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Italian listed companies become less contestable following the enactment of the Italian law decree 185/2008, which has modified the legal regime governing defensive measures that can be taken in the event of a public tender offer. Opportunity or missed chance for cross border deals?

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One of the key-provisions of the Italian consolidated financial act (*i.e.*, legislative decree of February 24, 1998, no. 58, the "**Consolidated Financial Act**") was that, in case of a public tender offer, the Board of Directors of the target listed company should obtain the prior authorization by the shareholders' meeting (with the favorable vote of 30% of the capital) before taking any action (other than seeking alternative bids) that might result in the frustration of the tender offer. This provision, which in effect prevented Italian listed companies from adopting most of the "poison pills" or "shark repellents" that are common in U.S. practice, is known as the "passivity rule."

The passivity rule concept – also set forth by the Directive 2004/25/CE - had been implemented by Italian tender offer rules, which provided that, unless previously authorized by a shareholders' meeting resolution, throughout the offer period, Italian listed companies should refrain from any actions or transactions that may frustrate the goals of a tender offer. In addition, if a shareholders' meeting was called to resolve upon such an authorization, the same required the favorable vote of a qualified majority of at least 30 percent of the target's outstanding shares.

The purpose of the passivity rule was to afford the target shareholders, as opposed to the target management, the right to decide on the merits of a tender offer. In the absence of such a rule, managers who found themselves in a conflict-of-interest position vis-à-vis the shareholders in a hostile tender offer scenario might try to protect their own interests and positions by frustrating a tender offer that would be beneficial to the target shareholders.

In order to further strengthen the contestability of Italian listed companies, the Consolidated Financial Act also regulated the so-called "breakthrough rule". Such rule caused certain provisions of the bylaws of shareholders' agreements relating to the target company to be ineffective in case the same could frustrate the purposes of the tender offer.

The above mentioned regulatory framework has been deeply amended by the enactment of law decree of November 29, 2008, no. 185, as converted by law of January 28, 2009, no. 2 (collectively, the "**Reform**"); in particular, Section 13 of such law decree has decreased the contestability of Italian companies by providing that the passivity rule and the breakthrough rule are applicable only to those Italian listed companies that have expressly elected to include such rules in their bylaws[1].

The fact that such rules are currently applicable only in case a specific provision is inserted in the bylaws of the target company, is likely to cause that, in practice, such rules will not be applied by Italian listed companies, since it is presumable that such companies would rather maintain the right to adopt defensive measures in case of hostile tender offers.

Therefore, on the basis of the Reform, in the absence of any specific provisions expressly inserted in the bylaws of Italian listed companies, the Board of Directors is now free to implement, against hostile tender offers, any defensive measures deemed appropriate (in compliance with Italian corporate law). The reasons underlying the Reform have been explained by the lawmakers as being correlated with the current crisis of the international financial markets and with the need to protect listed Italian companies from hostile takeovers which might be encouraged by the strong depreciation of share prices.

Moreover, the lawmakers also approved a law decree containing "*urgent measures to support the industrial sectors affected by the crisis*" (law decree of February 10, 2009, no. 5, as converted in law of April 9, 2009, no. 33, the "**2009 Law**"), which further limited the contestability of Italian listed companies, by amending specific provisions of the Consolidated Financial Act and of the Italian civil code (royal decree of March 16, 1942 – XX, no. 262, the "**Civil Code**"), in relation to the acquisition of own shares and consolidation tender offers, as better explained below.

The new regulatory framework arising from the above mentioned amendments is aimed at strengthening the position of the controlling shareholders. Such effect implies a risk - as also pointed out by the Italian antitrust authority - to cause unjustified damage to the competition with respect to listed companies. In fact, such measures sensibly increase the risk of freezing the controlling shareholdings, with possible negative impacts regarding the incentives to investments and the correct functioning of the market.

According to the Italian antitrust authority, it would actually be preferable to attribute to the recent amendments a temporary nature, which would confirm that the recent amendments represent a temporary exception to the general rules, linking their duration to specific needs arising from the current financial crisis.

[1] Section 104, paragraph 1, and 104-*bis*, first paragraph, of the Consolidated Financial Act.

However, for the time being, no temporary limit has been fixed in order to limit the applicability of the Reform and of the 2009 Law. Therefore the new provisions applicable to public tender offers - resulting in a decreased contestability of Italian listed companies - represent the rule rather than the exception.

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<u>The new passivity rule</u>

As mentioned above, due to the Reform, the passivity rule is only applicable to those listed companies that explicitly include a specific provision in their bylaws to that extent[2].

In case such rule is specifically provided in the bylaws of the target listed company, the Board of Directors, except in case of authorization by the shareholders' meeting, shall abstain from carrying out any acts or transactions that could conflict with the purposes of the tender offer[3].

Prior to the Reform, the passivity rule was immediately effective vis-à-vis Italian listed companies (without the need to insert a specific provisions in their bylaws) and the approval by the shareholders' meeting, with a qualified majority equal to 30% of the share capital, was required in order to derogate from the passivity rule and approve specific defensive measures to be used against a possible takeover.

As mentioned above, following the Reform, the passivity rule is only applicable if specifically provided for in the bylaws of the target company. Furthermore, in case the bylaws provide for the application of such rule, the authorization by the shareholders' meeting (necessary to adopt defensive measures) no longer requires a favorable vote of 30% of the share capital and may be taken with the ordinary majorities set forth by the law[4].

In case the passivity rule is inserted in the bylaws of the target company, the acts and transactions which the passivity rule refers to are the following[5]:

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2 Section 104-bis of the Consolidated Financial Act.
3 Section 104 of the Consolidated Financial Act.
4 <u>Ordinary Shareholders' Meeting</u>: The first call ordinary shareholders' meeting shall be validly held if shareholders representing at least half of the outstanding shares of the company are present and the relevant resolution shall be adopted with the favorable vote of the majority of the shareholders in attendance. The ordinary shareholders' meeting in second call shall be validly held irrespective of the percentage of the capital in attendance and shall resolve with the favorable vote of the majority of the capital in attendance.
<u>Extraordinary Shareholders' Meeting</u>: The first call extraordinary shareholders' meeting shall be validly held and resolve if shareholders representing the majority of the outstanding shares of the company are in attendance and vote in favor of the relevant resolutions. The second call extraordinary shareholders' meeting shall be validly held if shareholders representing at least 1/3 of the outstanding shares are in attendance and shall resolve with the favorable vote of shareholders representing 2/3 of the capital represented in the meeting.
[5] In this respect, since the Reform does not contain any new provision, reference should be made to the principles set forth by CONSOB (Communication no. 99039392 of May 18, 1999).

a) "*acts*" means single activities (having legal effects) that may be carried out by the Board of Directors, while the term "*transactions*" refers to a number of related acts, which would be allowed by the passivity rule as single acts, but whose effects, as a whole, may represent an activity prohibited by the passivity rule;

b) "*purposes of the tender offer*" refer to the purpose of acquiring the control of a listed company, through a financial disbursement;

c) acts or transactions "*that could conflict*" with the aforementioned purposes may be divided into three different categories:

   - those aimed at increasing the costs required to obtain the number of subscriptions of the offer which the offeror intends to reach;

   - those aimed at changing the financial and business structure of the target company; and

   - those aimed at disrupting the public tender offer, making it difficult to achieve the purposes thereof.

In any case, the search for a "white knight" is not prohibited by the passivity rule.

With respect to the possibility to implement defensive measures, prior to the Reform, for instance, it was possible to issue shares with voting rights subordinated to the launch of a tender offer, provided that such voting rights would only become effective with the approval of the shareholders' meeting, resolving with a qualified majority equal to 30% of the capital of the company[6]. Such provision has been abrogated by the Reform; as a consequence, the bylaws of listed companies may now provide for "preventive" defensive measures, such as the issuance of shares with voting rights triggered by the launch of a tender offer, without the need of shareholders' approval.

On the other hand, if the bylaws contain the passivity rule, the authorization by the shareholders' meeting (with the ordinary majorities provided by the law) is still necessary for the implementation of those preventive measures adopted prior to the launching of the public tender offer and which (i) have not yet been implemented, (ii) do not fall within the ordinary course of business of company and (iii) may conflict with the purpose of the tender offer.

[6] Previous version of Section 104, paragraph 1-*bis*, of the Consolidated Financial Act.

Finally, the Reform did not amend the provisions dealing with the liability of the Directors of the company who act in breach of the passivity rule, who are consequently sanctioned with an administrative fine ranging from Euro 25,000 to Euro 115,000[7]. However, such sanctions will be applicable only in case the bylaws of the target listed company contain the passivity rule.

The new breakthrough rule

Following the Reform, the breakthrough rule is also no longer mandatory for Italian listed companies, but is only applicable to those companies that expressly introduce such a rule in their bylaws[8].

When inserted in the bylaws, the breakthrough rule is aimed at neutralizing certain defensive measures to public tender offers that could be set forth in the bylaws or shareholders' agreements of listed companies. In fact, according to such rule, during the acceptance period of a tender offer, the following provisions are not effective vis-à-vis the offeror: (i) limitations to the transferability of shares (provided in the bylaws of the target company) or (ii) limitations of the voting rights (provided in the bylaws or in a shareholders' agreement relating to the target company) with respect to the shareholders' meeting held to authorize defensive measures pursuant to Section 104 of the Consolidated Financial Act.

In addition, if following a tender offer, the offeror holds at least 75% of the voting rights, the following provisions will not be effective during the first shareholders' meeting to take place after the public tender offer to amend the bylaws or to revoke/appoint the new members of the Board of Directors or the supervisory board: (a) limitations to the voting right (as provided by the bylaws or a shareholders' agreement); (b) any special rights relating to the appointment or revocation of Directors or of the supervisory body (as provided in the bylaws).

However, the offeror shall pay a fair indemnity to the shareholders that were entitled to the rights which became ineffective and that suffered a financial detriment as a result of the application of the breakthrough rule, provided that such rights were effective prior to the launch of the public tender offer.

In addition, the Reform has not changed the rule according to which each shareholder that is a party to a shareholders' agreement, the purpose of which is to prevent the acceptance of the tender offer, is entitled to withdraw from such shareholders' agreement, in order to accept the tender offer[9].

[7] Section 192, paragraph 3, of the Consolidated Financial Act.
[8] Section 104-*bis* of the Consolidated Financial Act.
[9] Section 123, paragraph 3, as referred to by Section 104-bis, paragraph 1, of the Consolidated Financial Act.

Reciprocity clause

According to the reciprocity clause, the passivity rule and the breakthrough rule are not applicable unless the same or equivalent rules apply to the offeror or its controlling company[10].

The reciprocity clause has not been directly amended by the Reform, however its applicability has been affected by the amendments to the passivity rule and the breakthrough rule. Following the Reform, as a result of the amendments to the passivity and breakthrough rules (which are no longer mandatory) the reciprocity provision shall also apply in case the offeror is an Italian company that has elected not to insert the passivity and breakthrough rules in its bylaws.

Defensive measures

As a result of the Reform, in case the passivity rule and the breakthrough rule are not inserted in the bylaws of Italian listed companies, the same may implement any defensive measures against hostile takeovers, such as:

(i) shark repellents: provisions of the bylaws which limit the powers of the future controlling shareholder;

(ii) poison pills: commonly used in the US, in order to make it more costly or difficult for the offeror to achieve its purposes. In this respect, as mentioned above, the Reform has allowed the issuance of shares with voting rights subordinated to the launch of a tender offer. As a consequence, the new shares may have some features that render them similar to the US "poison pills" (such as (a) setting a low issuance price; (b) granting a voting right to the holders of such shares, in case an offeror launches a public tender offer or acquires an interest higher than a predetermined percentage; and (c) providing limits to their transferability);

(iii) activities aimed at increasing the costs necessary to reach the expected or required level of acceptance by the offeror, such as capital increases, with the exclusion of the pre-emptive right, to be reserved to a third party or to the employees; acquisition of own shares; the increase of the reciprocal participations between the target company and the companies belonging to the same group. In this last respect, however, such a measure is strongly limited in Italy, since Sections 120 and 121 of the Consolidated Financial Act provide that in case of reciprocal participation exceeding the 2% (in listed companies) or 10% (in non-listed companies) of the capital, the company that has subsequently

[10] Section 104-*ter* of the Consolidated Financial Act.

exceeded the limit, may no longer exercise the voting right pertaining to the shares or quotas exceeding such thresholds and shall dispose of such shares/quotas within twelve months from the date the limit was exceeded;

(iv) acts aimed at changing the financial and business structure of the target company, such as, disposal of assets that are essential for the company;

(v) acts aimed at disrupting the offer, which render achieving the purposes of the tender offer more difficult, acts such as; the launching of a public tender offer on the shares of the offeror, (so-called turnabout or “Pac-man” defense). This rule, quite common in the United States (e.g. in the case Chesapeake v. Shorewood), could also be applied in Italy, since the rule mentioned above on the limits to reciprocal participations (2% or 10%, depending on the case) does not apply in case the acquisition of such participation was effected as a result of a public tender offer aimed at acquiring at least 60% of the capital.

In Italy there have been a few cases of hostile public tender offers and generally the limited transactions started as a hostile takeover and then turned into friendly deals with the agreement among the parties involved; therefore not many defensive measures have been adopted in the Italian practice. By way of example, the following cases are worth noting:

Telecom Italia / Deutsche Telekom

This is the first case in Italy where the possibility to adopt defensive measures in case of a hostile tender offer was questioned. The tender offer was launched in 1999 by Olivetti for Telecom Italia and the defensive measure adopted by the Directors of Telecom Italia could be classified as the search for a white knight. Based on an agreement between Telecom Italia and Deutsche Telekom, a special purpose vehicle held by the latter was incorporated, in order to launch a tender offer for Telecom Italia (which offer was considered “friendly” by the Board of Telecom Italia).

In such a case, it was questioned whether the agreement between Telecom Italia and Deutsche Telekom for the incorporation of a special purpose vehicle, and the consequent launching of a tender offer by such vehicle was in conflict with the passivity rule, thereby requiring the authorization of the shareholders’ meeting, or whether such authorization was not needed, in light of the fact that the agreement did not actually conflict with the passivity rule.

In such a case, the Italian supervisory authority, *Commissione Nazionale per le Società e la Borsa* ("**CONSOB**") deemed that the agreement between Telecom Italia and Deutsche Telekom, and the search for a "white knight" was not in contrast with the passivity rule.

Montedison / Italenergia

In 2001, Italenergia – a special purpose vehicle incorporated by Electricité de France, Fiat, Carlo Tessara, Banca di Roma, Sanpaolo-IMI and Banca Intesa – launched a public tender offer for Montedison and its subsidiary, Edison.

Prior to the launching of such tender offer, the Board of Directors of Montedison approved the dismissal of certain participations held, directly or indirectly by Montedison (e.g. in the capital of Fondiaria and Cantiere Burgo), alleging that such participations were no longer deemed as strategic. However, the real aim of such resolution was to frustrate the tender offer; in fact by transferring such participations, the Board of Directors would have deprived the company of important assets, to discourage Italenergia from launching the tender offer.

Such resolutions were questioned, in order to evaluate their consistency with the passivity rule, since they had not been authorized by the shareholders' meeting. However, it was deemed that no breach of the passivity rule had occurred, since the resolution of the Board had been taken prior to the communication of the launching of the public tender offer by Italenergia.

In any case, such doubt was no longer relevant after Italenergia increased the offer price, therefore the tender offer was considered "friendly" by the Board and was successfully completed on August 21, 2001.

Privatized companies

With respect to privatized companies (such as ENEL S.p.A., ENI S.p.A., Finmeccanica S.p.A., Terna S.p.A.) currently controlled, directly or indirectly, by the State, the impact of the Reform relating to the passivity rule and the breakthrough rule appears to be quite limited.

In fact, the bylaws of such companies already provide[11] for certain defensive instruments to guarantee sufficient protection for the controlling shareholder against, *inter alia*, possible hostile tender offers (the so-called golden shares).

In particular, the aforementioned bylaws provide for:

(i) a maximum percentage of the capital that may be held by subjects other than the State. In case such a maximum limit is exceeded, the voting rights and the other non-patrimonial rights may not be exercised with respect to the percentages exceeding such limit. However, the limitations regarding maximum participations are not applicable in case the limit is exceeded as a result of a public tender offer whereby the offeror acquires an interest equal to at least 75% of the capital with voting rights;

(ii) a power granted to the Ministry of Economics and Financial Affairs ("**MEF**") to contend the acquisition of "significant" participations (as identified by an *ad hoc* ministerial decree). Such power may be exercised by the MEF in case the acquisition of a significant participation by a third party would imply a threat to the fundamental interests of the State, therefore such a protective instrument should be applicable even in case the significant stake is acquired as a result of a public tender offer accepted by shareholders representing more than 75% of the capital of the target company.

In this respect, the European Court of Justice (judgment dated March 26, 2009, C 326/07) ruled that the above mentioned special powers of objection to the acquisition of significant participations were not sufficiently limited and pointed out that "*investors are not able to know the cases in which such powers will be exercised*". The Court outlined that such broad power would discourage potential investors who intended to acquire significant interests in privatized companies; thus contradicting the (EU?)principles of freedom of establishment and free movement of capital.

As a consequence of such judgment, the Republic of Italy should amend the relevant provisions of law which violate the aforementioned EU principles, failing which a new proceeding could be started by the EU authorities through the European Court of Justice, in order to enforce the existing judgment and impose a sanction against Italy.

* * *

RECENT AMENDMENTS INTRODUCED BY 2009 LAW

With respect to the measures adopted by the Italian Government in order to overcome the financial crisis, the 2009 Law introduced, *inter alia*, significant amendments to the Consolidated Financial Act and the Civil Code, in terms of:

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[11] Pursuant to law decree no. 332 of May 31, 1994, as converted into law no. 474 of July 20, 1994.

(i) public tender offers;

(ii) communication obligations with respect to “significant” participations;

(iii) acquisition of own shares by listed companies and companies with shares particularly spread among the public.

Amendments to the Consolidated Financial Act

Consolidation tender offer

The 2009 Law has introduced a few amendments to Section 106 of the Consolidated Financial Act and the relevant regulations adopted by CONSOB, with respect to public tender offers.

In particular, Section 106 of the Consolidated Financial Act provides for the obligation of any subject that, after acquisitions, holds, directly or indirectly, a participation higher than 30% of the capital, to launch a tender offer on all the securities admitted to negotiation on a regulated market.

In addition, prior to the enactment of the 2009 Law, with respect to subjects that already held, directly or indirectly, an interest exceeding 30% of the capital but that did not have the majority of the voting rights in the ordinary shareholders’ meeting, the obligation to launch a total offer was triggered by the acquisition of more than 3% of the capital with voting rights (so called “consolidation tender offer”).

The 2009 Law amended the size of the acquisition which determines the obligation to launch a consolidation tender offer in connection with subjects that already hold, directly or indirectly, a participation higher than 30% of the capital but that do not have the majority of the voting rights; such obligation no longer follows an acquisition of a percentage higher than 3%, but rather acquisitions higher than 5% of the capital.

This amendment may entitle the controlling shareholder of a listed company to increase its stake (for a higher percentage than prior to the 2009 Law) without being subject to the obligation to launch a total public tender offer.

Obligations to communicate significant participations

Pursuant to Section 120 of the Consolidated Financial Act, any subject that holds a participation exceeding 2% in the capital of an Italian listed company shall communicate such participation to CONSOB.

The 2009 Law granted CONSOB with the right to establish, for a limited period of time, a threshold lower than 2%, in order to trigger the above mentioned communication obligation, with respect to companies with an high market value and shares particularly spread out in the market.

The decision of CONSOB should be grounded on the need to protect investors and to ensure efficiency and transparency in the market. However, the power granted to CONSOB by the 2009 Law has a generic nature and requires CONSOB to determine a threshold lower than 2% with respect to communication obligations and the timelines during which such derogation should be applicable. This also implies the risk that the period of time necessary for CONSOB to determine such criteria is longer than the actual duration of the protracted downturn of the financial markets.

In addition, the 2009 Law has significantly strengthened the sanctions in case of a failure to carry out the above mentioned communications, by providing an administrative fine ranging from Euro 25,000.00 to Euro 2,500,000.00, while the delay in the communications (by not more than two months) is sanctioned with an administrative fine ranging from Euro 5,000 to Euro 500,000.

<u>Amendments to the Civil Code with respect to the acquisition of own shares</u>

Prior to the 2009 Law, Section 2357 of the Civil Code provided, among other things, that each company could acquire own shares – if certain requirements were met -, provided that the par value of same (also including the shares held by the controlled companies) did not exceed 10% of the overall share capital.

As a consequence of the 2009 Law, the maximum percentage of acquisition of own shares by listed companies or companies having their shares spread in a significant manner has been amended from 10% to 20%.

Following such an amendment, listed companies may therefore acquire a higher percentage of own shares, up to 20% of the share capital. Such possibility could result in an effective instrument for the possible defense against hostile tender offers, strengthening the position of the shareholders holding a significant stake (but not a controlling stake).

* * *

In light of the above observations, we can certainly affirm that the recent amendments have deeply modified the spirit of the Consolidated Financial Act, affecting certain of its most fundamental principles, the most important of which was the contestability of Italian listed companies.

In particular, the new provisions regarding the acquisition of own shares could effectively allow the (relative) majority shareholders to “lock” the corporate control (by causing the target company to acquire own shares for a percentage equal to 20% of the capital) in those cases in which the participation held by the (relative) majority shareholder of a listed company exceeds 30%.

In addition, It should be underlined that some of the approved measures are more stringent that the equivalent measures adopted at a European level: by way of example, the threshold concerning the communication obligations with respect to the significant interests - which was already lower than the level requested by the EU (2% as opposed to 5%) - may be further decreased, providing for the ability of CONSOB to identify lower thresholds for certain companies, in order to ensure the utmost transparency of the shareholding structures.

Finally, it should be noted that the amendments introduced with respect to the thresholds for the acquisition of own shares could affect the criteria for calculating the thresholds that may trigger the obligation to launch a total tender offer, as provided under Section 106 of the Consolidated Financial Act.

According to CONSOB, in fact, the own shares of a listed company should be taken into account for the purpose of verifying the thresholds which gives rise to the obligation to launch a tender offer, only in case of a listed company that is controlled by a majority shareholder. In such a case, the amount of the participations acquired should be calculated on the basis of the share capital of the listed company, excluding the own shares from the calculation. By way of example, if a listed company (i) holds 10% of own shares and (ii) is controlled by a shareholder that holds 29.9% of the capital; the purchaser of such 29.9% percentage will be under the obligation to launch a total public tender offer, because such purchaser will hold a participation equal to 33.2% [29.9% : 90%] of the shares with voting rights, in light of the existence of 10% of own shares.
Therefore, on the basis of such interpretation, in case a listed company, following the Reform, holds a percentage of own shares equal to 20% of the capital, the purchaser which acquires a stake equal to 25% of the share capital should be obligated to launch a pubic tender offer. In fact, by subtracting from the share capital the own shares held by the target company, such purchaser would reach a participation of 31.2% [25% : 80%] of the shares with voting right.

This could discourage potential investors that intend to acquire a significant participation in the capital of a listed company, but that are unwilling to launch a total public tender offer.

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