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A STOP TO PIK LOANS FROM THE COURT OF MILAN

By the Italian Restructuring &
Insolvency Department

PIK (Payment In Kind) loans are loans that typically do not provide for any cash flows from borrower to lender between the drawdown date and the maturity/refinancing date. Under PIK loans, interest generally accrues from period to period, thus increasing the underlying principal. Alternatively, PIK Loans sometimes include provisions whereby, interest payments are no longer deemed due upon the occurrence of certain events, and the corresponding amount is added to the principal amount, thereby generating further interest. This latter type of provision is usually included in loans granted in the context of restructuring proceedings where the borrower may not always be able to meet, either fully or partially, its obligations to pay the agreed interest as it falls due.

The 2014 Italian Stability Law⁽¹⁾ introduced material changes to the Italian banking regulation. In addition, it mandated the Committee for Credit and Savings (in Italian, “*Comitato Interministeriale per il Credito e il Risparmio*”; the “*Committee*”) to detail⁽²⁾ the terms and criteria for the accrual of interest solely in the context of banking transactions. The law also provided the following two firm guidelines: 1. interest periods on bank accounts must be the same for interest owed to and by the bank and 2. “*interest periodically capitalised cannot generate further interest which in subsequent capitalization transactions must be calculated exclusively on the principal amount*” (new wording of Section 120 of the Italian banking law as changed by the 2014 Stability Law).

PIK Loans have never had an easy life in Italy because the Italian Civil Code prohibits the capitalization of interest other than in certain limited circumstances³. Until now PIK Loans have been permitted thanks to a favourable secondary regulation by the Committee and the Bank of Italy that mitigated the rigidity of the Italian Civil Code. However such measures never really overcame the resistance of the Italian courts which, since the early 2000s, have frequently challenged the practice of compounding of interest by the banks⁽⁴⁾.

The aim of the 2014 Stability Law was to settle definitively such long-standing clash of approach and excluding once and for all any periodic capitalization of interest but the banking system has so far resisted the implementation of the new law based on the argument that such law is incomplete until the Committee has enacted the new rules on the capitalization of interest (rules not yet available). PIK Loans have thus continued to be negotiated and applied, particularly, as explained previously, in the context of restructuring proceedings.

A few weeks ago however a new piece has been added to the puzzle which may finally prevent PIK Loans in Italy: the Court of Milan in two recent decisions⁽⁵⁾ has ruled that the changes introduced by the 2014 Stability Law had the immediate effect of prohibiting the compounding of interest in banking transactions. In both cases (decided by the same panel of judges) the court has clearly stated that starting from 1 January 2014 any capitalization of interest in banking transactions is prohibited by law and has quashed the argument of the banks about the incomplete nature of the law on grounds that the Committee was mandated by the 2014 Stability Law only to enact secondary rules on the terms of accrual of interest without prejudice to the anti-capitalization principle set out in such law. The two cases were brought to the attention of the court by consumer associations that in accordance with their remit limited their petitions to the acknowledgment of the legal prohibition on interest capitalization and to an adequate publicity of such prohibition among the public. Yet it is fair to predict that these two decisions have paved the way for direct claims by borrowers requesting cancellation of PIK interest charged following 1 January 2014.

The banking sector is uncertain as to the way forward and for the time being continues to capitalize interest but “to the extent permitted by law” (this is what the new clauses on interest often say).

The next months will say whether these recent judicial decisions really have sounded the death knell for PIK Loans in Italy.

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¹ See Article 1, paragraph 629, of Law no. 147 of 27 December 2013.

² Execution of monetary policy has been usually vested in the Interministerial Committee for Credit and Savings, which is an entity headed by the Ministry for Economy and Finance.

³ Article 1283 of the Italian Civil Code allows only the capitalization of interest due by at least 6 months and only provided that the borrower consents thereto following accrual of the interest or the bank starts a legal action against the borrower.

⁴ The most notable cases are Court of Cassation [4 November 2004, no. 21095](#) and Court of Cassation [3 December 2010, no. 24418](#).

⁵ Court of Milan 25 March 2015 case no. 3558/2015; Court of Milan 3 April 2015 case no. 3562/2015.