Understanding Italy’s participating financial instruments

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Introduced to the Italian Civil Code in 2003, Participating Financial Instruments (PFIs) presented Italian companies with an alternative means of raising finance. Under the legislation, Italian corporations are able to issue PFIs to shareholders or third parties, in exchange for their provision of work or services to the company. PFIs grant their holders economic or administrative rights, but not the right to vote in general meetings of shareholders.

The terms and conditions of issue linked to a PFI are set out by the corporation's by-laws, along with the rights that are attributed to the holder, the penalties that will arise in the event of default in the execution of services and, if permitted, the relevant conditions of any future circulation of the PFI.

PFIs may be issued through a special meeting of the corporation (requiring broader voting quorums). A PFI may set out the holders' voting rights on specific matters, particularly the appointment of an independent member of the board of directors, the supervisory board or the issuer's statutory auditor.

**PFIs in restructuring transactions**

Changes in the economic landscape over the last decade have seen PFIs being increasingly used as a tool in debt restructurings or reorganisation transactions, with many creditors looking favourably on PFIs as a means to improving the state of a company's balance sheet.

Financing granted by financial institutions or intercompany loans is sometimes, within the framework of a restructuring, converted into an PFI (also through the liberation of a social capital increase performed via contribution of credits towards the company) in order to deleverage the issuer and, therefore, guarantee an increase in the company's value.

Through the conversion of existing claims into PFIs, lenders participate in the enterprise risk that the restructured entity may pass from a credit/debt relationship to a quasi-equity relationship, although they maintain a priority raking in the distribution of profits and in the waterfall of payments.

PFIs may be issued in different tranches, each characterised by specific terms and conditions regarding property rights and administrative rights. Therefore, when credits deriving from secured loans are converted into PFIs, the corresponding lenders may receive PFIs granting rights of priority, in the waterfall of payments, with respect to both company shares and the PFI subscribed by lenders of unsecured loans.

It should be understood that, in order to grant the issuer’s full deleveraging, PFIs should be issued on the basis of terms and conditions that may allow them to be deemed (from tax, corporate and accounting points of view) more...
similar to equity interests than debt instruments.

Lenders generally take part in the negotiations setting the rules for the PFI issuance and agreeing the remuneration, voting rights, conversion consideration and circulation regime of the PFI with the restructured entity and its shareholders.

There are certain limitations on the relevant acquisition of participations in non-financial corporations applying to Italian financial institutions which do not apply in case of subscriptions of PFI in relation to distressed companies in the frame of restructuring transactions, in accordance with Italian Bankruptcy Law and the applicable rules of the Bank of Italy.

**How can a PFI be distinguished from a share or bond?**

The issuance of shares requires the increase of the corporate capital in an amount equal to the value of contributions. The issuance of a PFI does not require an increase in the issuer’s corporate capital. It is possible to issue classes of shares that exclude the voting rights and specific rights that would ordinarily be attributed to them.

The issuance of bonds requires a financing in favor of the issuer. The company has therefore a debt vis-à-vis the bondholder for the repayment of the “loan” (at the maturity date) and for its remuneration (i.e. payment of interest rate). Bondholders are granted property ownership rights, but do not have equal administrative rights in the general and special meeting of the issuer’s shareholders, except for voting rights at bondholder meetings.

Italian law provides for certain “innovative” corporate bonds, such as:

- **subordinated bonds** that grant the bondholders the right to be repaid the principal and interest of the loan in whole or in part, subordinated to the rights of other creditors of the issuer;
- **bonds “of participation”** for which the time and the amount of the payment of interest may vary, depending on objective parameters related to the company’s financial status.

Although these are not bonds in the proper sense, they are in any case other financial instruments “of debt” and are characterised by the existence of a company debt for the repayment of the principal amount.

It is worth noting that (i) the regulation of bonds applies only to the financial instruments of “debt”; and (ii) administrative rights may only be granted only to the PFI.

**PFIS - A closer look**

Common features pertaining specifically to PFIs are as follows:

- the value of contributions increases the equity of the issuer through constitution of reserves of the balance sheet;
- the periodic remuneration is (de facto) a participation in the issuer’s profits, which may be effected with priority in respect of the remuneration of company shares;
- participation in the enterprise risk implies the (original) absence of a repayment debt of the initial contribution.

Unlike shares, however, PFIs usually have a “shorter life” than the duration of the issuer.

**Tax Implications**

From a tax perspective, the remuneration of a PFI may be considered:

- **as a dividend**, when the remuneration is linked entirely to the issuer’s profits; in this case it would be subject to corporate income tax at the ordinary rate of 27.5 percent on the 5 percent of the remuneration in the holder’s hand (an effective tax rate equal to 1.375 percent), while it would be not deductible for the issuer;
- **as interest**, when the remuneration is not entirely linked to the issuer’s profit (e.g., a minimum remuneration is guaranteed). Interest would be entirely taxed at the ordinary corporate income tax rate of 27.5 percent (an effective tax rate equal to 27.5 percent), while it would be deductible for the issuer under the ordinary rules.

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