A Comparative Analysis of Shareholder Protections in Italy and the United States: Parmalat as a Case Study

Lorenzo Segato
A Comparative Analysis of Shareholder Protections in Italy and the United States: Parmalat as a Case Study

_Lorenzo Segato*

I. INTRODUCTION

The Parmalat Group, Italy’s eighth largest company, ranked within the top ten international companies in the food products industry, collapsed and entered bankruptcy protection in 2003 after disclosing that some $9 billion was missing from its accounts. Its controlling shareholder and management have been indicted for fraud. Parmalat investors around the world, principally in Italy and the United States, who bought Parmalat shares and bonds based on false information, were significantly damaged by this fraudulent behavior.

The goal of this article is to compare the protections offered to minority shareholders by the Italian system of corporate law with those offered by the U.S. legal system of corporate and securities law in order to determine if Parmalat’s minority shareholders would have been better off had Parmalat been an American company listed in the U.S. financial market. This analysis will reveal several weaknesses in Italian corporate and securities laws, thereby providing a basis for suggestions on how to improve minority shareholders’ rights in Italy based on the U.S. experience.

Section II of this paper provides an overview of the structure of the Parmalat group, which was dominated by a strong, active majority shareholder and then discusses why Parmalat collapsed. It also describes the financial frauds that dragged the company into bankruptcy, again

---

* Special thanks to Professor Randall S. Thomas (John S. Beasley Professor of Law and Business at Vanderbilt University), Ms. Nancy Calonge and, most of all, my wife Lara Zordan, for their help and support.

underlining the determinant role of the controlling shareholder and management. It further delineates the corporate monitoring structure and analyzes whether Parmalat complied, at least formally, with the recommended standards of corporate governance in Italy. Finally, this section outlines the legal remedies used by the Italian minority shareholders to attempt to obtain compensation for the harms they suffered because of this collapse.

After a quick review of the legal sources of Italian corporate law, section III of the paper offers an overview of the main innovations introduced into Italian corporate law by the 2003 Reform movement. The innovations changed the structure of corporate governance of Italian stock companies and gave shareholders the opportunity to choose among three different systems of corporate governance. The innovations also created the mandatory requirement of an external auditor or auditing firm for each affected company. Section III next discusses the methods offered by Italian corporate law to protect listed companies’ minority shareholders. It concludes by discussing the role of the Commissione Nazionale per le Società e la Borsa (“CONSOB” or the Italian SEC) in protecting investors and monitoring the transparency and efficiency of the financial markets. Section IV gives a similar overview of the protection of listed companies’ minority shareholders in U.S. corporate law. It further explains the role of the Securities and Exchange Commission (“SEC”) in financial markets, focusing on the SEC’s investigatory and enforcement powers.

Section V addresses the question of how the U.S. system would have protected the Parmalat minority shareholders had Parmalat been a U.S. listed company. It finds that a Rule 10b-5 action would be an available remedy for U.S. minority shareholders against perpetrators of fraud, including the company. It analyzes the effectiveness of a private securities fraud class action and its relation to SEC enforcement actions. It concludes by suggesting that the Italian legal system, in light of what happened in the Parmalat case, should introduce a private securities fraud class action similar to the U.S. Rule 10b-5 action. It also suggests that the creation of such a class action should be accompanied by a significant increase in the powers of the CONSOB, specifically the power to enforce Italian securities law, in order to guarantee an adequate recovery of damages for injured shareholders and investors.

II. THE PARMALAT CASE: THE BIGGEST SCANDAL IN ITALIAN FINANCIAL HISTORY

To most Italians, prior to 2003, Parmalat represented a shining example of the Italian economic miracle. Calisto Tanzi, Parmalat’s founder, had taken his family’s salami and preserves business and within thirty years had transformed it into an industrial giant. Tanzi started by adopting new
technologies and applying them to the milk business. After purchasing its first agricultural business in Brazil in the 1970’s, Parmalat grew at an unprecedented rate of more than 50% a year. In addition to milk, Parmalat branched out into other areas such as juices, sauces, baking products, yogurts, soups, and mineral water. In the United States, Parmalat is known for its Mother’s Cookies brand, along with Black Diamond and Sunnydale Farms products.

By 2003, headquartered in the small northern Italian city of Parma (from which Parmalat takes its name), the company was active in thirty countries with its primary markets in North America, South America, and Europe. Employing well over 30,000 employees and with revenues reaching more than $7 billion, Parmalat was ranked 369 among Forbes’ top 500 international companies in 2003 and ranked within the top ten in the food products industry. Moreover, Parmalat was Italy’s eighth-largest company and controlled 50% of the Italian market in milk and milk-derivative products.

A. The Bankruptcy of the Group and the Accusation of Fraud

In 1997, Parmalat decided to become a “global player” in the world economy and expand outside of the Italian market. Parmalat started a campaign of international acquisitions, primarily in North and South America, financed through debt. In a relatively short time, the group became the third largest producer of cookies in the United States. But such acquisitions, instead of bringing in profits, began to fail in 2001. Because the group’s operational activities continued to operate at a loss, management decided to shift to the derivatives market and other speculative enterprises. Parmalat’s founder and former CEO, Tanzi, led the group into several different new enterprises, including a tourism agency called Parmatour, and a local soccer club, Parma F.C. Huge amounts of money were poured into these two enterprises, which had been running at a loss from the very beginning. It has been reported that Parmatour, no longer in business, had a loss of at least €2 billion, an incredible sum for a tourism agency. The losses of the Parma F.C. soccer club, on the other hand, have not yet been completely uncovered. Since it became part of the Parmalat

---

4 Murray, supra note 2.
5 Forbes, supra note 1.
7 Id.
8 Id.
Northwestern Journal of
International Law & Business

group, Parma F.C. purchased a remarkable number of high-priced soccer players from South America, mainly Colombia. These two enterprises that at first glance could be deemed insignificant in the global analysis of the Parmalat group, were "the tip of the iceberg" of an accurate and well-organized "financial plan." In fact, while accumulating losses and with debts owed to banks, Parmalat began to build a network of offshore mailbox companies (most of them registered in the Cayman Islands, tax harbor), which were used to hide losses through a mirror-game which made them appear as assets or provide liquidity. At the same time, the company began to issue bonds in order to raise capital. The security for such bonds was provided by the alleged liquidity represented by the offshore schemes. The largest bond underwriters were Bank of America, Citicorp, and J.P. Morgan. These banks, bond issuers as well as bond holders, like their European partners Deutsche Bank, Banco Santander, ABN and Italian, Capitalia, S. Paolo-IMI, Intesa-BCI, Unicredito, Monte dei Paschi, and many others, rated Parmalat bonds as solid financial products. While Bank of America participated as a partner in some of Parmalat's acquisitions, Citicorp is alleged to have played a substantial part in the organization of the fraudulent accounting system. The New York-based, Italian law firm Zini also played a central role in the Parmalat financial plan. Through Zini, companies owned by Parmalat were sold to certain American citizens with Italian surnames, only to be re-purchased later by Parmalat. The whole operation was a facade: the purchase price money for the sale came from other entities owned by Parmalat and the sales served only to create the appearance of liquidity on the books. Thanks to that apparent liquidity, Parmalat was able to continue to issue its bonds.

The Parmalat crisis finally became public on December 8, 2003, when Parmalat defaulted on a €150 million bond. Parmalat management claimed that this occurred because a customer, a speculative fund named Epicurum Fund, defaulted on its bills. Allegedly, Parmalat had won a derivatives contract with Epicurum Fund, betting against the dollar. But it was soon

9 Id.
10 Id.
11 One of the off-shore mail-box firms used to channel the liquidity coming from the sales of the bonds was called "Buconero," which means "black hole."
12 See Celani, supra note 6.
13 J.P. Morgan Chase sold the largest amount of Parmalat bonds for a total value of €1.6 billion, i.e., 21% of the bonds circulating in the U.S. market. Most of these bonds became part of investment and pension funds.
14 The first class-action suit in the United States on the Parmalat case was filed by the South Alaskan Miners' Pension Fund and is against Parmalat, its auditors, Bank of America and Citicorp.
15 See Celani, supra note 6.
16 See Peter Gumbel, How It All Went So Sour, TIME EUR., Nov. 23, 2004, at 44.
discovered that Epicurum Fund was owned by firms whose addresses were the same as some of Parmalat’s own offshore entities.\textsuperscript{17} In other words, Epicurum Fund was owned by Parmalat. On December 9, as rumors spread that Parmalat’s claimed liquidity did not exist, Standard & Poor’s finally downgraded the Parmalat bonds to junk status\textsuperscript{18} and in the next few days Parmalat stocks fell 40%.\textsuperscript{19} Three days later, Parmalat management somehow found the money to pay the bond, but on December 19 the game ended: Bank of America announced that an alleged account with $3.9 billion in liquidity, which Parmalat claimed to hold with Bank of America, did not exist.\textsuperscript{20} At that moment, the bankruptcy was revealed and Parmalat stock fell an additional 66%.\textsuperscript{21} Later, Parmalat CFO Fausto Tonna would confess that he had faked Bank of America documents, using a scanner, scissors, and glue, to “invent” the $3.9 billion account.\textsuperscript{22} On December 22, the Italian government rushed to pass emergency legislation in order to allow Parmalat to quickly file for bankruptcy in order to protect its industrial activity, payrolls, vendors, and others from creditors’ claims. The government appointed an administrator, Enrico Bondi, to devise and present a reorganization plan for the Parmalat Group by January 20, 2004.\textsuperscript{23} The government was extremely concerned about the more than 100,000 Italian owners of Parmalat’s bonds and shares, and therefore promised an immediate review of the current legislation protecting investors.\textsuperscript{24} The role played by the Italian, European, and American banks is extremely significant and dramatic. In fact, the banks had led unsophisticated investors (workers, pensioners, and professionals) into making high-risk investments. In most cases investors did not know where their money had been invested or were told that it was invested in “safe” financial products.\textsuperscript{25} On December 27 Calisto Tanzi and all of Parmalat’s executives were arrested under suspicion of fraud. Italian prosecutors investigated the alleged fraud and asked that in addition to all Parmalat executives, Bank of America and two auditors, Italian affiliates of Grant Thornton and Deloitte & Touche, be put on trial.\textsuperscript{26}

\textsuperscript{17} Id.  
\textsuperscript{18} See Celani, supra note 6.  
\textsuperscript{19} Id.  
\textsuperscript{20} Id.  
\textsuperscript{21} Id.  
\textsuperscript{22} Id.  
\textsuperscript{24} Id.  
\textsuperscript{25} See Celani, supra note 6.  
The first hearing of the Parmalat trial was held in October 2004. Judges estimated that $9 billion had disappeared from the Parmalat accounts.\textsuperscript{27} The investigation continues to find proof of where this huge amount of money was concealed. Moreover, Tanzi is suspected of misappropriating at least $600 million from the business over the years.\textsuperscript{28} To fully appreciate the gravity of the Parmalat scandal, it must be mentioned that the amount of money missing from the company’s accounts represents about 0.8\% of Italy’s gross domestic product.\textsuperscript{29}

The main question regarding Parmalat’s collapse still remains: how and why did this happen? Was it the fault of the two accounting firms, Grant Thornton and Deloitte & Touche, for failing to properly audit Parmalat’s financial statements? Was it a consequence of the Italian corporate governance rules, which permitted Tanzi and his management to conceal huge amounts of money to the detriment of the shareholders and investors? Or, finally, does the responsibility lie with the banks, which sold Parmalat shares and bonds to their clients’ investors allegedly without knowing that Parmalat was in an unreliable financial situation? The goal of this section is not to answer specifically the questions above, but rather to give a description of the Parmalat structure in order to shed light on whether effective protection of minority shareholders was guaranteed.

\section*{B. Ownership and Control Structure}

Generally, Italian corporations, both listed and unlisted, are owned by a small number of shareholders. These shareholders are often linked by family ties or shareholders’ agreements, and are willing and able to wield their power over the corporation.\textsuperscript{30} Parmalat was a composite group of companies controlled by a strong majority shareholder, the Tanzi family, through a pyramidal device.\textsuperscript{31} In this type of organization a holding company controls, directly or indirectly, the majority of voting rights of the companies that are part of the organization. The ultimate control over the entire organization is in the hands of either a single entrepreneur, a family

\begin{footnotes}
\footnotetext[27]{Id.}
\footnotetext[28]{Alessandra Galloni et al., \textit{A Global Journal Report: Scandal at Parmalat Broadens; Staff May Have Destroyed Files}, WALL ST. J., Dec. 29, 2003, at A1.}
\footnotetext[29]{See Wolfgang Munchau, \textit{Parmalat Affair Has Plenty of Blame to Go Round}, FIN. TIMES, Dec. 29, 2003, at 15.}
\footnotetext[31]{Pyramidal groups, widespread in Italy, have been defined as “organizations where legally independent firms are controlled by the same entrepreneur (the head of the group) through a chain of ownership relations.” See Bianco, \textit{supra} note 30.}
\end{footnotes}
A Comparative Analysis of Shareholder Protections

(as in the Parmalat case), or a coalition.

Parmalat S.p.A., representing the core milk and dairy food business of the Parmalat organization, had direct control of sixty-seven other companies (as of December 31, 2002), and indirect control of many others. Parmalat S.p.A. was an unlisted company and was controlled by Parmalat Finanziaria, which owned 89.18% of Parmalat S.p.A. voting shares. The remaining 10.82% of the shares were owned by Dalmata S.r.l., an unlisted financial company which was fully controlled by Parmalat Finanziaria. The latter company was listed on the Milano stock exchange and its majority shareholder was Coloniale S.p.A., which owned 50.02% of the company’s voting share capital (49.16% of it was held directly, while 0.86% was controlled indirectly through the Luxembourg based Newport S.A.). The major minority investors of Parmalat Finanziaria were Landsome Partners Limited Partnership (holding 2.06% of the company’s capital) and Hermes Focus Management Europe Limited (holding 2.20%). The holding company of the organization, Coloniale S.p.A., was under the control of the Tanzi family through several Luxembourg-based companies. The Tanzi family was the ultimate shareholder controlling Parmalat Finanziaria and the entire Parmalat organization. Furthermore, the Tanzi family was the ultimate shareholder of more than 50% of Parmalat’s equity.

The prevailing control structure in Italian companies is characterized by the existence of an active majority shareholder ("the blockholder") who is willing and able to monitor the management of the company effectively. This type of ownership and control structure seems to lessen the agency problem between management and shareholders. In fact, managers who seek to favor their personal interests to the detriment of the shareholders could be immediately discharged by the controlling shareholder. In truth, "the agency problem is only shifted towards the relationship between different types of shareholders: the controlling shareholder and minority

\[32 \text{ See Melis, } \textit{supra} \text{ note 30, at 5.}\]
\[33 \text{ See id. at fig. 1 (delineating a simplified structure of the Parmalat organization).}\]
\[35 \text{ The agency problem concerns the relationships between management and shareholders in a company. It consists of the fact that the shareholders should control the managers’ actions and behaviors in managing the company (unfortunately this does not happen very often, especially in big companies with a large amount of shareholders).}\]
\[36 \text{ See Melis, } \textit{supra} \text{ note 30, at 5.}\]
shareholder.”37 In fact, “the controlling shareholder may wield her power to pursue its interests even at the expenses of the minority shareholders.”38 While in the United States the main corporate governance issue is defined as “strong managers, weak owners,”39 the leading corporate governance issue in Italy is about “weak managers, strong blockholders and unprotected minority shareholders.”40 It will become clear in this section that in the Parmalat case the blockholder, the Tanzi family, used its power in the organization to pursue personal interests to the detriment of the minority shareholders by funneling most of the Parmalat companies resources to the family’s personal accounts.

C. The Corporate Monitoring Structure

The corporate monitoring structure of Italian listed companies requires the presence of two key gatekeepers: the board of statutory auditors, a particularly Italian device, and the external auditing firm, a common gatekeeper around the world. Each of these devices is briefly explained below.

1. Board of Statutory Auditors

The board of statutory auditors has the duty to monitor the company from the inside. Article 148 of the Legislative Decree n. 58/98 (the so-called “Testo Unico della Intermediazione Finanziaria” or “T.U.I.F.”) establishes that a company’s charter must indicate the number of auditors (not less than three) and ensure that one (or two, depending upon whether the board is composed of more than three auditors) of the auditors is appointed by the minority shareholders. In this way the board can express the will of all the shareholders.41 Parmalat Finanziaria’s board of statutory auditors was composed of three members, the legal minimum requirement. The number of members on the board of statutory auditors directly affects the level of protection for minority shareholders. In fact some powers (for

37 Melis, supra note 30, at 7 (citing Rafael La Porta et al., Investor Protection and Corporate Governance, 58 J. Fin. 3 (2000); Andrea Melis, Corporate Governance in Italy, 8 CORP. GOVERNANCE – AN INT’L. REV. 347 (2000)).
40 Melis, supra note 37, at 347–55.
instance, the power to call a shareholders’ meeting as a consequence of a director’s decision) can be exercised only by at least two members of the board in concert. In a board composed of five members, minority shareholders can elect two statutory auditors and thus have the ability to call a shareholder meeting.  

During the last ten years the Parmalat Finanziaria board of statutory auditors never reported any wrongdoing to the courts or to CONSOB.  

Neither did the statutory auditors of Parmalat S.p.A. or any other of its subsidiaries. It must be mentioned that in December 2002 a minority shareholder of Parmalat Finanziaria, Hermes Focus Asset Management Europe Ltd., brought a suit under article 2408 of the Civil Code (the main issue of the claim was about related-parties transactions), and even then the board of statutory auditors answered that “no irregularity was found either de facto or de jure.” The clear inefficiency of the board of statutory auditors has been connected to its lack of access to information related to shareholders activities and its lack of independence from the controlling shareholders.

2. External Auditing Firms

Italian corporate law requires that the external auditing firm be appointed at the shareholders’ meeting. However, the board of statutory auditors must give its opinion about the appointment of the external firm. Article 159 of the T.U.I.F. establishes that the external auditing firm appointment lasts three years and after two re-appointments (i.e., nine years) the company must change its audit firm. Italy is the only major economy that requires a mandatory external auditing firm rotation.  

From 1990 to 1998 Grant Thornton S.p.A. was the Parmalat Finanziaria external auditing firm. In 1999 Deloitte & Touche S.p.A. was appointed. However, the required external auditing firm rotation, did not lead to the disclosure of the accounting frauds perpetrated by Parmalat Finanziaria. In fact, for four years, from 1999 to 2003, Deloitte & Touche S.p.A. did not notice any form of fraud nor did it allege any irregularity related to the company’s

---

44 See Melis, supra note 30, at 8.
45 See Melis, supra note 42.
46 T.U.I.F., supra note 41, at art. 159.
bookkeeping in its reports or directly to the CONSOB.\textsuperscript{47} However, in October 2003 Deloitte & Touche S.p.A. published a review report, related to the period from January to June 2003, declaring that the firm was unable to verify the actual value of Parmalat's investment in Epicurum Fund because no published accounts of the fund were available. The auditing firm also "rendered a 'non-standard' report declaring that up to 49\% of the total assets of the group and 30\% of the consolidated revenues came from subsidiaries which were audited by other auditors."\textsuperscript{48} Deloitte & Touche S.p.A. admitted that its conclusions were founded solely upon other auditors' reports, more specifically, upon Grant Thornton S.p.A. reports. In fact, the mandatory rotation of the external auditing firms was not effective: Grant Thornton S.p.A. was the external auditing firm of Parmalat S.p.A. and other off-shore subsidiaries even after 1999.\textsuperscript{49} Therefore Deloitte & Touche S.p.A. had been relying on Grant Thornton's work when giving its opinion about Parmalat Finanziaria's consolidated financial statements.\textsuperscript{50}

D. Parmalat's Lack of Compliance with the Italian Code of Best Practice — The "Codice Preda"

In 1999, the managing company of the Italian Stock Exchange, the Borsa Italiana S.p.A., enacted the so-called "Codice Preda," a code of best practices for corporate governance of companies listed on the Italian stock exchanges. This Code was slightly modified in 2002. However, in a civil law based country such as Italy, the effectiveness of a code of best practices is limited because of the low enforceability of their recommendations in comparison with Anglo-Saxon common law based countries.\textsuperscript{51} It will be illustrated whether Parmalat complied, at least on paper, with the recommended standards of corporate governance in Italy. At the same time, a thorough examination of the company's organizational system will be presented in order to show whether the Parmalat organizational structure offered effective protection of the minority shareholders' rights. In effect, Parmalat did not comply with the recommended standards of corporate governance and its organizational structure did not guarantee any protection to minority shareholders.

\textsuperscript{47} See Cardia, \textit{supra} note 43.

\textsuperscript{48} Melis, \textit{supra} note 30, at 11 & tbl. 3.

\textsuperscript{49} Parmalat found a loophole in the law that allowed Grant Thornton S.p.A. to remain as a "subcontractor."

\textsuperscript{50} See Melis, \textit{supra} note 30, at 11 (raising the following policy question: "What is the point of setting up a mandatory rotation of the chief auditor if the latter relies on the report of an auditor that has not been forced to rotate?").

Paragraph 1.2 of the Codice Preda suggests that only the board of directors is competent to deal with certain specific issues, including the examination and approval of the company’s strategic, operational, and financial plans, the approval of the corporate structure of the group, and the examination and approval of transactions having a significant impact on the company’s profitability, assets and liabilities, or financial position. Parmalat Finanziaria, the listed holding company of the group, had complied with these suggestions since 2001. Paragraph 2.1 of the Codice Preda recommends that the board of directors shall be composed of executive directors and non-executive directors, and the number of the non-executive directors shall be such that their opinions can have significant weight in board decisions. Parmalat Finanziaria’s board of directors was composed of thirteen directors, four of whom, including the Chairman-

---

52 Paragraph 1.2 of the Codice Preda states that the board of directors shall:

(a) examine and approve the company’s strategic, operational and financial plans and the corporate structure of the group it may head; (b) delegate powers to the managing directors and to the executive committee and revoke them; it shall specify the limits to such delegated powers, the manner of exercising them and the frequency, as a general rule not less than once every three months, with which such bodies must report to the board on the activity performed in the exercise of the powers delegated to them; (c) determine, after examining the proposal of the special committee and consulting the board of auditors, the remuneration of the managing directors and of those directors who are appointed to particular positions within the company and, where the shareholders’ meeting has not already done so, allocate the total amount to which the members of the board and of the executive committee are entitled; (d) supervise the general performance of the company, with special reference to situations of conflict of interest, paying particular attention to the information received from the executive committee (where established), the managing directors and the internal control committee and periodically comparing the results achieved with those planned; (e) examine and approve transactions having a significant impact on the company’s profitability, assets and liabilities or financial position, with special reference to transactions involving related parties; (f) check the adequacy of the general organisational and administrative structure established by the managing directors for the company and the group; (g) report to the shareholders at shareholders’ meetings.


53 See Melis, supra note 30, at 12.

54 Paragraph 2.1 of the Codice Preda establishes that:

The board of directors shall be made up of executive directors (i.e. the managing directors, including the chairman where he or she has delegated powers, and those directors who perform management function within the company) and non-executive directors. The number and standing of the non-executive directors shall be such that their views can carry significant weight in taking board decisions.

Codice Preda, supra note 52, at para. 2.1.
CEO, were tied to the Tanzi family. In its 2003 report on corporate governance, Parmalat Finanziaria declared that five board members were non-executive directors. An executive committee was then created; it was composed of seven directors, three of whom were members of the Tanzi family. Paragraph 3.1 of the Codice Preda recommends that an adequate number of non-executive directors shall be independent in order to guarantee the protection of the minority shareholders. Parmalat Finanziaria declared that three board members were independent directors, whereas most Italian-listed company boards are composed by five independent directors. Paragraph 4.3 of the Codice Preda suggests that “chairmen and the managing directors each have their own tasks,” implicitly stating that a non-executive director should be appointed as Chairman. It was empirically proven that in most of the MIB30 listed companies, those two positions are disjointed. At Parmalat Finanziaria, the two positions of Chairman and CEO were held by the same person,

55 See Melis, supra note 30, at 12.
56 Id. at 13 & tbl. 4 (highlighting that the fact that non-executive directors are less than executive directors is quite unusual among Italian listed companies).
57 See id. (observing that eight of the Parmalat Finanziaria directors, including all the members of the executive committee and one non-executive director were also sitting at the board of directors of Parmalat S.p.A.).
58 Paragraph 3.1 of the Codice Preda indicates that:

An adequate number of non-executive directors shall be independent, in the sense that they: (a) do not entertain, directly or indirectly or on behalf of third parties, nor have recently entertained business relationships with the company, its subsidiaries, the executive directors or the shareholder or group of shareholders who controls the company of a significance able to influence their autonomy judgment; (b) neither own, directly or indirectly or on behalf of third parties, a quantity of shares enabling them to control the company or exercise a considerable influence over it nor participate in shareholders' agreements to control the company; (c) are not immediate family members of executive directors of the company or of persons in the situation referred to in points (a) and (b).

Codice Preda, supra note 52, at para. 3.1.
59 Id. at para. 4.3.
60 The paragraph, however, notes that “it is not infrequent in Italy for the same person to hold the two positions or for some management powers to be delegated to the chairman even where there are managing directors.” Id. The paragraph also makes clear that:

the board of directors, where it deems this to be desirable in order to achieve a more efficient running of the company, has the right to delegate management powers to the chairman alone or with others. In such case the board should include adequate information in its annual report on the duties and responsibilities of the chairman and the managing directors.

Id.
61 See Melis, supra note 30, at 17 & tbl. 5 (noting also that even when the positions are disjointed, the separation of the two roles of Chairman and CEO is often not adequately clear since the Chairman is often given some executive powers).
Calisto Tanzi, the major shareholder of the company. This is an example of a situation where an extremely significant amount of power was in the hands of a single person. However, the company did comply with the Codice Preda. In fact, paragraph 5 states that the executive committee and the managing directors shall periodically inform the board of directors of the activities performed in the exercise of their delegated powers,\(^\text{62}\) Parmalat Finanziaria created this report quarterly.\(^\text{63}\) Paragraph 6.1 of the Codice Preda states that the managing directors shall ensure the correct handling of confidential information, and to do so they shall propose to the board of directors the adoption of specific internal procedures for the handling and disclosure of information about the company.\(^\text{64}\) Parmalat Finanziaria adopted internal procedures in 2002, creating a structured system under the responsibility and control of Chairman and CEO Tanzi, thereby formally complying with the code of best practices.\(^\text{65}\) However, these procedures and structure were just an artful way of covering the accounting fraud for more than ten years.\(^\text{66}\)

The appointment of directors is regulated by paragraph 7.1 of the Codice Preda,\(^\text{67}\) which gives listed companies the option of establishing a

---

\(^\text{62}\) Paragraph 5 of the *Codice Preda* states that:

The executive committee—in the person of its chairman—and the managing directors shall periodically report to the board of directors on the activities performed in the exercise of their delegated powers. The bodies with delegated powers shall also provide adequate information on transactions that are atypical, unusual or with related parties whose examination and approval are not reserved to the board of directors. They shall provide the board of directors and the board of auditors with the same information.

*Codice Preda, supra* note 52, at para. 5.

\(^\text{63}\) See *Melis, supra* note 30, at 15 (pointing out that the separation between C.E.O. and Chairman is recommended by most of the international corporate governance codes of best practice).

\(^\text{64}\) Paragraph 6.1 of the *Codice Preda* states that:

The managing directors shall ensure the correct handling of confidential information; to this end they shall propose to the board of directors the adoption of internal procedures for the internal handling and disclosure to third parties of informative concerning the company, with special reference to price-sensitive information and information concerning transactions involving financial instruments carried out by persons whose positions give them access to relevant information.

*Codice Preda, supra* note 52, at para. 6.1.

\(^\text{65}\) See Anna Clara Cavallari et al., *Corporate Governance in the Italian Listed Companies* (2003), http://www.borsaitalia.it (reporting that the great majority of the Italian listed companies analyzed complied with this provision).

\(^\text{66}\) See *Melis, supra* note 30, at 18.

\(^\text{67}\) Paragraph 7.1 of the *Codice Preda* establishes that:
nomination committee to propose candidates for appointment to the position of director, especially where the board sees that it is difficult for shareholders to make proposals, as may be the case in listed companies with a broad shareholder base.\textsuperscript{68} Parmalat Finanziaria did not comply with this suggestion and justified that choice by making clear that shareholders never faced any difficulty in making proposals for candidates.\textsuperscript{69}

Paragraph 8 of the Codice Preda\textsuperscript{70} recommends that the board of directors shall create a committee on remuneration, the majority of whose members shall be non-executive directors.\textsuperscript{71} Parmalat Finanziaria had a remuneration committee of three members, two of whom were non-executive directors.

Paragraph 10 of the Codice Preda\textsuperscript{72} suggests that the board of directors

---

Proposals for appointment to the position of director, accompanied by detailed information on the personal traits and professional qualifications of the candidates with an indication where appropriate of their eligibility to qualify as independent directors as defined in Article 3, shall be deposited at the company's registered office at least 10 days before the date fixed for the shareholders' meeting or at the time the election lists, if provided for, are deposited.

\textit{Codice Preda, supra} note 52, at para. 7.1.

\textsuperscript{68} See Cavallari, \textit{supra} note 65.

\textsuperscript{69} See Melis, \textit{supra} note 30, at 16 (noting that this may be deemed a reasonable explanation considering the high level of concentrated control in the structure of the company).

\textsuperscript{70} Paragraph 8.1 of the \textit{Codice Preda} states that:

The board of directors shall form a committee on remuneration and stock option or equity based remuneration plans. The committee, the majority of whose members shall be non-executive directors, shall submit proposals to the board, in the absence of the person directly concerned, for the remuneration of the managing directors and of those directors who are appointed to particular positions and, acting on a proposal from the managing directors, for the criteria to be used in determining the remuneration of the company's top management. To this end the committee may employ external consultants at the company's expense.

\textit{Codice Preda, supra} note 52, at para. 8.1.

\textsuperscript{71} See Cavallari, \textit{supra} note 65 (reporting that more than 80\% of the companies formed a remuneration committee, and that 95\% of those companies have committees mostly composed by non-executive directors).

\textsuperscript{72} Paragraph 10.1 of the \textit{Codice Preda} establishes that:

The board of directors shall establish an internal control committee, charged with the task of giving advice and making proposals and made up of non-executive directors, of which the majority shall be independent. The chairman of the board of auditors or another auditor appointed by the same shall participate in the committee's meetings.

\textit{Codice Preda, supra} note 52, at para. 10.1. Paragraph 10.2 states that:

In particular the internal control committee shall: (a) assist the board in performing the tasks
establish an internal committee of non-executive directors, the majority of whom shall be independent, to give advice and make proposals. The internal control committee assists the board in performing the internal control system, supervises the activity of the persons responsible for internal controls, evaluates the appropriateness of the accounting standards adopted, and informs the board of directors of its activity and the adequacy of the internal control system at least once every six months. The Parmalat Finanziaria internal control committee was composed of three members, two of whom were also members of the executive committee. Therefore, contrary to the Codice Preda recommendation, non-executive directors were not the majority of the committee. Moreover, one of the internal control committee members, Fausto Tonna, had been the chief finance director from 1987 to March 2003 and was also the chairman of Coloniale S.p.A., the Tanzi family holding company and the major shareholder of Parmalat Finanziaria. The chairman of the committee was deemed to be an independent director. Nevertheless, he was “the chartered certified accountant of the Tanzi family (as well as an old personal friend of Calisto Tanzi).” It is clear that none of the members of the internal control committee could have been deemed independent. Finally, Parmalat Finanziaria did not comply at all with the recommendation in paragraph 3.2 of the Codice Preda, which suggests that when ownership is concentrated, some directors shall be independent from the controlling shareholder in order to allow the board to verify that potential conflicts of interest between

referred to in Article 9.2; (b) assess the work program prepared by the persons responsible for internal control and receive their periodic reports; (c) assess, together with the heads of administration and the external auditors, the appropriateness of the accounting standards adopted and, in the case of groups, their uniformity with a view to the preparation of the consolidated accounts; (d) assess the proposals put forward by auditing firms to obtain the audit engagement, the work program for carrying out the audit and the results thereof as set out in the auditor’s report and their letter of suggestions; (e) report to the board of directors on its activity and the adequacy of the internal control system at least once every six months, at the time the annual and semi-annual accounts are approved; (f) perform the other duties entrusted to it by the board of directors, particularly as regards relations with the auditing firm.

Codice Preda, supra note 52, at para. 10.2.

73 See Cavallari, supra note 65 (reporting that almost 90% of the Italian companies analyzed adopted an internal control committee, and that over 82% of those companies’ internal control committees are composed by of non-executive directors, who almost always are independent).

74 Melis, supra note 30, at 21 (pointing out that this showing is based on data not provided by the company and also concluding that the relationship between the Chairman of the committee and Mr. Tanzi clearly affected the former autonomous judgment in the committee).

75 Id. (noting that Parmalat Finanziaria did not give an adequate explanation for not complying with the recommendation).
the company and the controlling shareholders are subject to an adequate, independent judgment.\textsuperscript{76}

Paragraph 11.1 of the Codice Preda recommends that transactions with related parties shall comply with criteria of substantial and procedural fairness.\textsuperscript{77} Even though Paramalat Finanziaria alleged that a procedure to deal with these kinds of transactions was created and therefore the company had complied with the recommendation, such transactions were not handled following the criteria of substantial and procedural fairness.\textsuperscript{78} In paragraph 12, the Codice Preda\textsuperscript{79} recommends that the board of directors shall designate a person or create a corporate structure to be responsible for relations with institutional investors and other shareholders. Parmalat Finanziaria alleged that this recommended structure was created in 2001.\textsuperscript{80}

The analysis of the company’s structure and compliance with the Codice Preda clearly shows that Parmalat Finanziaria was under the tight control of a strong blockholder, the Tanzi family, and that the minority shareholders did not actively participate in the company’s decisions or have adequate protection. This point is underscored by the remarkable number of directors tied to members of the Tanzi family (four out of thirteen on the board of directors and three out of seven on the executive committee), the fact that only three of the non-executive directors were independent, and the fact that the positions of Chairman and CEO were both held by Calisto Tanzi. The analysis further illustrates that minority shareholders did not have the means to exercise any control over the internal procedures used to

\textsuperscript{76} Paragraph 3.2 of the Codice Preda states that:

[W]here the ownership is concentrated, or a controlling group of shareholders can be identified, the problem of aligning the interests of the managing directors with those of the shareholders continues to exist, but there emerges the need for some directors to be independent from the controlling shareholders too, so as to allow the board to verify that potential conflicts of interest between the interests of the company and those of the controlling shareholders are assessed with adequate independence of judgment.

\textit{Codice Preda, supra} note 52, at para. 3.2.

\textsuperscript{77} \textit{Id.} at para. 11.1.

\textsuperscript{78} \textit{See Melis, supra} note 30, at 22.

\textsuperscript{79} Paragraph 12 of the Codice Preda establishes that:

The chairman of the board of directors and the managing directors shall, while complying with the procedure for the disclosure of documents and information concerning the company, actively endeavor to develop a dialogue with shareholders and institutional investors based on recognition of their reciprocal roles. They shall designate a person or, where appropriate, create a corporate structure to be responsible for this function.

\textit{Codice Preda, supra} note 52, at para. 12.

\textsuperscript{80} \textit{See Melis, supra} note 30, at 22.
disclose information or over the activities of the company. In fact, the system of disclosing information to third parties was controlled by Chairman and CEO Tanzi, a nomination committee to propose candidates for appointment to the position of director was never established, and none of the members of the internal committee could have been deemed independent. The minority shareholders were practically excluded from any activity in the company and Parmalat Finanziaria was organized and structured to remain under the exclusive control of the majority stockholder in order to cover the perpetrated accounting fraud.

E. Remedies Available to Minority Shareholders in Italy

Unofficial data estimates that more than 100,000 Italian investors bought Parmalat stock.81 After the fraud was exposed, these investors' main goal was to obtain compensation for their damages. They have been assisted by many consumer advocate associations. Among the investors (both shareholders and bonds owners), shareholders are the least likely to recover any part of their investment. In fact, the Parmalat restructuring plan, led by Enrico Bondi, must first try to satisfy all the company's creditors, bond owners included. Only after the creditors are fully paid, and if any assets remain, can the company pay any money to satisfy the shareholders.82 Given the financial situation of Parmalat, this is not likely to happen. However, if the shareholders were aware of the true financial condition of Parmalat, it is unlikely they would have purchased any shares. It is clear that the shareholders were damaged by the fraudulent behavior of the Parmalat majority owners and managers.

The criminal trial for fraud against Calisto Tanzi and his managers commenced after the preliminary inquiries started in September 2005. Some shareholders have decided to become parties to the trial in the hopes of being able to recover compensation. Others are still undecided on whether to join the litigation, even though consumer associations are offering legal aid at reasonable rates. The main reason for their indecision is that being a party to this trial before the criminal court does not guarantee civil compensation.

On the one hand, it will be a fairly easy matter to prove that Mr. Tanzi and his managers were guilty (the prosecutors have the power to request discovery and are carrying out an investigation). On the other hand, it is absurd to hope that the criminal defendants will be able to repay all the damages they have caused. Therefore, the shareholders' attorneys will

81 See Tony Barber, Italian plan to compensate investors for their losses, FIN. TIMES, Jan. 13, 2005, at 10.
82 It must be noticed that the restructuring plan offers the bond owners the chance to become shareholders of the "new Parmalat."
likely try to file suits against the banks and the investment firms involved in the sale of Parmalat's shares. At present, only the Italian affiliates of Bank of America, Deloitte & Touche, and Grant Thornton have been named as defendants in the trial. It is clear, though, that shareholders who have decided to join this action with the prosecutor are not likely to recover damages. Nevertheless, the legal expenses associated with this kind of action are not onerous, leading some shareholders to believe that it could be worth trying.

Until now, almost none of Parmalat's shareholders have chosen to file civil claims for damages against Tanzi and his management. The reasons are straightforward. First, the legal expenses for civil cases are much larger than those for criminal proceedings. Second, Italian rules of civil procedure do not contemplate class actions. This means that each shareholder must file her own claim and bear the legal expenses alone. In addition, Italian law forbids contingency fees. Thus, the shareholder must pay the expenses of litigation in advance and would recover such expenses only in the case of a final victory. Third, the plaintiff bears the burden of proof. As a consequence, a shareholder in a claim against Parmalat must provide evidence of the fraud perpetrated and of the correlation between the fraud and the damages she allegedly suffered. It is quite clear that the difficulty of sustaining the burden of proof is significantly higher for an individual shareholder. This is even more difficult considering the "asymmetry of information" regarding a company's business and financial operations, and the bookkeeping typically existing between the company's management and the shareholders. Last, but not least, the average duration of lawsuits in Italy is almost twice that of lawsuits in most other EU countries. This combination of factors provides neither a strong incentive to file a claim nor an effective legal device to obtain a quick recovery of damages.

III. PROTECTION OF LISTED COMPANY MINORITY SHAREHOLDERS IN THE ITALIAN SYSTEM OF CORPORATE LAW

A. The Legal Sources of Italian Corporate Law

The principal source of Italian corporate law is articles 2060 to 2642 of

---

83 The legal expenses are determined by the judge and must be paid by the losing party. However, the amount of the expenses can be different, and even lower, than the amount paid in advance by the parties.

84 See Marco Ventoruzzo, Experiments in Comparative Law: the Recent Italian Reform and the Dubious Virtues of a Market for Rules in the Absence of Effective Regulatory Competition, fig. 43 (2004), available at http://www.ssrn.com, (indicating that in Italy the average number of months for first degree judgment amounts to 36 and for final judgment to 116).
the 1942 Civil Code.\textsuperscript{85} Articles 2325 to 2497-bis deal specifically with types of corporations: the "società per azioni" (stock company), the "società in accomandita per azioni" (stock company with personally liable directors), and the "società a responsabilità limitata" (limited liability company). The legislative model is the "società per azioni." Each type of corporate legal structure was conceived for organizations with different needs. In particular, the "società per azioni" was designed as an organizational form for medium to large businesses.\textsuperscript{86} The corporate law section of the Civil Code, unlike its other parts, has been amended several times. The most significant change since the Civil Code was enacted came in 2003 with the Legislative Decree 17.01.2003, n. 6, that determined the so-called "Reform of Italian Corporate Law." At present, the Civil Code is supplemented by a number of laws dealing with particular areas, the most important of which, for the purpose of this paper, is the Legislative Decree 24.02.1998 n. 58—the so-called "Testo Unico dell'Intermediazione Finanziaria" ("T.U.I.F.")—enacted in 1998 and regulating, among other aspects, the self-monitoring of listed companies. In addition, the "Codice Preda" was enacted in 1999 and modified in 2002. Finally, the updated interpretation and application of the articles of the Civil Code and of the supplementary laws are determined by the judgments passed by the "Corte di Cassazione" the Italian Supreme Court.

The Civil Code and the T.U.I.F., though, are the main sources of the listed companies' minority shareholder rights. Shareholders have the right to participate in shareholders' meetings\textsuperscript{87} and minority shareholders owning not less than 10% of the company's capital can call such meetings.\textsuperscript{88} At these meetings, the shareholders can approve the final budget, appoint and revoke directors, appoint internal auditors and the President of the Board of Auditors, decide the compensation for directors and internal auditors, and make decisions on the liability of directors and internal auditors.\textsuperscript{89} Article 2393-bis of the Civil Code allows minority shareholders owning not less than 5% of the outstanding shares to bring a derivative action against directors for liability toward the company. Shareholders can also file a complaint with the Board of Auditors concerning facts they deem censurable, and the board shall take the complaint into account in its report.
at the meeting. The Board of Auditors has a duty to investigate the facts set forth in the complaint when it is submitted by a group of members representing one-fiftieth of the company’s capital. If there is a basis for suspicion of serious irregularities in management by the directors in violation of their duties, Article 2409 of the Civil Code empowers the shareholders representing one-twentieth of the company’s capital to report the facts to the court. Article 2497 of the Civil Code states that a holding company, or its controlling shareholder, can be held liable to minority shareholders if the company caused damage through mismanagement of the controlled companies. Finally, all shareholders have the right to inspect the company’s books and the right of withdrawal.

B. The Recent Reform of Italian Corporate Law

1. Overview

The Reform of Italian Corporate Law, enacted by the Legislative Decree 17.01.2003, was inspired primarily by the need to simplify the procedure to incorporate and organize a stock company and a limited liability company. For the purpose of this article, attention will be focused on significant innovations provided by the Reform relative to the structure of the corporate governance of a stock company. Shareholders can now choose among three different governance systems: the traditional system, the dualistic system, and the monistic system.

The traditional system is characterized by the presence of a board of directors having the power to manage the company and composed of members elected at the shareholders’ meeting. It also provides for a board of auditors, composed of members elected at the shareholders’ meeting, which must ensure that the company respects the law and the charter, and the adequacy of the organizational, administrative, and accounting structure. One of the most significant innovations of the Reform, even for the traditional system, is that accounting control of the company is no longer in the hands of the Board of Auditors, but is now a duty of an external auditing firm, elected at the shareholders’ meeting.

In the dualistic system, management is carried out by a management board, the “Consiglio di Gestione,” whereas control of the company is exercised by a Supervisory Board, the “Consiglio di Sorveglianza.” The management board has the power to manage the company and must operate

---

90 Id. at art. 2408
91 C.c., supra note 87, at art. 2408.
92 Id. at art. 2422.
93 Id. at art. 2347; T.U.I.F, supra note 41, at art. 131.
94 C.c., supra note 87, at arts. 2325–2409.
to reach corporate objectives; its members are elected by the supervisory board. This board, whose members are elected by the shareholders at the shareholders' meeting, approves the balance sheet for the fiscal year (practically replacing the shareholders' meeting), supervises compliance with laws and the charter, ensures conformity with the principles of proper management and the adequacy of the organization, and manages the administrative and accounting structure adopted by the company.

In the monistic system, the responsibility of managing the company belongs exclusively to a board of directors, elected at the shareholders' meeting. The controlling activity is exercised by a committee established within the board of directors, called the Committee for the Control of Management. The members of this committee are elected by the board of directors, and at least one of the members must be chosen among those registered with examiners of accounts. Both in the dualistic system and in the monistic system (and also in the traditional system, as mentioned above) the accounting control of the company is exercised by an auditor or by an auditing company registered with the Ministry of Justice. For listed companies, the accounting control is exercised by an auditing company registered with examiners of accounts which, exclusively for such activities, is subject to both the discipline of the auditing activity contemplated for companies listed on the stock exchange and to the supervision of the National Stock Exchange Committee. It is clear that the Reform significantly increased the contractual freedom offered to shareholders organizing and structuring a company.

Two other important innovations characterize the Reform. The first is the introduction of the shareholders' derivative action against directors under article 2393-bis of the Civil Code. The second is the enactment of article 2497 of the Civil Code, which allows minority shareholders of a holding company to sue the company in case of damage caused by mismanagement of the controlled companies.

2. Broadened Contractual Freedom and the Necessity to Reinforce Protection for Minority Shareholders

As described above, the reform of Italian corporate law clearly offers shareholders broad contractual freedom in the organization of the management and control structure of a company. At the same time, the reform introduces certain new instruments to increase the protection of minority shareholders. These instruments are specifically designed to counterbalance such broad contractual freedom. The premise for these protections is that "broadened contractual freedom combined with the

---

95 C.c., supra note 87, at art. 2393.
96 C.c., supra note 87, at art. 2497.
existence of strong controlling shareholders, as well as the more extensive powers granted to directors appointed by the controlling shareholders, might easily result in oppression and exploitation of minorities unless they are granted effective counter-mechanisms.\textsuperscript{97} Withdrawal rights, derivative suits against directors, and the new regulation for groups of corporations are the three main areas of minority shareholders' rights affected by the innovations brought about by the Reform. Section IV will thoroughly illustrate these aspects.

C. Instruments Offered by Italian Corporate Law to Protect Minority Shareholders

\textit{1. The Shareholders' Meeting}

The shareholders' meeting must be held at least once a year. The role of the annual meeting of the shareholders differs depending upon whether the company has a Supervisory Board or not.

Article 2364 of the Civil Code indicates the role of the shareholders in the meeting of a company without a Supervisory Council. The shareholders can approve the final budget, appoint and revoke directors, appoint internal auditors and the president of the Board of Auditors, decide the compensation for directors and internal auditors, if it is not established in the charter, and make a decision on the liability of directors and internal auditors.

Article 2364-bis of the Civil Code indicates the role of the shareholders in the meeting of a company with a Supervisory Council. The powers of the shareholders in this case are significantly less and far more limited. In fact, the shareholders can only appoint and revoke the members of the Supervisory Council, decide the council member's compensation, if not established in the charter, and make a decision on the liability of members of the Supervisory Council. The approval of the final budget, as well as the appointment and revocation of the directors, are under the power of the Supervisory Council. This situation leaves the management of the company almost entirely under the control of the Supervisory Council and, therefore, practically excludes the shareholders. This rule has an exception. When the final budget is not approved or when there is a request from at least 1/3 of the members of the Supervisory Council, the charter may give the shareholders power to approve the final budget.\textsuperscript{98} However, shareholders are expressly prohibited from requesting that the approval of the final budget be shifted from the Supervisory Council to the shareholders' meeting. In all companies, regardless of whether there is a

\textsuperscript{97} Ventoruzzo, \textit{supra} note 84, at 35.

\textsuperscript{98} C.c., \textit{supra} note 87, at art. 2364-bis.
Supervisory Council, it is clear that minority shareholders have quite limited control of the management of the company, as there is no discussion about it; the law itself determines it.

Article 2365 of the Civil Code determines the purpose of the special meeting of the shareholders. Two of the most relevant purposes are that the shareholders can decide to amend the charter and the shareholders can decide on any matter on which they are specifically given the power to decide by law (e.g., mergers, decreasing the equity capital of the company, etc.). In the case of a company with a Supervisory Board, the charter may establish that the Supervisory Board has the power to decide on mergers, decrease of the equity capital, and removal of the headquarters of the company.

The directors usually call the shareholders’ meeting at least once a year. Directors must also call a meeting when the following specific situations occur: lack of the majority of the directors, a decrease of more than 30% of the authorized capital caused by losses, or the occurrence of an event that determines the dissolution of the company (e.g., a decrease of the authorized capital under the minimum amount of €100,000—established by article 2327 of the Civil Code). The decision to call a meeting for other reasons is at the discretion of the directors. However, not calling a meeting when it is clearly appropriate can be considered a breach of the duty of care for which the directors can be held liable.99 Nevertheless, article 2367 of the Civil Code also establishes that the minority shareholders can ask that a meeting be called. In fact, directors or the Management Board must immediately call a shareholders’ meeting when the request comes from a shareholder (or a group of shareholders) owning not less than the 10% of the company’s capital or the percentage indicated in the charter. If the directors do not immediately call the meeting and the refusal to do so is clearly unjustified, a court can order that the meeting be called. A court cannot order the calling of the meeting when refusal by the directors appears to be justified, i.e., when the directors can prove to the court that the shareholders’ request for the meeting abuses the right that article 2367 gives them. This often happens when the minority shareholders present recurring requests, indicating a clear abuse of the right established by article 2367.100 However, this rule does not apply for those matters in which the

99 Article 2409 of the Civil Code empowers a shareholder or a group of shareholders owning not less than the 20% of the authorized capital to denounce the directors before the Court in the case there is a well-founded belief that the directors committed grave irregularity in managing the company and, therefore, this behavior could have damaged the company.

100 See Carota, Società per azioni e convocazioni dell’assemblea su richiesta della minoranza, in Contratto e impresa, at 849 (1989); see also Martines, Abuso del diritto: la chicane del socio di minoranza, in Contratto e impresa, at 28 (1998).
calling of the meeting is at the exclusive discretion of the directors, i.e.,
decisions about a merger with another company or about an increase of the
authorized capital.

A decision made at the shareholders' meeting can be voided. A
decision is void only in the cases established by article 2379 of the Civil
Code.\textsuperscript{101} Otherwise, the decision is voidable in every other case in which
the decision was against the law or against the provisions in the charter.\textsuperscript{102}
The action to have the decision voided can be initiated by the directors,
Supervisory Council, auditors, or shareholders who did not attend the
meeting, voted against the decision or did not vote at all. To file the suit to
have the decision declared void a shareholder (or a group of shareholders)
must own voting shares representing not less than 1/1000 of the company's
capital.\textsuperscript{103} However, the shareholders have an alternative remedy if they do
not own the minimum number of shares indicated above. In fact, the
shareholders can file a suit against the company for damages suffered
because of an invalid decision. Both the action to have the decision declared
void and the action for damages must be filed within 90 days of the date of
the decision. The Court must judge only the legitimacy of the decision; any
judgment about the substance of them is definitively excluded.\textsuperscript{104} However,
there can be a judgment about the substance when it is necessary to
ascertain whether the decision lacks legitimacy. The Court can declare void
a decision that any reasonable person could deem to be disadvantageous to
the company.\textsuperscript{105} The presumption is that the majority of the shareholders
abused their power by using their prominent position in order to achieve
personal benefits to the detriment of the other shareholders and of the
company itself. Thus, again the Court must ascertain only the legitimacy of
the decision; there is no question about the economic reasons that pushed
the majority to vote in a certain way, but there is a strong attempt to prevent
them from abusing their voting rights to the detriment of the company.\textsuperscript{106}

\textsuperscript{101} The action to have the decision confirmed void can be brought up by anybody who
has an interest in it, and also the voidness can be directly declared by the judge without any
claim.
\textsuperscript{102} C.c., supra note 87, at art. 2377.
\textsuperscript{103} Id.
\textsuperscript{104} The jurisprudence is in total agreement on this point: see Cass. Civ., 30 oct. 1970,
1963, I, c.684.
\textsuperscript{105} See Trib. di Milano, 6 oct. 1986, Società 1987, 384; Trib. di Milano, 22 mar. 1982,
Foro It. 1982, I, c.2636.
\textsuperscript{106} ALDO MAISANO, L'ECCESSO DI POTERE NELLE DELIBERAZIONI ASSEMBLEARI DI
SOCIETÀ PER AZIONI (1968).
2. Shareholders’ Derivative Suits

The directors are responsible for their actions towards the company, the creditors of the company, and the shareholders. Article 2392 of the Civil Code establishes that the directors must fulfill the duties imposed by the law or the charter with the care required by the nature of the task and through their specific expertise. Besides the duty of care, directors must act with prudence and ability. The former requires the duty of not executing hazardous operations that a prudent entrepreneur would never undertake. The latter focuses on the capability of managing a company and on the necessary knowledge a director must possess in order to make the right decisions for the company.  

Article 2392 of the Civil Code also prescribes that directors shall fulfill the duties imposed upon them by law and by the charter with the diligence required by the nature of the appointment and by their specific competencies. It also prescribes that the directors are liable in solido to the company for damages deriving from the non-observance of such duties (duty of care and duty of loyalty). The directors’ liable behavior is deemed to be a violation of the provisions comprised in the charter.

The general rule under Italian law is that a suit seeking to hold directors liable must be approved by the shareholders’ meeting, i.e., by the controlling shareholder or shareholders. Therefore a conflict of interest could arise when, as commonly happens, controlling shareholders are the ones who appointed those directors. Consequently, “directors are rarely sued unless the corporation goes bankrupt, in which case the trustee in bankruptcy might sue them if he or she believes that they damaged the corporation or the creditors with their negligence. Obviously, in this situation minority shareholders have little protection or recourse against directors’ misconduct.” This problem occurred in 1998, when derivative actions by minority shareholders of listed companies were introduced through the enactment of the T.U.I.F. In fact, article 129 of the T.U.I.F. establishes that minority shareholders, on behalf of the company, can bring a suit against directors for liability towards the company. Minority shareholders who want to sue directors must represent not less than 5% of the outstanding shares and must also have held the shares for the last six

---


109 See Ventoruzzo, supra note 84, at 40.

110 Id.
months. In these types of suits, the shareholders can claim that the directors breached the duty of care or loyalty and seek damages suffered by the company (even though the action is taken by the minority, only the company benefits from it; in fact, in this case, the directors can be held liable exclusively to the company). The company can renounce or settle the case through a shareholders’ meeting resolution, provided that 5% of the shareholders do not oppose it. The rationale for this rule is that “in case of victory, the damages recovered by the corporation will increase the value of the participation of shareholders, and that increase in value might justify the cost of undertaking the litigation.”

The 2003 Reform introduced the new Article 2393-bis of the Civil Code. The Article allows both the shareholders’ meeting and minority shareholders (owning not less than 5% of the outstanding shares) to bring a derivative action against directors for liability towards the company and is applicable both to listed and non-listed companies. The Italian Supreme Court recognized that failure or irregularity in bookkeeping by the directors, as is alleged in the Parmalat case, must be considered an illicit behavior that could potentially damage the company and therefore justify a claim for damages compensation under article 2392 of the Civil Code.

The experience of listed companies after 1998 demonstrates that, even with the 5% threshold for the minority shareholders’ derivative suit, this instrument was never used. This lack of use can be easily explained. First and foremost, the economic incentives for minority shareholders to bring a lawsuit are relatively low. To bring a suit, they would have to advance the expenses of the litigation, which could be recovered only in case of victory and, even if this is the case, not necessarily in their entirety. The minority shareholder, therefore, bears a rather substantial risk of loss. Second, in the event of victory, only the corporation gets reimbursed. While it is true, as a theoretical matter, that the cash flow obtained by the corporation increases the value of shareholders’ participation, this effect is inevitably diluted, particularly since the shareholder holds a minority interest. Moreover, the very fact that a lawsuit is pending against current or former directors might itself adversely affect the value of the participation. It is not surprising, therefore, that in listed corporations shareholders prefer simply to exit the

111 Id. at 41 (stating that the “rule is designed to prevent speculation on shares for the purpose of bringing a strike suit against the corporation”; noting also that the charters of listed companies can establish a lower threshold of possession of shares required to bring a suit against directors, which would allow even smaller minorities to use this device, but that no listed companies has ever used this device).
113 Ventoruzzo, supra note 84, at 41.
115 See Ventoruzzo, supra note 84, at 41.
corporation and sell their shares on the market, rather than to engage the directors in a costly, uncertain, and potentially protracted litigation. In addition, Italian rules of civil procedure and professional regulation of attorneys do not provide for instruments that might encourage the use of such derivative actions. Under Italian law, in fact, there are no set rules concerning class actions, although some proposed legislation is currently being considered by the legislature. Contingency fees are forbidden, and there is nothing comparable to U.S.-style extensive, party-controlled “discovery.” As a consequence, in any derivative action minority shareholders are at a significant disadvantage in terms of information in relation to the director-defendants, who have better access to the relevant information and therefore can more easily defend against allegations of misconduct, i.e., the so-called “information asymmetry.” Finally, the average length of a civil lawsuit in Italy seriously discourages resorting to the courthouse as a means of protecting minority shareholders. However, even with respect to this instrument for protection of minorities, the 2003 Reform grants significant freedom of contract. Specifically, the charter can raise the threshold of shares that is necessary to bring a derivative lawsuit up to 1/3 of outstanding capital, therefore making it more difficult for minorities to meet the necessary prerequisite. Once again, the level of protection for minorities, in this case the cause of action that might be used to react to breach of fiduciary duties of directors appointed by the majority, is in great part left to the majority itself. As a consequence, while from any perspective this “Italian-style” derivative action seems like a relatively feeble instrument in comparison with its American counterpart, its effectiveness can be further reduced through by-laws.

Article 2395 of the Civil Code establishes that the provisions of the preceding articles regarding the responsibility of the directors towards the company and the creditors of the company do not affect the right to compensation for damages of an individual shareholder who has been directly injured as a result of malice, fraud, or negligence of the directors. The shareholder can bring a suit against the directors to be compensated for damages. This right, though, is granted only to the shareholder who has been directly injured by the directors (for instance, when the shareholder has been illegitimately excluded from a share of the profits). It is not granted to the shareholder who has been indirectly injured, e.g., when the directors damaged the company and therefore only indirectly affected the shareholder’s personal stake (in this case the only way to hold directors liable would be an action against the company under article 2392 of the Civil Code). Article 2395 of the Civil Code constitutes an integration of

116 C.c., supra note 87, at art. 2393-bis.
the general discipline regulating liability in the Civil Code (articles 2043 to 2059). The integration is manifested when the directors have directly caused an injury, through negligence or fraud. The duty of compensation, in addition to the company, weighs on the directors who acted negligently and/or fraudulently. The action must be brought within five years (starting from the date of the action that damaged the shareholder). Both the company and the directors can be held liable. However, article 6 of the Legislative Decree 08.06.2001, n. 231 allows a company to avoid this liability. To avoid liability, first, the company must prove that its organization and management was structured to avoid and prevent such illicit actions before the liable behavior has been committed by the director. Second, the director must have evaded the model of the organization and deceived the company’s management. In strict correlation with this provision, article 2381, section 3 of the Civil Code imposes on the Board of Directors the obligation to evaluate whether or not the company has an adequate organizational, administrative, and accounting structure.

3. Shareholders’ Rights Related to the Board of Statutory Auditors

The board of auditors, in the traditional model of the Italian società per azioni, is composed of three or five members and is elected by the meeting of the shareholders. The board of auditors has the duty to control the lawfulness and efficiency of the company; more specifically, to supervise the observance of the law and the by-laws, and comply with the principles of proper management. In particular, the board of auditors has the power to supervise the adequacy of the organization and the administrative and accounting structure adopted by the company and its functioning (article 2403 of the Civil Code).

Article 2407 of the Civil Code establishes that the auditors shall fulfill their duties with the professionalism and diligence required by the nature of the appointment; they are liable for the truth of their statements, and shall keep secret the facts and documents of which they have knowledge by reason of their office. Auditors are liable both to the company and the creditors of the company for the correct fulfillment of their duties. Auditors are also liable in solido with the directors for acts and omissions of the latter, when the injury would not have occurred if they had exercised vigilance in conformity with the duties of their office.

Auditors of listed companies have further duties and powers. Article 149 of the T.U.I.F. requires them to immediately inform the CONSOB

---

119 C.c., supra note 87, at art. 2395.
120 See Galgano, supra note 112, at 297.
about any irregularities discovered and also to send CONSOB the minutes of the board meetings, the assessments made, and any other documents deemed useful. Auditors, even as individuals, may ask the directors about the state of the company’s management or about other specific matters. They can also call a meeting both of the shareholders and of the directors. Finally, auditors can also report the facts to the court when they discover serious irregularities in the management by the directors in violation of their duties (article 151 of the T.U.I.F.).

Even though minority shareholders are indirectly protected by the board of auditors, as described above, the Civil Code provides some tools that give the minority shareholders the power to protect themselves directly. A mild measure of self-defense for shareholders is provided by article 2408 of the Civil Code. It establishes that any shareholder can file a complaint with the board of auditors concerning facts he deems censurable, and the board of auditors shall take the complaint into account in its report to the meeting. If the complaint is submitted by shareholders representing one-fiftieth of the company’s capital in listed companies, the board of auditors shall investigate, without delay, the facts set forth in the complaint and submit its findings and possible recommendations to the meeting. It must also, in the circumstances referred to in article 2406, convene a meeting of the members. The charter may contemplate, for purposes of the complaint, lower percentages of participation.

A second self-defense mechanism for shareholders is much stronger and more effective than the one described above. Article 2409 of the Civil Code establishes that if there is a basis for suspicion of serious irregularities in the management by the directors in violation of their duties, which may damage the company or one or more of the controlled companies, the shareholders representing one-twentieth of the company’s capital (the by-laws may provide for lower percentages of participation) can report the facts to the tribunal.

The matters that can be reported to the court can be only those related to the correct observance of the law and of the by-laws regulating the directors’ activity, and not to the advantage and opportunity of the director’s activity. Shareholders who report to the court do not bear the burden of proving the effective existence of the serious irregularities. They only need prove the existence of elements constituting a basis for suspicion of serious irregularities. When the court deems that the elements

---

121 Article 2406, second paragraph, of the Civil Code establishes that the Board of Auditors may, subject to communication to the chairman of the Board of Directors, convene the meeting if, in the performance of its duties, it notices censurable serious facts and there is the urgent need to take action.


123 See Galgano, supra note 112, at 316.
produced do not constitute a well-founded basis for suspicion, or considers that there are no elements justifying the serious irregularities required by law, the claim is rejected. Otherwise, the court, after hearing the directors and auditors in chambers, can order an investigation of the company’s management at the expense of the petitioning shareholders, conditioning such investigation, if appropriate, on the posting of a bond (article 2409, paragraph 2). The tribunal does not order the inspection and suspends the proceedings for a period of time if the shareholders’ meeting replaces the directors and auditors with individuals of adequate professionalism, who, without delay, do whatever necessary to verify if the breaches continue and, if so, to eliminate them, reporting to the court on the controls and on the activities performed (article 2409, third paragraph). If the reported irregularities exist or if the controls and activities performed in accordance with the third paragraph of article 2409 are inadequate for their removal, the court can take the appropriate precautionary measures and call a meeting for the purpose of making needed decisions. In the most serious cases, the court can discharge the directors and auditors and appoint a judicial administrator, specifying his powers and the time for which he will hold office (article 2409, fourth paragraph). “In the most serious cases” means situations in which collusion is clearly proved between a majority of the shareholders and the directors, who acted with the conscious tolerance, if not the incitement, of certain shareholders. As a logical consequence, it is reasonable to deem that the appointment of a judicial administrator deprives the shareholders’ meeting of its authority.¹²⁴

However, the two types of shareholders’ meetings described in the fourth paragraph of article 2409 still have significant freedom of action. In fact, if the court simply takes precautionary measures, the shareholders’ meeting maintains all its powers: it can discharge and replace both the directors and the auditors, decide about the distribution of the dividends, approve the final budget, and bring up a suit against the directors. On the other hand, “in the most serious cases” the meeting may still have the powers that are compatible with the appointment of the judicial administrator;¹²⁵ for instance, the meeting could determine the early dissolution of the company and the appointment of the liquidators so as to avoid the proceedings under article 2409.¹²⁶ This option clearly shows that the majority of the shareholders, even in such a situation, have total control of the company, can avoid any kind of personal involvement in the

¹²⁴ Id. at 318.
proceedings against the directors and/or auditors, and can also save the directors and/or auditors that were appointed, all to the detriment of the minority shareholders’ interest.

4. Shareholders’ Right to Information and Inspection

Article 2422 of the Civil Code establishes that shareholders have the right to inspect the books indicated in items 1 and 3 of article 2421 (respectively, the debentures book, the book of the sessions and resolutions of the shareholders’ meeting) and to obtain excerpts at their own expense. The shareholder can exercise her right both directly, by asking for information and inspecting the books, and indirectly, under article 2408 (complaint to board of auditors).

5. External Auditing Firm

The auditing firm, whose role is for the most part established by the T.U.I.F., has two different types of functions: a controlling function and a reporting function. In exercising the first function, the auditing firm must confirm that the accounts of the company are kept lawfully, that the accounts books are correctly describing the economic situation of the company, and that the rules in article 2426 of the Civil Code are complied with (article 155, first paragraph of the T.U.I.F.). In addition, the auditing firm has the power to obtain documents and information from the directors of the company that could be useful for the auditing activity as well as to carry out an inspection of the company’s documents (article 155, second paragraph of the T.U.I.F.).

The reporting function covers four different subjects: the shareholders, the public, the board of auditors, and the CONSOB. Regarding the shareholders, the auditing firm has to deposit reports and opinions about the company at the company’s head office so that the shareholders can examine it before participating in the meetings. Regarding the public, the auditing firm has to deposit the same reports and opinions described above with the minutes of the decisions taken at the shareholders’ meeting at the company’s public registrar’s office. Regarding the board of auditors, the auditing firm must inform the board of facts deemed grave for the company, so that the board, under article 2408, second paragraph of the Civil Code, can immediately investigate these facts and then express its opinions and suggestions regarding it at the shareholders’ meeting. Finally, regarding the

---

127 C.c., supra note 87, at art. 2421.
128 For instance, article 156, fifth paragraph, of the T.U.I.F. states that the report about the balance sheet and the balance sheet itself must remain deposited at the company’s head office during the 15 days preceding the shareholders’ meeting and until the final balance has been approved.
CONSOB, the auditing firm must immediately give notice to the public entity both when it expresses a negative opinion about the final balance or declares itself to be unable to express an opinion about the balance (article 156, paragraph four of the T.U.I.F.).

The auditing firm does not have any direct liability to the shareholders, only to the company, when it exercises its duty of auditing without the ability and attention required by law. The firm can be held liable for failing to discover fraud, subtraction of assets, and other malicious irregularities committed by directors, auditors, and employees of the audited company, only when this failure is caused by its negligence or its lack of auditing capability.129

6. The Right of Withdrawal

One of the most important ways to protect minority shareholders is to grant them an easy exit from the company—the ability to dis-invest at a fair price. One legal device which provides this type of protection is the creation of a right of withdrawal.130 When it is impossible to sell shares on the open market at a reasonable price, minority shareholders only have the choice of rescinding the contract with the corporation and getting the liquidated value of their shares.

When the shareholders decide at a meeting to amend the company’s charter, minority shareholders who do not take part in that decision (because they do not participate in the meeting, abstain from voting, or do not agree with the decision) have the right of withdrawal for all or part of their shares. Minority shareholders have this right granted when the amendments to the charter are significant and important, i.e., in general, when the level of risk that lead the shareholders to invest in the company has substantially changed.131

Article 2347 of the Civil Code lists the events which give rise to the right of withdrawal, including resolutions that modify shareholders’ administrative or economic rights, revoke the liquidation of the company, and amend the criteria to evaluate shares applicable in case of withdrawal. In addition to these events, article 131 of the T.U.I.F. establishes that shareholders can exercise their right of withdrawal in the case of a corporate merger if, as a consequence of the transaction, shareholders holding listed

130 See Ventruruzzo, supra note 84, at 35.
131 For instance, art. 2347, ¶ 1(a) of the Civil Code allows the right of withdrawal when a significant change in the company’s activity has been decided (for example, if a company shifts from the production of automobiles to the production of shoes).
shares would become owners of non-listed shares.\textsuperscript{132} No additional bases for withdrawal can be provided in the charter. The right of withdrawal is a unilateral act of the shareholder and does not require any acceptance by the company. The average share market price over the last six months is the value that withdrawing shareholders will receive for their shares.\textsuperscript{133}

7. Groups of Companies and the Liability of the Controlling Stockholder

Large- and medium-sized enterprises typically structure their organizations as a group of companies. When an enterprise reaches a substantial size, because of its activity in various and different markets, it is advantageous to organize the enterprise as a group of companies under the control and management of a holding company.\textsuperscript{134} The larger the enterprise, the more extensive the markets in which the company finds itself, and the more numerous the shareholders.

Article 2497 of the Civil Code establishes that a holding company (or its controlling shareholder) can be held liable to minority shareholders or creditors of the company if the holding company caused damage through mismanagement of the controlled companies. The rule, introduced by the 2003 Reform, cannot be considered a decisive remedy principally because of the conditions that must be met to bring a suit and the burden of proof on the minority shareholders (or creditors). First, the rule applies only in cases of "direction and coordination"\textsuperscript{135} of companies by a controlling shareholder or holding company. The meaning of this term is ambiguous. In fact, in a case of control through shared ownership there is a presumption that the controlling shareholder or holding company accomplishes "direction and coordination" of the controlled companies. But this presumption can be easily overcome by proving that the shareholder (presumably the controlling shareholder) has a "passive role" with regard to the group. In addition, the rule does not apply when the controlling shareholder is an individual; it applies only when the controlling shareholder is a company or a legal entity.\textsuperscript{136} The burden of proof on the

\textsuperscript{132} See Notari M., Comment to Article 131, in La Disciplina delle Società Quotate nel Testo Unico della Finanza, at 1101 (P. Marchetti & L.A. Bianchi eds., 1999).
\textsuperscript{133} See C.c., supra note 87, at art. 2347.
\textsuperscript{134} See Galgano, supra note 112, at 164 (stating that 50% of the Italian companies with not less than 50 employees are part of a companies group, and that almost all Italian companies with not less than 1000 employees are part of a group. Stating, also, that belong to a companies group are 90% of the Japanese companies, 70% of the German companies, 65% of the U.S. companies, 60% of the French companies, 55% of the British companies, and 50% of all Swiss companies).
\textsuperscript{135} C.c., supra note 87, at art. 2497.
\textsuperscript{136} Ventoruzzo notes that "as a consequence, many groups in which a large number of corporations are controlled by one single individual, a situation that is often a prelude to
shareholders of a controlled company presents a substantial obstacle to success in a claim against the controlling shareholder or holding company. To satisfy this burden, the plaintiff must prove that: (a) the controlling shareholder or holding company was “acting in the entrepreneurial personal interest or in the interest of other subjects,”137 (b) the “principles of good management” were violated, and (c) the action caused “damage to the profitability or value of the shares.”138 None of these elements are clearly defined by the Civil Code. It is difficult to precisely delineate the concepts of “principles of good management” and “entrepreneurial interest.”139 In addition, Article 2497 makes recovery difficult by putting a limit on the controlling shareholder or holding company’s liability when the damage caused is counterbalanced by some advantage to the group, the so-called “theory of compared benefits.”140 Moreover, shareholders of a controlled company may be discouraged from bringing a suit against a controlling shareholder or holding company because the Italian legal system does not allow for contingency fees and is characterized by the “loser pays” rule. This rule, together with the “information asymmetry” between the parties inherent in this type of lawsuit, clearly puts a shareholder of the controlled company in a weak position and therefore is a convincing disincentive to go

misappropriation of assets of controlled corporations” are not subject to article 2497 and highlighting that Article 2497, second paragraph,

provides for joint and several liability against whoever takes part in causing the damage or whoever knowingly took advantage of it, for up to the amount of the benefit received. Through this rule, individuals who intentionally participate in or take advantage of control might be held liable, but the subject who exercises direction and coordination must in any case be a legal entity.

See Ventoruzzo, supra note 84, at 46.

137 C.c., supra note 87, at art. 2497.

138 Id.

139 See Ventoruzzo, supra note 84, at 46.

140 See Montalenti, Conflitto d’Interesse nei Gruppi di Società e Teoria dei Vantaggi Compensativi, Giurisprudenza Commentata, at 710 (1995). See also Ventoruzzo, supra note 84, at 47 (giving the following example: “[I]f the holding company requires the controlled corporation to purchase goods at an inflated price, but also assists the controlled corporation in selling its own products at a higher price, the damage would be deemed to be offset and no liability would result.” Also,

[w]hile this limitation of liability seems logical in such a simplistic example, it is easy to imagine how any degree of complexity can make application of rule uncertain, and the burden of the proof unbearable for minority investors who, by definition, suffer from an information asymmetry (in particular in a system that does not have procedural discovery mechanisms). These circumstance [sic] provide obvious advantages for the controlling shareholder.

Id. at 47.
before a court and bear the risks of a trial.

D. The Role of the CONSOB—The Italian SEC

CONSOB\(^{141}\) is a governmental authority given the power to control the activities of all entities operating in financial markets (banks, investment firms, brokers, dealers, and agents). Its role includes ensuring observance of the law by the companies managing financial markets and monitoring the conduct of the companies issuing financial products. The rules governing CONSOB’s powers are mainly described in the T.U.I.F. The main purpose of CONSOB is to protect investors as well as to maintain transparency and efficiency of financial markets.

The supervisory controls over the issuing companies start before they are listed on the market. In fact, CONSOB controls the content of the listing prospectus and can authorize its publication.\(^{142}\) After the issuing companies have been listed, all communications from the companies to the public that contain important facts are supervised by CONSOB, which has the power to ask the issuing companies to disclose specific information and documents deemed necessary in order to properly inform the public. If the issuing company does not comply with this request, CONSOB can replace the company in disseminating this information.\(^{143}\) In fact, article 115 of the T.U.I.F. empowers CONSOB to verify whether the information given to the public by the issuing companies is true.\(^{144}\) To accomplish this, CONSOB can solicit information and documents from the issuing company and its controllers.\(^{145}\) Moreover, CONSOB can inspect the issuing company’s premises, as well the controlling company’s premises.\(^{146}\) Even auditing firms are under the supervision of CONSOB in order to guarantee their independence and technical skills.\(^{147}\) CONSOB can ask the auditing firm to communicate information, data, and documents,\(^{148}\) and can inspect the auditing firm’s premises and directly request information from firm shareholders and directors.\(^{149}\) In the case of a violation of the disclosure obligations, as well as communication to the public and CONSOB (articles 113, 114, and 115 of the T.U.I.F.), article 193 of the T.U.I.F. allows a monetary administrative sanction (from a minimum amount of €5,000 to a

\(^{141}\) CONSOB is an acronym for Commissione Nazionale per le Società e la Borsa, i.e. National Committee for the Companies and the Financial Market.

\(^{142}\) T.U.I.F, supra note 41, at art. 113, ¶ 2(a).

\(^{143}\) Id. at art. 114.

\(^{144}\) Id. at art. 115, ¶ 1.

\(^{145}\) Id. at art. 115, ¶¶ 1(a)–(b).

\(^{146}\) Id. at art. 115, ¶ 1(c).

\(^{147}\) Id. at art. 162.

\(^{148}\) T.U.I.F, supra note 41, at art. 162, ¶ 2(a).

\(^{149}\) Id. at art. 162, ¶ 2(b).
maximum amount of €100,000) for whoever exercises management, control, or directive activities. Solicitation activity without CONSOB authorization or the required communication (e.g., the listing prospectus) is also punishable by monetary administrative sanction (from a minimum of €5,000 to a maximum of €100,000).

IV. PROTECTION OF LISTED COMPANY MINORITY SHAREHOLDERS IN THE U.S. SYSTEM

A. The Instruments Offered by U.S. Corporate Law to Protect Minority Shareholders

Minority shareholders have an important role in the governance of a corporation. The influence of a minority shareholder may vary according to the type and size of the corporation. For instance, one distinguishing factor is whether the corporation is closely or publicly held. Although issues of corporate governance generally arise more frequently in publicly traded companies, minority shareholders' rights and actions are pertinent primarily in the context of closely held corporations. Thus, a public company may struggle with the fiduciary duties associated with the rights of minority shareholders, while a closely held corporation may find itself dealing more with issues of corporate governance. Publicly traded companies tend to eliminate preemptive rights or cumulative voting provisions when the implementation of these legal mechanisms depends upon the discretion of the corporation. Eliminating preemptive rights significantly impairs the rights of minority shareholders because it leaves them without economic protection and active participation in the business. However, other legal instruments for minority shareholders remain, such as shareholders’ agreements. Furthermore, the possibility of minority shareholder suits may pose a threat to corporations, especially those that are publicly held. Thus, the rights of the minority and the duties owed to them by directors may differ between a public company and a closely held one. Minority shareholders, however, are present in both entities and equally important in

150 Id. at art. 193, ¶ 1.
151 Id. at art. 191, ¶¶ 1–2.
the control of the company. Status as a minority shareholder confers certain legal rights that protect their role in the battle over company control.

1. Minority Shareholders and Oppression.

A minority shareholder is a shareholder who does not have the ability to elect a majority of the board of directors or has little power in the corporation. This definition, however, seems flawed because minority shareholders can exercise some control and even defeat the majority in certain circumstances. Thus, a complete analysis of minority shareholder status must include the examination of both the ability to control voting stock and the percentage of ownership. Because the minority shareholder has some control, the minority may disagree with the majority over certain business decisions. When a conflict arises, the majority may not wish to have any further confrontation with the minority by diluting, if not eliminating, the tangible and intangible value of the minority interest. The majority most commonly achieves the dilution of the minority interest through oppression.

a. Squeeze-Outs and Freeze-Outs

The weak position of minority shareholders in some corporations subjects them to the oppression of controlling shareholders and directors. The minority shareholders may become an obstacle for the majority in controlling the company if, for example, the minority vote is required to approve a corporate transaction or if the minority has the right to request periodic dividends. This nuisance, if not a real impediment, can lead majority shareholders and directors to utilize oppressive measures, such as withholding dividends or diluting shares. Such actions, known as freeze-outs and squeeze-outs respectively, allow controlling groups to exploit and remove minority shareholders. Minority shareholders hold special rights, however, that guard against these tactics. These rights originate from the fiduciary duties imposed on the majority shareholders, the corporation’s management, and the board of directors for the benefit of the minority shareholder.

There are three forms of freeze-out actions: management buyouts, short form mergers, and reverse stock splits.

---

154 See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 516–18 (Mass. 1975) (finding that minority shareholders may sue majority shareholders when they do not act with the “utmost good faith and loyalty”).

155 See O’Neal, supra note 152, at vol. 1, ch. 3, § 3:02, at 3 (listing a refusal to declare dividends as a common tactic to exclude minority shareholders); id. at vol. 1, ch. 3, § 3:20, at 191–92 (stating that the issuance of new stock and control over the disposition of that stock is another way to diminish a minority shareholder’s power).

156 See id. at vol. 1, ch. 3, § 3:02, at 3 (describing various oppressive techniques).
b. Management Buyout

A management buyout is the purchase of a target company by a newly-formed company comprising the target's old management and new partners as equity holders. 157 The old management and new partners use the new company to buy the old company, which is the target of the merger. Management has an incentive to make the merger succeed to the detriment of the old company. 158 This merger raises questions of self-dealing and fairness because majority shareholders buy their old company along with the minority's interest.

c. Short-Form Mergers

Short-form mergers allow a parent-subsidiary merger with a cash payout to minority shareholders of the subsidiary. 159 The potential problem presented by such a transaction is that when the subsidiary is merged, no shareholder vote is required. 160 In the parent corporation, shareholders do not have dissenter’s rights, such as appraisal and cash out options. 161 To avoid this result, several states now follow the Model Business Corporations Act ("MBCA") which allows a short-form merger only when the parent owns at least ninety percent of the subsidiary’s shares. Minority shareholders can be cashed out or seek appraisal. 162

d. Reverse Stock Splits

A reverse stock split merges shares into smaller units. After the split, shareholders owning less than a full share may be cashed out. 163 The corporation can create fractions small enough to insure the cashing out of all minority shareholders. 164 To avoid fractional problems, cash payouts are allowed by statute. 165 Insiders can use these laws to effectuate a freeze-out.

158 See id. § 23.02, at 639 (indicating that the target company’s management holds the responsibility for its merger into the new company).
160 See COX, supra note 157, § 22.12, at 611 (exposing a potential danger of the short-form merger).
161 Id. (placing shareholders of the parent in a disadvantageous position due to a diminution of their shareholder’s rights).
162 Id. at 612.
163 See O’NEAL, supra note 152, § 5:11, at 73 (stating the effect that a reverse stock split may have).
164 Id. (explaining the potential extreme consequences of a reverse stock split).
165 Id. (promoting corporate convenience by enabling the corporation to squeeze out minority shareholders).
Many states have enacted statutes to prevent reverse stock splits without a minimum percentage of shareholder approval.\(^{166}\)

2. Nature of the Fiduciary Duties Owed to the Minority Shareholders in Public and Private Companies: Duty of Care, Duty of Loyalty, and Duty of Good Faith and Fair Dealing

The fiduciary duties owed by controlling shareholders and directors to minority shareholders are one of the forms of granting protection to minority shareholders in a corporation. These duties impose an obligation upon majority shareholders and directors to act in good faith concerning the corporate affairs of the company. This obligation includes the promotion of corporate and shareholder interests above personal individual interests.\(^ {167}\)

The traditional principle of fiduciary duties owed to minority shareholders derives from the United States Supreme Court’s opinion in \textit{Southern Pacific Co. v. Bogert}.\(^ {168}\) The border separating duties owed to the corporation and those owed to shareholders by directors and officers is relatively difficult to discern. Traditional wisdom dictates that management serves the interests of the corporation by maximizing shareholder wealth.\(^ {169}\) Thus, directors should try to maximize shareholder value, which seems to imply a duty both to the corporation and to the shareholders.

\textbf{a. Duty of Care}

One facet of fiduciary duty is the duty of care that corporate actors may owe one another. Directors owe a duty of care to the corporation when exercising their managerial powers.\(^ {170}\) The duty of care is a standard of conduct that directors must follow. A non-statutory principle, known as the business judgment rule,\(^ {171}\) establishes the standard for imposing liability on

\(^{166}\) \textit{See CLARK, supra} note 159, § 12.1, at 503 (noting that insiders can use the “‘cash in lieu of fractional shares’ provisions to effect freeze-outs”).

\(^{167}\) \textit{See COX, supra} note 157, § 11.11, at 253 (suggesting that controlling shareholders owe the same duties as the directors and that self-dealing may be permissible if it also serves corporate objectives).

\(^{168}\) \textit{Southern Pacific Co. v. Bogert}, 250 U.S. 483, 487–88 (1919) (“The majority has the right to control; but when it does so, it occupies a fiduciary duty toward the minority; as much so as the corporation itself or its officers or directors.”)


\(^{170}\) \textit{See COX, supra} note 157, § 10.2, at 186 (describing broadly a director’s duty of care).

\(^{171}\) \textit{Id.} § 10.3, at 190 (noting that the business judgment rule was formulated by courts long before the creation of statutory duties). The business judgment rule is based upon the understanding that directors may make corporate decisions without being held liable when they are pursuing a legitimate business purpose that is within the scope of their authority. \textit{Id.} § 10.01, at 185 (stating that the applicability of the business judgment rule has limits).
directors for failing to exercise due care. The business judgment rule primarily addresses the care with which directors make decisions. The business judgment rule’s interaction with the duty of care is illustrated in Smith v. Van Gorkom. In essence, the business judgment rule establishes a presumption that the officers and directors have met the duty of care. Minority shareholders may challenge the duty of care taken on behalf of the corporation or through a receiver appointed following the financial collapse of the corporation. With respect to the dynamics of corporate governance, the duty of care represents an instrument of protection and, at the same time, of control. Shareholders possess dual interests: their economic investment and their level of active participation in the business. Fiduciary duties, including the duty of care, significantly assist minority shareholders in protecting their interests and exerting corporate control. Protection of these minority interests and enforcement of fiduciary duties reflects a necessary check on the exercise of power by the controlling director. Should a director violate his duties, a minority shareholder may bring a derivative suit to hold the director liable for actions in violation of the duty of care. Courts, however, are reluctant to ascertain whether directors acted in the best interests of a corporation, acknowledging that

Therefore, the rule is the counterweight to the duty of care. The line between these two principles is not well settled. See id. § 10.01, at 190 (deciding that courts must allow some business discretion in determining director negligence).

See id. § 10.01, at 184 (stating that “directors are not liable for losses due to imprudence or honest errors”).

See id. § 10.01, at 185 (suggesting courts will not second guess business decisions and will presume reasonable care and diligence in making those decisions).

Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (The directors approved a merger agreement, but they did not fully inform the shareholders, or themselves, of all material facts. The court determined that the proper standard of review under the business judgment rule was gross negligence. The opinion concluded that the actions of the board of directors were grossly negligent. Therefore, the board breached its fiduciary duty, warranting a determination of the damages to be assessed personally against the directors).

See Cox, supra note 157, § 10.2, at 187 (noting that the imposition of the duty of care encourages responsible management and ensures few transgressions).

Id § 13.1, at 328 (including rights to share in profits and rights of management control among the classes of rights owed to shareholders).

Id § 15.1, at 419 (calling shareholder derivative suits the main remedy minority shareholders can use to hold directors responsible for corporate mismanagement).

See Kamin v. American Express Co., 383 N.Y.S.2d 807, 812 (N.Y. Sup. Ct. 1976) (advocating the business judgment rule by saying that “the directors’ room rather than the courtroom is the appropriate forum for thrashing out purely business questions... [and] substitution of someone else’s business judgment for that of the directors is no business for any court to follow.”) But see Brane v. Roth, 590 N.E.2d 587, 592 (Ind. Ct. App. 1992) (holding that the business judgment rule does not shield the directors from liability when there is a breach of fiduciary duties. A finding of gross negligence by the directors is not necessary to hold them liable).
the "business and affairs of a corporation are managed by a board of directors not by a panel of judges."\(^ {179} \) In spite of this general reluctance by the courts, the threat alone of legal liability suffices as a remedy by persuading, if not compelling, directors to comply with the duties imposed upon them.

b. Duty of Loyalty

Under the duty of loyalty, directors can be accused of a conflict of interest for receiving a personal benefit from a business decision.\(^ {180} \) The duty of loyalty attempts to prevent any corruption and personal profit that may arise from self-dealing to the detriment of shareholders.\(^ {181} \) Self-dealing involves a transaction where a director may benefit personally from corporate action.\(^ {182} \) If the transaction is fair to the corporation,\(^ {183} \) no violation of the duty of care arises. The basic principle of fairness explains the intersection between the duty of loyalty, the duty of care, and the concepts of good faith and fair dealing.\(^ {184} \) Courts will likely look at the fairness, purpose, and intent of director and shareholder actions to determine whether they have violated a fiduciary duty owed to the minority shareholders.\(^ {185} \) Fiduciary duties implicate not only the director's duties owed to the corporation's shareholders, but also a duty of good faith and fair dealing.

c. Duty of Good Faith and Fair Dealing

The landmark case of *Weinberger v. UOP, Inc.*\(^ {186} \) indicated fair

---

\(^ {179} \) Jay P. Moran, *Business Judgment Rule or Relic?: CEDE v. Technicolor and the Continuing Metamorphosis of Director Duty of Care*, 45 EMORY L.J. 339 (1996) (noting that the business judgment rule recognizes the voluntary risk that a bad management decision may be undertaken and that judges are not directors).

\(^ {180} \) See *Cox*, *supra* note 157, § 10.09, at 204 (suggesting that the duty of loyalty is the motive behind a director's corporate action).

\(^ {181} \) See Arthur R. Pinto, *Corporate Governance: Monitoring the Board of Directors in American Corporations*, 46 AM. J. COMP. L. 317, 332 (1998) (stating that under a duty of loyalty directors can be held liable for a conflict of interest for receiving any personal benefit from a business director).

\(^ {182} \) See *CLARK*, *supra* note 159, § 4.1, at 142–43 (providing an example of how a director may become involved in self-dealing).

\(^ {183} \) *Id.* § 4.1, at 168–69 (allowing a self-dealing transaction to stand if it is fair to the corporation).

\(^ {184} \) *Id.* (acknowledging that good faith and fair dealing are components of the duty of loyalty).

\(^ {185} \) See *O'Neal*, *supra* note 152, § 7:03, at 11–12 (2003) (examining the components of corporate fiduciary duty).

\(^ {186} \) Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
dealing as a basic component of fairness. Good faith and fair dealing appear to be imprecise concepts and, as such, require fact-intensive analyses that have resulted in less than uniform case law. Several opinions, however, have addressed the fiduciary duties that directors owe to a corporation and its shareholders, as well as the right to fairness and general standards of treatment and fair dealing within a corporation. Burt v. Burt Boiler Works, Inc., and Coleman v. Taub, demonstrate that directors and controlling shareholders must consider minority interests and participation with respect to fair dealing and good faith, as well as other fiduciary duties.

B. Minority Shareholders Rights Under United States Law

Examining the role of the minority shareholders in the governance of a company reveals the protection afforded to them. These protections include investment rights, profit rights, corporate affairs rights, shareholder agreements, and derivative actions, all of which were created either as a means of protection or as a corporate weapon. In fact, these rights enable shareholders to advance their interest in a corporation and can sometimes become powerful weapons in the hand of minority shareholders.

I. Preemptive Rights

A preemptive right is the right of a shareholder to participate in capital increases of a corporation to the extent of his ownership of shares. Essentially, this right provides a shareholder with the option to purchase a share of new stock issued by the corporation and maintain his proportionate ownership interest in the firm. Thus, when a corporation offers new stock for the purpose of increasing its capital, the shareholders are entitled to opt for the acquisition of shares pursuant to their corresponding holdings before any third party interested in the venture may purchase new stock.

II. Share of Profits

The right to a share of the company's profits is another important right afforded to shareholders. A business corporation is organized and carried on

---

187 Id. at 711 (explaining fair dealing in the context of a merger and buyout of minority shares).
190 See COX, supra note 157, § 16.14, at 496-497 (stating that preemptive rights allow a shareholder to participate ratably in new issues of shares).
191 See CLARK, supra note 159, § 17.1.4, at 719 (explaining preemptive rights as an option for shareholders to maintain their interest by buying an equal percentage of new shares offered).
192 See COX, supra note 157, § 16.14, at 497 (noting that preemptive rights of existing shareholders are optional or void in most states).
primarily for the profit of the owners, i.e., the shareholders. Directors should utilize their powers to that end. Regardless of whether directors owe only fiduciary duties to shareholders or whether the directors’ only objective should be to maximize shareholders’ wealth, shareholders possess the right to receive the profits of their investment. Therefore, directors are obligated to make distributions to shareholders whenever it is in the best interests of the corporation.

3. Corporate Governance Rights

Share ownership empowers a shareholder to participate in the business and the affairs of a company. The most remarkable rights of a shareholder in connection with his ownership are voting rights. As a general rule, each outstanding share owned by a shareholder entitles him to one vote on each matter proposed at the shareholders’ meeting. Matters subject to the vote and approval of the shareholders include the election of directors, corporate transactions, and amendments to the articles of incorporation.

A shareholder’s main source of corporate control is his right to elect representatives to the board of directors. A minority shareholder or a group of minority shareholders who elect one or more members of the board of directors holds an advantageous position in the control of the company. Because corporations are run by directors, having representation on the board ensures that the directors and controlling shareholders will pay attention to the minority’s interests.

Section 7.28(a) of the MBCA provides that the directors win an election by a plurality of the votes, which may only be cast by the holders of shares entitled to vote in the election, at a meeting where a quorum exists, unless otherwise provided in the articles of incorporation. The approach of the MBCA in this section is known as straight voting, a system of voting that entitles a shareholder to cast one vote per share for

---

193 Id. at 328 (defining a “share of stock” as a profit-sharing contract that allows the right to participate in dividend distributions).
194 Id. § 13.1, at 328 (stating that the first class of shareholder rights, which centers on control and management, includes voting rights).
195 See Model Bus. Corp. Act § 7.21(a) (1984) (amended 1987) (providing that (i) except as provided by such Act or “unless the articles of incorporation provide otherwise, each outstanding share, regardless of class, is entitled to one vote on each proposition voted on at a shareholders’ meeting”; and (ii) only shares are entitled to vote).
196 See Cox, supra note 157, § 13.1, at 328 (listing the right to elect directors as a first-class right in a shareholder’s control and management).
198 Id. § 7.28(b) (denying the right to cumulative voting, unless it is provided in a corporation’s articles of incorporation).
each position on the board of directors. Under such a system, holders of a bare majority of voting shares have the ability to elect the corporation's entire board of directors. As a consequence, minority shareholders cannot obtain the amount of votes necessary to elect a director. Two methods, however, attempt to insure representation of the minority on the board: cumulative voting and voting agreements. Both methods demonstrate the effectiveness of statutory devices in safeguarding a role for the minority in corporate governance.

MBCA section 7.28(c) provides for the possibility of cumulative voting for directors. This means that the designated shareholders may multiply the number of votes that they are entitled to by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates. The election of corporate directors through cumulative voting is designed to grant representation on the board of directors to minority shareholders owning a substantial number of shares. It enables minority shareholders to monitor and report the actions of directors elected by majority interests. Cumulative voting provisions are corporate governance provisions because they give control to the minority, thereby affecting the governance of the company. The extent of this control depends on several factors: (i) the number of directors on the board; (ii) the use of other mechanisms to advance the interests of the minority, such as shareholders' agreements or preemptive rights; and (iii) the attendance and voting quorums set forth in the bylaws of the corporation. Although cumulative voting is not mandatory under many state statutes, in those jurisdictions where cumulative voting is required or for those corporations that choose to opt-in, cumulative voting can be considered an effective device for minority

199 See Cox, supra note 157, § 13.16, at 348 (defining straight voting as “casting votes according to the number of shares held for each vacancy”).

200 See ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 435 (6th ed. 1998) (providing an example of how straight voting may allow a majority shareholder to elect the entire board of directors).

201 See Cox, supra note 157, § 13.16, at 349 (explaining that the policy goal of cumulative voting is to provide the minority a greater chance of obtaining representation on the board).


203 See Cox, supra note 157, § 13.16, at 349–50 (observing that the usefulness of cumulative voting resides in the concentration of shares in the hands of a few that represent a large portion of the outstanding shares).

204 Id. § 13.16, at 350 (emphasizing that the “aim of cumulative voting is to allow a minority to secure representation on the board of directors.”)

205 Id. § 13.16, at 349 (describing the aim of cumulative voting and how, without it, minority shareholders would have no representation and no power over corporate affairs).
shareholders to participate in corporate governance.

Shareholders may also join forces to elect directors and gain power in the control and management of the company. Voting agreements gained legitimacy in Brightman v. Bates. A group of shareholders agreed to vote their shares in a certain way. Several minority shareholders objected, but the court allowed the agreement, stating that "[i]t is as legitimate for a majority of stockholders to combine as for other people." Following that judicial rule, MBCA section 7.31 established an additional mechanism to ensure minority representation on the board of directors—the voting agreement. MBCA section 7.31 also allows two or more shareholders to provide for the manner in which they will vote their shares by signing an agreement to that effect, which will be recognized as specifically enforceable.

Shareholders’ meetings involve more than decisions concerning the election of the board of directors. The real computation of power relies upon the value of the shareholder’s vote. Value must be determined in light of meeting attendance measured against the quorum requirements set forth in both statutes and the bylaws of a corporation. The higher the quorum requirement, the greater the chances for the minority to influence the outcome of the shareholder meetings and affect the adoption of certain resolutions. However, in the case of a disagreement, where the majority generally has the power to decide what it considers suitable, quorum requirements may demand the casting of minority shareholder votes. Therefore, statutory provisions that intend to promote or impede minority governance establish voting quorums correlative to the nature of the matters before a meeting. Matters concerning fundamental changes to the structure of a corporation, such as mergers or sales of assets, are subject to a greater quorum so that a minority vote is required to effect such major

207 Id. (reviewing the formation of the agreement).
208 Id. (concluding that any corporate shareholder may enter into a voting agreement).
210 Id. (explaining that an agreement under section 7.31 is not subject to the voting trust provisions of section 7.30). Id. §7.32(b)(1) (emphasizing that all shareholders must have knowledge of the agreement).
211 See CLARK, supra note 159, § 9.1.4, at 366 (addressing shareholders’ votes).
212 See O’NEAL, supra note 152, § 9:08, at 19 (stating that high voting requirements may be one of the most effective ways of protecting minority shareholders from squeeze-outs).
213 See COX, supra note 157, § 13.13, at 344 (exploring how various state laws can allow for varying percentages of a quorum and a vote, any of which could benefit or harm the minority shareholder).
214 Id. (stating that the vote required is only of those shares present, not the total of outstanding shares).
changes.\textsuperscript{215}

4. Appraisal Rights

The risk of oppression of minority shareholders’ rights because of mergers\textsuperscript{216} and certain other fundamental corporate changes are tempered by statutes, often referred to as “appraisal statutes” or “dissenters’ rights statutes.” These statutes empower a shareholder who dissents from such a transaction to demand that the corporation purchase her shares at a fair price.\textsuperscript{217} “Dissenters’ rights statutes are designed to protect non-assenting shareholders against being forced to accept membership in an enterprise fundamentally different from the one in which they originally invested or to participate on a basis drastically different from the one they contemplated when they invested.”\textsuperscript{218} The right to dissent or appraisal allows a minority shareholder to disagree with the decision made by the majority, abstain from continuing any further corporate activity, and obtain the fair value of his shares.\textsuperscript{219} Thus, appraisal rights give minority shareholders a “way out” when disagreeing with the corporate management.

In general, the MBCA offers dissenter appraisal rights for any situation

\textsuperscript{215} Id. (noting that in some states this quorum can be two-thirds).

\textsuperscript{216} See CLARK, supra note 159, § 12.1, at 501 (asserting that mergers can be referred to as cash-out mergers, which implies that there is a cash payment to some of the shareholders of a corporation in exchange for their shares, instead of an issuance of new shares as a result of the merger). It is also relevant to address the concept of freeze-out mergers, in which a minority shareholder is forced to accept cash or debt securities for his or her shares rather than stock in the surviving corporation. See Id. § 12.1, at 499–500 (denoting that the inevitable effect of a freeze-out is that common shareholders are regarded as holders of redeemable preferred stock).

\textsuperscript{217} See O’NEAL, supra note 152, § 5:29, at 5-201 (noting that appraisal statutes attempt to provide relief to the dissenting shareholder).

\textsuperscript{218} Id. (explaining that appraisal statutes are a legislative creation designed to blunt the harsh effects of common law rules requiring unanimous shareholder consent for fundamental changes to the corporation).

\textsuperscript{219} See Barry M. Wertheimer, The Purpose of the Shareholders’ Appraisal Remedy, 65 TENN. L. REV. 661, 666 (1998) (characterizing as “standard corporate law dogma” the notion that the appraisal remedy was granted to shareholders in exchange for the loss of the right to veto fundamental changes to the corporate structure). This right is a shareholders’ appraisal remedy and it has been noted to have the following purposes: (i) to serve as a “quid pro quo” for the loss of the right to veto fundamental transactions; (ii) to provide liquidity to keep shareholders from being locked into an investment in a corporation that has been fundamentally changed; (iii) to remedy a potential constitutional problem with statutes that permit a majority of shareholders to decide whether to engage in a fundamental transaction; (iv) to free the majority from the “tyranny of the minority;” (v) to relieve shareholders from concerns arising out of coordination problems or problems associated with the appropriation of corporate value by insiders; (vi) to serve as a check on corporate managers; and (vii) to ensure that shareholders whose investments are terminated by a cash out merger receive fair value for their shares.
in which the majority shareholders effect a fundamental change in the corporation, such as an amendment to the articles of incorporation or a major corporate transaction.\textsuperscript{220} Section 13.02 of the MBCA provides that a shareholder is afforded the opportunity to dissent to a merger proposal and receive the fair value of the shares if the merger is consummated.\textsuperscript{221} Dissenting shareholders may seek appraisal rights in the following corporate transactions: a consummation of a share-exchange plan where the corporation is the target; a sale or exchange of all, or substantially all, of the assets of the corporation other than in the ordinary course of business;\textsuperscript{222} a material amendment to the articles of incorporation that negatively affects a dissenting shareholder’s rights;\textsuperscript{223} or any action taken by the corporation in response to a shareholder vote for which shareholders have the right to dissent and obtain payment for their shares.\textsuperscript{224} Sections 13.20 through 13.28 of the MBCA direct shareholders to exercise appraisal rights before resorting to the courts. The procedure to do so is explained in the official comment following each section. The MBCA contemplates a judicial appraisal of shares in sections 13.30 and 13.31. A judicial appraisal results upon a failure to reach a settlement as to the payment of the value of the shares between the controlling and dissenting shareholders.\textsuperscript{225}

\begin{itemize}
  \item[a.] Lack of Adequate Protection for Minority Shareholders Through Appraisal Rights

Dissenters’ rights present two major gaps in the protection offered to shareholders. First, dissenter’s rights are triggered by only a limited number of transactions that affect fundamental changes in a minority shareholder’s rights.\textsuperscript{226} Second, these disputed transactions represent only a few of the possible transactions that can drastically restructure a company or


\textsuperscript{221} Id. § 13.02(a)(1). In cases where shareholder approval is required for the merger pursuant to MBCA section 11.03 or if the corporation is a subsidiary that has merged with its parent under MBCA section 11.04 or the articles of incorporation, a shareholder is entitled to vote on the merger.

\textsuperscript{222} Id. § 13.02(a)(3) (providing that sales as a result of a court order or for cash, as part of a plan whereby the net proceeds are distributed to shareholders up to one year following the date of sale, are not included under this provision).

\textsuperscript{223} Id. § 13.02(a)(4) (explaining that amendments affect dissenters’ shares by altering, abolishing, or creating rights, and excluding or limiting voting capabilities).

\textsuperscript{224} Id. § 13.02 (addressing the situations where a shareholder may disagree and refund its shares for cash).

\textsuperscript{225} See O’Neal, supra note 152, § 5:29, at 5-201 (explaining that statutes allow appraisal when the corporation and shareholder cannot agree on a reasonable price).

\textsuperscript{226} See Cox, supra note 157, § 22.18, at 617–19 (establishing which actions allow dissenting shareholders the appraisal remedy).
fundamentally change a shareholder’s rights.\textsuperscript{227} The majority can often utilize a type of transaction that does not trigger dissenters’ rights to achieve a corporate restructuring that if attempted differently would give a dissenting minority shareholder the opportunity to have his shares purchased. The laws governing these transactions appear to have the effect of offering more protection to the majority than to the minority.\textsuperscript{228} In fact, corporation statutes make as few concessions as possible to dissenting shareholders\textsuperscript{229} and only provide appraisal rights for fundamental changes.\textsuperscript{230} For instance, under Delaware law appraisal rights exist for mergers or consolidations but not for the sale of assets or amendments to the corporate charter.\textsuperscript{231} Therefore, controlling shareholders can easily structure a transaction to avoid triggering appraisal rights.\textsuperscript{232} Just as in the case of buy-sell agreements,\textsuperscript{233} dissenters’ rights give a “way out” to the minority when its interests conflict with those of the majority or the business no longer fulfills its expectations.\textsuperscript{234}

5. Derivative Actions

A derivative action is a lawsuit filed against a wrongdoer whose actions have caused harm to the corporation. The plaintiff shareholder has suffered no specific harm due to the wrongdoer’s actions, but has seen his or her investment decline in value because of the harm to the corporation. The corporation is the real party in interest in a derivative case. This right, the so-called derivative suit, is triggered when management takes an action that may injure the company and, indirectly, the shareholders. Shareholder derivative suits are the main remedy by which “defrauded minority shareholders may call directors, officers, promoters, and controlling shareholders to account for mismanagement, diversion of assets, and

\begin{itemize}
\item \textsuperscript{227} Id. § 22.19, at 619 (stating that appraisal rights exist for fundamental changes, sales of certain assets, and amendments affecting shareholder rights).
\item \textsuperscript{228} Id. at 621 (contrasting the theory and reality of the statutory appraisal remedy).
\item \textsuperscript{229} Id. (suggesting that the intent of appraisal statutes is to avoid interference and obstruction from minority shareholders acting in bad faith).
\item \textsuperscript{230} Id. at 619 (indicating that states generally allow appraisal rights for “certain fundamental changes”).
\item \textsuperscript{232} See COX, supra note 157, § 22.20, at 624 (showing how the majority may avoid appraisal rights altogether by leaving substantial assets in the corporation).
\item \textsuperscript{233} See Stephenson v. Drever, 947 P.2d 1301, 1302 (Cal. 1997) (stating that a typical buy-sell agreement provides for the mandatory or optional repurchase of a shareholder’s shares by the corporation or by the other shareholders upon the occurrence of a certain event, such as the termination of employment).
\item \textsuperscript{234} See CLARK, supra note 159, § 10.6, at 444 (allowing appraisal as a remedy against being forced unwillingly into a venture).
\end{itemize}
The possibility of bringing an action against directors or shareholders and obtaining damages is an attractive remedy for minority shareholders. Derivative suits are a remarkable instrument of power for the minority. Moreover, the threat of derivative actions makes derivative suits useful tools for obtaining corporate power. Examples of potential actions include violations of minority shareholders' rights, oppressive actions against the minority, or breach of fiduciary duties owed to the minority. Before executing any action, directors and shareholders must carefully consider the risks associated with a trial's outcome, which can range from the award of damages to the dissolution of the company.

There are some tight procedural requirements that, in most states, a shareholder must meet in order to maintain a derivative suit. First of all, to commence a derivative action, a shareholder must have been a shareholder at the time complaints are made. Second, whoever brings a derivative suit must continue to hold shares throughout the derivative proceeding, in fact a shareholder who transfers stock either before or during a derivative proceeding loses standing to further prosecute the case. Finally, before commencing a derivative action, the complaining shareholder must make a demand on the board of directors to seek redress for the alleged wrong done to the corporation. The demand requirement will be excused if the demand for action would be futile (e.g., in cases in which the sole or controlling directors are the alleged wrongdoers).

a. The Nature of Derivative Suits

Derivative actions do not advance the interests of the minority in a tangible manner. They do, however, protect minority interests and constitute an instrument of control. The potential for derivative actions brought by minority shareholders serves more as a motivation, rather than a method, for protecting minority interests. In theory, directors should avoid oppressive courses of action, taking into account the business and corporate position of the minority. In *Wessin v. Archives Corporation*, the
Minnesota Court of Appeals stated that in distinguishing between direct and derivative actions, courts must examine the nature of the shareholder's claim as well as the relief that could result from the action if successful.\textsuperscript{242} The court may consider, among other factors, "whether the injury results from the plaintiff's other relationships with the corporation; whether the alleged misconduct was specifically targeted toward the plaintiff"\textsuperscript{243} or whether the plaintiff is seeking only injunctive or prospective relief.\textsuperscript{244}

\textbf{b. Board Authority as a Limitation}

Although providing some protection, the success of derivative proceedings is limited and, paradoxically, subject to the "approval" of the board of directors. Once the complaint is filed, the corporation may investigate the charges made in the complaint. If the corporation does so, it may request a stay of further proceedings until the investigation is complete. When the investigation is completed, the corporation may determine that continued litigation is not in its best interests. In fact, even after a derivative proceeding commences, directors have the opportunity to prove the inconvenience of the proceeding and obtain a dismissal.\textsuperscript{245} 

\textit{Zapata Corp. v. Maldonado} established general rules in connection with derivative proceedings and the role of the board in determining the convenience of such proceedings.\textsuperscript{246} In Zapata, the Supreme Court of Delaware stated that a shareholder cannot sue on the corporation's behalf when the managing body refuses.\textsuperscript{247} Such an action would constitute an invasion of the discretionary field committed to the judgment of the directors, unless the refusal is wrongful.\textsuperscript{248} A committee composed of disinterested board members can move to dismiss derivative litigation that is potentially detrimental to the best interests of the corporation.\textsuperscript{249} The success of derivative actions is certainly rare because so much power is given to the discretionary business judgment of the directors. Still, courts remain concerned over the enforcement of bona fide shareholders' rights.\textsuperscript{250} Consequently, derivative actions continue to be instruments of power for the minority shareholders in a corporation. Generally, as the court stated in

\begin{itemize}
  \item \textsuperscript{242} \textit{Id.} at 385 (inquiring into the nature of a derivative suit).
  \item \textsuperscript{243} \textit{Id.}.
  \item \textsuperscript{244} \textit{Id.} (discussing the distinguishing factors between direct and derivative actions).
  \item \textsuperscript{245} \textit{Id.} (allowing directors an opportunity to demonstrate that a derivative proceeding is not in the corporation's best interest).
  \item \textsuperscript{246} \textit{Zapata Corp. v. Maldonado}, 430 A.2d 779 (Del. 1981).
  \item \textsuperscript{247} \textit{Id.} (describing the balance of power in a derivative suit).
  \item \textsuperscript{248} \textit{Id.}
  \item \textsuperscript{249} \textit{Id.} (noting that a board decision to dismiss will be respected, unless deemed wrongful).
  \item \textsuperscript{250} \textit{Id.} at 787.
\end{itemize}
Zapata: “It thus appears desirable to find a balancing point where bona fide shareholder power to bring corporate causes of action cannot be unfairly trampled on by the board of directors, but the corporation can rid itself of detrimental litigation.” 251 If the derivative proceeding is not dismissed, the court must approve any settlement or discontinuance of the action. The court approval requirement is designed to prevent abuse of the privilege of litigating on behalf of the corporation, to whom the plaintiff owes a duty that is somewhat fiduciary. 252

6. Direct Action

The basic distinction between a derivative suit and a direct action depends upon whether the shareholder, or a group of shareholders, claims an injury to the company or the violation of a personal right. In fact, through a direct action, a shareholder, or a group of shareholders, can allege direct injury by the company and therefore claim personal compensation. As mentioned above, courts often have some difficulty in classifying a plaintiff's claim as direct or derivative. However, the following actions were deemed to be direct: an action to enforce the shareholder's voting rights, 253 an action to compel the payment of dividends, 254 and a suit to protect a shareholder's inspection rights. 255 Because of the tight procedural rules required to bring a derivative suit, plaintiffs will usually prefer to have their suit characterized as direct rather than derivative. There are reasons that could persuade a plaintiff to choose a direct action instead of a derivative suit. First, a direct action does not require the demand on the board of directors. In a derivative suit the plaintiff is much more likely to lose control of her action than when a direct action has been brought up since the board of directors may investigate and recommend the termination of the suit. Second, the distribution of the recovery is likely to be more attractive to the plaintiff in a direct suit than in a derivative suit. In a derivative suit the recovery is always by the company and the plaintiff benefits only to the extent that her shares in the company (as well as the shares of all the others shareholders) increase in value. In a direct action, the plaintiff has a direct and personal compensation.

251 Id.
252 See John E. Brenneis, Shareholders, Shareholders' Agreements, Meetings, and Voting, CP FL-CLE 6-1.
254 See, e.g., Independence Lead Mines Co. v. Kingsbury, 175 F.2d 983 (9th Cir. 1949), cert. denied, 338 U.S. 900 (1949).
Rule 10b-5 is the “bedrock” of U.S. securities regulation. Most securities transactions are under its protection and scrutiny at the same time. For those involved in securities transactions, the rule guarantees that relevant security information is not intentionally false or misleading. For those who give securities information, the rule imposes standards of complete honesty and disclosure that carry risks of significant liability. Section 10 (b) of the Exchange Act does not specify a private remedy for violations of its rules but, despite the absence of a statutory mandate, it is now beyond question that Rule 10b-5 implies a private cause of action. Such claims can be brought only in federal district courts, which have exclusive jurisdiction over actions under the 1934 Exchange Act. Rule 10b-5 is also an effective tool in SEC enforcement actions. In fact, section 21 of the Exchange Act confers to the SEC extensive enforcement powers to sue before a federal court to prohibit violations of securities rules, including Rule 10b-5. The SEC can initiate only civil and administrative proceedings to investigate potential violations, and to rectify past and prevent future violations while the Department of Justice has sole jurisdiction over criminal proceedings.

Rule 10b-5(c) states that it shall be unlawful for any person, directly or indirectly, to “employ any device, scheme, or artifice to defraud,” “to make any untrue statements of a material fact or to omit stating a material fact necessary to make the statements . . . not misleading,” or “to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

Rule 10b-5 is basically an anti-fraud provision. It was adopted by the SEC under the authority of section 10 of the Exchange Act, which was designed to prohibit “any manipulative or deceptive device or contrivance,” and two of its three operative clauses are based on the concept of “fraud” or “deceit.” The Supreme Court has held that no person can be found to have violated Rule 10b-5, in either an SEC or a private action, unless he is shown to have acted with “scienter.” The scienter requirement, in the

---


view of some courts, does not require that the person act willfully, but may be met by showing that she or he acted recklessly.\textsuperscript{261}

Since the SEC’s rule-making power under section 10(b) is to be exercised “for the protection of investors,” it can be argued that the only persons entitled to the protection of Rule 10b-5 are those who can be classified as “investors.” However, the definition has been stretched in a number of ways such that shareholders are also considered included in it.\textsuperscript{262}

While the fraud must be “in connection with the purchase or sale,” the fraud need not relate to the terms of the transaction. In \textit{Superintendent of Insurance v. Bankers Life},\textsuperscript{263} the Supreme Court held unanimously that “since there was a ‘sale’ of a security and since fraud was used ‘in connection with’ it, there is redress under § 10(b), whatever might be available as a remedy under state law.”\textsuperscript{264} Subsequent lower court decisions have read this decision narrowly, holding that the fraud must have infected the securities transaction itself, rather than merely involving a misappropriation of the proceeds,\textsuperscript{265} and that there is no liability when there is a substantial time gap or no direct causal link between the sale and the alleged fraud.\textsuperscript{266}

The most important extension of the “in connection with” language came in \textit{SEC v. Texas Gulf Sulphur}.\textsuperscript{267} In that case, the Second Circuit held that misstatements in a press release issued by a publicly-held corporation, which was not at the time engaged in buying or selling any of its own shares, violated Rule 10b-5 because they were made “in connection with” the purchases and sales being made by shareholders in the open market. This holding has formed the basis for a large number of shareholder class actions alleging damages suffered because of misstatements in a company’s reports or press releases. The Second Circuit further expanded the concept with its decision in \textit{In re Carter-Wallace, Inc. Securities Litigation},\textsuperscript{268} where it held that technical advertisements in a medical journal could be considered “in connection with the purchase or sale” of a security. Courts consider the issuance by a corporation of its own shares as

\begin{itemize}
  \item \textsuperscript{261} See, \textit{e.g.}, Sanders v. John Nuveen & Co., 554 F.2d 790 (7th Cir. 1977).
  \item \textsuperscript{262} See, \textit{e.g.}, Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960) (this decision is important as the basis for a large number of derivative actions in which shareholders have alleged that management or controlling shareholders defrauded the corporation).
  \item \textsuperscript{263} Superintendent of Insurance v. Bankers Life, 404 U.S. 6 (1971).
  \item \textsuperscript{264} \textit{Id.} at 12.
  \item \textsuperscript{265} See \textit{In re Investors Funding Corp.}, 523 F. Supp. 563 (S.D.N.Y. 1980).
  \item \textsuperscript{266} See Ketchum v. Green, 557 F.2d 1022 (3d Cir. 1977); see also Rochelle v. Marine Midland Grace Trust Co. of N.Y., 535 F.2d 523 (9th Cir. 1976).
  \item \textsuperscript{267} SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968).
  \item \textsuperscript{268} \textit{In re Carter-Wallace, Inc. Securities Litigation}, 150 F.3d 153 (2d Cir. 1998).
\end{itemize}
a "sale" under Rule 10b-5.\textsuperscript{269}

In its first decision interpreting Rule 10b-5, the Supreme Court held that a merger involved a "sale" of stock of the disappearing company and a "purchase" of the stock of the surviving company for the purposes of the rule.\textsuperscript{270} The Supreme Court has held that a pledge of securities is a "sale" for purposes of the Securities Act of 1933, since Securities Act § 2(a)(3) defines "sale" to include "every contract of sale or disposition of a security or interest in a security, for value."\textsuperscript{271} The Supreme Court has stated that an oral option can support a Rule 10b-5 claim even if the defendant never had the intent to follow through on the underlying securities transaction.\textsuperscript{272}

A fundamental aspect of Rule 10b-5 liability is the potential for private class actions, i.e., securities fraud class actions. There are six common models of Rule 10b-5 actions: (1) securities trading, in which a party to a security transaction gives false or misleading information to persuade the other party to enter into the transaction, or remains silent when she has a duty to disclose; (2) corporate trading, in which a corporate manager induces her company to enter into a disadvantageous securities transaction (the company or a shareholder on behalf of the company sues the manager); (3) corporate disclosures, in which a company issues false or misleading information to the public about its securities, or it remains silent when it has a duty to disclose\textsuperscript{273} (purchasers or sellers, frequently in a class action, sue the company for their losses caused by the trading); (4) insider trading, in which company insiders either use confidential company information to enter into securities transactions or give the information to others who, even though knowing the confidentiality of it, trade on the basis of that information (traders sue the insiders and their tippees); (5) outsider trading, in which outsiders with no relationship to the company use confidential information about the company entrusted to them by others and trade on the basis of this information (traders, as well as the holders of the confidential information, sue the outsiders); and (6) customer-broker disputes, in which securities professionals engage in deceptive or other unprofessional conduct in connection with securities trading by or for their customers (the customers file claims against the broker and their firms). All of the Rule 10b-5 models have a common issue, i.e., that securities trades were based on an informational asymmetry, involving deception or other unfairness, between parties.

\textsuperscript{269} See Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960).
\textsuperscript{273} This is essentially what happened in the Parmalat case, in which the management never disclosed the bad financial situation of the company to shareholders and investors in order to conceal the perpetrated fraud.
Material omissions and misrepresentations, and insider trading are the two types of fraud that under Rule 10b-5 can be a basis for a securities violation, and therefore for a securities fraud action. The elements of the fraud and the burden of proof for the plaintiff in a securities fraud action are described below.

C. The Role of the SEC

The SEC's main duty is to protect investors and ensure the integrity of the securities market. To carry out this mandate under the federal securities laws the SEC has broad investigatory and enforcement powers.

1. Investigatory powers

The SEC has investigatory powers in various situations. SEC investigations, both formal and informal, are not public. However, the SEC has duties under the Freedom of Information Act to release documents and other information. The SEC also reports the results of certain investigations. Therefore, a SEC investigation may likely become public and be relevant, or even decisive, in subsequent civil or criminal proceedings. SEC staff may conduct informal investigations without a formal SEC order. If an informal investigation suggests that further information is needed, the SEC can issue a formal order of investigation indicating the scope of the inquiry. Once a formal order of investigation has been issued, SEC staff can issue subpoenas nationwide against any person who has information significant to the investigation. If a person refuses to comply with the subpoena, the SEC staff must apply to the federal district court to enforce it. Courts have held that the SEC does not need to prove probable cause that the securities laws have been violated; it is deemed enough that the investigation is for a proper purpose and the information sought is relevant to that purpose. Once the staff has completed its investigation, it must return to the Commission for permission to institute, if necessary, any enforcement action. However, the SEC, without taking any formal enforcement action after an investigation, can issue a "§ 21 (a) report" of

274 As established, for instance, in Securities Act § 8(e) (that determines whether to issue an order stopping registration of a public offering), in Securities Act § 19 (b) (enforcement of the Securities Act), and in Exchange Act § 21(a) (determining whether there has been a violation of the Exchange Act and its rules).


276 Id. § 21(c).

the investigation. Even though the report does not require any sanction, a negative comment about the target may result in deterrence and punishment.

2. Administrative Proceedings

SEC administrative proceedings are heard either by administrative law judges or the Commission itself and allow the SEC to impose sanctions to protect the public interest. The Securities Exchange Act of 1934 confers upon the SEC the authority to impose administrative sanctions if the SEC concludes, based upon a preponderance of evidence, that a violation of federal securities laws occurred. Before 1990, SEC tools to remedy securities law violations were limited to court applied sanctions, including injunctions and the disgorgement of illegal profits. However, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 gave the SEC administrative power to issue monetary penalties, cease and desist orders in response to violations of federal securities laws, and to bar a violator of securities laws from serving as an officer or director of a publicly held venture. These SEC sanctions are subject to the federal five year limitation period, which requires application within five years of the violation.

a. Cease and Desist Authority

Under the SEC's cease and desist authority, the agency may prohibit a person or business from continuing a particular course of conduct after the agency shows the target has engaged in a violation of federal securities laws. The SEC may issue temporary and permanent cease and desist orders against regulated persons. The standard for issuing a cease and

279 Id. § 15(b)(4).
282 Administrative proceedings include: stop order proceedings under § 8 of the 1933 Act, 15 U.S.C. § 77h (d)–(e); proceedings against broker-dealers under § 15(c)(4) of the 1934 Act, 15 U.S.C. § 78o(c)(4); proceedings against investment advisors, 15 U.S.C. § 80b-3(e), and investment companies, 15 U.S.C. § 80a-8(e); and sanctions against attorneys, accountants, and other professionals practicing before the SEC, pursuant to Rule 2(e) of the Commission's Rules of Practice.
285 Id. (adding new § 8A to the 1933 Act); 15 U.S.C. § 78u-3 (2000) (adding new § 21C

428
A Comparative Analysis of Shareholder Protections

desist order is the likelihood of “significant dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest.”\(^{286}\) Cease and desist orders require notice and opportunity for a hearing, unless the order is temporary and such notice and opportunity would be impracticable or contrary to the public interest.\(^{287}\)

b. Monetary Penalties in Administrative Proceedings

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 gives the SEC the power to impose monetary penalties, including fines and disgorgement,\(^{288}\) against securities professionals if it finds, after a formal hearing, that the penalty is in the public interest and the person willfully violated federal securities laws.\(^{289}\) These penalties are applied on a three-tier scale that looks at the nature of the crime and the potential for harm from the actions.\(^{290}\) Generally, the more egregious the violation, the greater the fine imposed.

3. Civil Remedies

The SEC has the authority to petition the court to grant injunctions, monetary penalties, and to disgorge illegal profits against an entity that violates federal securities laws.\(^{291}\) Unlike administrative proceedings, where the agency or administrative law judge adjudicates claims, the SEC files these actions in a federal district court, which has broad equitable discretion to craft a remedy under the 1934 Securities Act.\(^{292}\)

a. Injunctive Actions and Ancillary Measures

The SEC has historically used injunctions as one of its principle enforcement tools and may seek discretionary injunctive relief\(^{293}\) against both the perpetrators of securities fraud and those who aid and abet violators of securities laws.\(^{294}\) Injunctive relief is designed, not to punish,
but to deter individuals from future violations of federal securities laws. Injunctions may be temporary or permanent, and the SEC may request temporary restraining orders or preliminary injunctions in emergency situations. In order to receive injunctive relief, the SEC must offer positive proof of the likelihood of further violations. Factors considered by the court in finding a risk of future violations include (1) the severity of the violations, (2) the degree of scienter involved, (3) the defendant’s recognition of the wrongful nature of his conduct, and (4) his sincerity in refraining from future violations. Any failure to cooperate with the SEC to remedy the violations may suggest a propensity to engage in future violations. Consideration of hardship and equitable factors may be appropriate as well but the court must balance such factors against the public’s interest in preventing future violations. In the end, the court will require the SEC to demonstrate by a preponderance of the evidence that a defendant is likely to engage in the forbidden activity before granting an injunction. Additionally, courts have the power to bar securities law violators from serving as officers or directors of public companies and to bar their future association with securities brokers or dealers. The 1990 Act provides that a court may enter an order barring or suspending an officer or director of a company if the SEC has brought an injunctive action.

---


295 *See Fehn*, 97 F.3d at 1295 (requiring SEC to show “reasonable likelihood” of future violations for permanent injunction).

296 Preliminary injunctions are appropriate if the SEC makes a “substantial showing of a likelihood of success as to both a current violation and the risk of repetition.” SEC v. Cavanagh, 155 F.3d 129, 132 (2d Cir. 1998).

297 *See Fehn*, 97 F.3d 1276 (stating that “the SEC had the burden of proving there was a reasonable likelihood of future violations of the securities laws”).

298 *See SEC v. Lorin*, 76 F.3d 458, 461 (2d Cir. 1996) (finding that defendant’s “frequent and egregious” violations and persistent refusal to admit to wrong-doing indicated “propensity for future violations”).

299 Id. at 461 (including refusal to recognize wrongdoing among factors to consider as indication of likelihood of future violations).

300 *See Cavanagh*, 155 F.3d at 135 (describing factors court looks to before granting an injunction).

301 *See SEC v. AMX Int’l, Inc.*, 7 F.3d 71, 73 (5th Cir. 1993) (“financial inability is a defense for failure to comply with a court-ordered disgorgement”).


303 Id. § 77t(e) (1994).

304 Id. §§ 78(o)(6)(A)(ii), (iii) (1994).

305 Id. §§ 77t, 78u(d)(2).
The SEC may also seek ancillary relief in addition to injunctions, including appointment of a receiver.\(^{306}\) The SEC’s power to seek ancillary relief is extensive; in fashioning the relief the SEC need only satisfy one requirement: that the measure is appropriate to protect investors and effectuate the purposes of federal securities laws.

b. Disgorgement and Monetary Penalties

Disgorgement is an equitable remedy that returns profits that a defendant received through the securities fraud.\(^{307}\) The primary purpose of this remedy is to discourage securities law violations “by depriving violators of ill-gotten gains” and the prevention of unjust enrichment; it is typically not used for restitution.\(^{308}\) The court need not find that the defendant is likely to violate securities laws in the future, only that he “has no right to retain the funds illegally taken from the victims.”\(^{309}\) Once the profits have been disgorged, it remains in the court’s discretion to determine how the money is distributed.\(^{310}\) There is no requirement that the SEC return these funds to those harmed by the transaction or that the court tie the level of the penalty to the losses suffered.\(^{311}\) If the SEC demonstrates that the defendant has violated either the securities laws or a cease and desist order the court shall have the power to impose civil monetary penalties on the person committing the violation.\(^{312}\) These penalties are applied on the basis of the three-tiered structure that examines the nature of the crime and the potential for harm from the actions.\(^{313}\) These monetary penalties are similar to the monetary penalties the SEC may apply in administrative actions.

4. Criminal Enforcement

Willful violations of the substantive provisions of the principal

\(^{306}\) See SEC v. American Bd. of Trade, Inc., 830 F.2d 431, 436 (2d Cir. 1987) (acknowledging that neither the 1933 Act nor the 1934 Act explicitly gives courts power to appoint a receiver, but stating “courts have consistently held such power exists”).

\(^{307}\) See SEC v. Patel, 61 F.3d 137, 139 (2d Cir. 1995) (holding where stock purchased on basis of insider information, proper measure of damages is difference between the price paid and the price shortly after disclosure of information).

\(^{308}\) See Fischbach Corp., 133 F.3d at 175 (stating primary purpose of disgorgement is prevention of unjust enrichment).

\(^{309}\) SEC v. Colello, 139 F.3d 674, 679 (9th Cir. 1998) (stating requirement court find future violations likely only applies to permanent injunctions).

\(^{310}\) See SEC v. Fischbach Corp., 133 F.3d 170, 175 (2d Cir. 1997) (discussing purpose of disgorgement purpose).

\(^{311}\) Id. at 175–76 (discussing disgorgement payment theories). But in some cases the SEC may decide that returning the disgorged profits to the investors is appropriate.


\(^{313}\) Id. §§ 77t(d)(2)(A)–(C).
securities laws, including the registration and fraud provisions, are a criminal offense.\textsuperscript{314} The Commission has broad subpoena powers which it delegates to members of its staff to investigate apparent violations of the federal securities laws.\textsuperscript{315} Commission subpoenas, however, can be enforced only by a court and one is not in contempt until he has refused to respond to a court order enforcing the subpoena.\textsuperscript{316} The Commission's investigation may result from complaints made by investors or, as is more often the case, as a result of the initiative of its staff. Upon conclusion of an investigation, the Commission may refer the matter to the Department of Justice ("DOJ") with a recommendation that certain persons be indicted and prosecuted. If the DOJ follows the recommendation, the matter will be referred to a grand jury and, assuming indictment, it will be prosecuted by the U.S. Attorney. The DOJ may separately or in coordination with the SEC conduct investigations leading to criminal prosecutions that include securities fraud counts. It happens frequently that the DOJ acts with the guidance and in response to SEC reports. Moreover, it is quite common for SEC staff to be assigned to the DOJ to assist in the preparation of the case for trial. This kind of effort often results in the creation of a Task Force.

\textbf{a. Contempt Proceedings}

The injunction is one of the most effective and important tools in the SEC's enforcement arsenal and a defendant who violates the terms of an SEC injunction will likely face criminal or civil contempt proceedings. When faced with the need to initiate a contempt action, the SEC must choose between initiating a civil or criminal action. The main purpose behind an SEC contempt action is enforcement of the injunction, not necessarily punishment of the violator; thus, when possible the SEC prefers to initiate civil rather than criminal contempt proceedings.\textsuperscript{317} Criminal contempt proceedings are designed to force the party to follow the orders of the court issuing the injunction. Unlike other criminal penalties, the SEC may bring criminal contempt proceeding in court under Rule 42(b) of the Federal Rules of Criminal Procedure without DOJ intervention. This provides the SEC with significant power to compel compliance with injunctions. Another difference between original criminal prosecution and prosecution for contempt is the severity of the penalty imposed. The 1933 and 1934 Acts limit the number of years of imprisonment for criminal violations of their provisions.\textsuperscript{318} In contrast, the judge's discretion

\textsuperscript{316} See 2 HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 871 (2005).
\textsuperscript{317} STEINBERG, supra note 290, § 6:20.
determines the sentence for a defendant guilty of contempt. Civil contempt sanctions are remedial rather than punitive and serve one of two functions: (1) "to compensate the party injured as a result of the violation of the injunction, or (2) to coerce compliance with the injunction terms." If the SEC decides that criminal contempt proceedings are not needed, a court may issue an order of civil contempt, enforceable by fine or arrest, for willful disobedience of a specific order of the court. Foreign citizens convicted of violating the securities laws also risk the imposition of injunctions and contempt orders; the SEC may seek assistance from the relevant foreign court for enforcement.

V. WHAT PROTECTIONS WOULD HAVE EXISTED FOR THE PARMALAT MINORITY SHAREHOLDERS IF PARMALAT HAD BEEN A U.S. LISTED COMPANY?

A. Action to Recover Damages

1. The Rule 10b-5 Action

It is undisputed that Parmalat engaged in one of the largest and most brazen corporate financial frauds in history. Investors bought and kept Parmalat shares, confident in the information disclosed by the company. Most would have likely not purchased those shares if they had known that the company was issuing false information about its securities and hiding the truth. Rule 10b-5 of the 1934 Act offers defrauded investors in the United States a remedy to recover damages suffered when the fraud is determined to be a material omission or misrepresentation, which is what occurred in the Parmalat case.

In order to state a cause of action under Rule 10b-5, a private plaintiff must allege each of the following elements: (a) the plaintiff is a purchaser or seller of a security; (b) defendant made a material misrepresentation or

319 See United States v. Corn, 836 F.2d 889, 891–92 (5th Cir. 1988) (punishing violation of injunction prohibiting illegal trading in securities with five-year prison term and restitution to victims of securities fraud, but entitling defendant to warning of possibility of restitution before pleading guilty).

320 STEINBERG, supra note 290, § 6:20.

321 See Levine v. Comcoa, Ltd., 70 F.3d 1191, 1194 (11th Cir. 1995) (upholding civil contempt order against defendant’s attorney for violating temporary restraining order against transferring client’s funds even though order had lapsed).

322 See SEC v. Int’l Swiss Inv. Corp., 895 F.2d 1272, 1276 (enjoining defendants, residents of Mexico, from further sale of unregistered securities in the United States and holding defendants in contempt, freezing their assets, and ordering accounting).
omission.; (c) the misrepresentation or omission was “in connection” with
the purchase or sale of the security; (d) defendant’s misrepresentation or
omission caused plaintiff’s loss; (e) the plaintiff relied on defendant’s
misrepresentation or omission; (f) defendant acted with the requisite
scienter; and (g) plaintiff suffered damages from the harm.

A material misstatement is a misrepresentation or omission of a
material fact that, in light of the circumstances under which it was made, is
misleading. The Supreme Court stated that “an omitted fact is material if
there is a substantial likelihood that a reasonable shareholder would
consider it important” in making an investment decision.323 The Supreme
Court has stated that

To fulfill the materiality requirement there must be a substantial
likelihood that the disclosure of the omitted fact would have been
viewed by the reasonable investor as having altered the total mix of
information made available. An omission is actionable under the
securities laws only when there is a duty to disclose the allegedly
omitted information,324

or the alleged omissions render an affirmative statement misleading.325

To give rise to liability, the misrepresentation or omission must be
made “in connection with” the purchase or sale of a security. The element
of causation helps ensure that Rule 10b-5 does not become “an insurance
plan for the cost of every security purchased in reliance upon a material
misstatement or omission.”326 Both “loss causation” and “transaction
causation” are necessary for a 10b-5 claim. Transaction causation has been
characterized as a type of “causation in fact” or “but for” causation. It
requires the plaintiff to make a showing that the violations in question
caused plaintiff to engage in the transaction.327 Loss causation is often
referred to as “proximate causation” or “legal causation.” It involves a
“determination that the harm suffered by the investor ‘flowed’ from the

325 See Glazer v. Formica Corp., 964 F.2d 149, 157 (2d Cir. 1992); In re Time Warner
Inc. Sec. Litig., 9 F.3d 259, 267 (2d Cir. 1993) (holding that when a corporation is pursuing
a specific goal and announces that goal as well as an intended approach for reaching that
goal, the corporation may come under an obligation to disclose other approaches of reaching
the goal when those approaches are under active and serious consideration).
326 Huddleston v. Herman & MacLean, 640 F.2d 534, 549 (5th Cir. 1981), rev’d in part
327 Newton v. Merrill Lynch, 259 F.3d 154, 172 (3d Cir. 2001); Suez Equity Investors,
L.P. v. Toronto Dominion Bank, 250 F.3d 87, 95–96 (2d Cir. 2001).
A Comparative Analysis of Shareholder Protections

A plaintiff must rely on the alleged material misstatement in making the investment decision; reliance is a “critical element for recovery under 10b-5.” Reliance generally requires that the plaintiff knew of the misrepresentation at issue, believed it to be true, and because of that knowledge and belief, purchased or sold the security in question. Reliance by the plaintiff generally will be presumed based on the “fraud on the market” doctrine. Under that doctrine, investors do not have to prove individual reliance on a company’s false or misleading statements. Instead, the doctrine creates a rebuttable presumption that plaintiff relied on the integrity of the market and was defrauded even if he did not rely specifically on the false or misleading statements at issue in the complaint. The key to the “fraud on the market” theory is that “in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.”

In a securities fraud action, a plaintiff must allege that a defendant acted with “scienter,” i.e., intent to defraud. The Supreme Court in *Ernst & Ernst v. Hochfelder* defined scienter as “a mental state embracing intent to deceive, manipulate, or defraud” but did not decide whether recklessness satisfied the scienter requirement under Section 10(b) and Rule 10b-5. Courts in every federal circuit, however, have found that a sufficient showing of recklessness satisfies the scienter requirement. The circuits differ, though, on how they define “recklessness” and on the type of conduct sufficient to qualify as evidence of scienter.

A private cause of action under Rule 10b-5 is implied. Therefore, until the Private Securities Litigation Reform Act of 1995 (“PSLRA”), courts had no statutory guidance to determine the appropriate measure of damages. The result was uncertainty concerning the method to calculate damages because factors other than the information in dispute can impact stock price. One of the stated purposes of the PSLRA was to provide statutory guidance regarding the calculation of damages in securities fraud cases. The PSLRA

---

329 See Nathenson v. Zonagen Inc., 267 F.3d 400, 413 (5th Cir. 2001).
332 Id. at 194 n.12.
333 See, e.g., Aldridge v. A.T. Cross Corp., 284 F.3d 72, 78–84 (1st Cir. 2002); Novak v. Kasaks, 216 F.3d 300, 310–13 (2d Cir. 2000); In re Advanta Corp. Sec. Litig., 180 F.3d 525, 534 (3d Cir. 1999); Abrams v. Baker Hughes Inc., 292 F.3d 424, 430–32 (5th Cir. 2002).
attempts to address the uncertainty of damage calculations by adopting the 90-day “look back” or “bounce back” period. This “look back” or “bounce back” period seeks to limit damages to those losses caused by the defendant’s fraud and not by other market conditions. Therefore, damages under section 10(b) are limited to the difference between the price paid or received by the plaintiff and the mean trading price during either the 90 days after a disclosure is made correcting the false statement in question or the date on which the plaintiff sells or repurchases the security, whichever is earlier.335 A plaintiff in a Rule 10b-5 cause of action has the burden of proving damages.336 Under the PSLRA, a plaintiff has the additional burden of proving that the defendant’s wrongful act or omission caused the plaintiff’s loss.337

The federal statute of limitations applicable to securities claims was amended by section 804 of the Sarbanes-Oxley Act of 2002.338 Section 804 provides that the statute of limitations is either two years after discovery of the facts constituting a violation of the securities laws or five years after such a violation occurs, whichever is earlier.339 The Sarbanes-Oxley Act extended the statute of limitations established in the Supreme Court’s 1991 decision in Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson340 and left intact by the PSLRA.

Securities claims are often brought as class actions under the Securities Act of 1933 and Securities Exchange Act of 1934 against corporate insiders and their outside professionals. Typically, in the class action context, securities claims are brought on behalf of the purchasers of a particular security with respect to a specified “Class Period” during which defendants are alleged to have caused the price of the security to be “artificially inflated.” In such actions, accountants may be named as defendants, along with the issuer, officers and directors, underwriters and others involved in the process of issuing securities or making statements (either in press releases or documents filed with the SEC) that affect the value of the securities in the open market. In Central Bank of Denver v. First Interstate Bank,341 the Supreme Court held that a private plaintiff may not maintain an

339 Sarbanes-Oxley Act § 804(b).
340 Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991) (holding that actions under section 10(b) and Rule 10b-5 of the 1934 Securities Exchange Act must be commenced within one year after discovery of the facts constituting the violation and in no event more than three years after such violation).
Aiding and abetting action under Section 10(b) of the Securities Exchange Act of 1934, bringing an end to a 30-year line of authority to the contrary. As the Supreme Court made clear, however, professionals such as accountants and lawyers still remain subject to liability when acting as primary violators of the securities laws. The Supreme Court in fact stated that

any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators.\(^{342}\)

This observation follows directly from the wording of Rule 10b-5, which holds liable any person who, directly or indirectly, violates the substantive provisions of the rule. This means that any person who makes false or misleading statements and induces others to trade to their detriment can be liable. Significantly, corporate officials who make statements about the company or its securities expose the company to 10b-5 liability, even if the company does not trade in its own stock. This statement, the so-called "primary violator standard," allows shareholders to sue not only the directors of the company, but also the accountants, lawyers, and underwriters.

In actions brought against accountants pursuant to the securities laws, plaintiffs typically allege that the auditors misrepresented that the audit was conducted in accordance with Generally Accepted Auditing Standards ("GAAS")\(^{343}\) and that the financial statements were prepared in conformity with GAASP. Accountants named as defendants in securities class actions are thus almost always charged with making a false statement.\(^{344}\) The PSLRA, reversing, for SEC actions only, part of the effect of the decision in *Central Bank of Denver v. First Interstate Bank*. It established that for SEC Actions under the 1934 Act, any person who knowingly provides substantial assistance to a violator shall be deemed in violation.\(^{345}\) The PSLRA also reversed traditional joint and several liability standards for

---

\(^{342}\) *Id.*  

\(^{343}\) GAAS is a set of systematic guidelines used by auditors when conducting audits on companies' finances, ensuring the accuracy, consistency and verifiability of auditors' actions and reports. By relying on GAAS, auditors can minimize the probability of missing material information.  


claims based on "non-knowing" conduct against outside directors under section 11 of the 1933 Act and against all persons for claims under the 1934 Act. The proportionate liability of each such defendant found liable based on his or her non-knowing conduct is determined by the jury's answers to special interrogatories, based on the nature of the misconduct and the causal relationship attributable to each defendant.  

2. Private Securities Fraud Class Action

A private securities fraud class action is a lawsuit in which a shareholder, or a small group of shareholders who have lost money based upon misleading statements by the company, represent the interests of a larger group of shareholders. In a case such as Parmalat, in which a huge number of shareholders had been defrauded and injured, a securities fraud class action seems to be the right remedy for recovery. As noted by Thompson and Sale, the securities fraud class actions brought in recent years follow a typical pattern. These cases are brought under the federal securities laws mainly after a company's correction of a prior earning's misstatement. When the new earnings numbers are disclosed, as a consequence, the company's stock price drops. The stock price fall corresponds to the alleged damages. What happened in the Parmalat case was much more than a misstatement. In fact, as illustrated above, the majority shareholder and the management withheld facts that would have convinced shareholders to sell or not to continue purchasing Parmalat shares. Once the true situation of the company had been disclosed, the company's stock price dramatically dropped.

From the filing of the first complaint to the challenge of the pleadings, the long haul of discovery and ultimately settlement or trial, securities class actions must follow a specific procedure. First of all, under the PSLRA, where multiple plaintiffs have filed suits against the same defendants, the court is required to appoint the "most adequate plaintiff" as lead plaintiff for the consolidated actions. The PSLRA changed the standards and procedures for selecting the lead plaintiff in securities class actions in order to eliminate abuses involving the use of "professional plaintiffs" and the race to the courthouse to file the complaint. Prior to the enactment of the PSLRA, courts generally selected as lead plaintiff the first plaintiff to file suit. The PSLRA sought to eliminate that practice by directing the court to appoint as lead plaintiff the member or members of the purported plaintiff class that the court determines to be most capable of adequately

346 Id. § 78u-4(g) (1994).
representing the interests of class members. In addition, the PSLRA requires that the plaintiff in the first-filed action publish a notice advising of the pendency of the action so that any member of the proposed class can come forward and move to serve as lead plaintiff.349

In a case where more than one complaint has been filed, or a putative class member moves for appointment as lead plaintiff, the PSLRA further provides that the court “shall adopt a presumption that the most adequate plaintiff” is that person or group of persons possessing the largest financial interest in the relief sought and satisfies the requirements of Federal Rules of Civil Procedure Rule 23.350 This presumption may be rebutted by proof that the most adequate plaintiff will not fairly and adequately protect the interests of the class or is subject to unique defenses that render such plaintiff incapable of adequately representing the class. This presumption, however, is not rebutted simply because the plaintiff is unable to assert all of the claims brought by the class. That is, under the PSLRA, the selection of lead plaintiff is premised on the loss suffered, “not on... the most adequate complaint filed.”351 Courts, in some cases, have appointed the single investor with the greatest individual loss who has otherwise satisfied the statutory criteria.352 In other cases, courts have rejected the plaintiff with the largest financial loss for a more adequate plaintiff.353 Although Congress intended that the lead plaintiff provisions of the PSLRA result in an increased role for institutional investors as plaintiffs, non-institutional investors have continued to dominate as lead plaintiffs in post-PSLRA cases.354 The PSLRA provides that, “[t]he most adequate plaintiff shall, subject to the approval of the court, select and retain counsel to represent the class.”355 The PSLRA’s intent was to place greater control of the litigation in the hands of investors, rather than those of plaintiffs.

The motion to dismiss has taken on greater significance in PSLRA

350 15 U.S.C. § 77z-1(a)(3)(B)(iii)(I) (1994); 15 U.S.C. § 78u-4(a)(3)(B)(iii)(I) (1994). The class representative must establish, among other things, that: (1) common questions of law or fact predominate in the claims raised by the various members (the commonality requirement) and (2) the claim of the class representative is sufficiently typical of those of the class generally to conclude she is an appropriate representative (the typicality requirement).
352 See, e.g., Wenderhold v. Cylink Corp., 188 F.R.D. 577, 586–87 (N.D. Cal. 1999) (rejecting lead plaintiff application from aggregation of investors in favor of single investor with greatest individual losses).
securities class actions because cases not dismissed at the pleadings stage require defendants to face a long and expensive discovery process. Given the breadth of the issues, the large sum of money at stake, and the concomitant expense and burden of the discovery process on the defendants in securities litigation, cases that are not dismissed on their pleadings almost inevitably lead to large document productions and the distraction of senior management with internal fact investigations and depositions. Expense and delay are the types of substantial burdens plaintiffs count on to broker settlements. Dismissing the case at the outset is one of the few ways defendants can avoid this burden. It is quite clear, though, that the defendants have a strong interest in filing a motion to dismiss.

The PSLRA heightens securities fraud pleading requirements in two ways. First, the complaint must set forth “each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” Second, plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind and must do so with respect to each act or omission alleged to be a violation of the securities laws.

The PSLRA mandates dismissal, upon motion of the defendant, if the complaint fails to meet these requirements. All discovery and other proceedings must be stayed during the pendency of any motion to dismiss, unless the court finds upon motion of any party that particularized discovery is necessary to preserve evidence. This statutory prohibition is meant in part to prevent a situation in which a plaintiff sues without possessing the requisite information to satisfy the PSLRA’s heightened pleading requirements and then uses discovery to acquire that information to “resuscitate an otherwise dismissable complaint.”

Although class certification is rarely defeated in its entirety in a securities action, the size and definition of the class is ripe for early discovery and litigation, and is of particular importance to defendants because class size and class definition impact the magnitude of the plaintiffs’ alleged damages. If a defendant is able to limit the size of the class (e.g., by rebutting the presumption of reliance for one or more subsets of the class or by shortening the class period), the damages—and the settlement value—of the case may be dramatically reduced. Accordingly, class certification can be a critical battleground for securities litigation

356 Id. § 78u-4(b)(1)(B) (1994).
357 Id. § 78u-4(b)(2) (1994).
358 Id. § 78u-4(b)(3)(A) (1994).
359 Id. § 78u-4(b)(3)(B) (1994).
360 In re Comdisco Sec. Litig., 166 F. Supp. 2d 1260, 1263 (N.D. Ill. 2001).
The party seeking class certification bears the burden of demonstrating that each of the four requirements of Federal Rule of Civil Procedure 23(a) are met in addition to at least one of the requirements of Federal Rule of Civil Procedure 23(b). The court must conduct a “rigorous analysis” to determine whether the party seeking certification has met the prerequisites of Rule 23, which are (1) numerosity; (2) commonality, as a precondition of certification, in which there must be questions of law and fact common to the class that predominate over any questions affecting only individual members; (3) adequacy of representation by lead plaintiff and his counsel, which requires that the class representatives do not “have interests antagonistic to those of the class,” and are “the plaintiffs [who] will vigorously pursue the litigation on behalf of the class and their chosen attorney must be qualified, experienced, and able to conduct the litigation;” (4) typicality, it requires that the class representatives’ interests be aligned with those of the class so that the named plaintiffs’ claim truly represents those of absent class members. The individual circumstances, claims, and defenses of the class representative should not differ significantly from the class as a whole but the claims need not be identical.

The court, in deciding on class certification, may not decide the merits of plaintiffs’ claims, but may address them only insofar as they concern class certification. To test a plaintiff’s assertions concerning the propriety of class certification, defendants should seek discovery of the representative plaintiff with respect to whether the requirements of Rule 23 will be met. In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss, unless the court finds upon the motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party.

Settlement is strongly favored, particularly in complex class actions, to minimize potential litigation costs and reduce the strain on judicial

---

361 See Coopers & Lybrand v. Livesay, 437 U.S. 463, 476 (1978) (“Certification of a large class may so increase the defendant’s potential damages liability and litigation costs that he may find it economically prudent to settle and to abandon a meritorious defense.”)
363 See Realmonte v. Reeves, 169 F.3d 1280, 1286–87 (10th Cir. 1999).
364 See Hanon v. Dataproducts Corp., 976 F.2d 497, 508–09 (9th Cir. 1992) (analyzing named plaintiff’s investment history to determine propriety as a named plaintiff in a securities case); see also Degulis v. LRX Biotechnology, Inc., 176 F.R.D. 123 (S.D.N.Y. 1997) (finding that discovery of named plaintiff’s investment records, sophistication, and trading strategies was relevant to pending class certification motions).
365 See Hanon, 976 F.2d at 508–09. See also Degulis, 176 F.R.D. at 123.
resources.\textsuperscript{366} Federal Rules of Civil Procedure 23(e) provides that "[a] class action shall not be dismissed or compromised without the approval of the court."\textsuperscript{367} The court must therefore preliminarily approve or disapprove any settlement.\textsuperscript{368} After examining the proposed settlement and reaching a decision, the court will pursue one of two courses. If the court disapproves the settlement, the court is required to notify the parties of the provisions to which it objects and instruct the parties on what must be done in order to gain court approval of the settlement.\textsuperscript{369} If the court preliminarily approves the settlement, the court will require that notice of the settlement be given to all class members pursuant to Federal Rules of Civil Procedure 23(c)(2).

No clear-cut rule prescribes when the time is right to settle a case.\textsuperscript{370} Some advantages of early settlement may include reduction in litigation expenses, avoidance of disruption to a company's business or interference with its customers or clients, and minimization of adverse publicity.\textsuperscript{371} On the other hand, the disadvantages of an early settlement are a lack of sufficient factual knowledge to make an accurate assessment of the case and loss of the opportunity to win the case.\textsuperscript{372} Finally, it must be noted that securities class action trials are rare.\textsuperscript{373}

Private securities fraud class actions and SEC securities enforcement actions can overlap. It has been empirically proven that private suits with parallel SEC actions settle for significantly more than private suits without such proceedings, and that private cases with parallel SEC actions take substantially less time to settle than other private cases.\textsuperscript{374} The SEC, even after the enactment of the Fair Fund provision,\textsuperscript{375} does not seem to have sufficient authority "to recover from wrongdoers sums equal to those that can be recovered in private suits."\textsuperscript{376} Therefore, this implies that even when there is an ongoing SEC enforcement action, a private suit is necessary to

\textsuperscript{367} \textit{FED. R. Civ. P. 23(e)}.
\textsuperscript{368} See, e.g., \textit{In re Gen. Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig.}, 55 F.3d 768, 786 (3d Cir. 1995).
\textsuperscript{369} See \textit{In re Warner Comms. Sec. Litig.}, 798 F.2d 35 (2d Cir. 1986) (stating that it is not the function of the court to modify the terms of settlement as proposed by the parties).
\textsuperscript{372} See Snow, supra note 370.
\textsuperscript{373} Id.
\textsuperscript{374} Cox, supra note 157, at 737.
\textsuperscript{375} Section 308(a) of the Sarbanes-Oxley Act authorizes the SEC, at its discretion, to apply for the benefit of victims of a securities law violation the civil penalties (i.e., fines) collected in enforcement cases where disgorgement funds were obtained from the respondent.
\textsuperscript{376} Cox, supra note 157, at 779.
provide a more complete remedy for the damaged investor.\textsuperscript{377}

B. Can Italy Learn From the United States?

The Parmalat collapse clearly showed that Italian law offers minimum protection to minority shareholders and investors. However, while the U.S. legal system, after similar cases such as Enron and WorldCom, introduced stringent rules to prevent financial crimes, i.e., the 2002 Sarbanes-Oxley Act, Italy is still waiting for Parliament to approve and enact a specific law protecting investors' rights.\textsuperscript{378} The Parmalat case was an unquestionable case of accounting fraud, in which the majority shareholder and his management, for more than ten years, were able to conceal mismanagement and convince the market, the minority shareholders, and the investors that the company was in a solid financial situation and thus a reliable investment. Moreover, Calisto Tanzi and his management funneled huge amounts of the company's money into their personal accounts, not all of which have been discovered, to the obvious detriment of thousands of minority shareholders and investors. As described previously, Parmalat was a pyramidal group organized and structured in order to stand under the total control of majority shareholder, Tanzi, and to exclude minority shareholders from any activity or control of the company. Minority shareholders did not have the chance to prevent and oppose the fraud by bringing a suit against the directors for liability toward the company under article 2393-bis of the Civil Code, by filing a complaint with the Board of Auditors under article 2408 of the Civil Code, or by reporting alleged irregularities in the management of the directors to the tribunal under article 2409 of the Civil Code because management's statements about the financial situation of the company, as well as the auditing the firm's financial controls and reports, were completely false and misleading. There was no way for the minority shareholders to learn that the company was actually in very bad financial shape, that the stock price was overvalued, or that the management was perpetrating a fraud in order to move company capital into personal accounts. The Parmalat organization and structure, however, cannot be considered unique. Conversely, Parmalat's organization and structure are quite common among stock companies in Italy, where pyramidal groups are widespread.\textsuperscript{379}

Once fraud is perpetrated and disclosed, Italian law does not offer a legal remedy that allows minority shareholders to bring a direct action against the wrongdoers in order to recover the damages suffered. The only

\textsuperscript{377} Id.

\textsuperscript{378} At present, the Italian Parliament is still discussing the draft of a law for the protection of investors, the "disegno di legge sul risparmio."

\textsuperscript{379} See supra note 31.
remedies are a civil action for damages, a derivative action against directors for liability toward the company under article 2393-bis of the Civil code, or joining with the prosecutor in a criminal proceeding claiming compensation. None of these actions guarantees an effective recovery. A civil action, as discussed above, is characterized by a cloud of uncertainty and does not represent an attractive solution for a shareholder. First, the burden of proof lies with the plaintiff/shareholder. They must give evidence of the fraud perpetrated and of the correlation between the fraud and the damages suffered. The asymmetry of information about a company’s business, financial, and accounting operations traditionally present between the company’s management and the shareholders, clearly renders this burden of proof difficult to reach for a shareholder. Second, a plaintiff/shareholder must shoulder the remarkable legal expenses by himself and must pay for them in advance with a chance to recover only in the event of a final victory. Italian law, in fact, forbids contingency fees.

Finally, the plaintiff/shareholder must bear the costs of the typically long duration of lawsuits in Italy. The same considerations are valid for a derivative action under article 2393-bis of the Civil Code, but with two additional concern Above all, in the case of victory at trial, only the company receives an effective compensation. In fact, whereas the cash flow obtained by the company as a reimbursement theoretically increases the value of shareholders’ participation, in reality this positive effect is distributed among all shareholders and is therefore almost imperceptible to minority shareholders. The greater the number of shareholders, the lower the positive effect of the compensation on the shareholders’ participation will be.

Second, a lawsuit pending against current or former directors probably could have a negative effect on the value of shareholders’ participation, in particular if this information becomes public and influences the market. In this instance, shareholders of the listed company prefer to exit the company selling their shares on the market, rather than sue the directors and become entangled in an uncertain, expensive, and likely protracted litigation. Legal expenses associated with claiming compensation in a criminal proceeding are not as high as those required in a civil proceeding. In addition, the investigatory activity, including the power to request discovery, is exercised by the prosecutors and does not have to be paid by the shareholder. However, the chance to recover damages, especially in cases in which a large amount of injured shareholders and investor are involved, are slim. In fact, in these kinds of criminal proceedings, such as Parmalat, the defendants typically indicted for fraud are the managers of the company who clearly are not able to compensate with their personal estates all the

380 See Ventoruzzo, supra note 84.
damages they caused.

All of these reflections become more significant as we consider that Italian law does not contemplate a class action. This means that each shareholder must file his own claim, hire his own attorney, and sustain the legal expenses alone. Trials related to cases like Parmalat would likely last many years and clearly require substantial expenditures, including the attorneys' fees but also, for instance, the expenses necessary to carry out investigations or hire professional consultants. Moreover, as discussed above, there is no guarantee of recovery. It therefore seems obvious that an individual private action does not constitute an attractive or certain legal remedy for shareholders. Besides that, there is another aspect of the individual private action that must be considered. In cases like Parmalat, in which a large number of shareholders were damaged (as illustrated above, the number of Parmalat shareholders and investors was estimated between 100,000 and 200,000), if each damaged shareholder decided to file a claim against the company, the consequence would be a correspondingly large number of trials. Therefore, Italian judges would have to examine between 100,000 and 200,000 trials against Parmalat. These trials would most likely be heard by different judges and would involve different facts and evidence. Therefore, each would result in its own unique final judgment and opinion. The divergent outcomes likely to result from such a situation demonstrate that the individual private action is an unreliable and uncertain remedy for shareholders.

After the Parmalat bankruptcy, one hopes that the Italian Government will soon introduce an efficient legal remedy for defrauded investors and shareholders, as did the United States with Rule 10b-5 of the Exchange Act. Rule 10b-5, above all, holds liable any person who directly or indirectly violates its substantive provisions, including officers, lawyers, accountants, and even banks. Thus, any person who makes a false or misleading statement, which induces others to trade to their detriment violates 10b-5.

In cases similar to Parmalat, where fraud is allegedly perpetrated by management as well as banks and auditing firms, Rule 10b-5 actions assist injured shareholders seeking to recover their investments. Compared to criminal proceedings, the goal of Rule 10b-5, protection of shareholders' rights, is achieved because it more effectively and efficiently deters fraudulent activities that harm investors.

The securities fraud action in the Italian legal system should be bolstered by the introduction of the class action. The experience of the United States clearly shows that securities fraud class actions are the main, if not the only, effective legal remedy for defrauded shareholders to recover damages from companies. Italian shareholders and investors should have the option to file a joint claim against the wrongdoers in order to share the litigation expenses, bear the length of a trial, and strengthen the claim. Additionally, class actions would reduce the likelihood of confusion
resulting from thousands of trials. Therefore, class actions would offer shareholders more effective protection. The introduction of a class action in the Italian legal system is more urgent now than ever before.

The experience of the United States also reveals the role played by the SEC in the securities market regulation—more specifically, for the protection and compensation of defrauded shareholders. The SEC has a vast arsenal of tools it can utilize to enforce the securities laws (investigatory powers, administrative enforcement powers, injunctive relief, disgorgement and monetary penalties, and criminal and contempt proceedings). Above all, SEC enforcement actions can provide extremely important support for private securities fraud class actions. In fact, private actions with parallel SEC actions have proven to settle for significantly more and in significantly less time than private suits without such parallel proceedings. It seems clear that the active role of the SEC is necessary for securities fraud class actions to be an efficient remedy for recovering damages. Conversely, the CONSOB, the Italian SEC, has quite limited powers. As illustrated above, the CONSOB controls the activity of all the entities operating in financial markets but does not have the power to enforce the securities law. Following the SEC example, the power of the CONSOB should be significantly increased; in particular, it should be increased to allow the enforcement of the securities law. An increase in power seems necessary to achieve an efficient Italian securities fraud class action and for the effective protection of shareholders against new fraud cases.

VI. CONCLUSION

The Parmalat case has clearly revealed the deficiencies of the Italian rules of corporate governance. Above all, the Italian legal system lacks effective protections and remedies for minority shareholders and investors when a fraud has been perpetrated. In addition, the Parmalat case has highlighted the marginal role of the CONSOB in relation to the protection of investors and shareholders. A comparison with the corresponding U.S. laws reveals that the U.S. legal system offers minority shareholders a specific legal remedy, i.e., a private securities fraud class action under Rule 10b-5 of the Securities Exchange Act, to recover damages suffered. It also reveals that when SEC enforcement actions overlap with private securities fraud suits, these private suits settle quicker and for more money. Finally, it has been suggested that the Italian government should introduce a private securities fraud class action following the U.S. Rule 10b-5 action. The introduction of such an action should be accompanied by a significant increase in the powers of the CONSOB, in particular the power to enforce the securities law in order to guarantee an adequate and effective recovery of damages for injured shareholders.