up until the actual liquidation of the company.

As such, even if the COVID-19 Measures seek to prevent a set of conducts that would eventually lead to the company's winding up, they still allow many other alternatives leading to that same result.

Impact of the Restructuring COVID-19 Measures. Moving on to the Restructuring COVID-19 Measures, once again, there is no provision laying down clear exemptions from liability. As such, normal business decisions that seem to be justified in light of the liquidity injections and, generally, the COVID-19 Measures' *rationale* may still lead to substantial liabilities. Even more so if the company was already in distress before the present crisis.

Indeed, carrying on with the corporate activities means regularly performing payment obligations (e.g., to suppliers), making important and necessarily risky business decisions and, most of the times, incurring in new debt especially by taking advantage of those provisions incentivizing new liquidity injections. But all these conducts are potentially relevant for all of the criminal liabilities mentioned above which have not been neutralized. A reasonable concern that directors are now faced with consequently is to understand how any action taken requiring the continuation of a distressed business could *not* be considered "*highly imprudent*" in the wake of a global, economic and financial crisis.

Notwithstanding, the possibility to file for a company's bankruptcy has now actually been frozen except under certain specific circumstances. The Restructuring COVID-19 Measures do allow, to a certain extent, directors to cease the business of the company they manage *despite* the overall *rationale* of the COVID-19 Measures once again: preventing directors' swift decisions to liquidate companies when facing an unpredictable future. Such possibility would potentially avert an anticompetitive effect caused by already decocted companies taking advantage of the COVID-19 Measures despite having no actual recovery prospects.

The specific carve-out provided for under the Restructuring COVID-19 Measures (see point 3(a) above) allows, in fact, directors to file for *self-bankruptcy* in case the losses incurred by the company are *not* ascribable to the pandemic. In this respect, an *ad hoc* judicial proceeding may be necessary to ascertain whether the company's distress is actually due to the pandemic or not. A similar proceeding, however, would determine an additional workload that courts may eventually be unable to manage[10]. Moreover, that same carve-out allowing directors to file for *self-bankruptcy* may result in an unequal treatment for the company's creditors, as it does not take into consideration that also creditors may have an interest in having the company declared bankrupt. Yet any such filing from their side is still suspended, with only minimum exceptions (see point 3(b) above) which are clearly not enough to preserve creditors' interests.

Furthermore, the Restructuring COVID-19 Measures do not regulate the filing for pre-bankruptcy proceedings alternative to bankruptcy itself (i.e., to the judicial liquidation of the company), such as restructuring agreements and composition with creditors proceedings. Provided that the specific requirements for each proceeding are met, directors may thus be incentivized to file for the opening of any such pre-bankruptcy proceeding. Said filing may, in fact, result in substantial benefits, among other things, for the directors themselves, such as exemptions from criminal liabilities for actions taken in performance of the underlying restructuring plan (e.g., recurring to new finance or performing payments to certain creditors). However, a prudential approach still remains essential so to avoid that the use of the pre-bankruptcy proceedings may result in abusive initiatives taken for the sole purpose of delaying the actual bankruptcy of the company and neutralizing directors' exposure to criminal liability. Moreover, and most importantly, it must be considered that the present circumstances have made it more difficult than ever to lay down any long-term recovery plan given the absence of both reliable data (not distorted by the current emergency and governmental lock-down measures) and reasonable prospects for the future business of the company. As such, while it is not legally impeded, recurring to the above mentioned pre-bankruptcy proceedings may nonetheless prove as difficult as carrying on with the corporate business.

CONCLUSIONS

In conclusion, despite the extensive emergency legislation, directors are left with no clear guidance for managing a distressed company in times of unprecedented troubles. The only safe approach they could take is a case-by-case, short-term management based on general principles of corporate law. First among which that providing for a risk assumption *directly* proportional to the actual assets of the company. The more the company is in distress, the lesser is the risk that directors can reasonably undertake without jeopardizing the corporate assets and, ultimately, the creditors' interests.

Nevertheless, if a company is or becomes definitively insolvent and bankruptcy was already foreseen as a necessary epilogue, probably filing for *self-bankruptcy* remains the safest choice. On the other hand, keeping a business running despite severe difficulties that arose (or worsened) in the last few months, would be the best choice in the present circumstances. This way directors (i) would have more time to assess the actual conditions of both the company itself and of the market, (ii) would actually abide by the *rationale* of the COVID-19 Measures, and (iii) would contribute in keeping the economy running. For doing so, the best advice would be to have business plans mainly based on highly specific short-term goals, as well as on the constant monitoring of the company's conditions and achievement of the targeted short-term objectives.

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ENDNOTES

1 The COVID-19 Measures which will be examined in this paper have mainly been adopted by means of law decree No. 23/2020, converted into law by law No. 40/2020 (the "Law Decree").

2 The *rationale* behind the Corporate COVID-19 Measures was clearly stated in the explanatory report of the Law Decree, namely: "*[...] the provision in question aims at preventing that the loss of capital due to the COVID-19 crisis and which occurred during the financial years ending on the 31st December 2020, would place the directors of numerous companies in the - clearly abnormal - alternative between immediate liquidation, by consequently losing any prospect of continuity for said companies, including performing ones [i.e., those that were performing before the break of the pandemic], and the risk of exposing themselves to liability for non-conservative management within the meaning of article 2486 of the Italian civil code. On the other hand, the suspension of the obligations provided for by the Italian civil code in case of loss of corporate capital takes into account the need to face the difficulties of the COVID-19 emergency with a clear representation of reality, not deformed by a contingent and exceptional situation.*"

3 The *rationale* behind the Restructuring COVID-19 Measures was clearly stated in the explanatory report of the Law Decree, namely: "*[the decision] to remove businesses from bankruptcy proceedings [is based on] a twofold reason: on the one hand ... to avoid subjecting the entrepreneurial class to the growing pressure of bankruptcy petitions filed by third parties and to exonerate entrepreneurs themselves from the dramatic decision of filing for bankruptcy on their own in a situation in which the state of insolvency can derive from exogenous and extraordinary factors, with the related danger of dispersion of the corporate assets, without any correlated advantage for creditors since the liquidation of assets would take place in a highly disrupted market; on the other hand, to block an otherwise increasing flow of claims in a situation where courts are in great difficulty.*"

4 Art. 2446; 2447; 2482-bis, par. 4, 5, 6; 2482-ter, of the Italian civil code.

5 Art. 2447; 2484, par. 1, no. 4) of the Italian civil code.

6 Art. 2486 of the Italian civil code.

7 Art. 217, 224 of Royal Decree 267/1942 (the "Italian Bankruptcy Law").

8 Art. 216, par. 3 of the Italian Bankruptcy Law.

9 Art. 218, 225 of the Italian Bankruptcy Law.

10 This specific concern was specifically addressed in the explanatory report to the Law Decree. A specific comment to the Restructuring COVID-19 Measures, in fact, stated the following: "*[…] an exceptional and temporary measure has been identified, limited in duration but generally applicable in light of the extreme difficulty, in the current situation, to verify whether the state of insolvency is ascribable or not to the epidemiological emergency determined by the spread of the COVID-19 virus. Such an approach, in fact, would require a verification proceeding which, in the immediate future and subject to the progressive improvement of the situation, would determine an additional workload for the courts already in an emergency situation.*"

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