LEGAL INFORMATION 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.

AVOIDING THE DISPUTES AMONG SHAREHOLDERS OF CLOSELY HELD CORPORATIONS IN ITALY

Civil code, Article 2341bis
Civil code, Article 2341ter
Civil code, Article 2348
Civil code, Article 2351
Civil code, Article 2368
Civil code, Article 2388

INTRODUCTION – All business partnerships start out with good intentions. As time goes by and challenges begin to strain the business, one of the biggest threats to the stability of a business is disagreements within management and/or among shareholders. Internal disputes can be as costly as major litigation and far more devastating.

If a dispute ends up going to court, the litigation can be extremely costly, both emotionally and financially.

In addition, judicial and legislative remedies are often limited and inequitable.

Worst case, protracted court battles can drain a company of all of its assets and render it insolvent.

In Italy, comprehensive By-Laws and a good shareholder agreement are the most significant building block on which to found the business and are essential to helping the business run smoothly.

BY-LAWS – The By-Laws may grant certain rights to the parties with respect to the shares held by them.

These rights may include limiting share transfers and providing for certain pre-emptive rights, such as rights of first refusal, rights to purchase stock from departing shareholders and/or departing owners rights to sell their stock at prices set by objective formulas.

According to the statutory regulation that the Italian Civil code sets forth, the By-Laws clearly define the rights and obligations of shareholders, and set out the rules for how the corporation will be administered.

They describe, for example:

- What constitutes major decisions and how they will be made (e.g. by unanimous agreement, majority rules or a combination)
- How owner operators will be compensated (e.g. income, dividends or other means)
- How disputes will be handled (e.g. identifying an arbitrator and when he might be called in)
- How the business will be valued (e.g. by an independent appraiser and regularly updated).

SHAREHOLDER AGREEMENTS – The possible content of a shareholder agreement is defined in provision of the Civil code, Article 2341bis, where it is established that the agreements having as a purpose that of stabilizing the relationships among shareholders or the management of a company are essentially of three kinds.

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They may be those agreements:

- Having as an object the exercise of the right of voting in corporations or in their controlling companies
- Imposing limits on the transfer of the relevant shares or the participations in the controlling companies
- Having as object or as a result the joint exercise of a dominant influence on such companies.

To be noticed is that, according to the rule of Civil code, Article 2341bis the shareholder agreements cannot last more than five years. However, they can be renewed by the parties.

A shareholder agreement dealing with pooling voting rights is typically an agreement by which the parties have agreed:

- To vote their shares in a particular manner; and/or
- To provide for proxies which would allow the shares to be voted in a particular manner.

The shareholder agreements of publicly traded corporations must be communicated to the company and stated at the opening of each Shareholders Meeting.

The statement must be registered in the minutes of the Meeting and subsequently filed with the Companies' Register.

According to provision of Civil code, Article 2341ter, in the absence of such statement, the owners of shares to which the shareholder agreement refers to cannot exercise their right to vote and the resolutions adopted with their determining vote may be challenged.

A well-thought shareholder agreement will keep the corporation running smoothly in the face of future events such as the death, disability or retirement of a shareholder. It will answer questions, such as:

- What are the obligations or options of the remaining shareholders with respect to the departing shareholder's shares?
- What are the rights of the departing shareholder or his/her estate?
- How will the departing shareholder's stake in the business be valued?
- How would a buyout be funded in the case of a shareholder's death
- How should the buyout be structured to minimize tax and cash flow consequences?

SPECIFIC DEVICES – Specific devices typically used in the By-Laws include the provisions about non voting stock and/or super-statutory voting requirements, while provisions dealing with pooling agreements, those addressing the issue of shift in ownership of shares, arbitration and buy-out clauses, are as well used in shareholder agreements, as hereunder described.

Among other reasons, confidentiality leads to the choice to opt for a shareholder agreement.

NON VOTING STOCK - A device often used for balancing the interests of the shareholders are the provision about non voting stock.

This provision is in essence an understanding that some of the shareholders are not to participate in the decision-making process and are given nonvoting stock.

For instance, shareholders waive their rights with regard to general corporate business but demand a voice in any extraordinary action (e.g. amendment to the By-Laws, winding up of the business etc.).

Statutory provisions of Civil code, Articles 2348 and 2351 allow latitude in limiting the voting rights to such extraordinary action.

Other shareholders may be more interested in a minimum return on their investment and may be willing to waive their voting rights only if they receive stock which has dividend preference.

Provision for dividend preference is frequently coupled with a provision which permits the corporation to redeem the preferred shares, thereby giving management the right to eliminate the preferred shareholders if that becomes desirable.

Convertible preferred shares may as well be provided for.

A convertible feature might be added to the preferred so that the preferred shareholders would be in a position to convert their shares to voting common if they so desire.

Their right to receive preferred dividends will act as an incentive not to convert their stock, thus increasing the possibility that the holders of the outstanding common shares will be allowed to control the corporation without interference.

Another device not so frequently used is class voting for certain resolutions.

As under provision of the Civil code, Article 2351, class voting may be extended to all business or limited to specific items of business.

So there may be a class of common share exclusively entitled to vote on a specific corporate action, while other common shares are not.

SUPER-STATUTORY VOTING – The provisions of Civil code, Articles 2368 and 2388 set forth the general rule that a majority vote controls shareholder and director action.

Concerning the Shareholder Meetings however, a distinction is made between those resolutions adopted by the Ordinary General Shareholders Meeting and those of the Extraordinary Shareholders Meeting.

In the first case, the quorum for valid adoption of resolution is attendance by 50% of the voting stock capital and simple majority vote of those present for the adoption of the resolution, so, for instance 26% of the voting stock capital might be sufficient to pass a resolution.

In case of Extraordinary General Meetings, the voting majority is instead 51% of the entire stock capital, therefore a higher majority required than in the previous case.

It has to be noted that provision of the Civil code, Article 2368 in both cases sets forth quorum and majority for the adoption of a corporate resolution, by specifying "unless the By-Laws provide otherwise".

Therefore, if appropriate provisions are set forth in the By-Laws, a higher proportion of shareholder and director votes may be required for corporate action.

For example, the By-Laws might require a 66-2/3 percent vote for the transaction of corporate business.

The higher the percentage, the higher the protection for minority shareholders clearly.

However, in determining the appropriate percentage, it is as well necessary to weigh the disadvantages of giving a minority the power to frustrate corporate action against the advantage of affording the minority the right to have some degree of effective control.

The following other safeguards constitute other devices frequently used to the extent of protecting interests of the minority shareholders.

POOLING AGREEMENTS – In a pooling agreement, two or more shareholders agree that their shares shall be voted:

- As therein provided
- As they may agree, or
- As determined in accordance with a procedure agreed upon by them.

Pooling agreements are often coupled with the exchange of irrevocable proxies to assure compliance. It should be noted that a pooling agreement deals with shareholder voting, not director voting.

SHIFT IN OWNERSHIP OF SHARES – It is common in a close corporation to impose restrictions on the transfer of shares.

When drafting By-Laws or shareholder agreement imposing such restrictions, it is important to anticipate shifts in control which may result from a change in ownership of one or more shares.

The usual way to accomplish this is to require successive offers to each of the shareholders prior to any sale or other disposition of the shares to any other shareholders or outsiders.

A similar problem of shifting in control may arise if the By-Laws provide for redemption of shares by the corporation on death of a shareholder since such redemption will alter the percentage of outstanding shares owned by the other shareholders.

To avoid this situation, a provision could be included in the By-Laws that if the outstanding shares of a class are reduced beyond a certain point, all outstanding shares will be reclassified in a prescribed manner.

It sometimes happens that when a corporation is being formed, a minority group may decide to participate because they know and have confidence in those in control.

The controlling group may later decide to sell their interest to an outsider.
Even though a restrictive shareholder agreement provides that the shares must first be offered to the minority group, they may not be in a financial position to purchase the securities.

The outsider, having gained control, may then make changes in the corporation which are not agreeable to the minority and disputes arise.

In order to prevent this situation from occurring, some restrictive shareholder agreements provide that the controlling group cannot sell to an outsider unless the outsider makes the same offer to purchase the shares held by the minority group.

ARBITRATION – Where the majority controls, it is desirable to have an odd number of shareholders and directors to avoid an even split of votes in order to avoid possible deadlocks in voting.

A practical solution to break the deadlock is to solicit the assistance of an impartial person to resolve the dispute.

A commonly used procedure is to provide for one or more arbitrators to resolve the dispute if the parties are unable to resolve the controversy themselves.

Arbitration clauses are generally restricted to items such as valuation of stock under restrictive stock agreements and matters within the ambit of shareholder responsibility.

There are several reasons why arbitration is suitable for the resolution of intra-corporate disputes:

- Where, as often happens, time is of the essence in resolving the issue, the arbitration machinery can generally be set in motion and the matter finally resolved without too much delay

- Where confidential business data is involved, the arbitration hearings can be held in private thereby safeguarding confidential matters

- Where the issue involves a technical matter or one peculiar to the industry, persons with the necessary background and experience can be chosen as arbitrators.

COMPULSORY BUY-OUTS IN THE SHAREHOLDER AGREEMENTS – In other situations, the dispute may involve areas so sensitive that neither faction will want to remain in the corporation if the matter is not resolved in its favour. Under such circumstances, the following procedure might be provided in the shareholder agreement.

Each side to the dispute sets a figure at which it is willing to purchase the shares of the other, and the side making the higher per-share bid buys-out the lower bidder.

Another possibility under such circumstances is to provide that one side can make an offer to the other to purchase the stock at a specified price and if the offer is not accepted, the offeree must then buy the stock of the offeror at that price (he buys the other instead).

The major disadvantage of both of these alternative procedures is that a shareholder with available capital, by provoking a dispute and a subsequent deadlock, might place himself in a position to buy-out a shareholder who desires to remain in the corporation but is without sufficient resources to make the purchase.

To conclude, a minority interest in a close corporation may have little value without adequate safeguards guaranteed.

Thus, it is of primary importance forming a consolidation to find an equitable balance between protection of minority rights and maximum corporate flexibility.

Employing one or more of the techniques discussed here may furnish the mechanism to achieve this balance.

Article contributed by Mr. Riccardo G. Cajola, LL.M.