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# Contemporary Issues in Finance: Current Challenges from Across Europe

Simon Grima
Frank Bezzina
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Editors

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# CONTEMPORARY ISSUES IN FINANCE: CURRENT CHALLENGES FROM ACROSS EUROPE

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CONTEMPORARY STUDIES IN ECONOMIC AND FINANCIAL ANALYSIS VOLUME 98

# CONTEMPORARY ISSUES IN FINANCE: CURRENT CHALLENGES FROM ACROSS EUROPE

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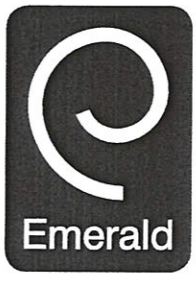


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# INTRODUCTION

The Emerald book series: *Contemporary Studies in Economic and Financial Analysis* special edition includes studies on different topical issues in finance by the participants of the 8th international scientific conference 'New Challenges of Economic and Business Development – 2016' organized by the Faculty of Economics and Management of the University of Latvia in May 2016 as well as papers of researchers from the University of Malta. The book contains research results obtained by researchers from various European countries, specifically Germany, Italy, Latvia, Malta and Poland.

The paper 'Impact of Financial Literacy on Domestic Economic Activity in the Baltic States' analyses the connection between financial literacy among several target audiences and the dynamics of domestic economic activity within the Baltic States (Estonia, Latvia and Lithuania). Considerable attention is also paid to literature about financial literacy and domestic economic activity in a historical, crisis-ridden and neoliberal perspective. By examining the relationship of financial literacy and domestic economic activity, a model based on the results of Delphi fuzzy method and a limited Organisation for Economic Co-operation and Development/ International Network on Financial Education (OECD/INFE) Core survey, carried out in the Baltic States has been elaborated and examined, concluding, that the relationship is weak, but trends that have been identified are clearly recognizable throughout iterations. The lack of promotion and implementation of institutionalized targeted financial literacy activities in the Baltic States partially explains a positive association between financial knowledge and consumption behaviour, although survey results show levels of financial literacy above 74% throughout the Baltics. The development and analysis of the model has been successful as well, even though the results are statistically only partially significant. The analysis of the model still is important in illuminating the most important factors that influence domestic economic activity in the Baltic States and the relations with key financial literacy indicators.

The paper 'Banking and FinTech: A Challenge or Opportunity?' studies financial technologies (FinTech), that have become an integral part of banking. Nowadays banks have started to compete beyond financial

services facing increasing competition from non-financial institutions providing for example payment services. Start-up service providers, search engines and social networks have expanded their services 'interfering' in the fields traditionally covered by banks. The rapid rise of FinTech has changed the business landscape in banking asking for more innovative solutions. These recent tendencies require the banks to increase investment in financial technologies, rethink service distribution channels, especially the business-to-consumers models, increase further standardization of back-office functions, etc. Some members of the financial services industry see the boom in FinTech as a threat to traditional banking industry. Others believe that FinTech has become a challenge that can be turned into an opportunity as it provides more flexibility, better functionality in some areas and aggregation of services. The aim of the paper is to analyse the recent trends in banking, identifying opportunities and risks of FinTech for banks. A timely integration of FinTech into business allows banks to get an advantage in growing competition. This paper provides an extensive analysis of recent trends in FinTech and banking, examining experience of leading European and US banks, as well as surveys conducted among members of the financial services industry in different countries. The authors have studied the development of the financial innovation and technology market, assessed the existing practices applied in the field of FinTech, identified the main risks related to development of Fintech and financial innovations the banks are exposed to on the micro and macro level. The paper provides recommendations for regulators and banks to ensure reduction of risks associated with development of FinTech. Analysis of FinTech market has shown growing competition, including from non-financial institutions. The paper provides practical recommendations to commercial banks for strengthening the position in financial innovations and controlling the risks associated with introduction of financial innovations.

The paper 'Analysis of Crowdfunding in European Union: Performance and Perspectives' examines development of crowdfunding in the European Union. After the great economic crisis of 2008, the absolute overcome of which is still a matter of discussion, such topics as the needed raise in private investments and possible support to Small and Middle enterprises (SME's) have been highlighted all over the European Union. Moreover, the paper highlights the opportunities in the alternative investment markets – in spite of the absent union understanding of the topic, alternative investment managed to increase significantly the access to finance mainly to start-ups and SME's. The decent development of alternative

investment market and the impressive capacity it holds is now a fact. Recent studies suggest European alternative finance market to reach 2,957 millions of euro by 2014. While being aware of various challenges alternative investment market faces, for instance weak legislative regulation and in some cases, overall investment market underdevelopment, there are cases where impressive investment activity has been noted. The top target of this paper is while analysing the development of crowdfunding in European Union to perform a diverse analysis of this form of alternative investment and evaluate the potential crowdfunding might still possess. In order to implement a comprehensive analysis of crowdfunding the profile of potential investors, key sectors of interest as well as statistic data of the previous activity will be acknowledged. It is believed that the provided analysis will not only promote the overall understanding of this type of alternative investment but, while identifying the most common possibilities and drawbacks of crowdfunding attraction, would also introduce a certain benchmark for the further development of the alternative investment market especially in the countries, where a poor crowdfunding activity has been seen so far.

The paper 'Misuse of Derivatives: Considerations for Internal Control' examines the main 'sources' of derivatives misuse. Derivatives are nowadays widely used globally both for speculative and hedging purposes. However, as experience shows, inadequate use of derivatives may cause severe problems and even bankruptcy of firms. Thus, it is essential to help organizations design a robust pro-active governance and internal control structure, which will help to prevent new financial debacles and scandals when using derivatives. Taking into account frequent use and the growing fraud caused by derivatives, the aim of the paper is to identify considerations for internal control important to ensure better governance of firms using derivatives. The main findings are based on an analysis of interviews that were conducted with experts directly or indirectly involved with derivatives from different European countries. The interviews were semi-structured following the approach proposed by Patton (1990). An analysis of the data collected from the interviews was carried out using a thematic approach. The paper identifies and analyzes the main 'sources' of derivatives misuse, including poor design and mis-categorization of instruments, convenience to blame derivatives, unsophisticated players, insufficient regulatory environment, poorly designed internal controls, inadequate communication, poor firm culture, etc. This study provides an extensive analysis of the main recommendation for internal control concerning awareness of derivatives design, the human aspects, regulations, communication,

knowledge and training. Sound internal controls could avoid new debacles without adding other restrictions to the market. The paper provides recommendations for internal control important to ensure better governance of firms using derivatives.

The paper 'Profiles of SMEs as Borrowers: Case of Latvia' analyses the factors that interfere with the availability of funding to the small- and medium-sized companies. The availability of funding is one of the key problems in the small- and medium-sized business not only in Latvia but also all over the European economic space. The lack of funds results in the starvation of the economy preventing it from full-fledged development. The aim of the research is by developing the profiles of Latvian SMEs to analyse the factors that interfere with the availability of funding to the small- and medium-sized companies and to design recommendations for the more effective raising of funding in Latvia. During the research the following research methods were used: the generally accepted quantitative and qualitative research methods in economics, including the comparative analysis and synthesis and graphical depiction. The results of the analyses will be discussed and recommendation will be provided for policy makers and academician in the last section.

The paper 'Avoiding Bankruptcy in Italy: Preventive Arrangement with Creditors' studies Preventive Arrangements With Creditors in Italy. Italian Insolvency Law has been widely reformed since 2005 in order to introduce new legal procedures aimed at preserving troubled companies, discerning viable from irredeemable businesses and increasing productivity through a more efficient management of insolvency proceedings. The Economist called this process 'beautifying bankruptcy'. The excessive duration of bankruptcy cases was repeatedly brought to the attention of the European Court of Human Rights, relating to the right to a fair trial in terms of reasonable duration. With this above mentioned reformation in Italian Insolvency Law, the Preventive Arrangement with Creditors (Concordato Preventivo) became Italy's equivalent of US's Chapter 11 and can be considered the main instrument used by small- and medium-sized companies (and sometimes large ones) to manage insolvency by avoiding bankruptcy. This paper provides an empirical analysis on filing of Preventive Arrangements with Creditors in the Court of Milan, one of the largest in Italy, in the 2005–2014 period. Through the exam of 720 cases, 60% of the total number, the research shows the different features of the procedure, analyses the characteristics of company that resort to it and its diverse purposes of liquidation and restructuring. Due largely to the newness of the

legislation, along with the complexity of the Italian system, it is rather difficult to generalize conclusions. Nevertheless, the paper shows how Preventive Arrangements with Creditors can be considered a more efficient instrument than the alternative bankruptcy, both in terms of timeframe as well as with creditors' satisfaction. As part of the overall European reform process of insolvency proceedings, following the 2014 Recommendation issued by the European Commission, Italy seems to provide useful insights for other countries in Europe.

The paper 'Mergers and Acquisitions: Examples of Best Practice in Europe and Latvia' examines examples of mergers and acquisitions of European and Latvian firms, the motivation for these transactions and their results, and to show that the process of mergers and acquisitions has a positive impact on the development of the industry overall and on specific firms by increasing their competitiveness. The authors analyse the reasons for, meaning and impact of mergers and acquisitions on firm development, focusing on the example of dairy companies in Europe and subsequently on these processes in Latvian dairy industry. The study is based on the qualitative and quantitative analysis of firm financial reports as well as reports of the International Dairy Federation, publications of the United Nations Food and Agriculture Organization, annual reports of the International Farm Comparison Network, reports on the dairy industry in the European Union, Latvian Central Union of Dairy Producers, Lursoft firm registry data as well as reports of the Ministry of Agriculture and Latvian Farm Consultation and Education centre. The study uses methods of statistical comparisons by analysing firm operations before mergers or acquisitions as well as during the process and afterwards. Thus the authors were able to identify the impact of mergers itself on particular firms or the industry, while abstracting from further developments and the factors driving those. Mergers and acquisitions in Latvian dairy industry had begun in 2011 and continued until 2013; however the positive impact of this process was fully offset due to the geopolitical situation in Europe in 2015. The deterioration in geopolitical climate due to Russian-Ukrainian relations has had a big impact on economic processes affecting also the development strategy of dairy firms. This study finds that often the problems of firm development are related to the lack of financial management especially deficiencies in decision-making on mergers and acquisitions of firms. Historical and statistical analysis as well as comparisons of successful experiences in Europe and Latvia allow the authors to conclude that in evaluating decisions on the possibilities for mergers and acquisitions

Latvian firms have to be guided by the most important results of this process: possible increases in foreign direct investment and the growth in market share. This will, in turn, give the firms an opportunity to acquire new technologies, reorganize manufacturing processes and start producing goods with larger value added. Ultimately this will allow to increase firm values.

The paper 'Critical Factors of Pre-Acquisition Due Diligence in Cross-Border Acquisitions' examines critical factors – and their inclusion in the pre-acquisition due diligence. Cross-border acquisitions play an important role in corporate strategic development and international expansion. During the past decades, mergers and acquisitions have been intensively researched through the lenses of strategic management, corporate finance, behavioural finance, etc. Despite the intense effort, the progress made is still fragmented and lacks unifying theories that approach the entire acquisition process on the one hand, and in-depth research of critical factors on the other. The intent of the research paper is to establish a vital link between academic research and practice of mergers and acquisitions, especially regarding the pre-acquisition evaluation. In detail, the research paper investigates critical factors – and their inclusion in the pre-acquisition due diligence, before decision about acquisition is made. Pre-acquisition due diligence theoretically conforms to organizational learning theory, which proposes the more the acquiring firm learns about the acquisition target, the higher the probability of a successful acquisition. The central hypothesis states that due diligence, including the critical factors, in the pre-acquisition phase is related to acquisition success. Using a multidimensional measure of critical factors, the empirical evidence is based on 85 cross-border acquisitions that took place between 2007 and 2013 in the European automotive industry. The quantitative analysis finds positive association between the Choice of Strategic Partner, Business Capabilities and HR Knowledge and Financial Factors and Acquisition Premium as critical factors of due diligence and acquisition success. The strongest relationship is between business capabilities and knowledge transfer as the main asset for realization of synergy values and successful acquisition. In this context, the valuation of the business capabilities of the acquisition targets is classified as the main challenge for reflecting suitability of the acquisition price and establishing value generation from the combined firms in the post-acquisition phase. By studying acquisition risk and critical factors – both success and failure reasons – this research tested and proved theoretically sound framework for successful acquisition. From a practical standpoint, the research results provide acquisition management

with a proven model for pre-evaluating acquisition candidates by means of comprehensive due diligence.

The paper 'The FDI Inflow to Special Economic Zones in Poland' examines why certain special economic zones in Poland attracted more FDI comparing to the others. One of the ways of convincing investors, in particular foreign ones, to take part in the implementation of state programmes and intentions is the development of Special Economic Zones (SEZ) designed to ensure more favourable business environment than those available in other locations. Poland has created and developed the SEZ. They play positive role in attracting foreign direct investment (FDI) or creating new jobs but also may have negative consequences, such as deepening regional disproportions in the country. This paper aims at examining why certain SEZ in Poland attracted more FDI than other. In our opinion that may result from the location in a particular region (understood as a unit of administrative division of the country at the level of a voivodeship). The study uses statistical methods (Spearman's rank correlation and Pearson correlation). We also used data that inform about the inflow of foreign investment to SEZ at regional level and rankings of investment attractiveness of voivodeships. In accordance with our calculations, there are statistically significant positive relationships between FDI inflow to SEZ and collective, as well as some partial, investment attractiveness coefficients and the level of economic advancement of voivodeships. Thus, it seems that SEZ do not reduce regional differentiation in Poland. The results may suggest the need to reconsider the so far applied policy designed to support investors. At the same time, they prove that State interference intended to mitigate market imperfections may itself become the source thereof.

The paper 'An Analysis of Audit Report Lags in Maltese Companies' investigates the audit report lag (ARL) in statutory audits. It tests a number of factors that may influence the ARL in 375 Maltese companies in the years 2006–2010. A mixed-methods research methodology is adopted, whereby company financial statements over the period are examined. Extracted information, including the ARL, is subjected to statistical tests on the relationship between such ARL and six independent variables: company size, audit firm size, audit opinion, profitability, the presence of an extraordinary item and type of industry. This is then complemented by the analysis of 12 semi-structured interviews with statutory auditors. The ARL is found to be shorter in large companies, when profit figures are positive, in financial service companies, and when the audit firms are large. A longer ARL is found when the audit report is qualified and in the absence of an extraordinary item. Interviewee response is generally

consistent with these results except for the relationship to ARL of the absence of an extraordinary item. ARL is also seen to vary according to the users' perceptions of the relevance and usefulness of the financial statements. Besides confirming or otherwise the relationship of the ARL to the stated major factors, the study also brings to light the need for co-operation by both audit firms and client companies to reduce such ARL.

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# AVOIDING BANKRUPTCY IN ITALY: PREVENTIVE ARRANGEMENT WITH CREDITORS

Alessandro Danovi, Patrizia Riva and Marina Azzola

## ABSTRACT

*As a sort of Italian equivalent of US's Chapter 11, the Preventive Arrangement with Creditors (Concordato Preventivo) is now the main instrument in Italy for small and medium-sized companies (and sometimes large ones) to manage insolvency by avoiding bankruptcy.*

*Through the examination of 60% of the total cases filed at the Court of Milan during the 2005–2014 period, authors investigated the different features of the procedure, the characteristics of the company that adopts it, and its diverse purposes of liquidation or restructuring. The complexity of the Italian system and the novelty of the legislation have made it rather difficult to reach definitive conclusions. However, Preventive Arrangements with Creditors can be considered a more efficient instrument than the alternative bankruptcy, both in terms of timeframe and creditors' satisfaction. Within the overall European reform process of insolvency proceedings, Italy seems to provide useful insights for other*

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*countries in Europe, following in particular the 2014 Recommendation issued by the European Commission.*

**Keywords:** Turnaround; enterprise value; preventive arrangement with creditors; restructuring; bankruptcy; insolvency

**JEL classifications:** G33; G3

## INTRODUCTION

After the reform, which Italian Insolvency Law (IL) underwent, the *Concordato Preventivo* or Preventive Arrangement with Creditors (PACs) has assumed the role of the main instrument for company recovery and turnaround becoming Italy's equivalent to US's Chapter 11. Regulatory reviews show how the actual use of this procedure has resulted in an alternative instrument to bankruptcy, mainly through the considerable freedom of initiative granted to the debtor; it is the debtor, in fact, who decides when and how to perform the company's restructuring. The system, created by IL, Royal Decree no. 267/1942, has been extensively revised since 2005 because of its inadequacy compared to the current socioeconomic reality and following EU Recommendation no. 135/2014.

The dynamic nature of the procedure, sometimes disharmonic compared to its original formulation, resulted in years of doctrinal legal papers and studies, while economic analysis on the topic have been less recurrent (Danovi, 2003, 2014; Falini, 2011).

After regulatory reviews, PAC has become a useful tool to avoid bankruptcy, mainly through the considerable freedom granted to the debtor (Lo Cascio, 2015). Recall that it is up to the debtor to decide timing and modalities of the company's restructuring plan. The role of creditors and of the Court becomes therefore residual, as the Court confirms or rejects the proposal subject to the approval of creditors.

In this context and in view of the upcoming further reform, it is beneficial to review the empirical use of the instrument over the past decade. As we will illustrate, after the IL reform and the post-2008 crisis, there has been an unprecedented growing number of PACs in all Italian courts. Nevertheless, there are significant doubts about the real effectiveness of the instrument in terms of restructuring and some concern about its possible opportunistic use.

This paper provides an empirical analysis of the filing of PACs in the Court of Milan, one of the largest courts in Italy, in the 2005–2014 period. Through the examination of 720 cases, 60% of the total number, the research shows the different features of the procedure, analyzes the characteristics of company that resorts to it, and its diverse purposes of liquidation or restructuring. Due largely to the novelty of the legislation, along with the complexity of the Italian system and considering the limit of studying a significant but geographically concentrated sample, it is rather difficult to generalize conclusions. Nevertheless, this paper shows how PACs can be considered a more efficient instrument than the alternative bankruptcy, both in terms of timeframe and creditors' satisfaction. As part of the overall European reform process of insolvency proceedings, following the 2014 Recommendation issued by the European Commission, Italy seems to provide useful insights for other countries in Europe.

## THE PREVENTIVE ARRANGEMENT WITH CREDITORS

In a few words, PAC is an arrangement with creditors that the debtor may propose filing at the Court where the company has its legal registered office. The procedure is similar to the US's Chapter 11, which was taken as a model in 2005. The purpose of the reform was to allow companies' restructuring while preserving their value.

In the PAC, the proposal consists of one of the following alternatives:

a) restructuring of debts and satisfaction of credits through any form, including the sale of assets and the allocation of shares or other financial instruments (the so-called "liquidation agreement");
b) business going on managed by the debtor ("*continuità diretta*") as introduced in the Italian IL in 2012;
c) business or part of the business going on transferring the property of it to one or more different companies ("*continuità indiretta*").

In the first case – liquidation agreement – the debtor must "ensure" payment of unsecured creditors and a minimum payment of at least 20% of the corresponding original unsecured debt.

The restructuring plan has to be revised by an Independent Expert (IE) – named "*Attestatore*" – who is called on the one side to audit the accuracy of the company's data and on the other side to assure the

feasibility of the plan. The IE is appointed by the debtor but he/she behaves as a third party and does not qualify as a company consultant. His work consists of verifying the quality of the plan and informing both the creditors and the Court about the situation of the analyzed company.

The Court examines the petition and, if it concludes that it is complete and compliant to the law, it admits the debtor to the PAC, appointing a Judge and a Judicial Commissioner (JC).

After an agreed period, the JC presents his opinion on the PAC to creditors so that they can vote on the proposal while fully informed. If the majority of unsecured creditors approves the proposal, the court opens the last phase of the procedure, which leads to the final decision ("*omologa*"), after which the PAC can be executed.

In 2012 the law was modified in order to introduce the possibility to gain, before the filing of a PAC, an automatic stay period, during which the law establishes protection against creditors ("*concordato in bianco*" or Prearrangement). Companies can ask the Court to have from 60 to 180 days to prepare their restructuring plan and all the documents necessary to fill in a PAC. The procedure was amended the following year as many insolvent entrepreneurs used this opportunity mainly to defer bankruptcy, instead of facing insolvency (Lo Cascio, 2015; Vitiello, 2013). More strict requirements regarding the obligation for the debtor to deposit the last three years' balance sheets are the possibility for the Court to issue periodic reporting requirements during the standstill period, and the inadmissibility of further applications if one has already had an accepted application in the previous two years.

In 2015 some more competitive market mechanisms in PACs procedures were introduced. On the one hand, creditors that represent at least 10% of the outstanding credits can file competing proposals in the 30 days before the creditors' meeting. On the other hand, if the PAC includes an offer for the transfer of specific assets, or the whole or part of the business as a going concern, the Court can seek other offers by opening a competitive market procedure.

## ITALIAN DATA, RESEARCH SAMPLE, AND METHODOLOGY

The general economic crisis and recent regulatory revisions have encouraged a surge in the numbers of bankruptcy procedures and PACs in all

Italian Courts. Since 2005, with the exception of 2011, the number of filing procedures has grown steadily (Dell'Oste, Maglione, & Nariello, 2015).

Different law modifications can explain these figures. As general Italian data show, the first introduction of the new rules caused a significant increase in the number of PACs filled in, especially in the first half of 2013 (87.5% more than the same period in 2012). Nonetheless, September 2013 regulatory reviews caused a decrease, which endured throughout 2014 and 2015. An interesting and opposite trend is registered in 2014 while the number of PACs decreased, bankruptcies reached their record (over 15,700). On the contrary in 2015, for the first time since the worldwide crisis started, bankruptcies decreased (14,700 procedures, 6.3% less than the previous year), still maintaining high values compared to the historical average. Such data show that in recent years PAC has assumed wide relevance as a company restructuring instrument, reaching thereby one of the first regulator objectives (Fig. 1).

The sample used in this research is composed by PACs filed at the Court of Milan, representing a large percentage of all the Courts of Italy. In 2005–2007 period, the annual number of PACs in Milan was around 30 units, while in the following years it tripled and increased to 11 times as much as in 2013. In 2009, in fact, there was a 48% increase (from 42 to 81 applications), while between 2010 and 2011 the number stabilized at around 80–90 requests. In 2012 it would have been likely to reach similar numbers (72 applications as of September 2012), but the introduction of the Prearrangement generated a significant discontinuity, as 146 applications were filed in only three months. In 2013, the number increased to 340 applications, while in 2014 and 2015 only respectively 252 and 191 application PACs were filed, a decrease of 26% and 24% over the previous year.

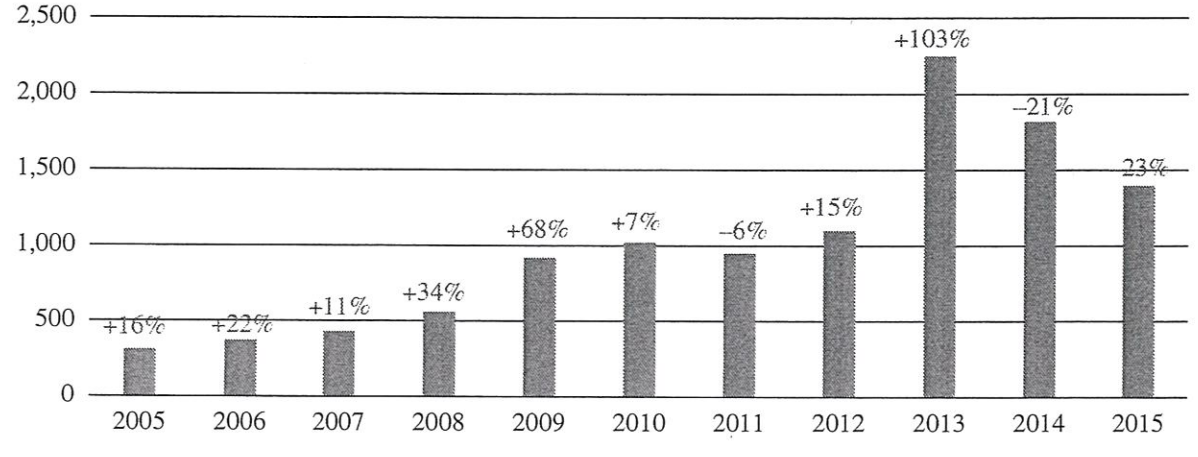


*Fig. 1.* PACs Submitted in Italy 2005–2015. *Source*: Elaboration from Cerved data. *Standstill Procedures Are Not Included.

It is also worth mentioning that in 2012 out of 146 applications submitted since September, 134 – which represent 92% of the total number – were Prearrangements. The same relevant figure can be found in the following years: in 2013 standstill procedures totaled 328, which is 96% of the total figure; in 2014 they were 227, 90% of the total figure; and finally, in 2015 they were 178 which is 93% (Fig. 2).

In the present paper, we investigate all applications filled in at the Milan Court to evaluate the effective use of the tool. The research, still in progress, collects information about the characteristics of the companies, the different ways the process has been managed, the role of the Court and of the advisors and of the independent experts, the contents of the restructuring plans, the costs, and results of the agreements.

Currently, the files of 875 companies that have applied for a PAC have been examined (60% of the total of Milan Court procedures). Table 1 shows the number of filling in per year and the percentage of those analyzed with respect to the total in the same period. The partial availability of documents for some procedures did not permit a complete reconstruction of all of the applications included in the database.

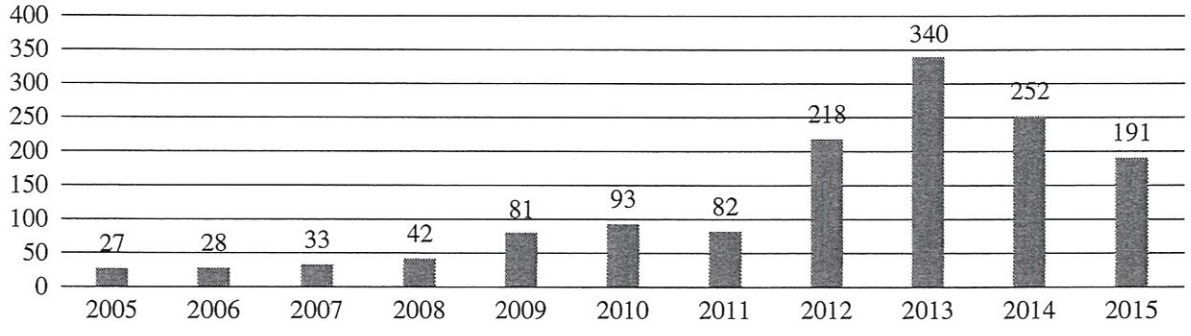


*Fig. 2.* Submissions Filed at the Court of Milan from 2005 until 2015. *Source*: Authors' elaboration.

***Table 1.*** Number of Examined PACs Submissions.

| Year | Sample | Total | % | Year | Sample | Total | % |
|---|---|---|---|---|---|---|---|
| 2005 | 5 | 27 | 19 | 2010 | 93 | 93 | 100 |
| 2006 | 6 | 28 | 21 | 2011 | 82 | 82 | 100 |
| 2007 | 8 | 33 | 24 | 2012 | 197 | 218 | 90 |
| 2008 | 30 | 42 | 71 | 2013 | 237 | 340 | 70 |
| 2009 | 63 | 81 | 78 | 2014 | 155 | 252 | 61 |
| | | | | *Total* | *875* | *1,196* | *60* |

The sample includes 120 Prearrangements in 2012 and 223 in 2013, but less than half of them were able to go on with the process, accomplishing it with a full PAC after the period granted to prepare the plan. We excluded 198 procedures from the analysis for which the plan was not completed.

The full applications were followed by admission to the PAC procedure in 84% of cases, after the Court assessed whether the necessary conditions were achieved. There were different results for which the admission/application was refused:

a) inadequacy or even wrong structure of the application or of the proposal to the creditors;
b) deficiencies in the IE opinion attached to the full application;
c) improper creditors classification;
d) prevision of inadequate payments for creditors;
e) prevision of a partial satisfaction of secured creditors noncompliant with art. 160 of IL asking for a special appraisal.

The approved PACs are on average only 60% of the ones initially admitted by the Court (Table 2). Among the causes for nonapproval, the following are the most relevant:

i) in 51% of the situations, the JC recommended to revoke the admission (under art. 173 IL);
ii) in 33% of the cases, the majority of creditors did not approve the plan proposed;
iii) in a few PACs the applicant issued a waiver or the company was not able to deposit the amount of money requested by the Court to face procedure expenses.

***Table 2.*** Number of Agreements Approved and Confirmed.

| Year | Not Admitted | % | Admitted | % | Approved | % | Not Approved | % |
|---|---|---|---|---|---|---|---|---|
| 2005 | 0 | 0 | 5 | 100 | 5 | 100 | 0 | 0 |
| 2006 | 0 | 0 | 6 | 100 | 6 | 100 | 0 | 0 |
| 2007 | 0 | 0 | 8 | 100 | 8 | 100 | 0 | 0 |
| 2008 | 0 | 0 | 30 | 100 | 22 | 73 | 7 | 27 |
| 2009 | 0 | 0 | 63 | 100 | 39 | 62 | 20 | 38 |
| 2010 | 22 | 24 | 71 | 76 | 33 | 46 | 38 | 54 |
| 2011 | 25 | 30 | 57 | 70 | 28 | 49 | 29 | 51 |
| 2012 | 21 | 16 | 110 | 84 | 66 | 60 | 42 | 40 |
| 2013 | 16 | 22 | 88 | 85 | 55 | 63 | 30 | 37 |

## THE CHARACTERISTICS OF COMPANIES IN THE SAMPLE

We first analyzed the main characteristics of the companies asking for admission. Then we go over the main events in a historical perspective to check the corporate governance and ownership of the debtor; and at last evaluate the characteristics of the sector (Gennari & Panizza, 2015). The purpose is to outline the business environment in which the companies operated and may still pretend to operate. This will lead to a better understanding and outlining of the causes of the financial collapse and consequently to a better formulation of the strategies necessary for the recovery. The sample is composed by private (71%) or public companies (24%). Sole proprietorships and partnerships are residual (5%).

More than half of the companies show a concentrated ownership (one to four owners) and 14% of the sample is composed of private companies with a sole owner. This data confirms the important presence of family businesses, typical of the entrepreneurial Italian environment (Table 3).

With reference to the size, adopting the definition of the European Commission, we divided the sample into four clusters based on the number of employees hired the year prior to the filing. As reported in Table 4, companies are mostly micro and small, that is, with a workforce of less than 50 employees. Approximately one tenth of the sample is medium sized, while large companies are almost missing as they altogether account for only 1% of the sample. This happens probably because large companies can fill in for a different and ad hoc procedure: the Extraordinary

***Table 3.*** Companies' Legal Form.

| Legal Form | *N* | % |
|---|---|---|
| Sole proprietorship | 2 | 0 |
| Partnership | 26 | 4 |
| Limited partnership | 4 | 1 |
| Private company | 508 | 71 |
| Public company | 171 | 24 |
| Limited partnership by shares | 1 | 0 |
| *Not available* | 1 | 0 |
| *Total* | *720* | *100* |

***Table 4.*** Companies' Size.

| Size | *N* | % |
|---|---|---|
| Micro (1–9 employees) | 260 | 36 |
| Small (10–49 employees) | 241 | 33 |
| Medium (50–249 employees) | 80 | 11 |
| Large (beyond 250 employees) | 9 | 1 |
| *Not available* | 130 | 18 |
| *Total* | *720* | *100* |

Administration. The annual turnover confirmed the analysis as within the sample it resulted in 10 million euro on average (median €2.7 million euro).

The distribution of the sample among different sectors of activity leads to the conclusion that the crisis has hit the tertiary and service sectors more strongly (46%), followed by the manufacturing one (36%). Even real estate and constructions appear to have experienced a sharp decline (18%). In the manufacturing sector, companies primarily hit by the crisis belonged to the metallurgy, paper and publishing, and electronics activities. Within the tertiary sector, the highest rates were registered in trade, both wholesale and retail, followed by catering and tourism. Anyway, in general, although some sectors were more exposed than others, all of them were affected by the phenomenon. In fact, at least one company in each sector applied for PAC.

## MAIN EMPIRICAL EVIDENCE ON PACs

All plans submitted by the 522 companies of the sample that fulfilled the PAC procedure were examined through a cover-to-cover reading of all the documents found in the Court's files. More specifically, for all the procedures, an analysis was carried out focusing on/regarding: (i) the application filed by the company; (ii) the opinion on the plan ("*Attestazione*") drafted by the Independent Auditor; (iii) the JC report pursuant to art. 172 IL or art. 173 IL; and finally (iv) the JC opinion pursuant to art. 180 IL. To further support the analysis, we processed the Court's decrees of admission (or nonadmission) and of approval (or nonapproval). The following pages summarize the results, paying particular attention to the main characteristics of the restructuring plans and to the intervention of the JC during the procedure.

The analysis starts considering the causes of the crisis as represented within the Court's files. As most scholars stated, from an economic perspective, corporate crisis is an evolutionary process that leads to the destruction of corporate value (Danovi, 2014). Crisis is not, therefore, a sudden event but rather it is characterized by a series of concurrent phenomena, perhaps a cluster of causes, which contribute to the deteriorating situation leading to the precipitating cause (trigger event). Models identified by literature suggest a clear distinction between factors that are exogenous or external to the company and factors that are endogenous or internal to the company. Following this classification, we considered on one side exogenous those causes arising from macroeconomic phenomena (general economic trends, changes in interest rates, exchange rates and prices of production factors, changes in legislation and environmental or sociodemographic changes) rather than from sectorial instability (variation of density, saturated demand, competitive tensions, and technological innovations). On the other side, endogenous causes were classified by considering the following factors:

i) *Strategic*: related to errors in drawing business plans and in management of the company;
ii) *Operational*: related to problems encountered in the process of purchase-production-sale and related financial transactions;
iii) *Corporate*: related to inadequate corporate governance and to operations of moral hazard in conflict with the company's objectives;
iv) *Extraordinary:* with unforeseen events (death or disease of the entrepreneur, fire, theft, or ineffective M&A transactions).

The picture outlined from the reading of companies application, Advisors reports, IE opinions, as well as JC evaluations make it clear that the crisis of companies depended equally on both business and macroeconomic factors, as well as on a mix of internal and external factors. In particular, the crisis of 2008 was often mentioned as the main cause of discontinuity determining a rupture in business going concern. Companies that fill in for a PAC should find themselves in a situation of financial difficulty, but they should not be in a condition of irreversible insolvency or in a situation where the risk of discontinuity is outlined. Italian legislator imagined PAC as an instrument to solve the crisis having mainly an anticipatory nature. On the contrary, the survey confirms that PACs are often used when the crisis has already disclosed its effects. It is enlightened that Italian entrepreneurs apply for the procedure late, when the crisis has already

shown its most serious consequences, thus delaying the positive effects of the restructuring procedure.

The choice of the best restructuring strategy actually first relates to the comparison between the liquidation value and the going concern value (Danovi, 2014). The liquidation choice is the most appropriate when the company's going concern value is under the liquidation value; conversely, the alternative of continuity is convenient when there is still a chance to recover and to create new value after the turnaround.

It is interesting to note that, as described in Table 5, liquidation occurs in more than half of the analyzed cases, precisely in 61% of the situations considered over time. The remaining can be qualified as agreements with the intervention of a third part (2%) or going concern agreements (34%). It is necessary in this regard to distinguish between (Riva, Bavagnoli, De Tilla, & Ferraro, 2011):

- *Direct managing of going concern* – (in 7% of cases) which implies that the firm continues to be carried on by the original entrepreneur from both an economic and a legal point of view, and
- *Indirect managing of going concern* – (in 27% of cases) which implies that the business goes on, but the business is transferred to another company. In this case (often before filing), the business is rented by a third party and later it is sold. Normally the acquisition takes place after the approval of the PAC. This occurs in 70% of the applications with the

***Table 5.*** Types of PACs Plans.

| Year | Liquidation | % | Continuity | | | |
|---|---|---|---|---|---|---|
| | | | Direct | % | Indirect | % |
| 2005 | 1 | 20 | 0 | 0 | 3 | 60 |
| 2006 | 2 | 33 | 0 | 0 | 1 | 17 |
| 2007 | 4 | 50 | 0 | 0 | 4 | 50 |
| 2008 | 21 | 70 | 0 | 0 | 8 | 27 |
| 2009 | 44 | 70 | 1 | 2 | 18 | 29 |
| 2010 | 49 | 53 | 7 | 8 | 31 | 33 |
| 2011 | 47 | 57 | 7 | 9 | 25 | 30 |
| 2012 | 76 | 58 | 11 | 8 | 41 | 31 |
| 2013 | 75 | 72 | 13 | 13 | 10 | 10 |
| *Total* | *319* | *61* | *39* | *7* | *141* | *27* |

indirect model. The immediate business sale was planned instead in the remaining cases, which reached 28%. Data confirm what scholars have been stating since the first year of the implementation of the new law: business rent is a useful tool to preserve a company's value, especially the intangible assets. The indirect strategy is appreciated because, on one side, it permits speed and flexibility in the execution of the PAC and, on the other side, it is easier to implement (Gitto, 2002; Panzani, 1998).

The analysis points out that PAC appears to be a tool used both as a turnaround procedure and as a liquidation procedure (Danovi, 2014). Although there is a clear prevalence of the last use, the attempt in 180 cases to propose a plan that allows the recovery of corporate value needs to be highlighted.

The assets and liabilities in PACs are summarized in Table 6. There is a high value of tangible assets, trade receivables, and inventories. Few are the cases with financial contribution by shareholders or third parties (16% of the sample). As expected, liabilities are always higher than the real value of assets and consist mostly of unsecured debts. In general, banks are the most recurrent creditors. This is in line with the literature, which suggests the use of a PAC when debts towards banks are relevant (Ranalli, 2015). Among secured creditors it turns out to be relevant the position of tax authorities together with social security institutions and employees, while suppliers mainly resulted among unsecured creditors: deferred creditors are 11% of the cases. Finally it should be noted that predeductible debts including the procedure costs (JC, eventual appraisals, and all other procedure expenses), the IE's opinion costs, and the possible negative margin generated from the business continuity after the application, represent an average rate of 0.2% on the total amount of liabilities.

The analysis shows interesting results about the percentages that are disclaimed as payable to creditors as reported in the documents deposited in Court's files. Considering this, it results that:

- on one hand, almost all of the sample companies (92%) offer the complete satisfaction of secured creditors where the others grant partial satisfaction of a further secured class of creditors, with an average rate of satisfaction of 49% (median 40%);
- on the other hand, companies offer unsecured creditors a percentage of satisfaction of on average 28%.

***Table 6.*** Assets and Liabilities as Indicated in the Restructuring Plan (euro/million).

| A. Assets | Average | % | Median |
|---|---|---|---|
| Tangible Fixed Assets | 1.7 | 32 | 0.1 |
| Intangible Fixed Assets | 0.2 | 4 | 0.0 |
| Financial Fixed Assets | 0.7 | 13 | 0.0 |
| Inventories | 0.8 | 15 | 0.0 |
| Cash and Equivalents | 0.3 | 6 | 0.1 |
| Trade Receivables | 1.4 | 26 | 0.4 |
| Financial Current Assets | 0.2 | 4 | 0.0 |
| *Total assets* | *5.3* | *100* | – |
| Cash from sale of the business as a whole or of branches | *2.6* | – | 0.0 |
| **B. Liabilities** | **Average** | **%** | **Median** |
| *1) Predeductable* | *0.6* | – | *0.2* |
| Secured: banks | 1.4 | 38 | 0.0 |
| Secured: suppliers | 0.4 | 11 | 0.0 |
| Secured: professionals | 0.1 | 3 | 0.0 |
| Secured: employees | 0.8 | 22 | 0.2 |
| Secured: Treasury and protection institutions | 1.0 | 26 | 0.2 |
| *2) Total secured creditors* | *3.7* | *100* | – |
| Unsecured: banks | 3.2 | 53 | 1.3 |
| Unsecured: suppliers | 2.8 | 47 | 1.3 |
| *3) Total unsecured creditors* | *6.0* | *100* | – |
| *Total liabilities* | *10.3* | – | – |

This finding is relevant because it helps reasoning about the sustainability of the thresholds introduced in 2015. The distribution of the companies in the sample suggests that 50% of the analyzed procedures would not have had the chance even to be submitted. This may be asserted when considering not the average value of the results obtained, but the value assumed by the median of the distribution, which stood precisely on 20%. That is exactly the minimum satisfaction value, which the debtor can legally offer to creditors. Out of the 522 cases considered so far, 261 would not have fulfilled the parameters necessary to obtain admission, with the exception of situations where third-parties intervention could have enhanced the opportunity to get external financial contribution.

It should be highlighted that the structure of 113 procedures propose dividing into more categories of unsecured creditors and thus, consequently, the average satisfaction rate decreases to 21% with a median of 13%. It is again important to specify that the debtor is responsible for choosing the criteria that identifies the creditors' categories, while the Court verifies the fairness of used criteria under art. 163 IL. Creditors' categories need to be designed to ensure consistent behaviors towards subjects with homogeneous characteristics. The prevision of unsecured creditors' categories is considered a useful tool to incentivize the approval of the PAC by creditors (Santoni, 2007).

Finally, the research highlights relevant aspects in terms of duration and execution approaches as presented in the PAC plan. A restructuring plan must be developed and closed within a defined period pointing out the relevant milestones that are the different activities and planned operations and their timing, explicating the starting and the expiring dates and indicating priorities. The plan also has to provide a monthly budget for at least the first year, along with the annual development of the plan for the subsequent years in terms of revenues and expenditures. The analysis indicates that the execution of the plan is on average expected to take:

a) 17 months for the satisfaction of secured creditors (median 12 months);
b) 26 months for the settlement of unsecured creditors (median 24 months), with an estimated 29 months for the full execution (median 24 months).

Only 45% of the analyzed cases have a structured action plan, consistent with the model proposed by the standards and the preset doctrine. A significant result allows room for improvement as a detail of the restructuring execution timing would allow conferring credibility to the plan. It seems that the more details are provided concerning the execution of the PAC, the more the debtor will be perceived as willing to go through a realistic and workable plan.

The IE checks the accuracy of data through inspections and by analyzing the company's documents in accordance with standards. To obtain this goal, a strict interaction is important with all corporate governance bodies, with the entrepreneur and the management, and in larger companies with all supervisory bodies and finally with the experts appointed to appraise special assets. Exchange of information with all company's control bodies, in particular, can be useful to better plan auditing activities and save precious time (Riva, 2009). The assessments expressed by the IE, as every audit and assurance opinion, are by nature probabilistic (as it analyzes the accuracy of data through the use of sampling techniques) and subjective

(being referred to estimates and assumptions formulated to evaluate the business).

The Court appoints the JC first and foremost for the protection of creditors. Among the attributed tasks there is the drafting of a report on the sustainability of the PAC as proposed by the company to be drafted and transmitted at least 45 days prior to the creditors' meeting (Michelotti, 2015).

Data show that in 66% of cases the Commissioner gives a positive and clean opinion (pursuant to art. 172 IL). In 12% of the examined cases, the opinion expressed in the report is positive but with exceptions as it includes references to critical situation that could lead to deviations from the straight execution of the plan, for instance, it can be in reference to special risks considered worthy of mention. Finally, in 22% of cases the JC expresses a negative opinion and releases a report in which he/she requests the Court to revoke the admission to the PAC procedure (pursuant to art. 173 IL) (Table 7).

The analysis suggests the existence of a correlation, already enlightened by some scholars (Fabiani & Guiotto, 2015), between tight controls and detailed and effective disclosure carried out by the Independent Auditor during the earlier steps of the procedure and the probability of a positive opinion by the JC in the following months of the procedure. In his/her report, the Commissioner in fact analyses the IE report to evaluate the accuracy of the data and the feasibility of the plan. When a substantial correspondence is found between what is directly observed and what the IE reports, the Commissioner can then choose to base his/her own analysis on the one already conducted and accurately disclosed in the audit report. When this is the case, the Commissioner can plan only some selected procedures of detail or he/she can simply reduce the sampling levels in all procedures set up.

***Table 7.*** The JC's Report.

| Type of Report | No. | % |
|---|---|---|
| "*Clean*" opinion 172 IL | 264 | 66 |
| Opinion with exceptions | 47 | 12 |
| Negative opinion 173 IL | 87 | 22 |
| No opinion released | 1 | 0 |
| *Total* | *399* | *100* |

Furthermore, it is significant to note that in only 62% of cases the Commissioner provides information on the suitability of alternative hypotheses to the PAC agreement, which is usually bankruptcy. This result is quite surprising, as Courts and scholars express their opinion considering the comparison relevant for creditors. In 54% of filed reports PAC arrangement is explicitly recognized as more effective than bankruptcy by ensuring a higher satisfaction of creditors. In the remaining cases, the Commissioner highlights the feasibility of the plan as well as the higher effectiveness of bankruptcy. In these special situations the PAC agreement is considered consistent, even if less convenient, the decision is indeed left to the creditors to accept the restructuring plan or to refuse it receiving, a better monetary result with bankruptcy, in accordance to the analysis of the Commissioner.

The survey has drawn attention to the following main disadvantages related to bankruptcy when compared with PACs: (i) the loss of extra-guarantees; (ii) the failure to realize the company's assets at fair values; (iii) the massive layoff of workers (Table 8).

The survey also covered all reports composed under art. 173 IL, released in 22% of the situations and leading to the direct request to revoke the admission of the PAC agreement. In it, the Commissioner is called, among other things, to describe his findings concerning criminal behaviors in the formulation of the PAC or debtor's illegal conduct registered during the period of application. The Commissioner must highlight the eventual assets concealments or dissimulations, the assessment of intentional omission of existing claims, the exposure of nonexistent liabilities, and, finally, the recognition of other frauds. Out of a total of 87 situations analyzed, the main findings regarded cover-ups of assets – 36% of cases – and the existence of acts of fraud – 19% of cases, while in more than 25% of cases multiple investigations and consequently a number of different situations is described. The JC's assessments, despite being seriously considered, are not binding for the Court that will provide an independent exam of the situation.

***Table 8.*** PAC and Bankruptcy in the Report Ex Art. 172 IL.

| | No. | % |
|---|---|---|
| Disadvantages of bankruptcy | 214 | 54 |
| Advantages of bankruptcy | 34 | 9 |
| The Commissioner does not express an opinion | 151 | 38 |
| *Total* | *399* | *100* |

In the event of a positive vote by the majority of creditors, the agreement is finally approved, but the JC is again called upon to draft a second final opinion (under art. 180 IL). Results were reassuring as in this last phase of the PAC path with few exceptions – 4% of contrary opinions in total – the Commissioner gave an approving result.

## CONCLUSIONS

The empirical analysis of Milan Courts evidence allows drafting some first conclusions on the use of PACS in the Italian system.

Collected data show that PACs have been widely used from the 2005 IL reform to 2015. The intent of the legislator to use PACs to ensure company continuity and restructuring does not seem to have taken on the role advocated as most PACs end with the company liquidation. Over the years, there has been either a substantial presence of liquidation agreements, or a significant number of applications with no further filing of a plan, thus not approved.

Most procedures from 2012 were filed with the Prearrangement scheme, but less than half presented a complete plan. Thanks to the introduction of the Prearrangements in 2012, the instrument has become very attractive for companies in crisis, even if often they are not able to start a real restructuring process.

The results are, however, quite interesting: more than 85% of PACs presented are admitted and nearly two-thirds are approved by the Courts.

Due largely to the newness of the legislation, along with the complexity of the Italian system, it is rather difficult to generalize conclusions. Nevertheless, the paper shows how PACs can be considered a more efficient instrument than the alternative bankruptcy, both in terms of timeframe and with creditors' satisfaction. As part of the overall European reform process of insolvency proceedings, following the 2014 Recommendation issued by the European Commission, Italy seems to provide useful insights for other countries in Europe.

From a statistical point of view, the research is only descriptive and the sample can be partially considered representative of the whole country. Obviously future research will be able to more profoundly investigate causal relationship through the different characteristics of companies and restructuring plans and the success of the recovery.

Due to the newness of the phenome and lack of previous empirical research on the topic, however, we hope that the data can be interesting for both scholars and practitioners.

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