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ITALY

Introduction

Small to mid-size companies (*“PMI, Piccole Medie Imprese”*) are the strength of the Italian corporate system: roughly 50% of Italian companies have a workforce of less than 10 individuals, more than twice that of France, Germany and the U.K..

Many of these companies, however, are critically undercapitalized, in the sense that equity used to start them is, in most cases, much lower than it should be compared to their total turnover.

Therefore, financing for Italian companies is highly needed, and comes predominantly from existing shareholders (this proves true for 50% of the companies) or loans from banks (accounting for at least 1 out of 3 companies).

The use of the market in raising financing for Italian companies is marginal: for instance, issuance of bonds is seldom used. IPOs have also been insignificant, compared to the Italian GDP, and the Italian Stock Exchange has not really proven successful.

In this context, often described as *“dwarfism”* of the Italian system, the venture capital and private equity markets could potentially boom, although this has not happened yet given the very *“traditional”* approach of Italian entrepreneurs and reluctance to give out corporate governance powers in exchange for equity.

A. REGULATORY FRAMEWORK

Companies Act and corporate law reform

Types of Corporate Financing of Capital

There are many types of corporate financing of capital in Italy, depending on the type of corporate structure chosen. Corporations (*"Società per Azioni"*, or *"S.p.a"*) and Limited Liability Companies (*"Società a responsabilità Limitata"* or *"S.r.l."*) have access to different corporate financing.

Società per Azioni

S.p.a.s under Italian law may issue different types of shares according to Articles 2346 – 2362 of the Italian Civil Code.

One effect of the recent reform of the Italian corporate law has been to allow corporations to distribute shares without nominal value, as long as the number of shares respective to capital invested corresponds with the total amount of capital.

However, in no case may the value of the shares be greater than the total capital value invested in the corporation.

Italian corporations may issue a number of different types of shares, each with its own corresponding rights and obligations (all types of shares issued except ordinary shares must be provided for by the corporate By-laws):

- **Ordinary shares** (*"Azioni Ordinarie"*): holders have the right to vote in the shareholders' meetings and the right to obtain back the value of their shares if the company is liquidated (provided that the corporation has not suffered losses which are greater than such amount);
- **Deferred Shares** (*"Azioni Postergate nella partecipazione alle perdite"*): such shares are deferred in bearing losses suffered by the corporation;
- **Privileged Shares in Liquidation** (*"Azioni Privilegiate nella liquidazione"*): holders are preferred in receiving benefits and partition in the event of liquidation;
- **Shares related to profits** (*"Azioni Correlate"*): holders receive dividends depending on the results achieved by the corporation in a specific field;

- **Dividend-bearing shares** (*“Azioni di Godimento”*): holders are without the right to vote and receive dividends equal to legal interest rate after payment of dividends to shares which are not reimbursed ;

- **Employee shares** (*“Azioni a Favore dei Dipendenti”*): may only be issued under an express clause in the corporate by-laws and must be accompanied by a corresponding increase in the capital stock;

In addition to issuing shares of stock, Italian corporations can also issue bonds (*“obbligazioni”*). By issuing bonds, corporations sell debt with the promise to pay it back within a certain time frame along with a certain percentage of interest. The payment of interest may be tied to a number of objective factors, including the economic performance of the corporation. Every bond must indicate its value and the rights and obligations connected to it. Corporations may not issue debt in an amount greater than twice the amount of existing capital.

Like shares of stock, bonds issued by corporations can take a variety of forms:

- **Deferred Bonds** (*“Obbligazioni Postergate”*): for such bonds the restitution of capital and interest may be subordinated to the claims of other creditors;

- **Variable Bonds** (*“Obbligazioni Variabili”*): for these bonds the restitution of capital and interest may be tied to objective factors including the performance of the corporation;

- **Convertible Bonds** (*“Obbligazioni Convertibili”*): these bonds give the holder the right to convert such bonds into shares of stock. As such, these bonds can be considered as contribution of equity to the corporation. The rate of conversion may be less than the value of current shares. If the corporation decides to offer such bonds, it must offer to the existing stockholders the right to maintain their percentage of ownership in the company, as well as the right to acquire such convertible bonds;

- **Hybrid bonds** (*“Strumenti Ibridi”*): the recent reform of Italian corporate law has introduced a new kind of financial instrument which is a hybrid stock / bond. This new type of instrument can be issued to existing shareholders or third parties in compensation for services and/or work. These instruments give bondholders the right to participate in the corporation (mainly monitoring and information rights), albeit at a level far below that of ordinary stockholders (for instance, the right to vote is excluded). The total amount of such instruments may not exceed that of the corporate capital.

One last method of raising capital, of exclusive use of S.p.A.s, is the dedication of assets to a particular project (*“patrimonio destinato a specifici affari”*). The project, however, cannot have a value greater than 10% of the net assets of the company. The assets raised which are dedicated to the particular project are separated from the other assets of the corporation. The corporation may also raise capital specifically destined for one of these special projects. One advantage of the special project is that the corporation can make the decision to reimburse the loans undertaken to finance the project from the proceeds of the project itself, isolating the rest of the corporation's assets. Each project is usually accompanied by a specific agreement with the financier containing a description of the project, the financing plan, the specific goods needed to effect the project, guarantee of reimbursement, inspections that the financier can undertake, which proceeds will be used to reimburse the financier, and the duration of the project.

In conclusion, the reform of Corporate Law, which came into effect in 2004, has brought some more interesting news for investors:

The introduction of a specific regulation on LBOs expresses a new generally positive approach towards LBOs, making it clear that a merger between two companies where one has borrowed funds to buy the other, will not necessarily be in breach of the prohibition of financial assistance;

The possibility for S.p.A.s to choose between four alternative corporate governance models: in addition to the traditional model, where shareholders appoint a board of directors and a board of auditors, shareholders may set up companies with a dual board system comprising a management board and a supervisory board, or they may set up a company with a unitary board system with a board of directors and an independent internal audit committee, or they may appoint two or more directors, each having full powers to act on behalf of the corporation;

Non-executive directors will not be liable in the same manner and degree that executive directors are.

Società a responsabilità limitata

Limited liability companies in Italy are not permitted to issue either stock or bonds. They can, however, issue certificates of debt (*“titoli di debito”*). Such certificates can only be purchased by professional investors under prudential supervision (*“investitori professionali a vigilanza prudenziale”*). The manner of such emission of debt will be conditioned by the by-laws of the company.

Another way to raise capital for S.r.l.s is contributions of capital via goods and servic-

es. The recent reforms to the corporate law have expanded what can be exchanged for a right to ownership in a company. Contributions can take the form of monetary units, articles of credit, goods and services. These types of contributions, however, must be supported by a report from an expert nominated by the company. The value of any non-monetary instrument may not be more than the actual value of the goods.

Testo unico dell'intermediazione finanziaria

Legislative decree number 58 (*"Testo Unico dell'intermediazione finanziaria"*), passed in 1998, represented a major shift in the system of regulating financial markets in Italy. First, it moved the regulation of financial markets from the field of law and into the field of secondary dispositions of the law, including operative regulations (*"regolamenti di attuazione"*). This occurred to give the law increased flexibility to be modified in case of necessity. The regulations themselves deal with the relationship of corporations and the brokers who help the company buy and sell its financial instruments in the open market.

The CONSOB (*"Commissione Nazionale per le Società e la Borsa"*), a governmental agency with powers roughly similar to the American SEC, determines the regulations and the content of publications that are used to solicit investment in the company before its securities are traded on the open market. The CONSOB can also specify the requirements of what information must be included in the company's financial prospectus.

According to the law, companies must release information that may affect the price of the securities. The CONSOB will set the conditions under which such information must be released, and also the manner in which it is to be released. The CONSOB can also officially request documentation from particular companies.

The CONSOB can also, pursuant to the regulation, set criteria which companies must meet in order to qualify for participation in the public market. The companies therefore must submit to review of their accounts by a qualified agency.

All shareholders in companies with holdings above a certain percentage (2% for S.p.A.s) must render such information to the CONSOB. The CONSOB will issue regulations regarding the calculation or participation of the shareholders, as well as the conditions for such communications. If a shareholder has a greater than 2% share in a corporation, he is prohibited from having a greater than 2% shares in any other corporation which is controlled by the first. Furthermore, any agreement which give the holders of one company the right to vote in another must be related to the CONSOB and must be published. All rights to vote in a company, to be valid, must conform to regulations set out by the CONSOB.

Regarding the shares that the corporations issue, the law states that such shares may be without voting rights as long as they have special economical rights. All shares must specify the rights and obligations given to their holders.

Lastly, the law lays out the procedures for the formation of the board of auditors (*“collegio sindacale”*), and the rights and responsibilities of such board in reporting and supervising the financial activities of the corporation. The law also calls for a reviewing agency to oversee the company’s balance sheet and ensure that the company is conforming with the applicable accounting regulations. The reform gives the auditing company the right to access company documents during their inspection, the results of which will then be conveyed to the CONSOB. The CONSOB itself will oversee the activity of the reviewing agency.

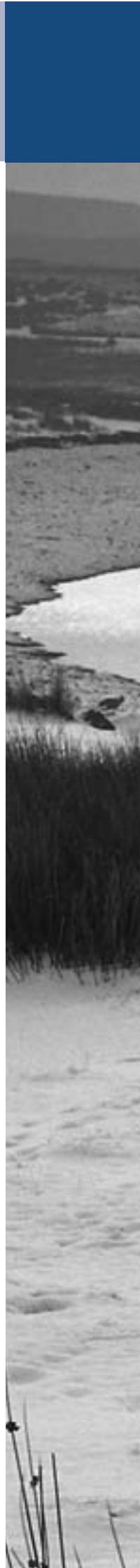
The Italian Stock Exchange

It may be surprising to the foreign observer how limited a role is played in the economy by the public, either directly or through the Stock Exchange (*la “Borsa”*, www.borsaitalia.it). Only a very limited number of companies are listed (278 as of today). Usually, traded shares represent only a minority interest in the listed company, and they are therefore of little significance in terms of corporate power. The system for raising funds in the public markets is relatively underdeveloped. Italians are known for having a high amount of savings in comparison to earnings, but also for reinvesting a very small proportion of these savings into the Italian financial markets.

It should be added to that that the recent Parmalat corporate scandal, which took place in 2004, has definitely not been of any help in raising Italian confidence in the Stock Exchange.

Therefore, most of the finance required for investments is procured from various sources of credit, rather than looking to the equity markets. By foreign standards, a very small amount of commerce and industry in Italy is privately and closely controlled by groups and families.

4 different “segments” can be observed in the Italian Stock Exchange: Standard, STAR, Blue Chip and Expandi.





The **Standard** segment of Borsa Italiana's equity market (also the "traditional" one) includes all companies with a capitalization of between Euro €40 million and Euro €1 billion which are currently not listed on the STAR segment (see below): mainly small and mid size companies.

The **STAR** segment is a special listing for companies in the equity market that obey to a more stringent ethical conduct and disclosure policy and have a capitalization of less than €1000 Mmillion of Euros. Companies in the STAR segment must comply with the following requirements:

High transparency and stringent disclosure requirements;
High liquidity (minimum 35% of stock on the market);
Severe rules of corporate governance, according to which some of the directors must be independent (non-executive).

Italian and foreign institutional investors as well as private investors appreciate the elevated quality of the STAR segment.

Borsa Italiana offers continuous support, during the course of the year, for the STAR segment's communication towards institutional investors, particularly by way of several road shows inviting listed companies to introduce themselves in the world's most important financial capitals of the world.

Blue Chip is the market segment of Borsa Italiana's equity market reserved to companies listed on the S&P/MIB and MIBEX Index, as well as other companies having a solid economical / financial structure and a capitalization of over €1 billion euros.

Borsa Italiana's **Expandi** market is created for those small and mid-size companies which are active in traditional sectors, with success in their respective fields, who can account for a consolidated economical - financial track record. Such market offers simple, affordable and fast listing.

B. CONSIDERATION OF TYPES OF FINANCING

1. Existing shareholders and directors

1.1 Shareholders' loans

Companies can raise capital via contributions or loans of monetary instruments, as well as good and services, by partners and other shareholders of the company. However, these contributions and loans are not considered equal to those given by persons not already members of the corporation. Due to their status as existing financiers of the company, these contributions may be later claimed as loans. Therefore from a legal perspective the purpose of the money must be judged based on declarations made by the shareholders. In the case that the shareholder demands restitution, he has the burden of showing that it was a loan and not a contribution of capital. Furthermore, the restitution claim of a stockholder will be subordinated to all other financial obligations of the corporation.

1.2 Leveraged buy-outs

Leveraged Buyouts

Much as in Anglo-American economies, Italy allows companies to merge in what is known as a merger leveraged buyout. In such a transaction one corporation is purchased by another who uses external funds to purchase a majority holding in the desired company. Once a majority share has been obtained, the purchaser will then complete the merger, assuming any financial obligations of the purchased company. Italian law requires that the buying corporation must identify in their financial documents the financial resources required to satisfy all financial obligations of the corporation being purchased, as well as a financial plan indicating the source of financial resources and the objectives that will result from such a merger. The goal is to minimize risk of default by the resulting merged company.

2. Grants and tax breaks

Government Programs to Assist Businesses to Raise Capital

In terms of government assistance, over the past two years the national agency for the development of business in Italy ("*Sviluppo Italia*", www.sviluppoitalia.it), has developed programs which can assist businesses in raising capital to finance particular projects. The programs developed by the agency have focused specifically on the improvement of underdeveloped portions of the country. Relating specifically to capital acquisition and development, the agency has undertaken to fund businesses which initiate



such projects via minority participation through either direct participation (L. 237/93) or the use of the national revolving credit fund (*“Fondo rotativo nazionale”*).

The first applicable program in which businesses can participate is one of Direct Participation in the Capital stock of a company (*“Partecipazione diretta al capitale”*). Under the program, the agency will increase the capital stock by purchasing up to a 49% share in small or medium sized businesses (PMI) and up to a 30% share in large businesses for a period of up to 5 years. In order to qualify for such a program, the business must be undertaking a project of enlargement, modernization, or a new business initiative. Furthermore, the project must be occurring in the so-called “under utilized” portions of the country, including the entire southern portion and 3,800 municipalities in the center and northern sections. Therefore, projects of this sort are strictly linked with a geographical location.

Projects will be judged by the agency based on their sustainability, the coherence between the proposed strategy and the market situation of the particular industry, and the likelihood that the company will reacquire the share of capital temporarily provided by the government. Currently, Sviluppo Italia participates in 26 businesses with a financial commitment of Euro €105 million. More of the applicable regulations for this program may be found in Legge 237/93, art. 5 and the Decreto MICA 15 Marzo 1996.

The second pertinent program funded by the agency is Participation in the Capital Stock through use of the National Revolving Credit Fund (*“Partecipazione al capitale con utilizzo del Fondo rotativo”*). This program, which began operation in January 2005, can only be utilized by medium sized or large businesses. Like the program of Direct Participation in the Capital stock, the business must be undertaking projects of enlargement, modernization, or a new business initiative. Unlike the prior program, however, for the National Revolving Credit Fund program there is no geographical limitation. For approved projects the agency will purchase a 30% share in the capital of the business for a period of up to 5 years. However, no single project can account for more than 20% of the endowment of the fund. Potential projects will be judged based on the inexpensiveness of the project as well as potential innovations to either products or processes. Projects co-financed by the Regions will be given special priority. More of the applicable regulations for this program may be found in Legge 350/03 (Finanziaria 2004), art. 4, commi 106-111 and Delibera CIPE 10/04.

The advantages to businesses which qualify for these programs are many. First, it gives them access to a large capital stock with advantageous terms. Second, the

temporary nature of the capital increase makes it so that the participation does not qualify as state assistance, allowing the business to benefit from potential reductions in payment. All public interventions via the aforementioned programs are regulated by special agreements that will regulate the acquisition of the share, the corporate governance rules, and the “way out” conditions. Generally, shares acquired by the government will be reacquired by the partners or majority shareholders of a company. The shares, however, may also be sold to third parties or on the financial markets.

3. Business Angels and other private investors

Business Angels exist in Italy, although the average investment they make ranges between Euro €100.000,00 and Euro €300.000,00, much less than, for instance, Angel Investors in the United States of America, where the average investment ranges between Euro €100.000,00 and Euro €1 Million.

The qualifications of angels in Italy are the following:

Possession of sufficient capital and accredited status, possibly as former executive. The angel often has often a solid experience in corporations;
Willingness to devote a portion of personal capital and personal experience to high-risk, potentially high-rewarding investments;
Informality, in the sense that such investors are not subject which institutionally invest in companies, such as venture capitalists and private equity firms/funds instead;
One or more ways out are already set out at the time of the investment. Usually the time span is 3 years from investment.

Italy is no exception to the rule that only 2-3 deals out of 10 are successful, 2-3 maybe repay the investment and the remainder just fail, with total loss of money.

The national organization of Italian Business Angels is called IBAN – Italian Business Angels Network (www.iban.it), and groups a number of local “clubs” located throughout Italy. IBAN supports business angels by providing occasions for them to meet with possible start-ups, white papers on how to evaluate business plans and how to structure the deal from a tax and legal point of view.

The market of business angels is still very limited in Italy, especially when compared with other, more mature, markets, such as the U.K., France, and, clearly, the U.S. One of the major problems of the Italian mentality is that the Italian entrepreneur is seldom willing to give up corporate governance powers in exchange for equity: this has to do with the fact that businesses are often family-owned in Italy, and therefore entrepreneurs find it hard to accept that anybody may have a say in the managing of the company.

The Italian corporate law reform of 2003 has enhanced the occasions for investors to have a saying in the management of the company and especially the S.r.l.s have now been made considerably flexible.

Investors may be given the following rights in S.r.l.s:

Right to a portion of revenues, even when no decision has been formally taken by stakeholders as to their allocations;
Possibility to obtain a stake in the company in exchange for knowledge or services;
Right to appoint one or more directors;
Veto power on a number of corporate decisions.

4. Venture capital and private equity

4.1 Venture capital

In Italy, small, young and more innovative firms are more likely to be financed by a venture capitalist. Venture capital may help reduce financial constraints for firms that are more difficult for external investors to evaluate.

Instead, larger firms resort to venture capitalists when their indebtedness with banks is high, and venture capital financing is more likely after periods of high growth and investments, due to the role of the venture capitalist as advisor.

It must be said, however, that Venture Capital is not truly picking up in Italy, and this might be due to the mentality of entrepreneurs, traditionally wary of giving decision power in their own companies in exchange for capital.

4.2 Private equity

In 2005, the Italian private equity industry accounted for 281 deals for a total investment of Euro €3 billion.

Private equity funds are becoming real players in the activity of ownership reallocation of Italian companies, as well as in the process of development and internationalization and the support for generational change.

Specifically, medium sized buy outs boomed last year: the industry was dominated by buy out deals between Euro €50 million and Euro €150 million.

In general, the growth registered by the Italian PE industry is consistent with the European trend that saw a strong development in the investment activity that reached levels never registered before, according to the results issued by the European Private Equity and Venture Capital Association (EVCA).

The number of players in the industry registered a sensible growth.

In 2005 and early 2006, there has been a sensible increase in the number of players

in our country: today AIFI (www.aifi.it), the national organization gathering VC and PE firms, counts 106 associates, up from 82 at the end of 2004. The current growing trends will probably continue, bringing the Italian market in line with the international markets.

In 2005, many new players were involved in raising new funds and, although the amount raised was inferior to that of the preceding years, the fund raising activity was particularly interesting thanks to a high number of new initiatives.

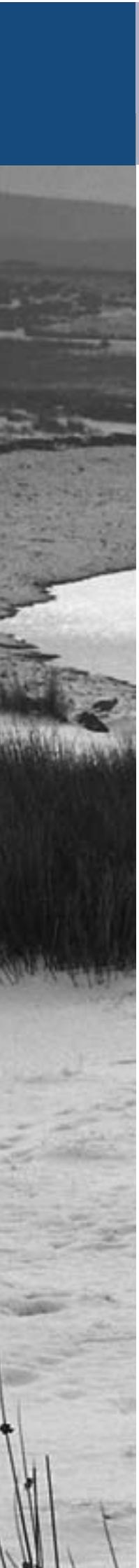
5. IPOs

There are three types of IPOs available in Italy: OPS, OPV, OPVS. For OPS (*"offerte pubbliche di sottoscrizione"*) offerings, companies offer to the public shares created from existing capital stock. In OPV offerings (*"offerte pubbliche di vendita"*) companies issue new stock for public acquisition through an increase in equity. Lastly, for OPVS offerings (*"offerte pubbliche di vendita e sottoscrizione"*), companies offer a mix of stock from existing capital and stock created via a capital increase. In Italy most IPOs are of the mixed variety: of the 45 IPOs offered in 2000, 36 were of the variable variety (OPVS) and had a ratio of new stock to existing stock issuing of over 60%.

There are a number of formal legal requirements that a company must meet before it can conduct an IPO. The requirements have been developed by the Regulations of the Italian Stock market (*"Regolamenti dei mercati di Borsa Italiana"*) and the CONSOB.

The pertinent financial requirements for the stock that will be issued are as follows: in the MTA/MTAX stock market, the market capitalization must be at least Euro €40 million and the outstanding shares must represent at least 25% of existing capital (with a minimum value of Euro €5 million and a minimum number of shares of 100,000) in order to ensure adequate diffusion of the stock among the public. In the Expandi market, the market capitalization of the company must be at least €1 million euros and the value of the stock placed on the market must be at least Euro €750.000,00.

The requirements for the company are, in the MTA/MTAX markets, a balance sheet report for the previous three (3) years, the most recent of which must have received a positive review by a reviewing agency, and proof that the company carries on an activity that has the ability to create revenue. The company must also show net assets of more than Euro €1.5 million. In the Expandi market, the company requirements consist of the same balance sheet reporting requirement as in the MTA/MTAX markets as well as a requirement to present certain financial information regarding the company's performance .



Other financial requirements for both markets include the prospect of growth and the creation of cash-flow, a positive financial track record, the position of the company in its respective market, and a realistic and sustainable business plan.

Lastly, there are organizational requirements. The pertinent prerequisites are the ability to manage the company transparently and with accountability, the quality and motivation of the management, and the adherence to basic principles of corporate governance. The company is also required to nominate an internal Investor Relator.



CONTACT

We have the ambition to foresee our clients' needs, anticipating the issues with a full understanding of all the potential hazards. We believe that truly cost-effective legal services in today's market are best delivered through close relationship with clients.

Therefore, we approach each matter with a clear focus on our clients' objectives and with a technical understanding of the business involved. Our object is to relate to the legal and business environments in which our clients make their decisions.

Our objective is to assist our clients in achieving their goals by consistently providing legal services which are innovative, timely and efficient. Therefore, we constantly invest in people, resources and technology.

All our attorneys are admitted to practice in Italy and many of them also acquired ample skills and experience in Anglo Saxon countries, through university recognitions (L.L.M., M.C.J.), training courses and professional activities.

We maintain constantly up-to-date office equipment and libraries to permit us to respond quickly and cost-effectively to our clients' needs.

Our offices are equipped with a fully integrated computer system which allow us to get access to the most updated technical instruments for modern communication (email, internet) and professional research (legal and business databases).

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