Shareholders' agreements in Italy: risks, remedies and alternative solutions

Matteo L Vitali
Greco Vitali Associati, Milan
matteo.vitali@gvalex.it

Filippo Caprotti
Greco Vitali Associati, Milan
filippo.caprotti@gvalex.it

When a foreign investor decides to participate in a local business, it is important to focus the entry strategy not only with reference to financial and industrial aspects, but also in relation to the overall knowledge of the national legal framework, and with particular regard to instruments and measures that can protect the investor's best interest. Planning an efficient legal strategy, as well as choosing the right partners and advisers, is fundamental for the start – and growth – of a successful business investment. In our experience, one of the most crucial aspects for a foreign investor is the negotiation of shareholders' agreements, especially when the target business is run by a closely held company whose ownership and management are strongly connected to the original entrepreneur's family. This is a commonly recurring scenario in the Italian economic environment. This article aims to highlight major legal risks that may arise in the execution of a shareholders' agreement in Italy and the alternative solutions that can be adopted to pursue the foreign investor's goals.

Shareholders' agreements: Italian legal framework

First, it may be useful to provide a general view of the Italian legal framework regarding shareholders' agreements.

The Italian Civil Code (ICC) does not provide for any specific regulation on shareholders' agreements related to limited liability companies (*società a responsabilità limitata*), which are the most popular among closely held companies in Italy, allowing parties a great level of freedom to determine their content.

On the other hand, the ICC provides limited rules only with regard to joint stock companies (*società per azioni*). According to Article 2341-bis of the ICC, shareholders' agreements stipulated to stabilise the ownership's structure or management of such companies (or their controlling entities, even if they are limited liability companies) are subject to a maximum duration of five years when the agreement is directed to: (1) regulate the voting rights in the company; (2) limit the shares' transferability; and (3) determine (directly or indirectly) a dominant influence on the company.

The parties cannot set a longer duration; when the agreement exceeds the legal limit, the duration is automatically reduced to five years. However, agreements are renewable at their expiration. Should no duration clause be provided, parties are entitled to withdraw from the shareholders' agreement at any time, with a prior 180 days' notice. Moreover, Article 2341-ter of the ICC provides specific disclosure prescriptions when a shareholders' agreement is related to joint stock companies making recourse to the risk capital market (but not listed); the shareholders' agreement shall be notified to the company and mentioned at the opening of every shareholders' meeting.

Finally, Legislative Decree No 58/1998 (Consolidated Finance Law) provides a more restrictive regulation for shareholders' agreements regarding listed companies: the maximum duration is three years and the agreements shall be notified to the Italian Financial Authority (Commissione Nazionale per le Società e la Borsa (CONSOB)), filed with the relevant company register and an abstract is required to be published in Italian newspapers – but, of course, that is not the case for a closely held company.

Shareholders' agreements versus bylaws

In Italian contractual practice, shareholders' agreements usually regulate a wide range of corporate matters, mainly related to the company's control and exit conditions. The most common provisions concern: (1) the board of directors' appointment; (2) voting agreements, special majorities or veto rights for relevant shareholders' meeting decisions; (3) restrictions on the shares' transferability and special rules regarding purchase rights; (4) pre-emption rights, drag along and tag along clauses, and call/put options; (5) financing of the company; (6) dividends' distribution policies; and (7) special rights granted to founders or particular shareholders.

According to the unanimous case law, shareholders' agreements bind only their parties: they do not have any legal effect against the company, other shareholders and any eventual third parties. Consequently, they cannot be enforced against them. In the event of a breach, the only remedy granted to the parties is a claim for damages against the breaching shareholder. No specific performance remedies are allowed against the violation of shareholders' agreements. This is the main difference from bylaws' provisions, which legally bind the company and each (current/future) shareholder and, furthermore, are also enforceable against them by way of specific performance.

This different regime can be appreciated in the case of a breach: while a vote contrary to the company's bylaws may lead to the invalidity of the shareholders' meeting resolution, a vote against a provision included in the shareholders' agreement – but not in the bylaws – will not have any impact on the legitimacy of the shareholders' resolution, being only subjected to eventual claims for damages.

Damages versus specific performance

An economic analysis of law has already noted that, with regard to shareholders' agreements, specific performance represents a better remedy leading to a more efficient allocation of resources: the damaged shareholder wishes to hold the breaching shareholder to duly perform the acts and duties agreed between the parties.[1] In addition, considering the nature of a shareholders' agreement's breach, there are many reasons that make damage indemnification a suboptimal remedy compared with specific performance. The effective damage resulting from the breach of the shareholders' agreement is usually difficult to measure and – most importantly – to prove; it is very complex for a judge to assign (*ex post*) an appropriate monetary value to the damage suffered. Every time the asset lost has no substitute on the market or no objectively – and easily – determinable price, any judicial estimation runs a high risk of error.

Even if specific performance is probably the best remedy to protect shareholders' interests, as said, Italian case law maintains a clear distinction between corporate and shareholders' agreements plans, considering the breach of the latter relevant only among the subscribing shareholders, which are entitled to protect their interest only by suing for damages.

Therefore, in everyday business, a need to find legal remedies that may effectively ensure the respect of shareholders' agreement provisions is strongly required. From this perspective, in practice, various instruments have been created that should be kept in mind to mitigate any risk arising from a shareholders' agreement breach.

Alternative remedies

Let's put ourselves in the shoes of a foreign investor. In this case, it is advisable to consider two scenarios.

In the first scenario, the investor has already signed a shareholders' agreement and, assuming that for some reason he or she cannot amend the agreement, wants to guarantee its compliance. Unfortunately, the viable options are quite limited and probably expensive. As said, the breach of the agreement by the investor's counterparty is threatened only by an eventual claim for damages, which, moreover, would be not a completely satisfying remedy for the investor.

The best strategy is then to ensure the self-enforcement of the agreement by depriving the other subscribers of the chance to breach the contract. In practice, a series of possibilities has been developed and, among others, we suggest the following because of their particular effectiveness: (1) the fiduciary entrustment of the shares; (2) the transfer of the shares to a holding company; and (3) the establishment of a voting trust with the transfer of the ownership of the shares to a trustee.

These possibilities are all linked by some common features: (1) the involvement of a third party that ensures the exercise of the rights arising from the shares in accordance with the shareholders' agreement; (2) the loss of direct ownership of the shares in favour of the trust company, holding company or trustee; and (3) the need to bear further costs.

In the second scenario, the investor is willing to sign a new shareholders' agreement and has the chance to draft it. In this situation, the legal instruments available are obviously wider.

First, the parties may immediately adopt one of the aforementioned solutions and, in this way, grant the self-enforcement of the agreement. However, the most immediate and reasonable option to mitigate the risk arising from any possible breach of the contract, which also avoids the need to involve a third party, is to include in the agreement a penalty clause that could be triggered in the event of default and, therefore, will oblige the breaching party: (1) to pay a certain amount of money; or (2) to execute a predetermined performance.

Choosing option (1), the penalty clause works as a liquidated damage clause and is intended to estimate damages in the event of non-performance or breach of contract: this can be particularly effective in a shareholders' agreement because it allows the measurement of damages in advance that are difficult to prove in court once incurred.

These penalty clauses are unanimously considered legitimate by both the authors' interpretation and case law. In practice, a penalty – agreed upon the aim of causing the parties to comply with the agreement – is usually considered very effective because the parties can predetermine a measure of damages that is considered satisfactory to the damaged party. In fact, such a provision not only predetermines damages that are difficult to quantify and prove, but also induces parties to perform the contract and encourages them to settle before trial, saving the costs associated with litigation. In this regard, it should be noted that Article 1382 of the ICC provides that the creditor may claim for additional damages only if it is provided by the contract. Therefore, the penalty clause should include this provision in order to eliminate the creditor's possible disadvantage in the event that the amount of the penalty is below the amount of recoverable damages.

According to option (2), the object of the penalty clause consists of a performance different from the simple payment of an amount of money. It is possible to provide that, in the event of default by one party, the other is entitled to exercise a call (or put) option on the shares of the breaching party upon the payment of a punitive price. The contractual protection, from a certain perspective, can be considered a way of specific performance: the damaged party has the right to exclude the breaching party from the company or exit from the company upon a satisfying price. In any event, it is necessary to highlight that although authoritative authors and courts have recognised the legitimacy of such clauses,[2] an Italian court decision has recently considered them to be illegitimate because against the provision of Article 2744 of the ICC, this prohibits forfeiture covenants (ie, agreements that entitle the creditor to acquire the property of an asset in the case of the default of the other party).[3] Therefore, this particular type of provision shall be construed considering the most recent interpretation arising from courts' decisions.

Conclusions

Considering all the risks related to the undertaking and execution of a shareholders' agreement, when an investor is interested in participating in an Italian closely held company, it is essential to inform him or her about the clauses that can be included in the agreement to ensure and incentivise the fulfilment of the other parties' obligations and the related risk mitigation remedies that are available. The importance of drafting a tailored and well-written shareholders' agreement highlights the need for lawyer-advised negotiation from the beginning of the investment transaction. A successful legal strategy should avoid undesired contractual disputes, long re-negotiations or, at worst, very expensive lawsuits. In our practical experience, the lawyer's advice should always be directed to the best interest of the client and deal, overtaking all unnecessary contractual complications and legal loopholes.

Notes

1 See Alessandro Pomelli, *Stipulazione per facta concludentia, efficacia e coercibilità dei patti parasociali di voto*, note to Tribunale di Belluno, 23 January 2010 in Giurisprudenza commerciale, 2011, II, 1498.

2 See the arbitration award of Collegio Arbitrale Bologna, 19 February 2011 in Giustizia civile 2014, 4, with note of Gabriele Salvi, *Patti parasociali, clausola penale e divieto di patto commissorio: concreti segnali di apertura*.

3 Please refer to the decision of Tribunale di Milano, No 10937, 19 September 2011 in Le Società, 2012, 1, 9.