ITALIAN CORPORATE GOVERNANCE: ONE AMERICAN'S PERSPECTIVE

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I. INTRODUCTION

In recent years, the topic of corporate governance has received a tremendous amount of attention in Italy. In 1992, the Bank of Italy began a major research project, the goal of which was to analyze the extent of the corporate governance problems facing Italian companies, both large and small.[1] Following completion of that project, the Bank of Italy has continued to place the topic of corporate governance high on its research agenda. Corporate

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[1] The results of this project have been published in a series of working papers of the Banca d'Italia and in four books: *see* BANCA D'ITALIA, TEMI DI DISCUSSIONE NO. 237-247 (1994); F. BARCA, IMPRESE IN CERCA DI PADRONE: PROPRIETA' E CONTROLLO NEL CAPITALISMO ITALIANO (1994); F. BARCA ET AL., ASSETTI PROPRIETARI E MERCATO DELLE IMPRESE: VOLUME I. PROPRIETA' MODELLI DI CONTROLLO E RIALLOCAZIONE NELLE IMPRESE INDUSTRIALI ITALIANE (1994); F. BARCA ET AL., ASSETTI PROPRIETARI E MERCATO DELLE IMPRESE: VOLUME II. GRUPPO, PROPRIETA' E CONTROLLO NELLE IMPRESE ITALIANE MEDIO-GRANDI (1994); L. CAPRA ET AL., ASSETTI PROPRIETARI E MERCATO DELLE IMPRESE: VOLUME III. GLI INTERMEDIARI DELLA RIALLOCAZIONE PROPRIETARIA IN ITALIA (1994). For an overview and synthesis of these research results (in English), *see* Fabrizio Barca, *On Corporate Governance in Italy: Issues, Facts and Agenda*, in SPECIAL ISSUE ON CORPORATE GOVERNANCE AND PROPERTY RIGHTS 1 (Fondazione Eni Enrico Mattei Working Paper Series No. 10.96, 1996). *See generally* Associazione Disiano Preite, Rapporto sulla societa' aperta: la proposta di una societa' aperta per la riforma del governo societario in Italia (1996) (unpublished manuscript, on file with author).

HeinOnline -- 1998 Colum. Bus. L. Rev. 121 1998

governance is also frequently the subject of articles in the popular press, a trend that may have reached a high point in connection with the recent problems at Olivetti, the Ivrean information systems giant.[2] Perhaps most importantly, the Italian Parliament is also studying corporate governance reform, and its work will undoubtedly be influenced by the work of the Bank of Italy, a highly prestigious and largely independent Italian institution.

Corporate governance refers to the mechanisms and processes by which corporations are governed. At the most elementary level, corporate governance can be described as the processes by which investors attempt to minimize the transaction costs[3] and agency costs[4] associated with doing business within a firm. Andrei Shleifer and Robert Vishny framed the issue very effectively when they stated:

> [C]orporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?
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> At first glance, it is not entirely obvious why the suppliers of capital get anything back. After all, they part with their money, and have little to contribute to the enterprise afterwards. The

[2] *See, e.g., Crolla Olivetti, i sette dubbi della consob*, CORRIERE DELLA SERA, Sept. 10, 1996, at 3.

[3] Coase's classic explanation for the existence of the firm in a modern exchange economy focused on transaction costs. *See* R. H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* RONALD H. COASE, THE FIRM, THE MARKET AND THE LAW 33 (1988).

[4] Michael C. Jensen & William H. Meckling, *Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

HeinOnline -- 1998 Colum. Bus. L. Rev. 122 1998

> professional managers or entrepreneurs who run the firm might as well abscond with the money.[5]

Early academic discussions about corporate governance in the United States focused on such issues as the merits of the conglomerate merger and the hostile takeover as mechanisms for controlling agency costs. However, more recently, there has been renewed focus on the legal responsibilities of corporate boards of directors, and the efficacy of shareholder litigation as a mechanism for controlling agency costs.

Serious comparative corporate governance is an even newer phenomenon for Americans. Of great interest recently has been the role played in corporate governance by institutional investors, particularly banks in the United States and abroad.[6] While there is a tremendous amount of debate about specific details, over the past thirty years the broad outlines of a general consensus about corporate governance seems to have emerged.

The structure of this article is as follows. Part II sets out the broad outlines of the consensus regarding corporate law that appears to have emerged in the United States over the past three decades. In Part III, the lessons from the United States are then applied to make a number of observations about corporate governance in Italy.

II. CORPORATE GOVERNANCE: AN EMERGING CONSENSUS

A consensus appears to exist on at least four important issues. There seems to be agreement among scholars and commentators on the incomplete nature of the corporate

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[5] ANDREI SHLEIFER & ROBERT W. VISHNY, A SURVEY OF CORPORATE GOVERNANCE 2 (National Bureau of Econ. Research Working Paper No. 5554, 1996).

[6] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994); Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States,* 48 STAN. L. REV. 73 (1995).

HeinOnline -- 1998 Colum. Bus. L. Rev. 123 1998

contract, the need to control managerial shirking where there is a separation of ownership and control, the political sources of corporate law, and the need to protect specific capital investments.

A. Measuring the Performance of Alternative Systems of Corporate Governance

While there may be a consensus on certain broad issues in the field of corporate governance, there certainly is no consensus about which corporate governance system is best. In fact, there is not even a consensus about the appropriate means to *measure* alternative systems of corporate governance. That is to say, there are no formalized, generally accepted criteria for determining if a particular system of corporate governance is working or not.

However, by drawing on recent research in corporate finance, possible empirical methods can be suggested for measuring and comparing the performance of corporate governance systems. Following the suggestion of Shleifer and Vishny and building on the work of Zingales, the performance of corporate governance systems can be categorized on the basis of how well they impede managers' ability to divert firm resources to their own, private uses.[7] Investors who are confident that a particular system of corporate governance provides a good level of protection against managerial self-interest will be more inclined to make investments in the first place. It is in this sense that a system of corporate governance can be said to contribute to the overall success or failure of a particular economy.

Comparing the variations among legal systems in the size of premiums paid for voting stock, as distinct from non-voting stock, provides one empirical measure of the performance of a particular system of corporate governance. As Zingales has observed, the fact that outsiders are often willing to pay sizeable premiums for voting, as opposed to

[7] *See* SHLEIFER & VISHNY, *supra* note 5. *See generally* Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994).

HeinOnline -- 1998 Colum. Bus. L. Rev. 124 1998

non-voting, stock suggests that there are high private benefits to control, and that these private benefits are not shared with outside, non-voting shareholders.[8]

Similarly, as Shleifer and Vishny suggest, if a corporate governance system is functioning well, then public markets for capital will function well. Firms will be anxious to go public, because doing so provides a low-cost method of funding projects. On the other hand, if the corporate governance system in a particular jurisdiction is not functioning well, entrepreneurs will not be able to make credible commitments to outside investors that they will be treated fairly *ex post* (i.e. after their initial investments have been made). Thus, the fact that there are large numbers of firms that are eligible to go public, but refrain from doing so, indicates the existence of a corporate governance system that is not functioning well.

B. The Consequences of Having a Non-functioning Governance System

As Part III makes clear, according to either of these measures, the corporate governance system in Italy is not functioning very well. On the other hand, the Italian economy is, in fact, functioning rather well. This raises the question whether corporate governance, like corporate law, is trivial.[9] I conclude that corporate governance is not trivial. The Italian economy has incurred enormous costs to adjust, or "innovate around" its lack of a properly functioning system of corporate governance. I argue that the consequence of the absence of a properly functioning system of corporate governance has been an economy dominated by small firms, an inability to effectively privatize large, inefficient state-owned firms, and an inability to build modern capital markets, including venture capital markets.

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[8] Zingales, *supra* note 7.

[9] *See* Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis?*, 84 NW. U. L. REV. 542 (1990).

HeinOnline -- 1998 Colum. Bus. L. Rev. 125 1998

C. What We Know About Corporate Governance

1. The Corporate Contract

It is well known that the contractual arrangements that exist among firms and investors are necessarily highly incomplete and contingent.[10] It is not possible to specify in advance (i.e. at the time an investment in a firm is made), the problems that managers of a complex enterprise will face in the future, with any degree of specificity. Moreover, the need for managerial discretion exacerbates the high cost of anticipating future problems. While there is some debate about the optimal solution to the problem of complex contracting, it seems clear that the rules requiring directors and officers to treat shareholders "fairly" (fiduciary duties in American parlance) are an attempt to permit the courts to complete the highly incomplete firm-investor contracts. Minority shareholders appear to be in particular need of the protection provided by the fairness requirements for two reasons. First, minority shareholders are, by definition, unable to organize an effective political coalition to oppose managerial actions that are adverse to their interests. Second, the market for corporate control cannot function when independent shareholder groups control only a minority of the voting shares in a company.

2. Managerial Shirking

It is also clear that some mechanism for controlling managerial shirking is necessary if a firm is to attract significant outside funds. Whether the best such mechanism is a robust market for corporate control in the context of the highly dispersed pattern of shareholdings in the United States, or active monitoring by institutional

[10] *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991); Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185 (1993); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

HeinOnline -- 1998 Colum. Bus. L. Rev. 126 1998

investors in the context of the more concentrated patterns of shareholdings in Germany or Japan, can be debated. But the fact remains that these mechanisms for monitoring management are clearly viewed as substitutes for one another, and that some mechanism or other is highly desirable.

3. Corporate Law and Politics

There appears to be an emerging consensus about the close relationship between corporate law and politics. In the United States, everything from state and federal laws governing hostile takeovers,[11] to the decision to leave corporate law to the states,[12] to the details of particular corporate law rules,[13] to the very structure of corporate law,[14] have been explained from a political or public choice perspective. The economics of corporate law has been infused with politics, and economic efficiency cannot be used to explain either the patterns of corporate governance or the ownership structure that can be observed among firms.

4. Protection of Firm-Specific Investments

One of the most important insights of modern economics, as it relates to the structure of the firm, is that the firm-specific investments necessary for a firm to flourish present opportunities for opportunism due to the non-simultaneity of investments and compensation. The risk of opportunism in firm-specific capital investments arises from the existence of an appropriable quasi-rent.[15]

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[11]Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988).

[12] Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation*, 76 VA. L. REV. 265 (1991).

[13] Jonathan R. Macey & Geoffrey P. Miller, *Toward An Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

[14] *See* ROE, *supra* note 6.

[15] Benjamin Klein et al., *Vertical Integration, Appropriable Rents and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

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Appropriable quasi-rents arise when an asset or an individual employee, is so specialized in its function, or so expensive to remove, that its value to other users is considerably less than its value in its current application. Klein, Crawford and Alchian illustrate the opportunism problem that comes with firm-specific investments with an example from the automobile industry.[16] They point out that the giant presses for stamping out auto bodies are customized for particular cars. After a stamping machine is customized, manufacturers of the presses are unable to sell them to other automobile companies, because they can only be used for the cars for which they were designed.

In addition, buying these presses involves a huge initial (sunk) cost but only a small incremental (operating) cost. The danger, then, is that an auto manufacturer will act opportunistically by reneging on its initial contract to buy a press from a press owner, such as by offering to pay only a steeply discounted price for the auto bodies made by the customized presses. The auto manufacturer could do this by feigning some reason to renegotiate the contract, such as claiming that the auto industry is depressed. Such behavior is difficult for courts to detect. If the auto manufacturer engaged in such behavior, it might only pay the owner of the press for the small marginal costs of operating the press and appropriate the press owner's huge sunk investment in the original construction of the press. Oliver Williamson[17] and Klein, Crawford and Alchian[18] have used these insights about the opportunities for exploitation that come with asset specificity to develop explanations of vertical integration in firms.

Vertical integration (i.e. control of assets by a single owner) is "an effective method for reducing the scope and impact of opportunistic behavior in the performance of

[16] *Id.* at 308.

[17] Oliver Williamson, *Corporate Finance and Corporate Governance*, 43 J. FIN. 567 (1988).

[18] Klein et al., *supra* note 15.

HeinOnline -- 1998 Colum. Bus. L. Rev. 128 1998

these activities."[19] However, as Harold Demsetz points out, vertical integration solves the problems associated with firm-specific investments far more easily for physical assets, such as the press described in the above example, than for human capital, which continues to belong to the employees with whom it is associated.[20] As human capital becomes increasingly important in economic development, providing incentives for employees to develop specific human capital skills becomes more critical. Rational workers who fear that any investments they make can be exploited, will refuse to make such investments unless compensated in advance. In various countries, different legal and cultural regimes strongly affect the ability of firms and workers to bargain successfully over investments in human capital.

III. CORPORATE GOVERNANCE IN ITALY

A. The Corporate Contract: Fiduciary Duties and Protection of Minority Shareholders

The well-known legal remedies that protect shareholders from opportunism by management, or by controlling blocks of shareholders, are non-existent in Italy. It is difficult to exaggerate the extent of this problem. One possible measure is provided by the incredibly large premium (eighty-two percent) attributed to voting shares on the Milan Stock Exchange.[21]

It is one thing to describe the institutional details of a particular system of corporate governance. While even the process of description can be challenging, developing an instrument with which to *measure* the performance of a

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[19] HAROLD DEMSETZ, THE ECONOMICS OF THE BUSINESS FIRM 19 (1995). *See also* Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes,* 1989 DUKE L. J. 173.

[20] DEMSETZ, *supra* note 19, at 19 n.9.

[21] Zingales, *supra* note 7, at 125-26.

HeinOnline -- 1998 Colum. Bus. L. Rev. 129 1998

corporate governance system is even more difficult. In my view, one highly useful measure of the efficacy of a system of corporate governance is the premium accorded by the market to control shares. The right to control a corporation brings with it the right to realize all of the private benefits associated with such control. Large premiums for the shares needed to control a corporation suggest that the private benefits of control, including the ability to transfer wealth from minority shareholders, are great. Such large premiums also indicate that the protections for outside investors in general, and minority shareholders in particular, are weak.

Under Italian law, while multiple voting shares have been illegal since 1942, since 1974 firms have been able to issue non-voting stock (called savings shares "azioni di risparmio") in addition to one share/one vote stock. Ironically, savings shares were introduced as a means to promote stock ownership among small investors. Savings shares are entitled to a minimum dividend equal to five percent of the par value of the certificates, and such shares have a priority in bankruptcy over other shares equal to the par value. In addition, dividends on savings shares cannot be decreased by a charter amendment, nor can companies reduce the bankruptcy priority of such shares. Moreover, whenever dividends are paid to common stockholders, owners of savings shares are entitled to an equal dividend plus two percent of the par value of their shares.

The existence of savings shares provides a means for estimating the value of voting rights in Italy because owners of savings shares enjoy at least all the rights of "regular" voting shareholders to dividends and distributions upon liquidation. In the absence of preferential treatment to savings shareholders, the price estimate of a voting right would be the difference between the price of a voting share and the price of a savings share.

Zingales studied the share price performance of all companies having both voting and non-voting stock traded on the Milan Stock Exchange between 1987 and 1990 (excluding convertibles). He found that even before taking

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into account the additional dividends to which holders of savings shares are entitled, voting shares with inferior dividend rights trade at an average premium of 82% above non-voting shares. When the greater dividend rights of the savings shares are taken into account, the premium for the right to vote rises to more than 90%.[22]

This premium for voting stock is by far the highest in the world. It greatly exceeds the world average of between 10 and 20% (the United States premium is 5.4%) and is double that of Israel, the country with the second largest premium.[23] The very high premiums for voting shares in Italy suggest that the private benefits of control are extremely high. In other words, these premiums suggest that the ability of controlling shareholders to exploit minority shareholders is very high.

One example of the exploitation of minority shareholders is given by the Finsiel transaction in 1992. IRI, a wholly state-owned holding company, decided to sell its 83.3% stake in Finsiel, a software company, to STET, the Italian (state-controlled) telecommunications group. The Italian government owned 100% of IRI, but "only" 53% of STET. Small private investors owned the other 47% of STET. Clearly the government could profit from control and transfer wealth from the small private investors to itself by causing STET to buy Finsiel for a grossly inflated price, which is exactly what happened. STET paid 700 billion lire for Finsiel, 50 times the company's earnings. This was significantly over the industry standard of between 20 and 30 times earnings, particularly for a company that was on the verge of losing its privileged ability to obtain government contracts due to European Union ("EU") regulations. Further evidence of overpricing arose from the fact that Olivetti, an arms-length buyer, had made an offer of 266 billion lire for Finsiel the previous year. STET stock

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[22] *Id.* at 126-27.

[23] *See* Ronald C. Lease et al., *The Market Value of Control in Publicly-Traded Corporations*, 11 J. FIN. ECON. 439 (1983); Haim Levy, *Economic Evaluation of Voting Power of Common Stock*, 38 J. FIN. 79 (1982).

HeinOnline -- 1998 Colum. Bus. L. Rev. 131 1998

lost 20% of its value on announcement of the Finsiel transaction.[24]

Of importance for this discussion is the fact that there appears to be no adequate legal remedy for the sort of exploitation of minority shareholders of STET that one observed in the Finsiel transaction. No lawsuit was ever brought against any of the participants. Indeed, it is not possible to bring derivative lawsuits in Italy.

A similar anecdote is found in the Ferruzzi-Monetedison transaction. Ferruzzi was an unlisted company owned by Mr. Raoul Gardini, who also owned 42% of Montedison, a company listed and quoted on the Milan Stock Exchange. META, another in the Gardini group, was listed and publicly traded, but Montedison owned a majority of its shares. Mr. Gardini transferred META to Ferruzzi for inadequate consideration (i.e. for Ferruzzi stock at a price based on an artificially low, pre-1987 crash valuation for Ferruzzi). In response to criticism in the press of this transaction, Mr. Gardini replied that he would not be judged by "Wall Street criteria." He also noted that "[t]his is an [I]talian operation in the Italian context and those shareholders who do not like it can leave it."[25]

These examples illustrate that there is no mechanism within Italy for completing the incomplete contracts that exist between firms and their shareholders. Control groups are free to do what they wish. There is little or no regard for minority shareholder interests, and the applicable legislation is not effective in protecting minorities from exploitation.[26]

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[24] *See* Zingales, *supra* note 7, at 146; *Stock in Italy's STET is Sold Off in Protest of Privatization Plan,* WALL ST. J., Oct. 6, 1992, at A15.

[25] 2 DEPARTMENT OF TRADE AND INDUSTRY, BARRIERS TO TAKEOVERS IN THE EUROPEAN COMMUNITY, ¶ 5.13 (1989).

[26] Cristiana Ghezzi, L'abuso di Potere a danno della Minoranza Assembleare 3 (Nov. 1996) (unpublished manuscript, on file with author).

HeinOnline -- 1998 Colum. Bus. L. Rev. 132 1998

Derivative lawsuits are not permitted under Italian corporate law.[27] In fact, for directors to be sued, shareholders must pass a resolution authorizing such a suit at the general meeting of shareholders.[28] As Roberto Weigmann has observed, the formal, legal protection that minority shareholders have under Italian law is more apparent than real.[29] Shareholders have the right to make a complaint to the firm's internal auditors, whose only obligation is to take the complaint into account in their annual report. However, if the complaining shareholders own at least five percent of the firm's shares, the auditors must conduct an investigation and put forward proposals at a general meeting of shareholders on how to correct the problem if they find that the complaint identifies legitimate problems within the firm.[30] In practice, this is only a very limited right as the officers about whom the shareholders are complaining generally dominate the general meeting.[31] Minority shareholders of at least ten percent of a firm's shares also have the right to file for a court-ordered inspection, which can result in the nomination of a representative who can sue the directors for money damages.[32]

The premium paid for voting shares is strong evidence of the cost of the lack of protection for non-controlling shareholders. The premium for the voting shares can also be viewed as a discount for the non-voting, savings shares. Still further evidence of the staggering cost of the lack of protection for Italian non-controlling shareholders is given by the fact that, in Italy, publicly traded companies are very rare. During the 1982 to 1992 period, 1700 companies

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[27] ROBERTO WEIGMANN, RESPONSIBILITA' E POTERE LEGITTIMO DEGLI AMMINISTRATORI 104-13 (1974).

[28] Codice civile [C.C.] art. 2393 (Italy). *But see* C.C. art. 2373(3) which prohibits directors that are shareholders from voting on such a resolution.

[29] WEIGMANN, *supra* note 27.

[30] C.C. art. 2408.

[31] WEIGMANN, *supra* note 27, at 112.

[32] C.C. art. 2409.

HeinOnline -- 1998 Colum. Bus. L. Rev. 133 1998

satisfied the listing requirements of the Milan Exchange, but there were only 66 new listings of non-financial companies during that period.[33] Those companies that were eligible to list were, on average, four times as large as their U.S. counterparts (based on annual sales).[34] In fact, there was approximately the same number of firms listed on the Milan Stock Exchange in October 1996 (218) as there was in 1910 (210).[35]

The above analysis raises significant doubts about the usefulness of improved disclosure as a means for solving Italy's corporate governance problems. The lack of a means to redress shareholder grievances, coupled with a highly illiquid stock market, and the complete absence of a market for corporate control, suggest that disclosure is not likely to provide meaningful benefits to shareholders. More importantly, the empirical evidence indicates that investors in the Italian capital markets take account of the costs of the corporate governance system when they purchase shares. That is why so few firms go public, and why discounts are paid for non-voting shares. In other words, it appears that relevant information about the governance system is already impounded into share prices. Disclosure would not add anything.

The effects of the lack of legal protection for outside shareholders are exacerbated by the prevalence of pyramidal ownership structures in Italy. Such structures enable a single firm or entrepreneur to control multiple companies through mutual and overlapping investments. Approximately sixty percent of listed companies are part of corporate groups, and, unlike most other countries, even relatively small companies tend to be part of such groups.[36]

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[33] *Facciamo crescere la Borsa*, LA STAMPA, June 23, 1994, at 19; MARCO PAGANO ET AL., WHY DO COMPANIES GO PUBLIC? AN EMPIRICAL ANALYSIS 15-17, 19 (National Bureau of Econ. Research Working Paper No. 5367, 1995).

[34] PAGANO ET AL., *supra* note 33, at 20.

[35] *Id.* at 14.

[36] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD ECONOMIC SURVEYS: ITALY 59 - 60 (1995).

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In Italy, as elsewhere, particularly in Sweden, such pyramidal ownership structures can be used to make it more difficult for outsiders to monitor and control incumbent managers. As has long been recognized in Italy, the pyramidal ownership structure allows controlling investors to obtain significant amounts of leverage. As Fabrizio Barca has observed:

> By spreading the voting rights of minority shareholders out over a large number of firms, and concentrating those of the entrepreneur in the company at the top of the pyramid, this [pyramidal structure] allows [the entrepreneur] "to obtain control over the greatest possible amount of other people's capital with the smallest possible amount of his own." This way of achieving separation puts the interests of minority shareholders in all the subsidiaries of the group at particular risk. These interests might in fact systematically diverge from those of the entrepreneur, whose interests are linked to the performance of the group as a whole.[37]

It seems likely that these pyramidal structures are used not only to entrench management, to disadvantage minority shareholders and to elude capital market discipline, but also to substitute for the absence of legal protection for a contracting party. Membership in such groups helps prevent opportunistic behavior. This is because the controlling parties at the top of the organizational pyramid of a group can force the members both to comply with their actual and implicit contractual obligations and to treat other parties fairly.

B. Managerial Shirking in Italy

An important part of any system of corporate governance is some mechanism for controlling managerial

[37] Barca, 1996, *supra* note 1, at 14 (quoting R. HILFERDING, DAS FIANZKAPITAL (Europäische Verlagsansstalt 1968) (1910)).

HeinOnline -- 1998 Colum. Bus. L. Rev. 135 1998

shirking. As Michael Jensen and William Meckling observed, investors will discount the price they are willing to pay for a firm's shares by the expected levels of managerial shirking.[38] Accordingly, a firm must be able to make a credible commitment to control such shirking if it is to attract significant outside funds.

As noted above, there is no agreement among corporate governance scholars as to whether the best mechanism for controlling managers is a robust market for corporate control (the U.S. model) or active monitoring by institutional investors (the German model).[39] But the fact remains that the existence of some kind of mechanism is critical.

There is no possibility of a market for corporate control developing in Italy, regardless of whether there is any legal liberalization, because of the prevalence of pyramidal ownership structures, complex cross-holdings and non-voting shares. As of 1989, only seven companies had offered more than 50 percent of their shares to the public in general. In five of the seven companies, voting control remained in a small group, leaving only two, Pirelli, and Assicurazioni Generali, as potential targets of contested takeover bids.[40]

In Germany and Japan, commercial banks replace the market for corporate control as monitors of firm performance. This is not the case in Italy where banks hold almost no shares in non-financial companies.[41] Indeed, in Italy, the state owns almost three times the amount of stock in listed companies as the banks.[42] This is not surprising given that prior to June 1993, banks in Italy, as in the United States, were prohibited from holding securities on

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[38] Jensen & Meckling, *supra* note 4.

[39] *See supra* Part II.C.2.

[40] DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 25, at ¶ 3.21, 3.27.

[41] BARCA ET AL., ASSETTI PROPRIETARI E MERCATO DELLE IMPRESE: VOL. II., *supra* note 1.

[42] Banks own 9.9% of the equity in listed companies, while public authorities own 27.0%. *See* ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 36, at 59.

HeinOnline -- 1998 Colum. Bus. L. Rev. 136 1998

their own behalf. Shares could only be held under direction from private or institutional investors.[43] Further, other institutional investors such as mutual funds and pension funds do not replace the role played in corporate governance by the large banks in Germany and Japan.[44] Mutual funds are quite weak, and there is little pension investment because of the generous unfunded, pay as you go system of public pensions.

All in all, there is no evidence of any active monitoring or other involvement in corporate governance by any institutional investors group.[45] For these reasons, constraints on managerial shirking appear to be non-existent. There is no market for corporate control, and no institutional investor group is willing or able to monitor Italian companies.

C. Corporate Law and Politics in Italy

There is no reason to believe that the structure of Italian corporate governance has been randomly determined. Rather, as in the United States and elsewhere, it seems likely that the structure of corporate governance reflects the preferences of powerful interest groups and the well-entrenched elite. For example, as in the United States, industrial leaders are not enthusiastic about the idea of hostile takeovers. As a study on takeovers in Italy pointed out:

> The concept of a public takeover offer is not accepted by the leaders of the [Italian] industrial establishment. For example, Gianni Agnelli, the chairman [now honorary chairman] of the Fiat group, has said that public takeovers are not in the Fiat "style". Cesare Romiti, Fiat's managing

[43] DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 25, at ¶ 2.7.

[44] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *supra* note 36, at 59.

[45] M. BIANCO & P.E. SIGNORINI, EVOLUZIONE DEGLI ASSETTI DI CONTROLLO: GLI INVESTITORI ISTITUZIONALI (Banca d'Italia, Temi di discussione No. 243, 1994).

HeinOnline -- 1998 Colum. Bus. L. Rev. 137 1998

> director [now titular chairman] has attacked the notion of the broadly held company on Wall Street. The Agnelli family, like other "old guard" Italian leaders in business, have started forming special limited partnerships known in Italy as Societa' in accomandita per azioni (Sapa). According to a comment by Franzo Grande Stevens, Agnelli's lawyer, the idea is to keep "outsiders strictly outside".[46]

Politics plays a more central role in Italian corporate governance than in any other G-7 nation due to the fact that the state controls about fifty percent of the nation's medium and large companies, and about eighty percent of the nation's banks as measured by deposits.[47] It is well documented that:

> [T]he State has constantly made up for failures in the governance environment of private companies by providing them with a steady flow of resources. The State has transferred large funds to entrepreneurs to overcome situations of financial distress, has bought out mismanaged companies, has provided subsidies to realize delayed restructuring, [and] has subsidized loans.[48]

Fabrizio Barca, an influential commentator on corporate governance at the Bank of Italy, has asserted that the political market can replace the market for corporate control.[49] In light of the fact that governments in Italy and elsewhere have done a very poor job of allocating capital and making other managerial decisions, it is hard to imagine how this could be the case. In particular, since politicians must, by definition, survive in a political market, they inevitably will make business decisions on the basis of how such decisions will be received politically, rather than

[46] DEPARTMENT OF TRADE AND INDUSTRY, *supra* note 25, at ¶ 3.37.
[47] Barca, *1996*, *supra* note 1, at 12.
[48] *Id.* at 13.
[49] *Id.* at 12.

HeinOnline -- 1998 Colum. Bus. L. Rev. 138 1998

on the basis of how such decisions will effect the profitability of the firms with which they are involved. This will lead to the politicization of everything from hiring managers to plant relocations, to capital budgeting decisions.

Public choice teaches that the occasional, well-meaning politician who attempts to manage a firm efficiently will be replaced by a rival politician who gathers more political support by promising to manage the plant for the benefit of powerful interest group coalitions.[50] Thus as real world experience from Bulgaria to Moscow has shown, it is not possible for state ownership and control to replace private sector initiatives in corporate governance.

Similarly, it would be wrong to suggest that providing a bigger role in corporate governance to Italian banks will have a positive effect on corporate governance structures. Such a move might be defended on the grounds that it would bring Italy into line with the continental paradigm. However, unlike the situation in the rest of Europe, the Italian banking sector is largely under state control. Since June 1993, following the implementation of the European Community Second Banking Directive[51] and in conformity with EU practice and policy, Italian banks have been permitted to own shares in non-financial companies. In 1990 steps were taken to have Italian banks sold to private investors, but as of now the voting stock in Italian banks is often held by an unusual entity known as a "foundation." These foundations are in turn controlled by central and local governments, and it does not seem likely that these institutions will move into private hands in the near future.

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[50] *See generally,* Jonathan R. Macey, *Public Choice: The Theory of the Firm and the Theory of Market Exchange,* 74 CORNELL L. REV. 43 (1988).

[51] Council Directive 89/646, art. 12, 1989 O.J. (L 386) 7.

HeinOnline -- 1998 Colum. Bus. L. Rev. 139 1998

D. Implications: The Italian Miracle, Firm Size, Regulatory Avoidance, and Firm-Specific Capital Investments

To this point, this article has documented the complete absence of any of the basic features of a fully functional system of corporate governance. There are no enforceable fiduciary duties. There is a complete absence of protection for minority shareholders.[52] Also there is no operational mechanism for outside monitoring in the form of either a market for corporate control or institutional investor oversight by banks or other institutions.[53]

Italy is a successful economy, with respectable output growth and GDP per capita above the EU average (at least until recently), and higher than that of the United Kingdom.[54] Given this economic success, one is tempted to conclude that corporate governance must not be particularly important. After all, if corporate governance were important, Italy could not have done so well economically in light of the fact that its corporate governance system is so poorly developed.[55]

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[52] The very few successful actions brought by minority shareholders are often due to the peculiarity of settings or to a loophole in the otherwise tight majority principle, a loophole that takes a toll on directors only in small, unsophisticated companies (C.C. art. 2373 bars shareholders who are also directors from voting on their own liability, so that minority shareholders can authorize the action.) No authentic departures have been found from the principle that directors can be held liable only if the majority authorizes it. *See* Lorenzo Stanghellini, *Corporate Governance in Italy: Strong Owners, Faithful Managers. An assessment and a proposal for reform*, 6 IND. INT'L & COMP. L. REV. 172 n.271.

[53] Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of MSIC in the Corporate Governance Debate*, 45 STAN. L. REV. 985 (1993).

[54] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD ECONOMIC SURVEYS: ITALY 166 app. (1997).

[55] Although, it should be noted that the most recent OECD economic survey has noted an important setback to the strong economic growth previously evident in the Italian economy. *See id.* at 1.

HeinOnline -- 1998 Colum. Bus. L. Rev. 140 1998

However, a look at the industrial structure of Italy shows why corporate governance is unimportant in that country. In Italy there are a very large number of small businesses, defined as firms with less than 10 employees, and a very small number of large or even medium-sized companies.

Size of Businesses in Italy:

No. of employees	No. of companies (thousands)	% of total
1-9	2680.0	94.10
10-19	103.2	3.60
20-49	43.4	1.50
50-99	11.8	0.40
100-499	8.3	0.30
500-999	0.8	0.05
>1000	0.5	0.05
TOTAL	2848.0	100.00[56]

Corporate governance doesn't matter very much in Italy because there are so few large and medium sized firms relative to what one would expect.[57] In other words, one might say that corporate governance matters a lot because

[56] Data provided by Istituto Nazionale di Statistica (ISTAT), a statistical reporting agency of the Italian government. The data was collected in 1988 and was supplied by ISTAT in response to requests from the Bank of Italy. Part of the industrial structure of the Italian economy doubtlessly can be explained by the fact that Italian firms with more than 15 or more employees are much more strictly regulated than firms with fewer than 15 employees. In particular, it is extremely difficult to terminate employment in firms with 15 or more employees. Codice civile [C.c.] legge 15 luglio 1966, n. 604 – *Norme sul licenziamenti individuati*, legge 11 maggio 1990, no. 108 – *Disciplina dei licenziamenti individuali*, in Giorgio de Nova, Codice civile e leggi collegate, 1997/98 (Zanichelli). However, this data does not explain why there are so few companies with 10-14 employees, or why less than one percent of Italian firms have 50 or more employees.

[57] *Cf.* F. BARCA & M. MAGNANI, L'INDUSTRIA FRA CAPITALE E LAVORO (1989) (observing the relative paucity of medium and large-sized firms in Italy).

HeinOnline -- 1998 Colum. Bus. L. Rev. 141 1998

the industrial structure of Italy reflects the problems in the country's corporate governance system. In the single-owner or family-owned firm that dominates the economy of Italy as in no other developed country, complex corporate governance structures are unnecessary because individual entrepreneurs have strong incentives to monitor and control their own firms. Institutional investors, fiduciary duties, takeovers, and protection for minority shareholders are unimportant in the Italian context.

The striking dominance of the Italian economy by small firms has two other advantages. First, in a country dominated by very high taxes and incredibly complex, and often nonsensical, regulation of business, small firms can more easily maneuver "under the radar screen" of regulators.[58] For example, Pagano, Panetta and Zingales found that after going public, Italian firms paid about two percent more in taxes per year than before.[59] This is likely due to the greater accounting transparency enforced by the stock exchange on listed companies.[60]

In addition to being able to avoid burdensome regulations and to be relatively unencumbered by the problems that plague the system of corporate governance, the small firms that dominate the Italian economy have another advantage. Within such firms there is a strong incentive to make firm-specific human capital investments in workers. This is because these firms, which are closely held and often staffed with family members or close friends of the owner, can make credible, long-term commitments to employees that, in turn, provide the employees with incentives to make such firm-specific capital investments. Thus it is not surprising that most of the small firms in Italy "produce complex yet traditional products, employ a large share of relatively skilled labour with a flexible organization and have attained through the years a more

[58] Robert Graham, *A Year of Corruption: Corruption has Become so Pervasive the Practice Carries No Stigma,* FIN. TIMES, December 30, 1994, at 4.

[59] PAGANO ET AL., *supra* note 33, at 32.

[60] *See id.*

HeinOnline -- 1998 Colum. Bus. L. Rev. 142 1998

stable and successful performance than that of large firms."[61]

IV. CONCLUSION

In recent years, comparative corporate governance has focused on the systems of Germany, Japan and the United States. This has given the impression that the only alternative among rival corporate governance systems exists between the system of bank governance in Japan and Germany and the protections provided by the legal system and the market for corporate control in the United States.[62] If nothing else, a study of the Italian corporate governance system shows that there are alternative systems. The Italian system appears to be a failure in the sense that it provides only extremely modest legal protection for minority shareholders, and does not provide a mechanism for constraining managerial excess, either through institutional investor monitoring, a market for corporate control, or strong legal rules.

However, the Italian economy, at least until recently, was very strong. As noted at the outset of this article, this raises the question of whether corporate governance, like corporate law, really matters.[63] This study of Italian corporate governance suggests that corporate governance does, in fact, matter. The Italian economy succeeded by being able to contract around its systemic corporate governance problems, but it has incurred enormous costs in doing so. The Italian model of an economy dominated by small, efficient family firms that subsidize large, highly inefficient state-controlled firms is unlikely to survive European unification. In addition, Italy's inability to build modern capital markets, including venture capital markets, will impose increasing costs on entrepreneurs.[64]

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[61] Barca, 1996, *supra* note 1, at 7.

[62] *See, e.g.*, SHLEIFER & VISHNY, *supra* note 5.

[63] Black, *supra* note 9.

[64] As this article went to press, the Italian government was debating a new statute designed to reform Italian corporate governance. On

HeinOnline -- 1998 Colum. Bus. L. Rev. 143 1998

In the near-term, therefore, it seems likely that the system will change. One possibility is for the banks to be privatized successfully (i.e. taken out of direct and indirect government control), and for the banks then to emerge as the dominant force in the country's corporate governance system. There seem to be strong political obstacles to achieving this result, but it is possible that these obstacles will be overcome, particularly if the European Union begins to encourage Italian privatization more forcefully as a way of opening up Italy's highly protected banking markets to outside competition.

Alternatively, it is possible that the market will generate credible, self-enforcing protections for minority shareholders that will enable capital markets to develop. While there are barriers to innovation of this kind, such an outcome is not impossible. There are early signs that change is occurring on both of these fronts, so there is some reason to be optimistic about the future of corporate governance in Italy.

February 12, 1998, the newspaper *La Republica* reported that the Italian House (Camera) had approved these reforms, which are collectively referred to as the Draghi proposal. The most important aspects of these reforms are that it would simplify the procedures for making an unsolicited tender offer for a publicly held Italian company. In particular, the reforms would require that any bid for a certain threshold percentage of the shares of a target firm (which is likely to be set at 30 percent) must be extended to 100% of the shareholders. The original proposal would have permitted minority shareholders with 5% of a firm's stock to bring a form of derivative lawsuit (azione di responsibilità). But the threshold has been raised, and the rights significantly diluted. *See* La Repubblica.it, "Bozza Draghi Disco Verde "Entusiasta" della Camera" http://www.repubblica.it/cgi-bin/prima.cgi?dday=980212&sez=EC&name=23BOZZA; Il Sole 24 Ore On Line Quadderno, "Le Proposte di Modifica" http://www.ilsole24ore.it/quaderni/cg/modifica.htm.

HeinOnline -- 1998 Colum. Bus. L. Rev. 144 1998