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Italian Criminal Court of Cassation Issues Important Decision on IBLOR Fronting Structures

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Under Legislative Decree No. 385/1993 (the "Banking Act"), the activity of granting of loans to the public, in any form whatsoever, can be carried out exclusively by financial intermediaries duly licensed by and recorded in a specific register held by the Bank of Italy or entities otherwise registered according to the Banking Act. Additionally, under Article 132 of the Banking Act, granting of loans without the required licenses or registrations represents a criminal offence.

Italy's Court of Cassation, in its judgment No. 12777 of 2019, stated the criminal liability of the directors of an Italian bank duly licensed to operate by the Bank of Italy (the "Licensed Entity") and a foreign unlicensed bank (the "Unlicensed Entity") for having set up a fronting structure to grant loans in pool between them in the Italian market.

The Licensed Entity and the Unlicensed Entity carried out certain financing transaction loans in pool on the basis of an undisclosed mandate (*mandato senza rappresentanza*) and an intercreditor agreement disclosed to the customers. Additionally, the relevant IBLOR (Italian Bank Lender of Records) scheme contemplated, among other factors, the sharing of the customers' insolvency risk and the execution of certain agreements between the Unlicensed Entity and the Licensed Entity for the supply of liquidity to the latter. Such liquidity has then been used to grant loans by the Licensed Entity to customers in Italy.

The Court of Cassation recognized that not all IBLOR fronting structures are illegal and a case-by-case analysis must be carried out, focusing on the substance of the activities performed by the pooling entities rather than the contractual form used by them.

In the judgment at hand, the Court of Cassation confirmed the (conclusions of the Court of Appeal and) the indicia identified by the Court of Appeal that made the relevant fronting structure illegal. The Court dismissed the arguments of the banks claiming that the activity of the Unlicensed Entity was limited to the financing of the Licensed Entity and that the latter was the only entity to enter into an agreement with the customers, as confirmed by the existence of the undisclosed mandate. The Court of Cassation agreed with the Court of Appeal's view that such mandate is not sufficient to legitimately carry out financing activities in Italy and does not fully protect Italian customers.

The indicia that were confirmed by the Court are the following:

- the sharing of the customers' insolvency risk;
- the Unlicensed Entity's independent assessment of the customers' credit ratings;



- the signing by the customer of the lenders' intercreditor agreement;
- the foreign bank's ability to interfere in the day-by-day credit relationship, with the provision to be informed of and to approve all the circumstances suitable to modify the assessment of the credit rating;
- the greater financial commitment of the Unlicensed Entity as compared to the Licensed Entity; and
- the Licensed Entity's reporting to the Central Risk Database only in respect of its own exposure to the customer, rather than the overall amount of the loan.

Therefore, if a fronting structure is distinguished by the above indicia or other indicia similar to the above, it is at risk of being considered illegal under Italian law.

Although the decision has been adopted in the context of a criminal proceeding, it may be relevant from a contractual perspective also. Notably, according to Italian law, agreements entered into in breach of Italian mandatory provisions, such as criminal law provisions, may be considered null and void, in whole or in part. As a consequence, a fronting structure having features similar to the indicia identified by the Court of Cassation may lead to one or more of the relevant agreements defining the financial transaction being considered null and void, in whole or in part.

We recommend that participants in, and alternative lenders considering, IBLOR structures review their features and, if they identify any of the elements considered by the Court of Cassation, seek advice as to the risks posed by the structure and any potential mitigant that can be introduced to cure or mitigate any risk.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Milan lawyers:

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