

All in the Family – Corporate Governance Lessons for Family-Owned Italian Companies

A look at how privately held and publicly listed Italian companies controlled by families are innovating in corporate governance.

Key Points

- Italy hosts a number of dynamic family-controlled companies (FCCs) that are issuing a variety of capital markets instruments with increasing frequency.
- The institutionalization and formalization of key institutions both within and outside the FCC can strengthen internal controls and address the environment, social, and governance (ESG) concerns of outside equity and debt investors.
- For privately held FCCs, a voluntary corporate governance code tailed for FCCs also provides a helpful benchmark on a “comply or explain” basis.
- For publicly listed FCCs, recent pronouncements indicate emerging best practices.

“G” for governance and generational shift

In recent years, the investor community, asset managers, regulators, employees, and various other stakeholders have focused on engaging with companies on ESG matters, including identifying risks stemming from their business models, scoping key performance indicators for related benchmarking, and establishing best practices. Stakeholders have highlighted environmental and social concerns as catalysts for changing business practices, however, in times of stress, such as during adverse macroeconomic conditions, low price environments, and the disruption caused by the COVID-19 outbreak, the governance controls and supervision structure of companies can have an inordinate impact on preserving shareholder and creditor value, retaining jobs, and safeguarding business.

Research into FCCs, generally defined as those with majority, controlling, or significant shareholder(s) connected to one or multiple families, suggests that FCCs are able to take a long-term view focused on value creation and preservation, by implementing and recalibrating business strategy swiftly and more decisively, fostering strong ties with stakeholders such as employees, suppliers, and customers, and incorporating social and environmental concerns into business planning due to the generation-long time horizon.¹ Research also suggests that listed FCCs outperform listed peers that have more dispersed ownership in terms of revenue growth, operating profit margins, and leverage, though the connection between family ownership and the foregoing performance indicators has not been definitively established.²

The lessons from a wave of bankruptcy and restructurings connected to the global financial crisis have highlighted why governance matters, as less transparency and more opaque decision-making can obscure indicators that may otherwise prompt a company to restructure or change strategy to preserve the business as a going concern. Additionally, the funding alternatives for FCCs have multiplied significantly in recent years — many FCCs have successfully transitioned into listed companies or accessed the capital markets through high yield bonds, US or European private placements, and other capital instruments that require more disclosure of corporate affairs. This trend is likely to accelerate, as a key European Capital Markets Union objective is to support the financing of small- and medium-size enterprises (SMEs). Furthermore, many successful FCCs are now in their second, third, or even fourth generation of ownership, and are approaching a generational shift as current family members in management or director positions may be nearing retirement, further reinforcing the utility of governance structures. At this inflection point, as financing sources are becoming more diverse and families are deciding whether to go public, sell to private equity or strategic buyers, or continue managing the business as a family concern in tandem with minority investors or public creditors, the importance of governance controls in mitigating risks to non-controlling shareholders and creditors cannot be overstated.

Research has shown that FCCs anchored by a transparent shareholding decision-making structure may be better placed to pursue deeper relationships with employees, suppliers, customers, and other stakeholders.³ Good governance can also facilitate access to capital markets and the attendant benefits of diversified funding sources. Moreover, recent high profile proxy fights and activist investor campaigns in several European countries have highlighted how perceived governance shortcomings can lead shareholders to vote against an incumbent board.

Italy provides a useful case study for understanding the application of good governance practices for FCCs as shareholders, that may be relevant to other developed countries with similar conditions for the following reasons:

- 85% of SMEs in Italy are family-owned⁴
- The largest 100 family-owned groups collectively generated annual revenue equivalent to approximately 20% of gross domestic product⁵
- 66% of the listed companies on the Italian Stock Exchange are FCCs,⁶ and one in three companies in the FTSE MIB benchmark index of listed companies are FCCs or have one or more families as significant shareholders⁷
- 20% of all recently announced Italian M&A with a deal value above €500 million involved an FCC target⁸

Institutionalization and formalization of the FCC

Generally, family shareholders (FSHs) of FCCs focus on:

- Transferring the FCC to the next generation
- Preserving family control of the business while coexisting with external stakeholders and debt or equity investors, and maintaining good relations with employees and suppliers/customers

- Positioning the FCC for continued success, including through acquisition or expansion activity in a quest for scale

In order to accomplish these objectives, FSHs must consider the institutionalization and formalization of certain bodies and processes both within and outside the FCC, as summarized in the graphic below.

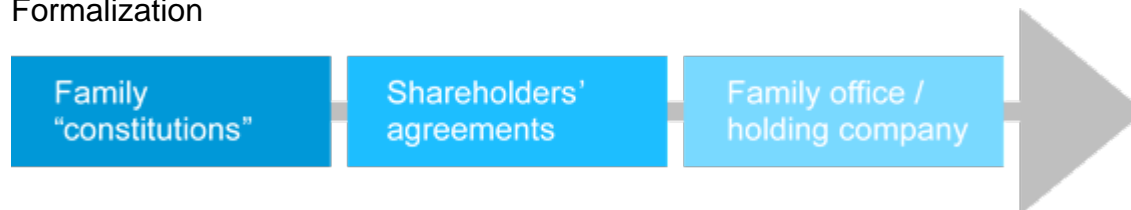


Shareholder Institutions and Processes

While incorporation of an FCC often takes place during the early stages of the FCC's development, formalization of shareholder institutions and processes can offer numerous governance advantages to FSHs and can provide additional internal controls for the FCC, which can help to attract outside investors. Traditionally, a variety of FSHs will hold shares in a FCC directly and the circle of shareholders will generally increase with the passage of time through alienation, inheritance, and divorce and dissolution of matrimonies, to include a greater number of legal and natural shareholders. A greater number of FSHs, including those involved in the day-to-day business and those who may view their shareholding primarily as an investment, typically increases the risk of shareholder discord. Institutions and processes at the shareholder level can help set expectations and provide a framework for FSH decision-making; if appropriate mechanisms are in place, a diversity of FSHs can provide a wealth of experiences and perspectives that inform the FCC's business strategy.

Shareholder institutions can be grouped by varying degrees of formalization as indicated by the graphic below.

Formalization



The first step towards institutionalizing the FSHs is a family "constitution." This non-legally binding document articulates the mission, values, vision, and strategy of the FSH with respect to their ownership and management of the FCC. Family constitutions also typically set out a series of processes and procedures for, among other matters, the employment and remuneration of family members within the FCC, dispute resolution for differences in business strategy, succession plans for key FSH managers, and information rights for FSHs that are not involved in the day-to-day running of the FCC. Family constitutions are widely used in Finland, Germany, and certain emerging markets. The goal is to equip all

FSH group members with a common framework and tools to enable them to engage with each other outside of the formal governance of the FCC.

Shareholders' agreements, which are often included as an annex to a family constitution, are legally binding agreements between shareholders that organize, among other matters: (1) the election of board of directors (BoD); (2) agreements on voting and setting of enhanced voting thresholds or vetoes for certain corporate decisions; (3) transfer restrictions on shares; (4) drag and tag along provisions and put and call options; (5) dividend policies; and (6) special rights granted to founders or particular shareholders. In Italy, shareholders' agreements for joint stock companies (*società per azioni*) are subject to the regulation of the Italian Civil Code (*Codice civile*) that limits the duration of such agreements to five years (renewals are permitted) when certain provisions are included.⁹ For listed FCCs, shareholders' agreements are limited to three years and — under pain of nullity — must be notified to the Italian Financial Authority (*Commissione Nazionale per le Società e la Borsa - CONSOB*) and an extract of the operative provisions must be filed with the companies register and published in Italian newspapers.¹⁰ Shareholders' agreements can be enforced in the courts, but specific performance is not granted and damages are awarded (though shareholders' agreements may include sanction clauses that would be ordinarily enforced by courts).

Family office / holding companies permit FSHs to add an additional layer of institutionalization and formalization to their control over the FCC. Family offices / holding companies, typically incorporated as a limited liability company and holding the family's entire shareholding in the FCC, can reassure other shareholders about the process by which the members of the FCC's governing bodies are elected and can empower a smaller circle of persons to speak with the authority of the FSHs in their official capacities as officers/directors of the family office / holding company. Additionally, for listed FCCs, the ability to incorporate as a family office / holding company can facilitate access to margin loans, issuance of exchangeable/convertible securities, and other types of shareholder financing that would otherwise be difficult with a more dispersed shareholding structure.

Governing bodies

Not surprisingly, the most relevant institutions concerning the governance of the FCC can be found in the establishment, organization, and management of the FCC's governing bodies itself, such as the BoD, internal audit functions, and external auditors. In Italy, the most common bodies empowered by law and the bylaws to exercise management and internal control policies are for joint stock companies (*società per azioni*):

- The BoD (*consiglio d'amministrazione*) for companies with a unified management and control system
- The supervisory board (*consiglio di sorveglianza*) and management board (*consiglio di gestione*) for companies with a dualist management and control system
- The board of statutory auditors (*collegio sindacale*)
- The control and risk committee within the meaning of Legislative Decree 231/2001 (*comitato per il controllo e rischi*)¹¹

Companies with more robust internal control systems and appropriate duty-sharing between the various governing bodies will be able to navigate difficult periods and better positioned to detect fraud and other breaches. Independent directors (which remain rare for non-listed companies), or recourse to an advisory

board with non-family members that can be consulted in connection with strategic decisions, can also produce better governance outcomes.

Succession planning

Often the retirement of a long-standing Chief Executive Officer (CEO) or other senior business manager or founder-shareholder is a critical point in the history of a FCC. Research indicates that FCCs that have engaged in succession planning are more likely to be able to entrust the company to the next generation successfully. Transparent succession planning may be daunting, but formalized shareholder institutions can create a basis for articulating the preparation, identification, and training of successors within a reasonable period prior to the retirement of the CEO or other business leader. FCCs that have maintained successive generations of ownership demonstrate the benefits of this approach, whereas FCCs that fail or dissolve in acrimony often provide a cautionary tale for failure to engage in succession planning.

A tailored governance code for FCCs

In October 2017, the AIDAF (*Associazione Italiana delle Aziende Familiari*), the Italian Family Business Association, and Milan's Bocconi University published a corporate governance code for privately held FCCs (the Code).¹² The Code is intended to create a benchmark for FCCs, encourage best practices and, in respect of corporate governance, supplement the controls provided for by law.

The main takeaways of the Code are as follows:

Shareholders' assembly

Article 2364 of the Italian Civil Code requires that the ordinary shareholders' assembly of a joint stock company meet at least once a year to approve annual financial statements, resolve the election and revocation of directorships and statutory auditors, determine the remuneration of the directors and statutory auditors if not set by the bylaws, and deliberate on all other matters that applicable law grants under its purview. The Code, however, recommends turning the shareholders' assembly into an tool of corporate governance, a medium of communication with FSHs who may not be involved in the day-to-day of the business, and a forum for FSHs to meet, debate, and resolve issues of fundamental importance to the FCC.

Board of directors (BoD)

Article 2380 bis of the Italian Civil Code requires joint stock companies to establish an administrative body with one or more members. The Code recommends that FCCs establish a BoD rather than a sole director (*amministratore unico*) and provides for a BoD of between three and nine members, according to company size. Again, the Code favors institutionalizing the BoD as the deliberative body to set the FCC's medium- to long-term strategy, provide management and accounting oversight, and consider extraordinary transactions. In order to exercise adequately the foregoing functions, the Code recommends that the BoD meet at least once per quarter. The Code provides that at least one member of the BoD should be independent from the FSHs, either a trusted advisor to the family (which is common for FCCs with annual revenue greater than €10 million), or preferably, an independent director — noting that independent directors among privately-held Italian FCCs remain the exception rather than the norm. The Code also recommends that BoD membership selection takes into account, among other factors, diversity of gender, profile, and experience.

Succession planning

The Italian Civil Code is silent on a company's succession planning. For the Code, the shareholders' assembly and BoD should consider succession planning — the capacity of the FCC to face generational transition or change of ownership effectively — which is an integral part of their remit. The Code recommends that both bodies consider preparing succession plans and identifying and training the next generation of leadership (whether a member of the family or otherwise). The Code also recommends creating a family holding company to provide additional organizational structure to succession planning and election of the BoD.

The Code therefore seeks to orient privately held FCCs towards more formalized and institutionalized internal controls and greater transparency.

Additional considerations for listed FCCs

Much has been written on corporate governance in the context of listed companies generally, and the Corporate Governance Code (*Codice di autodisciplina*) published by the Italian Stock Exchange's Committee on Governance (the Corporate Governance Code) is voluntarily and widely followed by listed companies. The Corporate Governance Code's new edition that will apply for the year ending December 31, 2021, however, does address unique considerations of, and provides additional guidelines for, listed FCCs and any other companies that have "concentrated ownership" structure. These considerations include that at least one third of the directors on the BoD be independent and that succession planning should be reconsidered at least annually.¹³

According to CONSOB's latest corporate governance study, listed FCCs have increased their market capitalization of all listed companies' ordinary shares from 26.4% as of December 31, 2012 to 33.0% as of December 31, 2018, forming the second-largest bloc of listed companies after companies controlled by state and local authorities (e.g., utilities).¹⁴ Listed FCCs are particularly present among the Star segment (74.1% by market capitalization) and Mid Cap (50% by market capitalization), and less represented among the FTSE MIB index companies (18.9% by market capitalization).

The principles articulated in this *Client Alert* regarding institutionalization and formalization of the FCC still apply to listed FCCs, and perhaps even more so. The requirements of transparency and adequate disclosure founded in, among other sources of law, the Prospectus Regulation, the Transparency Directive, the Market Abuse Regulation, and applicable CONSOB regulations, should direct FCCs towards further strengthening their internal controls, more robust communication, and dialogue in ESG matters.

Conclusion

The European Commission observed that "an effective corporate governance framework is of crucial importance because well-run companies are likely to be more competitive and more sustainable in the long term."¹⁵ While the medium- and long-term consequences of the COVID-19 outbreak are still unclear, the Italian economy and the global economy likely will suffer a significant impact. Both the Italian government and European institutions are marshalling unprecedented resources to assist businesses and individuals affected by the economic downturn. However, the scale of the funding deficit will require private funding from debt and equity investors (in addition to banks). Companies with captured, ineffective boards and with opaque shareholding structures may find themselves shut out of the lending and capital markets. Many investors and portfolio managers have recently committed to mainstreaming ESG across their asset management activities, and they likely will scrutinize the governance, internal controls, and succession planning of companies prior to deploying funds.

FCCs are integral actors on the Italian corporate and economic stage. FCCs and their FSHs should therefore consider improving shareholder institutionalization and processes, strengthening governing bodies and planning for succession of key directors or founders as discussed in this *Client Alert*. Adopting best practices, including those in the Code, in corporate governance for FCCs may also represent a first step for privately held FCCs to join the Italian Stock Exchange's ELITE Program. This selective platform co-sponsored by Confindustria (the main business association in Italy), aims to support qualifying private companies in their organizational and managerial development to increase internationalization and access to the capital markets.

The successive reforms of Italian law that have facilitated access to the capital markets, as well as the attractive valuations that established FCCs have commanded in the M&A market, indicate that FCCs will continue to be active capital markets issuers. Research suggests that FCCs have many justifiable self-interested reasons to implement corporate governance reforms in order to perpetuate the family's control of the going concern; however, FCCs that adopt best practices may also find there are rewards for companies that respond to investor attention to ESG concerns with concrete action.

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Endnotes

- ¹ John Davis, "What Makes a Family Business Last?" *Harvard Business Review* (February 2020). <https://hbr.org/2020/02/what-makes-a-family-business-last>.
- ² Credit Suisse Research Institute. The CS Family 1000 in 2018 (September 2018). <https://www.credit-suisse.com/media/assets/corporate/docs/publications/research-institute/the-cs-family-1000-in-2018-en.pdf>.
- ³ Claudio Fernandez Araoz, Sonny Iqbal, Jörg Ritter and René Sadowski, "6 Traits of Strong Family Businesses" *Harvard Business Review* (June 2019). <https://hbr.org/2019/06/6-traits-of-strong-family-businesses>.
- ⁴ Data for the year ended December 31, 2016.
- ⁵ Data for the year ended December 31, 2016.
- ⁶ Data for the year ended December 31, 2018.
- ⁷ As of October 2019 prior to the subsequent update of the index.
- ⁸ Data by deal count, non-financial services deals from January 1, 2018 through April 5, 2020.
- ⁹ See Article 2341-bis of the Italian Civil Code which restricts shareholders' agreements that (i) control voting of a joint stock company or its holding companies, (ii) limit transferability of the shares of a joint stock company or its holding companies, (iii) have as a goal or that result in the dominant influence of the joint stock company.
- ¹⁰ See Legislative Decree No. 58 of February 24, 1998, as amended.
- ¹¹ Legislative Decree 231/2001 of June 8, 2001 provides a shield against the criminal liability of companies if a compliance model has been adopted which, among other things, risk mapping has been conducted, specific policies on internal control and risk management adopted and a monitoring body with autonomous powers of control, audit, and monitoring has been created and duly empowered.
- ¹² AIDIF and Bocconi University. The Governance Code for Privately-held Family-Controlled Companies (October 2017). http://www.codiceaziendefamiliari.it/wp-content/uploads/2018/05/01.-Codice_Autodisciplina_ottobre2017.pdf.
- ¹³ Italian Corporate Governance Committee. Corporate Governance Code (January 2020). <https://www.borsaitaliana.it/comitato-corporate-governance/codice/2020eng.en.pdf>.
- ¹⁴ CONSOB. Report on Corporate Governance of Italian Listed Companies (February 2020). <http://www.consob.it/documents/46180/46181/rcg2019.pdf/941e4e4e-60db-4f89-afb3-32bddb8488e0>.
- ¹⁵ European Commission. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies." COM/2012/0740.