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Discussion document: The recent reforms of the law of companies
The framework within which companies operate

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1. *A comparison with tradition* – In order to better understand the recent innovations in the law of companies and the current proposals for reform, for a more effective comparison with the directions that are being taken in Europe and in the US, it is useful to look back at tradition and re-visit the principles underlying company law and the model of a company.

The company with liability limited by shares is a fundamental component of the fabric of the economic system, and every reform entails not only legal analysis, but also economic and social studies - both empirical and theoretical – as well as political choices.

2. *What are the principles?* – The company has been established in market economies in order to allow investments in capital-intensive businesses through the collection of savings from the general public.

To this purpose the company is then founded upon *mechanisms* that make it appropriate for the collection of savings from the general public. The *problems* raised by this peculiar feature of the company have, over time, been faced and resolved through the application and operation of specific *principles*.

2.1 The *mechanisms* are the following: **a)** the company assets and not the shareholders and directors are liable for the company obligations. The shareholders are third parties to the company, whereas the directors are agents or fiduciaries; **b)** the identity of the shareholder is not relevant; **c)** the investment is divided into, and represented by, shares that can be freely bought and sold; **d)** the shares, representing a non-liquid investment, become liquid when traded on the stock exchange.

The formula encompassing all such mechanisms is *legal personality*. The company is derived from the *merchant company* (today known as a partnership), given legal personality, which issues shares that can be traded on the stock exchange.

2.2 The ability of the company to collect savings from the general public gave rise to *problems* of investor protection, for the solution of which special regulations were developed. These problems were new and different from those traditionally faced under the common law.

The problems arising from this orientation towards the public are:

a) the concentration of power in the hands of directors who manage large amounts of capital without assuming any risk (separation of ownership from control);

b) the investors, who invest in small amounts, are weak parties in the company/shareholder relationship because of the small size of their investment; they are thus unable to negotiate or bargain the terms of their relationship;

c) the market for securities is anonymous and impersonal, it does not allow face-to-face negotiations; hence the supply and demand mechanisms will correctly function if, and only if, the single investor acquires trust in the correct functioning of the market. This element of trust is necessary because the individual investor has a lack of knowledge of the risks involved in the formation of the price.

Under *b)* and *c)* above, the position of the investor (who wants to become involved to the extent of his or her insignificant amount of investment) *vís-à-vís* the company (which manages the whole asset base) is similar to the position of the consumer *vís-à-vís* the producer under principles of consumer law. A significant difference, however, is that in the investor/company relationship the product is difficult to understand and costly to manage, because of its financial nature. In this type of relationship, the parties (*i.e.* the company and the shareholders) have a common interest in exchanging the management of the investment with the income deriving from it. Apart from that all their other interests diverge.

Under *a)* above, on the other hand, the problem concerns the presence of agents (the directors) who act without having a principal, because of the passivity of the shareholders/investors when shares are spread among the public. The problem is political and concerns the concentration of power.

The directors are interested in the management of the business; they are appointed at the general meeting of shareholders by those shareholders who are interested in the management because of the amount they have invested in the company. The directors have the power to make decisions and to dispose of the assets of the company. Although they are accountable to the company as a whole, as a matter of practice they will refer to the main shareholders in the business when looking for approval for their decisions. Indeed, often these main shareholders will themselves be the directors of the company. The directors have the financial means to sustain the cost of their power; they have an incentive to retain the profits within the company in order to strengthen the business: the payout of a dividend is an expense for the business but it is income for the investor. Their power to dispose of the assets of the company further strengthens their position of power (knowledge of the business, able to use the assets of the company for actions which may also benefit them, *e.g.* the adoption of defensive measures in case of takeovers, or the use of proxies on behalf of the company). The assets of the company are not liquid, hence the controlling stake of the company is, in turn, not liquid. The investors, on the other hand, are only interested in the financial return on their shares and in the marketability and liquidity of their investment, which depends on the quality of the share market - investors are said, in fact, to vote by trading their shares.

The described situation fits the publicly-held company. The relationships within the company will generally find different balances when the ownership structure of the company is different. In case of closely-held companies, in fact, the relationships resemble very much what happens in partnerships: shareholders are tied to each other by a fiduciary connection and they are themselves, *de facto* or *de jure*, the managers of the company. There are also situations where companies may be described as *publicly-held* but *privately-controlled*. It happens when there is one controlling shareholder (or group of shareholders) facing widely scattered shareholders. In such a case, it is generally said that there is a fiduciary connection between the controlling shareholder and the company as a whole.

The rules that give structure and shape to these interests are there to prevent abuses of power and to create trust in the company institution, in order to favor the development of economies. The legal basis for such rules centers upon the fiduciary relationship.

2.3 In history, the occurrence of crises forced legislators to identify solutions.

As a result of the English crises at the end of the 18th century came the Companies Act of 1856; from the American crises of the thirties came *stock exchange regulations*, which were then followed in Europe and in Italy as well. Recent crises have given rise to other problems and possible solutions.

In all these cases, solutions to the problems that gave rise to the crises were actually identified by professionals rather than by academics. Indeed, academics had originally suggested that the use of companies be confined exclusively to large scale undertakings for public utilities purposes (this was indeed Adam Smith's opinion).

Company legislation, as it originated in England, provided for the freedom of establishment of companies, by imposing three conditions.

a) Firstly, it codified the company relationship so that the interests of the parties, and their balancing, were set out by law. The organization of the company and the rights and obligations of shareholders are legally standardized, in view of the number of investors and their position of weakness.

b) Secondly, it made the *accounts public*, providing for annual publication of the accounts and for auditing so that the shareholder would be informed about the company asset situation. Accounting is the very basis of any disclosure and information regime, which, in turn, is essential for the formation of the share price.

c) Finally, it required the presence of more than one person involved in the ownership of the company. The rules requiring more than one shareholder make the company a social and economic entity that is different from the ordinary individual business person, different enough to justify the limitation of liability to the amount of the company assets. The regulations that make limitation of liability conditional on there being a certain number of shareholders reflect the symmetric idea that the company is nothing else but *the shareholder's personal business* if there is only one of them, and provide the principles which make liable those who abuse legal personality.

The crisis of the 1930s highlighted the problems of the *quality of the share market* that the legislators tackled through the regulation of the stock exchange. The investor's main interest is for the liquidity of the investment. It is therefore necessary that such liquidity be made effective, since it *de facto* substitutes the corporate rights of the shareholder. The quality of the share market depends not only on sufficient and reliable information being given by the issuing company, but also on *the organization of the stock exchange* in the setting of prices, the information and behavior of intermediaries - both those involved in dealing and those involved in asset management (*e.g.* brokers, mutual funds), from prevention and regulation of *conflicts of interest.* Conflicts of interest are physiologically generated by the position of the intermediaries, who are fiduciaries to their investor clients but, as a consequence of their profession, have greater familiarity with the issuing companies. The main pillars of the regulations are the setting up and operation of a *securities exchange authority* for information and disclosure, the *divisions* and the separation of activities where necessary to regulate conflicts of interest (eg. Chinese walls), and the *liability* for damages (to which the legal system through the courts has made a considerable contribution).

2.4 The *principles of law* that directly derive from these political choices are then established.

a) With power comes liability. Personal liability for damages caused to the shareholders or to the assets of the company or to third parties (*i.e.* to the market) makes up for the lack of an effective and active principal *vís-à-vís* the power of the directors (both in their exercise of management functions and when, for example, soliciting proxies). Also personal liability for company obligations ("*piercing the corporate veil*") will result from the abuse of legal personality by those who treat the company as their own property.

b) "*Shareholders' rights*" is the formula embodying the protected position of the shareholder within the corporate organization, in particular: disclosure, tort liability, attendance at meetings, voting, and the right to challenge corporate decisions in court.

c) There is an underlying principle in the system: any limitations on the shareholders' voting rights have to be compensated for by economic advantages; should the voting rights be fully excluded, then there should be the right to withdraw *ad nutum* from the organization; if this is not so, the company relationship becomes something different, and resembles more a trustee – beneficiary relationship than a traditional directors – shareholders relationship, with quite different restrictions, limitations and structures. The implementation of this principle through regulations is not always uniform, but the principle must be considered as the relevant framework when making exceptions. We should remember that voting rights do have a value, as the existence of a market for corporate control shows: voting rights affect management, when they are exercised, or through the sale of the shares.

d) The principles of *disclosure* and prevention of *conflicts of interest* have been the basis for the development of the securities exchange regulatory systems. The securities exchange authorities are special agencies whose task is to protect private interests. The stock exchange is monitored for information and for the behavior of intermediaries. The duty of intermediaries is to look after the interests of investors, in evident conflict with the interests of companies who collect savings. The quality of the markets is insured by: *i)* the quality of disclosure and information issued to the market (giving content to the object of trading); *ii)* the quality of the negotiation, resulting from the correct behavior of the intermediaries.

e) Criminal sanctions reinforce the civil remedies, and are usually focused on the truth of information and the various forms of fraud, such as misuse of funds. In the context of corporate and financial markets, legislation must focus on civil remedies, since the interests at stake have a merely "monetary" nature, whereas the criminal system must come into playing in order to prevent (or punish) fraudulent behaviors that do not allow the civil mechanisms to function effectively.

The setting up of regulatory systems was necessary in order to prevent confidence crises, and accordingly to allow the maximum expansion of the use of the company. Their *immediate* objective is to enhance freedom of contract, which is effective only if the parties are protected against fraud and abuse of power, which make one party the slave of the other. Collection of publicly held savings involves the problem of maintaining a balanced equilibrium between the parties. Equality is compromised by the nature of the operation: without the legislator's intervention the freedom of investors would be sacrificed to the benefit of those with stronger and dominant contractual power. As experience has shown, mistrust very quickly atrophies the share market. This system of protection of investors is absolutely necessary if the firms are to be able to use an efficient capital market to finance their activities, whether the capital market is oriented to the public (direct collection of savings) or is oriented to the intermediaries (collection of savings through banking institutions). The very *final* objective of the regulations is to grant freedom to entrepreneurs to finance their activities, putting *direct* collection of finance from the market in competition with *banking* intermediaries.

3.- *Market economies vs. State driven economies.*- The corporate model that was so far described reflects an economic system driven by market forces. However, it must be considered that in some very relevant instances (*e.g.* Germany), industrialization developed in the 19^{th} century according to a state-driven capitalism. The main feature of such model of capitalism is the absence of hardly any direct collection of capital from the public (neither risk capital, nor debt capital) in the financing of businesses. Large businesses are financed through the participation of large financial institutions (banks and insurance companies), who exercise control and grant credit. Family businesses are self-financed, through retention of earnings and banking credit. In this context, the securities market is at the margins of the system and mainly has a speculative role; whereas the ownership structure of companies and the very function of companies themselves are quite different from what happens in a market-driven system. Large firms operate as if they were "institutions" or "foundations".

4. *Directions of reform in the global economy.*- Today's economy is generally said to be global because for many products there is a market with no borders.

In the global market, competition drives businesses and economies. Market economy systems tend to prevail over mixed economy directed by governments since by necessity the sovereignty of a state is limited by the extent of its territory, while the sovereignty of a business can become global, depending on its ability to hold up to competition in the markets for goods and services. In this context private commercial law dominates. The quality of the law becomes a competitive factor. It is the general regulation of companies that matters, and not only that of companies that look to publicly held savings, since it is the product sold by a company, and not the size of the company, that makes a company local or global.

In global competition it is the previously described basic principles that shape the laws of companies in different legal systems, and such principles are traditionally common to all legal systems. National differences, when the economies open up to global competition, are destined to be phased out when they do not conform to such uniform principles, and in particular when the legal shape of the company is affected by the intervention and the direction of the state, as in mixed economies (France and Italy), or by the concentration of management, as in socially-oriented economies (Germany).

We are witnessing the rapid drawing together of the different legislations because of the commonality of the problems in international competition. The influence of the USA is dominant, because of its weight and dimension, but also because market economies traditionally are anchored on shared principles which set a path for change and development, while in the mixed or social economies of European countries changes need to be imposed upon. For this reason, in our discussion for reforms we need to distinguish between what is common to the various systems and what is peculiar to our specific systems.

5. *The state of the law and prospects for change.*- Fundamentally, company law is generally held to be up-to-date, not needing any revolutionary change unless systems intend to apply theories with an anti-capitalist orientation. National legislations, in their evolution, continue to refer back to tradition.

A company can have numerous members, some of whom may not be directly involved in the management, as it often occurs in family companies that see the broadening and differentiation of the ownership structure through the natural continuation and succession of the generations. In this case traditional regulation is held to be sufficient, with its basis and effectiveness in the organisation and the rights of members. It is a common occurrence in a family company that the investor members leave the management to the controlling members, reserving for themselves the supervisory functions within the company. The laws for the regulation of these situations are generally good, and have been tested by considerable legal precedents. The original structure of Italian company law in the 1942 Code may need a few updates, *e.g.* in the procedure for the setting up of companies, flexibility of the charters, some refinements and updates (shares, proxy voting, civil liability etc.), otherwise the law has worked well and should not be changed.

Despite the fact that the company can be used for any kind of business, the tendency of legislators is to establish different forms of companies with limited liability for smaller scale undertakings. This is either a development of partnerships or a simplification of the company, and often the adoption of such forms is motivated by tax reasons. They are precluded from raising funds from the public, they are involved in local activities or artisan businesses, and the identity of the members is emphasized, on the presumption that they are all able to take up management and interested in management. Thus the administrative and control structures are simplified, the protection of creditors is left to contractual relationships. Substantially they operate as if they were partnerships (the choice of structure being influenced by tax reasons).

The traditional regulatory system, reinforced and integrated according to traditional policies, is still valid for companies that look to public savings for financing.

The recent legality crises in the USA and the awareness of these problems in Europe have given the legislators reason for intervention. The main issues are the following:

a) the reinforcement of the rights of shareholders – attendance at meetings, voting, challenge of decisions in court, more effective legal auditing;

b) a greater guarantee of the accuracy of the accounts and information;

c) greater care in the regulation of conflicts of interest;

d) introduction of new divisions in the activities of management and auditing etc.;

e) review and improvement of powers and competences of stock exchange authorities;

f) the role of financial advisors and analysts;

g) finally, a focus on the composition and the powers of boards of directors (corporate governance), also as a way to guarantee the rights of the shareholders.

The pursuit of these, however, is not meant to change the character of the body.

In this respect, the proposal is to stimulate the collegial functions of boards of directors in order to counter-balance the power of the CEO. The strengthening of the board, however, must be correctly understood and implemented. It does not mean opening the board to a wider set of constituencies and values being represented: the interest of the company, in fact, is predetermined by the law to be the pursuit of profit. Neither does strengthening the board mean encouraging the collective management of the company, since this may turn out to be inefficient and should be left to the internal entrepreneurial organization of the company. Strengthening the role of the board must indeed mean strengthening the supervisory powers and functions of the board, having in mind that, differently from the ordinary supervision carried out by auditors, the board of directors must exercise business judgement and, in doing so, will be able to affect and address the merits of the business decisions of the company. The US legislature has introduced measures in this area recently, and the same direction is being taken in the reforms being approved or debated in France, Germany, the UK, and Spain.

In Italy, as in other countries of continental Europe, we have the unusual and various problems that are brought about by the transformation of mixed economies or social economies. The transformation has brought about privatisation. The institution of the company limited by shares is concerned with the following: capital assets, cross or circular ownership (of shareholdings, voting, groups), tort and conflicts of interest. It is a political decision whether to, and how to, join the global market. These problems need to be considered in conjunction with the reform of the financial and banking system, of the bankruptcy procedures and of the privatisation of markets. It needs to be kept in mind that our legislature seems to approach the global market with the attitude of defending the controlled economy, whether mixed or social, encouraged by Germany and France. In this spirit the recently proposed reforms have several objectives, as some critics have seen, to reduce the rights of minorities, to increase the powers of directors, to limit the possibilities for conviction for fraud offences, to assist the collection of publicly held savings without providing sufficient guarantees.

The return to the market of the Italian mixed economy is a strategic choice that requires not only consistent decisions in the reform of several sectors, but also graduality. It has material and legal costs. It is a good general rule not to copy reforms out of the context of the system in which they operate without first having reformulated them and translated into the national legal system.