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LEGAL INFORMATIVE NEWSLETTER

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We are pleased to provide you with the new issue of our legal information newsletter.

Topical legal questions are discussed and those related to issues that you might encounter.

We hope that you will find it of interest. We would welcome any comment you might have.

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**CORPORATE GOVERNANCE SYSTEM IN DOMESTIC CORPORATIONS AT A GLANCE**

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**Introduction** - In Corporations, different models of corporate governance may be adopted. By-Laws may regulate more freely the internal organization of the Board competent for management, its functioning, the circulation of information among its members and the members of the Board of Auditors.

If By-Laws do not provide otherwise the model of corporate governance and control applied is still represented by the traditional system.

[1] Traditional System – The reference model is the traditional system (General Shareholders' Meeting, Board of Directors, Executive Committee, Board of Auditors and external auditing when required by the Law).

Under this system, the accounting control is attributed to an external Auditor or an Auditing Company.

A Provision of the Civil Code establishes that the office term for appointed directors is the same office term set of directors appointed by the time of their election.<sup>1</sup> In case of conflict of interest, the executive director shall refrain from undertaking operations and shall empower the Board of Directors for their enforcement.

If a resolution would have not been approved without the vote of the director in conflict of interest, such resolution may be challenged within 90 days, and

during this period of time operations carried out with bona fide third parties are valid.

Directors and members of the Board of Auditors “...must act with the same professionalism and diligence required by the nature of the action undertaken”.<sup>2</sup>

Such standard does not require Directors to be necessarily experts on accounting, finance and any other sector of management and governance of the enterprise, rather it means that their decisions shall be informed and pondered, based on knowledge and on a calculated risk, and not on irresponsible and negligent improvisation.

[2] Dualistic System (German tradition) - It may be established on By-Laws that governance of the company is exercised by the Management Board, which is appointed by the Supervisory Board (with the exception of the first election resulting from the certificate of incorporation).

Management Board can assign specific executive powers to one or more of its members.

Rules regulating relationship between Board of Directors and the Executive Committee, and directors in general apply to this corporate model. Management Board cannot remain in office for more than three consecutive fiscal years.

It may be however be confirmed and removed for “good cause” by the Supervisory Board.

General rules apply to individual claims against members of the Management Board, as well as to claims raised by the Supervisory Board against them. When the resolution is adopted by 51% of its members, the member of the Management Board against whom the claim has been raised, is automatically removed from office.

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<sup>1</sup> Civil code, Article 2386.

<sup>2</sup> Civil code, Article 2704.

The Supervisory Board, which exercises general supervision over activity of the company, is elected by the General Shareholders' Meeting (with the exception of the first election resulting from the certificate of incorporation).

Its membership has to be no less than three. Their office lasts three fiscal years. At least an effective and a supplemental member have to be auditors members of the Roll of Auditors. It is not possible to be member of the Management and of the Supervisory Board at the same time. The Supervisory Board exercises supervision over:

[i] Compliance with legal and accounting rules and regulations

[ii] Corporate operations, reporting any unlawful act.

Moreover, once a year the Board reports to the Management Board.

Members of the Supervisory Board share joint and several liability with members of the Management Board for acts and omissions of the latter, whenever the activity of supervision of the Board could have avoided damages.

[3] Monistic System (British Tradition) – By-Laws may set forth that a Board of Directors have the duty of corporate management, but a Committee appointed internally will be appointed for the purpose of supervising the management.

This system of governance must be explicitly set out in By-Laws. There is a close connection between the Board of Directors and the Committee for supervision of the management, in fact only those who have been previously elected members of the Board of Directors may serve as members of the Committee.

The Board of Directors set the number of members for the Committee (not less than three, if the company solicits investment at large). Half of the members at least must be independent, and further standards and by ethical codes are set by business associations or by legal entities of management of trading markets. It is not allowed to serve at the same time as member of the Committee for supervision of the management and as member of any other Executive Committee.

Further, it is not permitted for a member of a Committee for supervision of the management to

have specific assignments, powers or offices regarding the management of the company.

At least one director, among members of the Committee for supervision of the management must be an auditor member of the Roll of Auditors. The same powers and duties of the Board of Auditors are attributed to the Committee.

**Shareholders Meetings and amendments to the By-Laws** - The General Meeting may be called at any place within the municipality where the company has its own registered office, unless the Bylaws provide otherwise.

The Meeting has to take place once a year within the 120<sup>th</sup> day after closing of the corporation's fiscal year. By-laws may set a longer period of time not exceeding 180 days for companies required to file a consolidated tax return and when there is a specific need in connection with structure and business activity of the company.

In this latter case Directors have to make mention of the deferral in their report.<sup>3</sup>

The following powers previously reserved to the extraordinary general Meeting may be assigned to the Board of Directors, to the Board of Auditors or to the Management Board, if any:

[A] Issue of non convertible bonds or of financial instruments without voting rights

[B] Merger with a wholly owned company

[C] Creation or suppression of secondary offices

[D] Attribution of powers of attorney

[E] Capital reduction due to a shareholder's withdrawal

[F] By-Laws amendments in compliance with statutory regulations

[G] Transfer of the registered office within the national territory.

Companies without outstanding shares held by public investors may avoid formalities and requirements established for the call of the meeting (notice on the Official Gazette 15 days before the meeting).

By-Laws may allow calls through means of communication that guarantee the effective

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<sup>3</sup> Civil code, Article 2428.

knowledge of the call at least 8 days in advance on the date scheduled (Certified letter with receipt, fax are proper means; some doubts about e-mails with automated reading receipt message).

Shareholders are not allowed to call the meeting solely on arguments concerning the competence of Directors.

Upon petition by 10% of the Shareholders, the Tribunal may also call the general meeting, but only if the management did not call it without justification.

Quorum and majorities for the resolution of the Shareholders Meetings of a corporations are different among closely held and publicly traded corporations. They may be summarized as follows.

### **FIRST CALL**

[A] Companies without outstanding shares held by public investors (closely held corporations):

[1] Ordinary General Meeting – In order to effectuate corporate business a quorum of 50% of shares entitled to vote must be represented. Unless Bylaws provide otherwise, shareholder actions must be approved by the majority of shares represented at the meeting and entitled to vote.

Call formalities need not to be observed if the meeting is attended by:

- [i] Shares representing the entire capital
- [ii] The majority of Directors
- [iii] The majority of members of the Board of Auditors.

Absentees must be given immediate notice about adopted resolutions. Participants may claim they have not been sufficiently informed on the argument.

[2] Extraordinary General Meeting – Unless Bylaws provide otherwise a quorum of 50% of shares entitled to vote must be represented and shareholder actions must be approved by the majority of shares represented at the meeting and entitled to vote.

[B] Companies with outstanding shares held by public investors (publicly traded corporations):

[1] Ordinary General Meeting – Same rules as above

[2] Extraordinary General Meeting – A quorum of 50% of the shares (entitled or not to vote) must be represented and shareholders' actions must be approved by 2/3 of the shares represented at the meeting.

### **SECOND CALL**

If the above quorum required for the first call of the shareholders' meeting are not met, the meeting has to be recalled on another day, within 30 days.

[A] Companies without outstanding shares held by public investors (closely held corporations):

Only resolutions on arguments to the order of the day of the first meeting may be adopted, with the following quorum:

[1] Ordinary General Meeting – No minimum quorum required

[2] Extraordinary General Meeting – A quorum of more than 1/3 of the shares must be represented and shareholder actions must be approved by 2/3 of the shares represented at the meeting.

By-Laws may increase quorum required, but not for annual financial reports approval, appointment and revocation of corporate management.<sup>4</sup>

A quorum of at least 1/3 of the shares representing the stated capital is required for passing a resolution on the following arguments:

[i] Change of the corporation's purpose

[ii] Modification of form of business association, anticipated winding up, extension of duration for the company

[iii] Revocation of the winding up procedure

[iv] Transfer of the registered office abroad

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<sup>4</sup> Civil code, Article 2369.

[v] Issue of preferred stock.

[B] Companies with outstanding shares held by public investors (publicly traded corporations):

Same quorum set above for those companies which do not solicit investment at large, with the exception of those Extraordinary General meetings with calls subsequent to the second one, where a quorum of at least 1/5 of the shares must be represented to effectuate corporate business.

## Decision-making bodies

[A] **Qualification and powers of Directors** - The management of the company exclusively belongs to the directors, who perform the actions necessary to the achievement of the corporate object. In corporations, the management of the company may be entrusted to non shareholders. It cannot be entrusted to entities other than individuals.<sup>5</sup>

If more than one person is entrusted, they constitute the Board of Directors. The Board of Directors selects the chairman among its members, unless she/he is appointed by the Shareholders Meeting.

If the By-Laws or the Shareholders Meeting allows so, the Board of Directors may delegate its functions to an executive committee composed by one or more of its members.

The Board of Directors set out the content, the limits and the modalities for the exercise of delegated powers. Even when delegates, the Board of directors may always give guidelines to the delegated bodies and bring back anytime power delegated.

On the basis of the information received, the Board of Directors assess the adequacy of the corporate organization, management and accounting structure of the company; it reviews the strategic and industrial plans of the company assessing as well the general trend of the management.

Not all of its functions can be delegated, as for instance the drawing up of annual account, the decisions about issuance of debt securities, the power to increase the stock capital etc.<sup>6</sup>

The delegated bodies take care that the organizational, administrative and accounting structures are adequate to the nature and the size of the company and report to the board of

Directors and to the Board of Auditors as the By-Laws set forth and at least every six months, on the general trend of the management and on its expected evolution, as well as on most relevant transactions entered into by the company or by its subsidiaries.

The directors are required to act being informed. Each director may request the delegated bodies to report to the Board about the management of the company.

The powers of representation granted to the directors by either the By-Laws or the Shareholders Meeting are of general character.

[B] **Liability of Directors** - The directors are liable to:

[1] The company, if they have not exercised due care over the general management of the company, they have not done what they could for preventing damages to the company to occur, and they have not fulfilled their duty with the professionalism and diligence required by the nature of the action undertaken.

A claim of their responsibility may be promoted by resolution of the General Shareholders' Meeting. With reference to the balance sheet, without previous notice, a claim of responsibility may be carried out during discussion about balance sheet approval by shareholders representing 1/1000 of the stock capital and within the five years subsequent to their removal from office.

Outside the General Shareholders' Meeting, even a minority of shareholders may make the claim (1/5 of the stock capital for companies which do not issue capital of risk and 1/20 of the stock capital for the others)

[2] Creditors of the company, whenever the preservation of the stock assets is not guaranteed and the stock assets are not sufficient to satisfy their credits. In case of bankruptcy, the claim for responsibility may be initiated by the bankruptcy administrator, and in case of extraordinary administration, by the extraordinary administrator.

[3] The single shareholder or the third may carry out a claim for damages within five years.

[C] **Fiduciary duties** - As the provisions of the Civil code sets forth, the Directors of a company are required to perform their mandate and to

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<sup>5</sup> Civil code, Article 2380bis.

<sup>6</sup> Civil code, Articles 2420ter, 2423 and 2443.

carry out their duties with the diligence of a good *pater familias*.<sup>7</sup>

They must fulfil the duties that the law and the By-Laws establish with the diligence required by the nature of the appointment and by their specific skills.

Directors are jointly and severally liable to the company for damages arising from the non observance of such duties, save for functions vested solely in the executive committee or in one or more executive directors.

They are in any event jointly and severally liable if, being aware of prejudicial acts, the directors did not act as they could to prevent their performance or to either eliminate or reduce their harmful consequences.

Liability for acts or omissions of directors does not extend to that director who, being without fault, has had her/his dissent entered without delay in the minute book of the meetings and resolutions of the Board of Directors and has immediately given notice to the Board of Auditors.

**[D] Restrictions on Directors** - Interdicts, bankrupts and those who have been sentenced to a penalty entailing interdiction even though temporary, from public office or incapacity to exercise managerial functions, cannot be appointed as directors and if appointed they forfeit their office.<sup>8</sup>

Also, according to the provisions of the Civil Code<sup>9</sup>, directors cannot act as unlimited liability shareholders in competing ventures, neither can they carry on a concurrent business activity on their own or on behalf of third parties, nor as directors or general managers in competing ventures, unless with explicit authorization by the General Shareholders Meeting.

The directors must inform the other directors and the Board of Auditors of any interest they have on their own behalf or on behalf of third persons in a specific transaction of the company, by specifying its nature, terms, origin and relevance.

In case of interest by a managing director, she/he must abstain from the transaction remitting it to the Board of Directors and giving notice about it at the first appropriate Meeting.

The relating resolution by the Board must adequately justify the reasons and the convenience of the transaction for the company.

**[E] Removal of Directors** - Removal of a director can be effected by a resolution from a Shareholders Meeting.

In case of corporations, when in the course of the fiscal year a vacancy of one or more directors occurs, the others provide for their replacement by resolution approved by the Board of Auditors provided that the majority is always constituted by directors appointed by the Shareholders Meeting.

If vacancies of the majority of the directors appointed by the Meeting occur, those who remain in office shall call the Shareholders Meeting to provide for filling the vacancies.<sup>10</sup>

In case of Limited liability companies, there are no specific provisions that the civil code sets forth. Consequently, provisions of the By-Laws have to regulate replacement of the directors.

**Annual accounts - Financial and operating results: Duties and Liabilities** - The Meeting for approval of the annual balance sheet has to take place once a year within the 120<sup>th</sup> day after closing of the corporation's fiscal year. By-laws may set a longer period of time not exceeding 180 days for companies required to file a consolidated tax return and when there is a specific need in connection with structure and business activity of the company. In this latter case Directors have to make mention of the deferral in their report.<sup>11</sup>

**[A] Auditors in Corporations: the Board of Auditors** – Only one out of the three or five of the effective members (and one of the supplemental members) of the internal Board of Auditors must be an auditor member of the Roll of Auditors; other members may be chosen among members of other professional categories or among professors in juridical or economical sciences.

According to the statutory provision of the Civil Code<sup>12</sup>, the Board of Auditors exercises a control of Law and Bylaws regulation compliance and over principles of fair management. In other words its duty is to exercise administrative and legal control, while duty of control over

<sup>7</sup> Civil code, Articles 1710 and 2392. The standard refers to the diligence that a normally diligent director would use under the same circumstances.

<sup>8</sup> Civil code, Article 2382.

<sup>9</sup> Civil code, Article 2390.

<sup>10</sup> Civil code, Article 2386.

<sup>11</sup> Civil code, Article 2428.

<sup>12</sup> Civil code, Article 2403.

accountancy, which characterized the activity of the Board, has been eliminated.

Members of the Board of Auditors have to attend both the Board of Directors' and the General Shareholders' meetings, as well as meetings of the Executive Committee. They are removed if they do not attend without justification two consecutive meetings during a fiscal year. The supervisory board must meet at least each 90 days and may meet through the use of electronic means (e.g. videoconferences).

When some shareholders report an unlawful action by Directors, the Tribunal cannot intervene if the General Shareholders' Meeting substitutes members of the Board of Directors and of the Board of Auditors as a whole, and elect new members of adequate professionalism for curing eventual illegality.

The following cannot be elected members of the Board of Auditors:<sup>13</sup> those who are in the condition listed on Article 2382 (Insanity etc.), parent and relatives within the 4<sup>th</sup> degree of company's Directors, Directors of the company, parent and relatives within the 4<sup>th</sup> degree of either controlling or controlled company's Directors; those who are bound to either the company or to controlling/controlled companies by an employment relationship, a continuative consulting relationship, a remunerated service activity, or by other economical interested relationship that affect their independency.

Among other duties, members of the Board of Auditors have also to certify that a bond issuance does not override legal limitation.<sup>14</sup>

**[B] Accounting Supervision** – Supervision over accounting has to be exercised by an external auditor, who cannot be member of the Board of Auditors. His appointment may be mentioned in the Certificate of incorporation or he may be elected by the General Shareholders' Meeting. Accounting supervision over companies with outstanding shares held by public investors has to be exercised by an auditing company.

Accounting supervision over companies without outstanding shares held by public investors and required to have consolidated financial statements may be exercised by an auditor.

Accounting supervision over companies without outstanding shares held by public investors and not required to have consolidated financial

statements may be exercised by an auditor as well. In this latter situation, however, By-Laws may provide that accounting supervision is exercised by the Board of Auditors, whose members shall be in this case only auditors members of the Roll of Auditors.

The auditor is elected by the General Shareholders' Meeting, takes his office for three years and may be removed only for "good cause".

The auditing activity is in conflict with the office of member of the Supervisory Board of:

[1] The company

[2] Controlling/controlled companies

and with other activities listed in the relevant provisions of Civil code.<sup>15</sup>

**Corporate governance issues for Publicly Traded Companies** - Pursuant to the general principles indicated by CONSOB (which is the Italian Security Exchange Commission), the managing bodies of publicly traded companies must adopt rules ensuring substantive and procedural transparency and the fairness of the business transactions with related parties and disclose them in the management report. For this task, they may be assisted by independent experts on the basis of the nature, value or characteristics of the business transaction.

The above provisions apply to business transactions directly entered into or through subsidiaries and regulate such transactions in terms of powers, decision, reasonableness and documentation. The supervising body exercises its control over the transaction and has to report to the Shareholders Meeting.

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<sup>13</sup> Civil code, Article 2399.

<sup>14</sup> Civil code, Article 2412.

<sup>15</sup> Civil code, Articles 2399 and 2409quinques.