

Participative Financial Instruments: What Opportunities?

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Economic crises, debt restructuring and new “instruments” of solution

Participative financial instruments (the “Strumenti Finanziari Partecipativi - SFP”) have been introduced by Legislative Decree no. 6 of January 17, 2003 (the “Reform”) by amending the existing article 2346, paragraph 6, of the Italian civil code. This provision reads “The company may issue financial instruments that have economic or also voting rights, with exception of voting rights in the general shareholders’ meeting, in exchange for the contribution by shareholders or third parties of services and activities”.

This entirely new class of financial instruments, made possible only for S.p.A, is coherent to the purposes of the Reform which were meant to ease financing possibilities for corporations and enhance their competitiveness both on Italian and international grounds. The goals of the Reform seem to be even more specific in light of the current financial and economic crises which has flattened financing possibilities and has made it necessary for companies to search for new ways of gathering resources through the market.

Unfortunately in the last years many companies have had financial disorders and have consequently turned to debt restructuring in order to manage the crises and re-engage a growing process. Debt restructuring can either involve suppliers or credit institution such as banks, but the latter is more frequent since banks who have already invested on a specific company, entrusting its capability of generating profit, often do not take in count the possibility to lose their bet and rather directly enter as part of the company's stock. In light of the above, an excellent instrument for the captioned purpose is the SFP for a number of reasons: (i) it could have the effect to decrease borrowings; (ii) stabilizes and empowers the company's balance sheet; (iii) gives priority on shareholders reimbursements to its owners; (iv) it can give voting (read veto) rights to its owners; and gives the chance to (v) appoint a member of the administrative or auditing body.

Statutory provisions

First of all, an SFP must be provided for by the company's by-laws which shall indicate: (i) procedures and conditions of issuance; (ii) financial and administrative rights conferred (also subjects on which voice can be expressed and faculty to appoint members of administrative and auditing bodies); (iii) sanctions in case of breach of the obligations; and (iv) circulation provisions if allowed. It is clear that, in line with the rationale of the Reform, the regulation of SFP is widely deferred to the private self-government which may arrange each SFP according to its contingent needs.

Voting and appointment rights

With reference to administrative rights listed under point (ii) above, there is a further provision of the Italian Civil Code, article 2351, which defines more precisely to which extent these rights can be brought, and it reads as follows "SFP as of article 2346, paragraph 6 [...], can be endowed with voting rights on specific indicated subjects and in particular it can be reserved, according to by-laws, the possibility to appoint an independent member of the administrative or auditing body. To those accordingly appointed the same provisions for other members of the administrative or auditing body apply". Since these SFP are frequently used, or could be more frequently used, in restructuring procedures, it is important for those who use such instruments to be involved in the decision making

process of the company, not only to monitor more closely their investment, but also in order to have a steady grip on the future possibilities to obtain the reimbursement of the same.

To this extent voting rights are fundamental. It is clear that voting rights relate to those matters on which the shareholders' meeting is competent, also if only in an indirect way (authorizations to act for the administrative body). At this point a query arises as the words "exception of voting rights in the general shareholders' meeting" in article 2346 of Italian Civil Code make readers wonder where such voting right on specific matters must be expressed. Scholars agree that such instruments cannot be given the right to vote in the shareholders' meeting, but must, on the contrary, be expressed in another specific meeting organized and ruled with reference to SFP. Nevertheless it is true that prominent commentators (supported by the notary publics' council) argue, and we believe to entrust their view, that what the provision in the captioned article limits is actually the possibility to issue SFP endowed with the general right to vote in the shareholders' meeting, but enables the issuer to provide the right to vote only on predetermined and specific subjects (to be set forth in the company's by-laws) in the general shareholders' meeting. In other words it is forbidden to issue SFP with general voting rights, but it is permitted to issue the same instrument with specific and limited voting rights, which are to be expressed in the "general" shareholders' meeting. Moving onto the extent of the mentioned voting right, it is important to set at least two limits: (a) SFP voting rights endowed can never be of such depth to substantially deprive shareholders of their prominent rights; (b) SFP voting rights can never overrun administrative body's decision power (unless, of course, corporate by-laws subdue certain decisions of the mentioned body to the approval of the shareholders' meeting or, if provided, to the vote of SFP.)

Furthermore, another very important right that can be endowed to SFP is the right to appoint a member of the administrative or auditing body. Surveys on how often these instruments have been used and how, show that when restructuring debts of companies, banks usually wish to closely participate to the management of the same through directors that they entrust; in this respect, more and more frequently SFP have been spent in these types of operations. However, the mentioned right enlightens the necessity to solve issues on (i) how the appointment of such independent member relates to the appointment of all others (does the SFP holder directly appoint a member, or does it have to be inserted into the resolution of the shareholders' meeting on the same agenda?); (ii) how do different

types of SFP appoint such member (does each class of SFP appoint a member, or do all SFP holders gather in one special meeting for the appointment of one single member?); (iii) how to define independent according to article 2346 of the civil code; as well as, (iv) who is entitled to revoke such member (does the SFP who appointed the member also have the exclusive right to revoke him, or does this fall under the provision of the same article that states that “To those accordingly appointed the same provisions for other members of the administrative or auditing body apply”?)

Equity or Debt, an accounting choice?

In this respect, SFP seem to play a main role being their nature far more flexible than other existing financial instruments, such as shares or bonds. Before looking into their specifics, it is very noteworthy to ascertain whether such financial instruments can be qualified either as equity or debt. On this point scholars and commentators have expressed controversial views. On one hand, some part of doctrine suggests that SFP can be qualified as debt or as equity depending on the contingent characteristics of the financial instrument issued from time to time (for instance, an instrument which does not grant any voting powers, if not on very limited and secondary subjects, but, on the contrary, has very broad economic prerogatives shall be most certainly recognized as debt; vice versa a SFP with pervasive administrative rights is more likely to be considered as equity). On the other hand, commentators also hold that SFP are exclusively qualifiable as debt, even if of a different kind in respect to bonds, because on the company there always is the obligation to reimburse the SFP holder with priority. It is easy to guess that the choice has practical consequences. When SFP is qualified as debt, its holders benefit of fiscal edges, of all those protections provided for the creditors of the company (actions for guardianship of the company’s assets, insolvency procedures’ benefits, warranties, insensitivity to the company’s losses, etc.). Nevertheless, there are also negative sides to the choice of this type of nature, which are mainly represented by the duty to issue SFP in compliance to article 2412 of the civil code (debt cannot be issued for an amount greater than twice the corporate capital, the legal reserve and disposable reserves) and the increase of the amount of global debt on the company’s balance sheets sharpening the relevant critical economic situation. Otherwise (and in the greater number of occasions), SFP is qualified as equity. The issuance of an equity-like SFP is specular to the contribution in cash conferred

to finance the company at certain different conditions in respect of a regular share holder. The same considerations can be made also with reference to accounting methods since there is no provision in particular which states whether the SFP is to be registered among debt or equity. The choice will then be driven by contingent evaluations depending either on the specific rights endowed with the financial instrument or the choice of accounting standards (IAS,GAAP, IFR).

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In light of the above we deem this kind of instruments to be potentially useful as alternative to conventional securities although they have not yet been widely implemented due to the lack of certainty about some crucial issues such as the voting rights and the accounting qualification. Nevertheless these latter issues can be overrun by means of the by-laws' detailed provisions governing each highlighted aspect. Said that, investors may have interest in using such SFP, in lieu to enter directly into the corporate capital as shareholders, also in situations of financial crisis since, they will always be reimbursed with priority in respect of any kind of class of shares, even if preferred.

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