



Università
Ca' Foscari
Venezia

31 October 2024



UNIVERSITÀ
DEGLI STUDI
DI TRIESTE

The polycentric system of corporate controls in public limited companies

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Controls on administration in companies limited by shares

= Organizational framework through which a company conducts its business:

- 1) the **shareholders' meeting**;
- 2) the **board of directors**;
- 3) the **board of statutory auditors**.

→ Corporate bodies of the **traditional** management and control system

Corporate control functions

The control function is divided between:

- 1) a corporate body: the **board of statutory auditors** (*collegio sindacale*);
- 2) the **external auditor** (*revisore legale dei conti*).

Article 2403 Civil Code → **supervisory** functions:

- over **compliance with the law and the bylaws**;
- over **compliance with the principle of proper management**.

Corporate control functions

The latter includes **supervision**:

- over the **adequacy of the organizational, administrative, and accounting structure** (*assetti*) adopted by the company and its effective functioning;
- over the adequacy of the structure **in detecting crises** and the loss of business continuity (Article 2086 Civil Code)

!! Supervision does not extend to evaluating the merits of directors' decisions...

Corporate control functions

The **auditors** do not directly oversee accounting control (*controllo contabile*) > it **belongs to the external legal auditor**.

BUT bylaws may provide for a different choice in:

- i. closed companies limited by shares;
- ii. which are not required to prepare consolidated financial statements;
- iii. do not control or are not controlled by non-closed companies.

In these cases, the bylaws may assign the accounting control function to the board of statutory auditors → in this case, **all auditors must be qualified as external auditors**.

→ Article 2409-bis.

Other mandatory functions...

The board of statutory auditors has also mandatory information towards the shareholders' meeting.

→ Upon the approval of the annual financial statements, the board must file a **report** (to inform shareholders) covering:

- i. the activities carried out in the performance of their duties;
- ii. an evaluation of the results of the financial year;
- iii. proposals regarding the financial statement.

Appointment and requirements of the statutory auditors

The appointment of the board of statutory auditors represents a non-delegable competence of the **ordinary shareholders' meeting**.

Article 2400

The numerical composition is rigid:

→ **3 or 5 members** (shareholders or non-shareholders)
+ 2 substitutes

Article 2397

Professionalism

The statutory auditors must meet certain **professional requirements** provided by Article 2397:

- i. at least **one** must be an **external auditor**;
- ii. all auditors have to be included in **professional official registers** (lawyers, accounting experts) or chosen from **university professors** in economic or legal subjects.

If the company has chosen to assign the accounting control duties to the board of statutory auditors, all auditors must be external auditors.

Professionalism

These requirements are a **condition of nullity of the appointment** or of subsequent automatic **removal** (*decadenza*; Article 2399, last paragraph).

The appointment must be followed by **acceptance** by the designated auditors (also through conclusive conduct) and must be registered in the Business Register within 30 days of the resolution (under penalty of administrative sanctions).

The acceptance of the *substitute* auditor must necessarily be **expressed**, as she/he automatically steps in when a “regular” auditor is no longer available.

Causes for termination from office

a) Expiration of term (Article 2400, para. 1)

Statutory auditors hold office for **three fiscal years** and the expiration is simultaneous for the entire board.

Until a new board is appointed, the previous auditors remain in office (prorogation regime).

Causes for termination from office

b) Causes of removal / forfeiture (*decadenza*)

b.1. Causes related to the **loss of eligibility requirements** (professionalism or independence: Article 2400);

b.2. Causes due to the **failure to perform a duty**

- ✓ unjustified absence from two meetings of the board of statutory auditors or the shareholders' meetings;
- ✓ or from two consecutive meetings of the board of directors.

Causes for termination from office

c) Resignation

It is allowed at any time.

It has to be communicated to the chairman of the board of statutory auditors, and the substitute auditor automatically steps in.

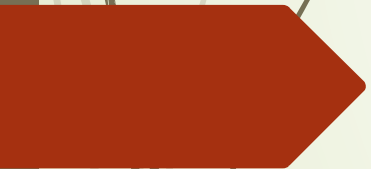
Generally, resignation takes immediate effect.

If it is impossible to replace the board, the resigning statutory auditors remain in office under prorogation (analogously applying Article 2385, para. 1, provided for directors).

Causes for termination from office

d) Revocation/removal (*revoca*).

See *infra*.



Independence of statutory auditors

Eligibility requirements

Certain cases imply, through an absolute presumption (*iuris et de iure*), the **lack of the independence** of the statutory auditors. This imply:

- **nullity** of the appointment or
- automatic **removal** from office (if these cases arise afterward)

(Article 2399)

Legal grounds for ineligibility / removal

The non-waivable legal grounds for ineligibility and removal are:

- a) legal incapacity, bankruptcy, disqualifications;**
- b) marriage, parenthood, or affinity** up to the fourth degree with directors of the company or other group companies;
- c) employment relationships** (subordinate or independent) of a continuous nature with the company or other group companies;
- d) other economic relationships** that compromise independence (i.e. consultancy).

Stability of statutory auditors

= Sub-aspect of the statutory auditors' independence.

Removal/revocation (Article 2400, para. 2).

Auditors can be removed for **just cause***, with a resolution of the **ordinary shareholders' meeting**, which must be approved by the **court** (with a decree) to be effective.

* **Just cause:**

- i. a **failure to fulfill duties**,
- ii. the **deterioration of relations** between the statutory auditor and the company (e.g., legal disputes),
- iii. personal **circumstances that compromise the statutory auditor's reliability** (lots of appointments in other companies).

Immutability of remuneration

Remuneration is determined at the time of appointment by the shareholders' meeting.

It **cannot be modified** during the mandate (Article 2402), thus preventing incentives for collusion.

Article 2402

Operation and powers

The statutory auditors operate **collegially**.

→ Convocation > meeting > discussion > voting > proclamation > recording.

The board must meet at least **every 90 days**.

The board is constituted with the **majority** of the statutory auditors (*quorum* for constitution) and resolves by the **absolute majority of the presents** (*quorum* for resolution).

The investigative phase

- ✓ An auditor may *individually* **examine company documents** and **question employees** (Article 2403-*bis*);
- ✓ the board can **request for information from directors** on specific matters or the company's performance (Article 2403-*bis*);
- ✓ the board has the power to **participate in board of directors' meetings and shareholders' meetings** (Article 2405);
- ✓ the board has the power-duty to **exchange information with the external auditor** (Article 2409-*septies*).

The evaluative phase

This phase must be exercised by the statutory auditors **collectively**.



The reactive phase

- ✓ The board of statutory auditors may and must **convene the shareholders' meeting** if the directors fail to convene it or delay doing so without justification (Article 2406, para. 1);
- ✓ they must **convene the shareholders' meeting** to adopt **urgent measures if there are serious censurable facts, committed by directors** in violation of their duties (Article 2406, para. 2).
- ✓ in the event of serious irregularities in management, the statutory auditors may file a **complaint with the court to initiate judicial control** under Article 2409 (*see infra*).

The reactive phase

- ✓ The board of statutory auditors is entitled to challenge shareholders' or directors' resolutions (Articles 2377 and 2388, respectively), if it believes they should be annulled in the company's interest.
- ✓ It has the power-duty to initiate corporate liability actions against directors, with a two-thirds majority of its members (Article 2393).

Liability of the statutory auditors

In light of these powers and duties, the auditors are also liable.

Statutory auditors are held to a **standard of qualified diligence**:

→ they must perform their duties with the professional diligence required by the nature of their role.

Article 2407

Liability of the statutory auditors

1) Statutory auditors are jointly liable with directors who are **guilty of misconduct** (concurrent liability) if the damage would not have occurred if the auditors had exercised their function in accordance with their duties (Article 2407, para. 2).

→ A statutory auditor will be exempt from liability if she/he can prove to have *diligently* carried out the control functions.

= **causal link** (*nesso causale*) between the statutory auditor's act/omission and the damage caused by the directors' misconduct.

Liability of the statutory auditors

2) There may be cases where the damage is **solely** and **exclusively** caused by the statutory auditors' behavior (**exclusive or direct liability**).

In such cases, the statutory auditors *alone* will be liable.

For example: violation of confidentiality, resulting in damage to the company.

Article 2407, para. 1.

Complaint to the board of statutory auditors

→ Article 2408

A shareholder who identifies a potentially censurable act may **report** it to the board of statutory auditors, who has to take it into account.

= This confirms the role of the board of statutory auditors as an **intermediary between directors and minority shareholders.**

Complaint to the board of statutory auditors

If an individual shareholder or multiple shareholders representing **5% of the share capital** file the complaint, the statutory board must not only take it into account, but also:

- i. **investigate** the reported facts;
- ii. **present its conclusions** to the shareholders' meeting.

Furthermore, if the reported censurable facts are deemed to be of significant gravity by the statutory board, it must promptly convene the shareholders' meeting.

Judicial control over management

→ Article 2409

External, judicial control

- ✓ Shareholders, representing at least **one-tenth of the share capital** or **two-twentieth** in listed companies;
- ✓ the **board of statutory auditors**;
- ✓ the **Public Prosecutor** in listed companies:
 - are entitled to initiate **judicial control over management** when **serious irregularities** committed by the **directors** in violation of their duties occur.

Requirement: **well-founded suspicion of serious irregularities**

= “clues” of serious irregularities (not full proof)

Judicial control over management

The serious irregularities must:

- ✓ concern **management**;
- ✓ consist of **violations of the directors' duties capable of harming the company** → preventive function (**potential damage**, not actual);
- ✓ be **current**;
- ✓ be attributable to the **directors**.

... the procedure

The procedure begins with a **complaint** filed by one of the eligible parties.

The court may decide:

- i. to **dismiss the case** for manifest lack of merit;
- ii. to **suspend the procedure** for a set period following the company's corrective actions (i.e. replacing the directors and auditors with individuals of appropriate professionalism).
- iii. If no corrective action is taken and the complaint has a plausible basis, the court may order a **judicial inspection** of the company, appointing an **inspector**.
- iv. After the inspection, if the irregularities are found to be present and current, the court may take appropriate **interim measures** and **convene a shareholders' meeting** for subsequent decisions.

Judicial director (court-appointed)

- v. In the **most serious cases**, a **judicial director** will be appointed to replace the directors, and possibly the statutory auditors, who will be judicially removed.
 - The judicial director will remain in office for the time set by the court.
 - He has to **restore the company**.
 - In urgent cases, the judicial director may also exercise the **powers of the shareholders' meeting**, but the effectiveness of related resolutions will depend on court approval.
 - He has autonomous standing to initiate **liability actions against the removed directors and auditors**.
 - At the end → he must **convene the shareholders' meeting** to appoint new corporate bodies or proceed with the **company's liquidation**.

External audit of accounts

It consists in the function of accounting control and in giving a technical evaluation on the financial statements.

The function of accounting control is assigned to an external auditor (with the exception of the statutory reassignment of this function to statutory auditors in certain cases, as already mentioned) → Article 2409-bis.

This matter is regulated by **Legislative Decree No. 39 of 2010**, implementing Directive 2006/43/EC. The decree establishes a **Register of Legal Auditors**, where those authorized to conduct legal audits of accounts are registered under the supervision of the Ministry of Economy (Article 2).

The function of accounting controls:

- i. to verify the **regular keeping of company accounts** and the **correct recording of transactions** in the accounting records.
- ii. to issue a **technical evaluation on the financial statements**, which is divided into four categories:
 - ✓ positive;
 - ✓ positive with reservations;
 - ✓ negative;
 - ✓ declaring an inability to issue an opinion.

Regulation and liability of the external auditor

- i. The appointment is made by the **shareholders' meeting**;
- ii. the term is set at **three fiscal years**;
- iii. the **auditor's remuneration** must be appropriate for the assignment, established at the time of appointment, and it cannot be altered during the term;
- iv. the **removal** of the auditor is decided by the **shareholders' meeting** for **just cause** and is subject to a **non-binding opinion from the statutory auditors** (there is a difference compared to the removal of auditors, which must be approved by the court);
- v. the external auditor can **resign** from the assignment.

Regulation and liability of the external auditor

Article 10 Legislative Decree No. 39/2010

→ **General clause on the independence of external auditors**

External auditors must not be involved in the decision-making processes of the audited company (**objectivity**).

They cannot have employment relationships or hold positions in the company's corporate bodies that could present conflicts of interest.

External auditors have to adhere to **professional ethical standards** developed by associations and professional orders.

Regulation and liability of the external auditor

External auditor has **informational powers**:

= obtain documents and information useful for the statutory audit from the directors

+ **inspection powers** (Article 14 para. 6, Legislative Decree No. 39/2010).

The external auditor has an **obligation of confidentiality** regarding facts and documents learned in the course of their duties.

Regulation and liability of the external auditor

The external auditor's liability is joint with that of the directors towards the company, shareholders, and third parties for damages caused in violation of their duties, according to standards of professional diligence (Article 1176 para. 2).

An action for damages shall be time-barred within **five years from the date of the audit report** on the financial statements issued upon conclusion of the accounting auditing to which the action for compensation relates.

Thank you for your attention!

