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CLIENT ALERT

Covid-19 emergency and measures to support liquidity: private equity investments and SMEs definition

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AUTHORS: Maurizio Delfino | Anna Laura Pettoello

Introduction

*As of the end of February last, the Italian Government has adopted important initiatives to mitigate the impact of the Covid-19 pandemic. Financial measures have been approved to support micro, small and medium-sized enterprises ("**SMEs**") and their liquidity*[1]*, including, standstill, moratoria or other rescheduling mechanisms of existing indebtedness*[2] *and an enhanced system of guarantees under the Guarantee Fund in favour of SMEs*[3]*, now extended to mid cap enterprises*[4].

The new regulatory package turns the spotlight on the concept of "SMEs", whose perimeter is sometimes uncertain, in particular when a significant part of the company equity is held by private equity funds or venture capitalists. In this connection, it is worth reminding that the "SME definition" is «the structural tool to identify entities that are confronted with market failures and particular challenges due to their size and therefore [should be allowed] *to receive preferential treatment in public support»*[5].

[1] The purpose of such measures is to alleviate the financial impact of the pandemic on SMEs helping them to cover immediate working capital needs, in order to ensure the continuation of their activities and preserve jobs.

[2] Article 56 of Law Decree 18/2020, published on 17 March 2020 – the so-called "*Cura Italia*" Decree.

[3] Article 49 of the "*Cura Italia*" Decree.

[4] Enterprises with up to 499 employees, under Article 13 of Law Decree 23/2020, published on 9 April 2020 – the so-called "*Liquidity*" Decree.

[5] See the public consultation on the review of the SME definition, in https://ec.europa.eu/info/consultations/public-consultation-review-sme-definition_en.

This is a longstanding debate since the EU Commission introduced a "European" definition for SME[6]. Ultimately, the actual involvement of an investor in the management of the target company should be considered when determining whether the size of the investor should be taken into account.

1. What is a micro, small and medium-sized enterprise ("SME")?

According to the definition provided by the EU Recommendation 2003/361/EC of 6 May 2003 (the "**EU Recommendation**") as transposed into our legal system by Decree of the Ministry of Productive Activities of 18 April 2005 (the "**Ministerial Decree**"), the category of SMEs includes those enterprises which:

(i) employ less than 250 persons, and

(ii) have an annual turnover not exceeding EUR 50 million and/or an annual balance sheet value not exceeding EUR 43 million.

2. Are staff headcount and financial parameters sufficient to select which enterprises can be considered "genuine" SMEs?

No, staff numbers and financial data are not a definite criteria to draw the line between a "genuine" SME and a larger entity, especially in today's increasingly globalized business scenario, where enterprises which are "small" in terms of *size* may have financial, operational or governance relationships with other entities. Indeed, a company belonging to a large group can have access to additional resources that are not available to competitors of equal size which do not have such links.

Therefore, according to both the EU Recommendation and the Ministerial Decree, **independence / ownership** and **control** are also appropriate criteria to determine whether or not an enterprise is entitled to be classified as a SME or not.

3. How do links between enterprises affect the definition of SME?

Both the EU Recommendation and the Ministerial Decree contemplate:

(i) enterprises which are totally "*independent*", *i.e.,* do not have any "*partners*" or "*linked entities*";

[6] For the sake of an easy consultation of the applicable rules and the main issues which may result from the definition of SME, please see the "*User Guide to the SME Definition*" issued by the EU Commission in 2015: https://op.europa.eu/en/publication-detail/-/publication/79c0ce87-f4dc-11e6-8a35-01aa75ed71a1. Also, AIFI, the Italian Association for the Private Equity, Venture Capital and Private Debt, has recently called for a governmental intervention to better clarify the eligibility standards to rank as a SME.

(ii) "*partner enterprises*", when an enterprise holds a participation in the share capital of another entity ranging between 25% and 50%;

(iii) "*linked enterprise*", when holdings with other enterprises exceed the above 50% threshold[7].

In case of relationships with third parties, either as "*partners*" or "*links*", the staff numbers and financial data (turnover and balance sheet value) of the other entities must be added to those of the enterprise taken into consideration. In case of "*partner*" entities, the sum must be calculated on a *pro rata* basis, thus reflecting the percentage of shares or voting rights that the upstream enterprise holds in the downstream entity.

4. Making the calculation does not seem to be so easy.

The calculation becomes even more complex if we consider that "*partner*" entities may, in turn, have links with other enterprises. To cut a long story short, data of the "*partner*" of a "*partner*" are not to be included in the calculation, whilst the data of an enterprise which is "*linked*" to a "*partner*" or to a "*linked enterprise*" is to be taken into account.

The "*User Guide to the SME Definition*" by the EU Commission[8] contains certain practical examples which may be of help in understanding how the relationships between enterprises are to be taken into consideration in making the SME calculation.

In addition, the Italian Ministry of Economic Development ("**Ministry**") appointed a special commission for the determination of the size of a company for the purposes of

[7] According to Article 3 paragraph 3 of the Annex to the EU Recommendation, "*linked enterprises*" are "*enterprises which have any of the following relationships with each other:*

(a) An enterprise has a majority of the shareholders' or members' voting rights in another enterprise;

(b) An enterprise has the right to appoint or remove a majority of the members of the administrative, management or supervisory body of another enterprise;

(c) An enterprise has the right to exercise a dominant influence over another enterprise pursuant to a contract entered into with that enterprise or to a provision in its memorandum or articles of association;

(d) *An enterprise, which is a shareholder in or member of another enterprise, controls alone, pursuant to an agreement with other shareholders in or members of that enterprise, a majority of shareholders' or members' voting rights in that enterprise […]*".

[8] Please see footnote no. 6.

granting aids to productive activities. Existing guidelines of the Ministry may also be useful for the purpose of the SME calculation[9].

5. How does the equity held by venture capitalists or private equity funds affect the ranking as a SME?

Both the EU Recommendation and the Ministerial Decree provide that an enterprise may be qualified as "*independent*" even if the 25% threshold set forth above is reached or exceeded by certain categories of investors, such as venture capitalists, "*business angels*" and institutional investors, provided that said investors are not "*linked*" – individually or jointly – to the enterprise in question.

From a national perspective, the Appendix to the Ministerial Decree, containing *Explanatory notes on how to calculate the dimensional parameters,* reads as follows: "*where such investors are not directly or indirectly involved in the management of the enterprise in question, without prejudice to their rights as shareholders or quotaholders, they shall not be considered to be "linked" to said enterprise*"[10].

The wording, unfortunately, is not crystal clear.

6. What happens when one of the above entities – for example a private equity fund – owns a shareholding of more than 50% without being involved in the management of the enterprise in question? Is such enterprise eligible to be ranked as an "*autonomous*" enterprise?

Based on the current regulatory framework, the answer is not straightforward.

According to a possible interpretation[11], the exception to the 25% threshold provided by the EU Recommendation and the Ministerial Decree in case of participations held by certain categories of investors is aimed at avoiding that the enterprise in question is considered as a "*partner*" of said investors, but does not exclude the existence of "*links*" between the enterprise and investors at issue. This is because there is a rebuttable presumption that no "*dominant influence*" exists if the investors at issue are not involved in

[9] https://www.mise.gov.it/index.php/it/component/content/article?id=2004048:commissione-per-la-determinazione-della-dimensione-aziendale-ai-fini-della-concessione-di-aiuti-alle-attivita-produttive.

[10] https://www.mise.gov.it/images/stories/documenti/DM_18_4_2005_Definizione_PMI.pdf.

[11] Opinion no. 56 issued by the Commission for the determination of the size of a company for the purposes of granting aids to productive activities on 3 March 2015, in https://www.mise.gov.it/index.php/it/component/content/article?id=2004048:commissione-per-la-determinazione-della-dimensione-aziendale-ai-fini-della-concessione-di-aiuti-alle-attivita-produttive.

the management of the enterprise in question[12]. The existence of a possible "*dominant influence*", however, is only one of the prerequisites through which the "*linkage*" relationship can take shape.

Therefore, in the event that an investor holds the majority of the share capital, the criteria for calculating the size of the enterprise must follow the rules laid down for the case of "*links*" between enterprises, whatever the legal nature of the shareholder is, *i.e.*, regardless of the fact that such shareholder is a venture capitalist, a private equity fund, an institutional investor, *etc*.

7. What are the concerns that this interpretation raises for private equity and venture capital investments?

The above reading is not satisfactory. Indeed, such interpretation would mean, for example, that – as pointed out by **AIFI** in its recent Circular No. 37 of 6 April 2020 – when a private equity fund holds the majority of the share capital of a company which is below the enterprise size thresholds set forth in the SME definition, if the fund has only one investment, then the company would be eligible to be ranked as a SME (there being no other companies to be "*linked*"), while if the fund has other investments in its portfolio, then the participated company may no longer meet the requirements to be considered a SME. This appears illogical, not to mention the fact that the goal of managing companies for investment funds is to optimize a risk/return correlation in each portfolio company separately, without pursuing any common strategy throughout the whole portfolio, as stressed by **Confindustria,**[13] the Italian association of manufacturing and service companies.

Long before the current pandemic, also **ABI**, the Italian Banks Association, expressed its disagreement with the principle that portfolio companies in which venture capitalists own more than 50% equity cannot be eligible as SMEs even if they individually meet the staff headcount and financial thresholds provided by law[14].

[12] Article 3 paragraph 3 of the Appendix to the EU Recommendation.

[13] When it submitted to the EU Commission in May 2018 its consultation paper in relation to the possible review of the SME definition. See https://ec.europa.eu/info/consultations/public-consultation-review-sme-definition_en.

[14] This was stated in relation to the recommended revision of the regulated framework. See https://ec.europa.eu/info/consultations/public-consultation-review-sme-definition_en.

At this time of health emergency, a literal reading of the current regulatory framework would lead to the exclusion of private equity portfolio companies from any financial support measures reserved to SMEs, which also appears illogical.

8. Can an alternative approach to the SME definition be envisaged? How do corporate governance and the concept of "control" enter the battlefield?

We believe that a more convincing interpretation of the SME definition is possible, which would better reflect the reality of business.

When assessing the size for the purposes of qualifying as a SME, the involvement in the actual management of the target company should be considered in determining whether the size of one of the investors should be taken into account. In this respect, the exercise of the voting rights pertaining to the majority shareholder would reflect the administrative rights vested to any shareholders and would not constitute, in itself, an "involvement" in the management of the target company[15].

Investigating the governance structure of the company is essential in order to establish whether the fund exercises a "*dominant influence*". A case by case examination of by-laws and of shareholders' agreements governing the relationships among shareholders and investors would be necessary.

Thus, to assess if a company falls in the SMEs category, we have to investigate, for example, whether the fund has the right to impose and push through certain board resolutions in the portfolio company[16], or whether the financial investor has a mere veto right, *i.e.,* the right to prevent the adoption of decisions on certain matters.

An approach based on this case-by-case analysis would be more consistent with the dictates of corporate law and the governance models that private equity and venture capital investors are used to adopt and is not expressly contradicted by the Ministry[17] or by the recent rulings by the European Court of Justice limiting the scope of the relationships to be taken into account for the purposes of the SME definition[18].

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[15] See footnote no. 7.

[16] See the ordinance issued by the Court of Milan on 24 July 2018, in http://www.giurisprudenzadelleimprese.it, which ruled that the entity having the power to impose the adoption of a certain resolution to the company in which it holds a participation, even when it is not a majority shareholder of the same, exercises a "*dominant influence*" (not being a veto right to merely prevent the approval of a resolution sufficient to give rise to a "*dominant influence*").

[17] See opinions no. 6, 20, 63 and 75 issued by Commission for the determination of the size of a company for the purposes of granting aids to productive activities on 1 and 28 March 2006, 27 June 2006, 6 May 2016 and

9. In conclusion, in the current regulatory framework, the concept of "SME" is disputable. Is there a need for clarity in the private equity sector?

Yes, the present regulatory framework should be improved, considering that the current SME definition is unclear. As a result of the Covid-19 pandemic, the Italian Government has decreed that SMEs may apply for loans guaranteed by the government in order to deal with the liquidity issues resulting from forced closures, which makes it urgent to decide whether companies controlled by financial investors qualify for the government intervention[19].

In this emergency context, to ensure that the measures adopted produce the expected effects in supporting the Italian companies and limiting the negative impact of the outbreak, companies backed by private equity or venture capital investors should not fall outside the definition of "SMEs" solely by virtue of their ownership structure as they were "normal" corporate groups[20]. In any event, it would appear that the new Covid-19 related measures have adopted a novel approach.

10. What are in a nutshell the main measures for SMEs under the "*Cura Italia*" and the "*Liquidity*" Decrees?

The main measures adopted under the "*Cura Italia*" and the "*Liquidity*" Decrees to support SMEs include the following:

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14 December2017 in https://www.mise.gov.it/index.php/it/component/content/article?id=2004048:commissione-per-la-determinazione-della-dimensione-aziendale-ai-fini-della-concessione-di-aiuti-alle-attivita-produttive.

[18] See Judgments of the General Courts (Sixth Chamber) of 15 September 2016, Case T 587/14 and Case T 675/13, in (http://curia.europa.eu/juris/liste.jsf?language=en&num=T-675/13 and http://curia.europa.eu/juris/liste.jsf?language=en&num=T-587/14).

[19] In fact, just a few days ago AIFI asked the Italian Government to formally confirm that an enterprise can be considered a SME regardless of whether the private equity fund invests or has invested in other enterprises, as reported in AIFI's Circular No. 37/2020. Current interpretations of the SME definition remain – according to AIFI – unsatisfactory for companies controlled by private equity funds because they generate uncertainty.

[20] With reference to the need of a broad interpretation of governmental measures, please see the recommendations issued by the Bank of Italy: *Raccomandazione su tematiche afferenti alle misure di sostegno economico predisposte dal Governo per l'emergenza Covid-19*, in https://www.bancaditalia.it/compiti/vigilanza/normativa/orientamenti-vigilanza/Comunicazione-intermediari-aprile.pdf and AIFI's Circular No. 41/2020 of 16 April 2020.

1. Credit support through the banking system

SMEs suffering a temporary shortage of liquidity due to the Covid-19 pandemic can request[21] banks, financial intermediaries and other lenders:

(i) the suspension until 30 September 2020 of interest and of principal repayments due on commercial loans and the extension of the relevant amortizing plan;

(ii) a standstill until 30 September 2020 in relation to any withdrawal of uncommitted credit facilities (*apertura di credito a revoca*) or of invoicing financing accounts (*anticipi su crediti*).

2. The Central Guarantee Fund[22]

The "*Liquidity*" Decree has extended until 31 December 2020 and under certain favourable conditions access to a state guarantee, *i.e.,* the Central Guarantee Fund scheme, to secure new loans and renegotiated loans, with a guaranteed amount up to Euro 5 million, provided by banks and other lending institutions to Italian SMEs and to companies based in Italy with a maximum of 499 employees[23].

Banks and credit institutions granting the above mentioned (i) suspensions of termination and of installments repayment and (ii) extension of loans may automatically access a special section of such Central Guarantee Fund scheme[24] to secure their risk.

The SME's referred to under these provisions are those that were eligible to access the Central Guarantee Fund, that is, the companies that have up to 499 employees. It therefore appears that the definition of SME under the Covid-19 legislation has become more straightforward and simpler to apply than under previous legislation.

[21] See Article 56 of the "*Cura Italia*" Decree.

[22] This measure replaces the one provided in Article 49 of the "*Cura Italia*" Decree.

[23] See Article 13 of the "*Liquidity*" Decree, replacing Article 49 of the "*Cura Italia*" Decree. Note that access to such guarantee scheme is without any creditworthiness valuation in case of SMEs requiring new funding, having a maximum duration of 6 years and providing a 24-month grace period and an amount not exceeding 25% of 2019 revenues and Euro 25,000 total amount of loans.

[24] See Article 56 paragraph 6 of the "*Cura Italia*" Decree.

3. Guarantee by SACE S.p.A

Until 31 December 2020, SMEs affected by the Covid-19 epidemic which have exhausted the capacity to access the Central Guarantee Fund may obtain guarantees provided by SACE S.p.A. – the Italian credit agency fully owned by Cassa Depositi e Prestiti, a state-owned company, whose majority shareholder is the Italian Ministry of Economy and Finance. Maximum financial commitment of SACE S.p.A. under this measure is Euro 200 billion (of which Euro 30 billion reserved for SMEs).

For any clarification or queries please contact: mdelfino@delfinowillkie.com or apettoello@delfinowillkie.com