THE CORRELATION BETWEEN MANAGEMENT POWER AND RISK IN THE ITALIAN COMPANIES

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Abstract

The shareholders can not directly manage the business but they have powers of pulse and control by voting right that is essential for the correct functioning of the company. In 1942 the Italian legislature, although with some exceptions, adopted One share – One vote rule. The legal framework changed significantly after the enactment of corporate law reform in 2003. The objective of this research is to examine the status of the principle of correlation between management power and risk in the context of the regulatory framework of Italian public companies, as it emerged after the enactment of above mentioned corporate law reform in 2003.

Keywords: Corporate Governance, Legal Framework, Management Power, Risk

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The entrepreneur who operates in the market must daily face up to the risk. Risk Management is necessary to ensure the survival of the firm in the long term.

The existence of a correlation between management power and risk, in the context of entrepreneurial activities, is evident: there should be a balance between power and risk. This correlation comes from a simple economic rule in order to allow a wise direction.

Exercising initiative in enterprise-oriented ways with partners is a Risk Management technique based on risk sharing.

With the partnership agreement, two or more people invest their resources in a business activity to divide the profits. Thereby partners share the risk and its possible negative consequences.

The Italian legal system provides for a clear division between companies and partnerships. The members of partnerships have unlimited and jointly liability for the partnerships' obligations. Instead the members of companies have limited liability and they may lose only their contributions. The limited liability allows the capital raising.

Therefore companies carry into effect Risk Management techniques more advanced than partnerships.

The shareholders can not directly manage the business but they have powers of pulse and control by voting right that is essential for the correct functioning of the company. Indeed the partnership agreement is incomplete. The mechanism of completion usually chosen consists in attributing voting right to certain subjects who are called, for example, to appoint the directors and to approve the balance sheet.

The shareholders, as *residual claimants*, have the power of "completing" the partnership agreement through the exercise of voting rights in shareholders' meeting. The voting right is above all functional to achieve the shareholders' cash flow rights.

Instead traditionally creditors have not voting right because they do not bear – or rather, should not bear – the business risk. Creditors, who as fixed claimants, do not interfere in management decisions.

Shareholders' decisions could be selfish and opportunistic.

In this context the attribution of administrative rights to creditors can stem moral hazard and shareholders opportunism but solely in the presence of long-term or variable remuneration loans. In other situations creditors would choose quiet life or short term policies.

In 1942 the Italian legislature, although with some exceptions, adopted for the first time One share – One vote rule in public companies. Indeed it was believed that the management power should be directly proportional to the risk borne to ensure optimal management of the firm. However companies should create limited-voting stocks and public companies should create nonvoting stocks. In both cases limitation or exclusion of voting right had to be offset by economic privilege.

The legal framework changed significantly after the enactment of corporate law reform in 2003 that has introduced the possibility of assigning shares in a non-proportional manner as well as the possibility of creating special share categories such as preferred

stocks, redeemable shares, tracking stocks, nonvoting stocks, limited-voting stocks, shares with a voting right subordinated to the existence of not solely discretionary conditions. Furthermore, the so-called "closed companies" enjoy a greater autonomy, because their article of association may provide, in pursuance with the third paragraph of article 2351 of the Italian Civil Code (ICC), that "in connection with the quantity of shares held by the same person, the voting right is limited to a maximum or in arranged in instalments". The law allows restricting voting rights, or even entirely eliminating them; yet, there is no mention of any need to institute any special economic privilege as a consequence of the restriction or exclusion of voting rights but the *default* rule does not diverge from the *one-share one-vote* model.

The principle of proportionality between management power and risk shall be put under review – although it still operates as a *default* principle. The only explicit limit on the matter of shares void of voting rights, or with limited voting rights, is a quantitative one, which can be found in the second paragraph of article 2351 of the ICC, which stipulates that the maximum amount of special shares issued cannot exceed half the company's capital. Such a limit undeniably serves an organizational purpose, as the existence of at least one class of shares with full voting rights is essential to company operations. However, the said limit does not appear sufficient to prevent a minority of shareholders from managing the company while risking the resources of other shareholders. Indeed, regardless of the fact that the actual distribution of shares may thwart the actual functional scope of the limit, no regulation stipulates that shares with full voting rights – which indeed shall represent at least half of the company's capital - must also correspond to a *residual claimant* position, as the shares with full voting rights may as well be exactly these which enjoy economic privileges and be, therefore, characterized by a 'reduced risk' profile.

Corporate law Reform in 2003 allows companies to issue participating financial instruments with cash flow or administrative rights in exchange for a not further specified contribution from partners or third parties, which may also consist of services or contributions in kind. Yet paragraph 5 of article 2351 of the ICC specifies that the articles of association may assign the owners of the participating financial instruments precisely that right to vote that apparently could not be assigned to them, although restricted to certain specified matters, as well as the right to appoint an independent member of the board of directors or a member of the auditing body. Therefore these new participating financial instruments may be useful in assigning administrative rights to qualified creditors.

It can also be inferred from the previous considerations that the voting right is no longer a necessary element of a share. In any case, consequent to the introduction of the participating financial instruments, the necessary connection between being a shareholder and having the power to contribute to the formation of the will of the firm has inevitably disappeared. Indeed the owners of participating financial instruments may now intervene in the firm's decision-making process, though they are not shareholders and don't contribute capital-at-risk.

These provisions have increased the ongoing academic debate on the distribution of entrepreneurial risk allocation.

Indeed pathological risk transference is amplified in companies, which are characterized by the externalization of part of the entrepreneurial risk to the detriment of creditors as a consequence of a partial relief from responsibility for the shareholders and, therefore, from the consequent incentive for *moral hazard*.

Hence, it is essential to look for a trade-off between the containment of the pathological implications of limited liability and the need to provide development of the financial structure of companies, in order to facilitate their growth and profitability. Indeed, this last necessity has inspired legislative interventions on share classes and participating financial instruments.

Yet, such legislative interventions might increase the ongoing decoupling of management power and risk. The decline of the proportionality between risk and management may lead, in the most extreme hypothesis, to irrational choices that will inevitably produce degenerative consequences. Therefore, in some circumstances, the articles of association could recover the above-mentioned proportionality.

In the case of preferred shares – and even more so for deferred, redeemable or correlated shares – recovering the correlation between the economic content of a share and its administrative rights, in order to prevent – from a long term perspective – egotistical 'class' choices from affecting the activities of a company, could prove to be useful. Choosing to suppress or limit voting rights – which, although in principle may be considered 'desirable' choices if applied to certain share classes as they would help in preventing certain types of conflicts – might lead to other choices. A possible corrective measure may consist of assigning a voting right that would be «subordinated to the existence of certain conditions which cannot be merely discretionary», as set forth by the second paragraph of article 2351 of the ICC, for instance by considering the failure to distribute profits to a special category for a given number of accounting periods as a «not merely discretionary» condition.

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