Client Alert | Insurance

Italy

Urgent measures by the Italian government in the wake of the COVID-19 outbreak – Impact on D&O insurance policies

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In the wake of the COVID-19 pandemic the Italian government enacted the Decree No. 23 of 8 April 2020 (aka "*Decreto Liquidità*"), a comprehensive set of rules and emergency measures broadly aimed at supporting the economy.

Amongst the new provisions are rules - aimed at facilitating companies facing financial difficulties and insolvency - which, broadly speaking, deal with (*i*) temporary relaxation of certain important corporate and governance rules dealing with protection of the company's share capital and (*ii*) temporary changes to certain aspects of insolvency procedures.

These important statutory changes - which are subject to parliamentary confirmation but are already effective – may potentially have some direct and indirect impact on D&O policies (and professional indemnity policies with D&O extensions) and on the liability scenario for directors and officers insured thereunder. Below is a very short description of these measures, together with some preliminary thoughts on the possible impact on D&O underwriting and claims.

1 - Measures dealing with protection of share capital and financial statements – D&O implications

Loss or material reduction of share capital

Art. 6 of the Decree provides that until 31 December 2020 certain articles of the Italian Civil Code (namely 2446, par. 2 and 3, 2447, 2482-*bis*, par. 4, 5 and 6, and 2482-*ter*) concerning the loss or reduction of share capital for losses will not apply to events occurring prior to the end of 2020. For the same period, the statutory provisions (articles 2484 par. 1 No. 4, and 2545-*duodecies*) imposing liquidation on companies whose share capital falls below the statutory threshold (and are not recapitalized) will also not apply.

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Broadly speaking, the measure aims at avoiding that (due to the material losses impacting on the share capital) directors and shareholders are forced to choose between the immediate liquidation of the company and recapitalization. This "relaxation" of the above rules (normally aimed at preventing companies' activity without a minimum share capital) is designed to allow the company to continue trading (even without such minimum share capital) during the crisis and throughout 2020.

The new legislation is potentially important for D&O underwriters and those dealing with D&O claims.

In the first place, the set of rules which are now "suspended" provide the usual backdrop to most action for damages against directors and auditors in Italy, typically on the initiative of receivers once insolvency has materialized. A vast amount of such actions, in Italy, are based on actual or alleged breaches by the directors (and auditors) of such statutory rules which are now "suspended".

On the one hand this may - in the short term (and temporarily) - alleviate the liability of directors and auditors, relaxing their duties and preventing perspective claimants to use a quite common tool (i.e. the violation of the now "suspended" provisions) to support their actions.
On the other hand, however, the new rules may allow the company's activity to proceed in a situation where the share capital is lost (and no recapitalization is forced on shareholders), thus potentially increasing the overall losses and the claims against directors (and auditors) if things go wrong and insolvency materializes later on.
This potential increase of liability exposure in the mid and long-term is of particular importance, considering that the new legislation does not alleviate or relax any obligation of directors and auditors (except those carried by the temporarily suspended provisions). Future actions for damages by receivers or other claimants remain possible, and in many ways likely, considering the expected significant downturn and increase in corporate insolvencies in the near future.

In the second place, the "suspension" of these rules may provide different (and unexpected) operating scenarios, which may impact underwriting and claims handling alike.
Insurers should consider that the mechanisms and procedures provided by the "suspended" rules will not be in place for some time and no reliance should be made on their application.
Insurers may find that they are insuring (or accepting/renewing cover for) directors and officers of a company which continues trading (legally) with no share capital or with negative net worth, i.e. a situation which – in normal time – would mean that the company must be liquidated.
In a number of cases, proposal forms and policy wordings may have to be reviewed in the light of this situation. For example, policy terms and exclusions dealing with circumstances in which the company has negative net worth or reduced share capital, or is in a technical liquidation status, would have to be carefully reconsidered.

Ability to operate as a going concern and financial statements

Art. 7 of the Decree provides that, in the financial statements for the year in progress at 31 December 2020 valuation on a going concern basis (i.e. in the perspective of continuity of the company's activity) can be applied as long as such valuation was applicable in the last financial statements pre-pandemic. The aim of this measure is to allow companies to avoid the negative impact on balance sheet resulting from the possible lack of going concern outlook during (or due to) the Covid-19 emergency. In other words, a pandemic-related lack of going concern outlook can be temporarily disregarded for financial statement purposes.

On a liability perspective, though, this will mean that an actual lack of going concern outlook (though pandemic-related) may not be reflected in the financial statements. This, in turn, may for example have an adverse impact on future claims (if things go wrong and especially in case of future insolvency). The point is also relevant as underwriters may end up accepting or renewing a D&O risk basing on an analysis of accounts which do not reflect the actual (though maybe only pandemic-related and temporary) lack of going concern outlook. Again, careful review of wordings and/or proposal forms may be appropriate.

2 - Temporary suspension of insolvency applications; postponements of terms of arrangements with creditors; postponement of entry into force of the new "Insolvency Code"

Article 10 of the Decree provides that all applications for insolvency (*istanze di fallimento*) filed between 9 March and 30 June 2020 will not be heard and will be automatically dismissed by the insolvency courts (though of course they can be re-submitted in the normal way after 30 June 2020). This emergency rule does apply to virtually all companies, with certain limited exceptions.
Also, the Decree provides for postponement of deadlines of existing arrangement with creditors procedures or debt restructuring agreements (*concordati preventivi* and *accordi di ristrutturazione*) and includes measures aimed at allowing more time for, and facilitating the, actual completion of such arrangements.
Finally, the Decree provides that the date of entry into force of the new Italian Insolvency Code (Legislative Decree No. 14 of 12 January 2019) is pushed back from 14 August 2020 to 1 September 2021.

It is quite likely that the 4-months suspension of insolvency applications (and, to some extent, the time extensions allowed to the alternative arrangements) will lead to less insolvencies in the short term.
This may be good news for D&O Insurers in a short-term perspective: considering that the majority of claims for damages against directors and auditors are brought by receivers in the context of insolvency procedures, a lower number of insolvency procedures would lead to less claims.
However, and importantly, in most cases insolvency applications will still be possible and will still be made after 30 June 2020 and insolvency procedures (*fallimenti*) will still happen, though belatedly. In actual fact, it is well possible that the main, if not only, effect of this provision will be that of concentrating a significantly high number of insolvencies at a later moment (and possibly in a subsequent Year of Account). In fact, there is a possibility that in a number of cases the delay in the start of an inevitable insolvency procedure will increase the overall indebtedness of the company and, thus, the severity of potential claims and liability.

On a different perspective, Insurers should consider the impact of the above on their wording and future claims. For example, policy terms and exclusions which make express or implied reference to insolvency declaration or insolvency situation (e.g. clauses dealing with communication of circumstances, renewal or termination, discovery periods, exclusions etc.) may be impacted and may have to be carefully reviewed.

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In summary, there is a distinct possibility that the above "relaxation" and emergency measures may somehow limit insolvencies and claims against directors and auditors in the short term. It is however likely that, by the same token, claims and liabilities will increase exponentially in the mid and long term.

More in general - although it is clearly too early to assess the actual impact of the emergency legislation (also as emergency legislation may continue to develop) - Insurers should be aware that these measures may change the claims and liability scenario and they should consider adapting their wordings and underwriting decisions accordingly.

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