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## **Non-executive Directors and Auditors in the Context of the UK Corporate Governance: Two (or Too Many?) “Pirandellian” Characters still in the Search of an Author?**

PIERDOMENICO DE GIOIA-CARABELLESE\*

### **1. Foreword**

The *Companies Act 2006*,<sup>1</sup> while providing a rigorous framework for Corporate Governance, abstains from extending a likewise courtesy to the classification of non-executive directors, despite a significant use by listed companies of said category. Similarly, UK company legislation continues to place a telling emphasis on the audit of company accounts, whilst the legal-management audit, albeit quite familiar to foreign legislations,<sup>2</sup> remains extraneous to domestic legislation and corporate practice.

Such apparent aberrations are analysed in this work as a possible weakness of corporate governance in the UK and, to a certain extent, one of the potential explanations for the market failure which has plagued businesses (particularly within the financial sector) over the previous two years in Britain.<sup>3</sup>

Against this backdrop of suspect legal frailties lies the very essence of this article – a studied undertaking, grounded in legal methodology, as to whether sufficient scope

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<sup>1</sup> Henceforth also the “CA 2006”.

<sup>2</sup> In this respect, the yardstick for the purposes of a comparative analysis will be the Italian jurisdiction.

<sup>3</sup> It is worth mentioning that as of today the British banking system is formally private but substantially (and hugely) public. The intervention in the banks, in certain cases up to 100% of their share capital, materialised through different but clear “episodes” in between August 2007 until March 2009. Corporate names such as “Northern Rock”, “Halifax Bank of Scotland” and, on the top of all, “Royal Bank of Scotland” are the sad epitome of the “Waterloo” (from the French perspective!) of such a collapse.

For details see de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditors sull’Asse Roma-Londra’ (2009) *Le Società* (12) 1556,1557, particularly footnote 2. See also M De Poli, ‘Crisi Finziaria e Salvataggio delle Banche Inglesi. Il Banking Act 2009’ (2009) *Rivista Trimestrale di Diritto dell’Economia* (1 – Annex) 5,59. The latter Author refers in the title to the “English” banks (*banche inglesi*), whereas the entire “British” banking sector has been the subject of the perusal.

At journalistic level, see New York Times, Private Ownership of Banks is Called Crucial to Britain, in <http://dealbook.blogs.nytimes.com/2009/02/25/private-ownership-of-banks-is-crucial-uks-darling-says/>, retrieved on 5th September 2009; Banking Times, Lloyds Banking Group passes to majority stake ownership, in <http://www.bankingtimes.co.uk/08032009-lloyds-banking-group-passes-to-majority-state-ownership/>, retrieved on 5th September 2009; This-is-money, Lloyds can’t avoid State ownership, in [http://www.thisismoney.co.uk/news/article.html?in\\_article\\_id=490175&in\\_page\\_id=2](http://www.thisismoney.co.uk/news/article.html?in_article_id=490175&in_page_id=2), retrieved on 5th September 2009.

exists within the UK legal system to facilitate the adoption of an altogether more convincing and clear-cut system of corporate governance hinged upon the creation of a committee responsible for the supervision of management and functionally independent from the board of directors. This committee, which should, to all intents and purposes, neutralize the somewhat controversial figure of the non-executive directors – currently existing at formal level in listed companies and acknowledged by the vast majority of the British scholars as also pertaining to non-listed companies<sup>4</sup>, is ideally conceived in this work as a body to be rendered mandatory for all typologies of companies.<sup>5</sup> Moreover, the collegiate body in question should assume full responsibility for handling *the audit of management within* the company, leaving the *auditing of accounts* still within the remit of external auditors.<sup>6</sup>

In this respect, it is furthermore the purpose of this work to demonstrate that the possible “birth” of a committee charged with management supervision, in tandem with the appropriate “euthanasia” of non-executive directors, might encourage the development of an altogether more prudent and sound business ethic, facilitated by the company-wide presence of an autonomous corporate “organ”, instigated at a legislative level and duly bestowed with specific powers of initiative aimed at protecting the shareholders. Such a micro-structure, it is conclusively argued, when carefully reconciled within the confines of the relevant British corporate entities, would not affect the harmonious and perpetual momentum of entrepreneurial activities, nor would it substantially burden the same with excessive incremental costs.

In order to corroborate this proposal, a comparative legal analysis will be undertaken incorporating alternative systems of corporate governance, such as that evident in Italy – a system traditionally founded upon a more articulated set of norms, and in particular upon those aimed at regulating the (mandatory) existence of an independent body (the board of statutory auditors) which, for listed and non-listed companies alike, is compelled to audit both the management and the accountancy of the company.

## 2. The “Ontological” Explanation of Corporate Audit

As a concept, the corporate audit may divulge two ramifications: a first one relating to the accounts; a second one legal-administrative in nature. The accounting audit is entrusted with the technical verification that the accounts of the audited company are in order. Habitually, due largely to the technicalities entailed in the relevant tasks, this audit is performed *de iure* by experts qualified as accountants.<sup>7</sup>

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The bail-out of Northern Rock and its moral hazard unleashed on the British Banking system are analysed in P de Gioia-Carabellese, ‘From “Uncle Scrooge” to “Fred the Shred”’: the Legend of the Sound and Prudent Scottish Banker’ forthcoming.

<sup>4</sup> See *infra* further explanations.

<sup>5</sup> In reality, and based on the explanations provided further on in this work, it is more realistic to limit the utilisation of this body to quoted companies. See *infra* Part 10.

<sup>6</sup> See Sect. 495 of the Companies Act 2006.

<sup>7</sup> According to the common definition, “[t]he purpose of the statutory audit is to provide an independent opinion to the shareholders on the truth and fairness of the financial statements, whether they

In contrast, the “legal” (or regulatory) audit may be defined as a check, carried out by an external body (or alternatively by a group of directors, so long as they are independent), overseeing a general observance, on the part of the management body, of the law and by-laws as well as of the principles of proper management.<sup>8</sup>

As far as UK legislation is concerned, the second typology of audit is roundly ignored when it comes to non-listed companies; conversely, listed companies are subjected to a form of regulatory audit where, under the entrusted jurisdiction of the audit committee, the secondary legislation requires the compliance of each and every issuer.<sup>9</sup>

In some foreign legislations such as the Italian, the corporate playing field tends to be considerably more geared towards promoting the culture of the audit;<sup>10</sup> it is hardly a coincidence that characteristic of all these jurisdictions is the stipulation that all companies should appoint a board of statutory auditors (ancillary to the external auditor), whose specific purpose is to perform a managerial-legal audit, in addition to the accounting one which remains assigned to an external auditing firm.<sup>11</sup>

### 3. The State-of-the-art of the Audit in the UK: “Glimpses” of Legislation (Companies Act 2006)

The transparency of the law regarding accounting auditing is garnered from a brief reading of the legislation currently in force in the UK decreeing it mandatory for all companies (either private or public, listed or non-listed, with specific limited exceptions<sup>12</sup>), under the supervision of a professional external firm. In this respect, and without labouring the subject, the most telling provision of law is that contained under Sect. 495, CA 2006, stating that:

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*have been properly prepared in accordance with the Companies Act and to report by exception to the shareholders on the other requirements of company law such as where, in the auditors' opinion, proper accounting records have not been kept.*” (see ICAEW, July 2006, cited in T Copnell, ‘External Audit, Internal Audit and the Audit Committee’ in R Smerdon (ed), *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 277.)

<sup>8</sup> The definition is that inferable from the description of the duties of the board of statutory auditors, provided with by Art. 2403, of the Italian Civil Code (henceforth the “CC”); see *amplius* Part 6 *infra*, particularly 6.2. Similarly, the “legal audit” is taken for granted within the Italian law literature: see *ex plurimis* LA Ferrari, ‘Il Controllo Sindacale alla luce della Riforma’ in G Paolone (ed), *Le Nuove Regole di Governance alla luce della Società a Base Azionaria* (Giappichelli, Torino 2004) *passim*, particularly at 54; L Benatti, ‘Commentary to Artt. 2397–2406’ in A Maffei Alberti (ed), *Il Nuovo Diritto delle Società* (CEDAM, Padova 2005) II, at 892.

<sup>9</sup> Reference is made in this respect to FSA Rule DTR 7.1.1 R. For a more ample analysis see the following Part 3 *infra*.

<sup>10</sup> Parts 6 and 7 *infra*.

<sup>11</sup> See *amplius* under Part 3 *infra*.

<sup>12</sup> According to Sect. 475, these exceptions are those relating to “small” companies (Sect. 477), for dormant companies (Sect. 480) and for non-profit-making companies subject to public sector audit (Sect. 482). As to relevant comments, see *amplius* L Sealy & S Worthington, *Cases and Materials in Company Law* (8th edn Oxford University Press, Oxford 2008) at 73.

*“A company’s auditor must make a report to the company’s members on all annual accounts of the company of which copies are, during his tenure of office –*

- (a) In the case of a private company, to be sent out to members under section 423;*
- (b) In the case of a public company, to be laid before the company in general meeting under section 437.”*

This audit relating to the accounts carries echoes of the set of provisions set forth by the correspondent over-layer<sup>13</sup> where Article 1 defines the prerogatives of the Directive in ruling the regulatory audit of annual and consolidated accounts. Embedded within the accounting audit, to which every company is fundamentally answerable to in Britain, is a system of duties (mainly a duty of care) which each auditor owes to the company concerned (but not to its members) – a culmination of blossoming jurisprudence over the past century.<sup>14</sup> With the enactment of the *CA 2006*, auditors’ liabilities remain untouched, although certain rules, such as that enshrined in Sect. 534 which considers certain valid agreements aimed at limiting the liability of the auditors, may constitute a step backwards,<sup>15</sup> rather than a positive development to the matter at hand.<sup>16</sup>

In contrast, the regulatory audit is not contemplated at all with regard to non-listed company activity in the UK, nor do scholars traditionally indulge in its legal analysis at domestic level.<sup>17</sup> Actually, as for “quoted” companies, an audit committee is indeed prescribed by some soft legislation.<sup>18</sup> In an explanatory way, the FSA Rule DTR 7.1.1, bearing resemblance to Art. 41(1) of the Directive, states that:

<sup>13</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, henceforth also the “Directive”.

<sup>14</sup> See among others *Caparo Industries plc v. Dickman* [1990] 2 AC 605 (HL) but also *Equitable Life Assurance Society v. Ernst and Young* [2003] EWCA Civ 1114. See *amplius* PL Davies, *Gower and Davies Principles of Modern Company Law* (8th edn Thomson/Sweet & Maxwell, London 2008) Ch. 22, but also N Grier, *Company Law* (3rd edn W Green/Thomson Reuters, London 2009) at 275,277.

<sup>15</sup> See the *Companies Act 1985*. G D Morris, ‘Auditors’ in B Hannigan and Others (eds), *Butterworths. Corporate Law Service. Corporate Administration: Corporate Finance* (Issue 2004 Lexis Nexis, London 2004) at 13/1, 13/83.

<sup>16</sup> Likewise, critical views seems to be expressed by those authors (*inter alios*, L Sealy & S Worthington, *Cases and Materials in Company Law* (8th edn, Oxford University Press, Oxford 2008) 73) who clearly track such norms to the lobbying activity of the auditors’ association.

<sup>17</sup> In commenting on the audit, UK Company Law manuals usually impinge on a mere analysis of the accounts, whereas the regulatory audit seems to be extraneous to the interests of the domestic researchers. See, eloquently, PL Davies, *Gower and Davies Principles of Modern Company Law*, cit. at 759,828; S Mayson, D French & C Ryan, *Mayson, French & Ryan on Company Law* (26th edn Oxford University Press, Oxford 2009) at 520,541; L Sealy & S Worthington, *Cases and Materials in Company Law* (8th edn, Oxford University Press, Oxford 2008) at 73,82.

<sup>18</sup> First comments as regards the Audit Committee at its dawn may be found in M Bruce, *Rights and Duties of Directors* (Butterworths, London 1998) at 180,182, as well as in PL Davies, *Gower and Davies Principles of Modern Company Law*, cit. at 784,787.



*“An issuer must have a body which is responsible for performing the functions set out in DTR 7.1.3 R. At least one member of that body must be independent and at least one member must have competence in accounting and/or auditing.”*

In addition to this, pertaining to the functional scope of the auditors, the following DTR 7.1.3 R. prescribes that:

*“An issuer must ensure that, as a minimum, the relevant body must:*

- (1) monitor the financial reporting process;*
- (2) monitor the effectiveness of the issuer’s internal control, internal audit where applicable, and risk management systems;*
- (3) monitor the statutory audit of the annual and consolidated accounts;*
- (4) review and monitor the independence of the statutory, and in particular the provision of additional services to the issuer.”<sup>19</sup>*

Of no less importance, as the audit committee is *de facto* encapsulated within the same management body (the BoD), the FSA rules require that the company verifies whether the requisite of independence has been duly satisfied; more specifically, according to the FSA Rule DTR 7.1.2:

*“The requirements for independence and competence in accounting and/or auditing may be satisfied by the same member or by different members of the relevant body.”*

Despite the variegated picture of provisions hitherto alluded to under this Part, it must be critically noted that the functions vested in the audit committee do not appear to focus on an autonomous activity; rather they constitute, for the most part, a duplication of the tasks already entrusted to the external auditor, essentially with a total exclusion of any regulatory audit. Significantly, the members of the audit committee – themselves already ‘honorary members’ of the “directorship” – are not bound by any liabilities different from those entailed of normal directors, whereas in other jurisdictions<sup>20</sup> the statutory auditors, in addition to forming a separate body, are, on the one hand, clearly bound by specific duties (*culpa in*

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<sup>19</sup> Also in this case, the wording is similar to the Directive, particularly Article 41(2) stating that: *“Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, inter alia:*

- (a) Monitor the financial reporting process;*
- (b) Monitor the effectiveness of the company’s internal control, internal audit where applicable, and risk management systems;*
- (c) Monitor the statutory audit of the annual and consolidated accounts;*
- (d) Review and monitor the independence of the statutory auditor or audit firm, and in particular the provisions of additional services to the audited entity.”*

<sup>20</sup> See *infra* under Parts 6, 7 and 8 the scenery depicted in the matter of the Italian legislation.

*vigilando*) while, on the other, can play an active role in terms of protecting the minority shareholders,<sup>21</sup> well beyond the (fundamentally weak) duty of periodical report currently entrusted with the audit committee in Britain.

Finally, while (soft) UK legislation does require the appointment of internal auditors, the role of these professionals (usually employees of the company) merely consists of a rather arbitrary analysis of the reputational, operational and strategic risk.<sup>22</sup> Such an activity does not differ from that performed by similar professionals in other countries and, on a more pertinent note, the liabilities they can therewith incur are merely of a labour law nature, given the fact that they do not reside at the “pinnacle” of the corporate hierarchy.<sup>23</sup> In light of this, they will lie outwith the parameters of analysis set out in this work.

To simplify, in the UK:

- a. The company legislation does not cater for any independent body in charge of a regulatory audit of non-listed limited companies, given the fact that the audit for such companies impinges exclusively upon that concerning the accounts;
- b. Exclusively, in respect of listed companies, the “soft legislation” requires the appointment of an audit committee within the same board of directors; however, the relevant tasks, because constituting a duplication of the roles already entrusted with the external auditors, appear to be mainly, if not exclusively, of a non-regulatory nature.<sup>24</sup>

#### 4. Non-Executive Directors

##### 4.1. *The “Mission Impossible” of a Legal Categorization?*

Set apart from the external auditors, duly characterised at a legislative level, the demarcation line between executive and non-executive directors runs true to an empirical, rather than a theoretical strand,<sup>25</sup> and seems to arise from the practical

<sup>21</sup> See also in this respect *infra* Part 8 as their power of initiative *vis-à-vis* the judicial authority.

<sup>22</sup> R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 284. According to the Institute of Internal Auditors (*Code of Ethics and International Standards for the Professional Practice of Internal Auditing*, March 2004, www.iaa.org.uk), “internal auditing is an independent, objective assurance and consulting activity designed to add value and improve organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes”.

<sup>23</sup> See P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditors sull’Asse Roma-Rondra’ cit. at 1560.

<sup>24</sup> P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditors sull’Asse Roma-Londra’ cit. at 1560.

<sup>25</sup> It is properly reminded (S Mayson, D French & C Ryan, cit. at 424) that:

“The distinction between executive and non-executive directors has no significance in company law though it may cause difficult problems in employment law”.

observation that in companies, particularly the listed ones, certain directors tend quite naturally to play a more active role than others.<sup>26</sup> The first “officers” will be, almost by definition, “executive” and will oversee the management of the company, while the ‘second tier’ will be defined “non-executive”.<sup>27</sup>

Also, among commentators, there is a certain proclivity to somehow differentiate between the two categories, particularly on the basis that executive directors display a stronger connection with the company, simply entwined in a contract of employment. It is not the case that, among these scholars, the conclusion (or the tautology?) usually drawn is one where, as a result of a contract of employment subsisting between the company and the director, the latter shall qualify automatically to “executive” status.<sup>28</sup>

In reality and *re melius perpensa*, under the same area of common law, this conceptual automatism is far from being corroborated, given the fact that, through a slow, albeit significant, “Darwinian” evolution, court decisions such as *Re City Equitable Fire Insurance Co*<sup>29</sup> and *Lister v. Romford Ice & Cold Storage Co Ltd*<sup>30</sup> (the “guns” are usually loaded” by those intent on strenuously defending the alternative category of the non-executives) might be more than compensated by more recent *decisa* such as *Dorchester Finance Co Ltd v. Stebbing*<sup>31</sup> (where, by contrast, non-executive direc-

<sup>26</sup> It is emphasized (see S Mayson, D French & C Ryan, *ibidem*) that:

“An executive director of a company typically devotes his or her whole working time to the company (or a number of companies in a group), often as an employee of the company, and has a significant personal interest in the company as a source of income.”

See also A Dignam & J Lowry, *Company Law* (Oxford University Press, Oxford 2009) at 270. The Author spells out the axiom that:

“Non executive directors are normally appointed to the boards of larger companies to act as monitors of the executive management”.

<sup>27</sup> See D French, S Mayson & C Ryan, *cit.* at 424.

<sup>28</sup> *Inter alios*, J Birds & Others, *Boyle & Birds’ Company Law* (Jordans, Bristol 2009) at 601. There is probably a Freudian slip in the authors’ statement when they declare:

“In any event, directors employed under a contract of service, that is in effect an executive director, will be bound to execute objectively reasonable care, skill and diligence by virtue of his position as employee.” [emphasis added]

In reality, critical – and well demonstrated – views on the category of the non-executive directors may be read in R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 123,127.

<sup>29</sup> [1925] Ch. 407. Particularly and beyond the same narrative, which may nonetheless be read in C Wild, S Weinstein & J Bisacre, *Smith & Keenan’s Company Law* (14th edn Pearson Longman – Scottish Edition, Edinburgh 2009) at 338, the paradigm of the care “drawn” by that court decision, in the words of Romer J, is worthy of mention:

“(a) A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from someone of his knowledge;

(b) A director is not bound to give continuous attention to the affairs of the company;

(c) where duties may properly be left to some other official, a director is justified, in the absence of grounds for suspicion, in trusting that official to perform his duties honestly.”

<sup>30</sup> [1957] AC 555.

<sup>31</sup> [1989] BCLC 498. The narrative of both this court decision and those cited in the following two footnotes may be read ultimately in C Wild, S Weinstein & J Bisacre, *cit. passim*.

tors were deemed liable for *culpa in vigilando* because they signed blank cheques, following a simple request from the full-time director, for loans made to third parties which violated a piece of legislation then applicable, namely the Moneylenders Acts), and substantiated in *Re D'Jan of London Ltd*<sup>32</sup> and *Norman v. Theodore Goddard*<sup>33</sup>. It should be duly noted that, in “*Dorchester*”, the perennial doubt that the liability was affirmed, given the peculiarity that the non-executive directors were ultra-qualified chartered accountants and specifically hired for their expertise, will never be completely dispelled.<sup>34</sup> However, it is nonetheless undeniable that the ultimate judicial assumptions tend to clearly track a joint liability to all the directors, irrespective of whether they enjoy executive status or not, in cases of maladministration.

An indirect confirmation of any definitive stance advocated by the British Courts in the matter of non-executive director liability is offered by two comparatively recent cases: *Re Barings plc (No 6)* (1999);<sup>35</sup> *Equitable Life Assurance Society v. Bowley and others*.<sup>36</sup>

The former dealt with the degree of supervision which a director was expected to exert on a delegated business (more specifically, the deputy chairman of a banking group which had been delegated to the business unit in Singapore and ended up reporting huge losses due to the mismanagement of an employee). The principle propounded was that the director in question did indeed have a duty to acquire and maintain sufficient knowledge of the company's business in so much as to enable him to discharge his responsibilities.<sup>37</sup>

As for *Equitable*, the company sued each director for damages in a violation of duties incurring losses amounting to upwards of £3 billion. However, in 2003 Langley J<sup>38</sup> rejected a non-executive director's *interim* application, whose aim was to dismiss the company's claim, on the assumption that their (*i.e.* the non-executive directors') decisions were somewhat mitigated by an entitlement to rely on the executive directors. Quite eloquently, the judge explained that the claim for negligence against the non-executive director had a real possibility of success,<sup>39</sup> given the fact that:

<sup>32</sup> [1994] 1 BLCL 561.

<sup>33</sup> [1992] BCLC 1028.

<sup>34</sup> See L E Talbot, *Critical Company Law* (Routledge-Cavendish, Oxon 2008) at 184 and C Wild, S Weinstein & J Bisacre, *cit.* at 339.

<sup>35</sup> (2000) 1 B.C.L.C. 523.

<sup>36</sup> [2003] EWHC 2263. Furthermore, an Australian case (*AWA Ltd v. Daniels* (1995) 37 N.S.W.L.R. 438) might be deemed as following the same line of reasoning of “*Equitable*”.

<sup>37</sup> A Dignam & J Lowry, *cit.* at 323. *Re Barings Plc (No. 6)* is echoed by *Re Barings Plc (No. 5)* [2000] 1 B.C.L.C. 523., particularly in the judgment of Moritt LJ In this respect, see also R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 125.

<sup>38</sup> Page 41.

<sup>39</sup> Remarkably, a dismissal of a similar *interim* claim in a parallel proceeding was pronounced against the auditor, Ernst & Young (*Equitable Life Assurance Society v. Ernst & Young* [2003] EWCA Civ 1114. See L Sealy & S Worthington, *cit.* at 73,82. *Cases and Materials in Company Law* (8th edn Oxford University Press, Oxford 2008). The Authors correctly place emphasis on the fact that:

“*Companies do not appoint NEDs [non-executive directors] without good reason; they are usually chosen for their specific expertise, experience or business connections. NEDs who provide*

*“[A] company may reasonably, at the least, look to non-executive directors for independence of judgement and supervision of the executive management”.*

Interestingly, such a hypothesis – paving the way for a successful claim – did not come to fruition as the relevant parties (in particular the company and the non-executive directors concerned) managed to reach a mutual understanding. Consequently, Equitable Life dropped their claim against all nine directors and the former auditors and, furthermore, paid all the costs.<sup>40</sup>

The aforementioned court decisions, however, clearly leave room for speculation that there are very limited circumstances whereby non-executive directors may claim immunity from liability, despite the tenor of the Code.

Doctrinally, an unmistakable death knell has called time on the days when a non-executive director could be deemed simply a “watchdog”; if not now an angry “bloodhound”, he must certainly act as an astute “terrier”.<sup>41</sup>

Even more persuasively, the UK corporate legislation (particularly in its recent developments, *idem est* the *CA 2006*), on the one hand, completely misjudges the concept of non-executive directors, while, on the other, spelling out quite unequivocally the axiom of the joint and several liability of the directors. In this respect, the “twofold objective/subjective test”,<sup>42</sup> recently revamped and “launched” under statute, on the one hand requires all directors to exercise reasonable care, skill and diligence,<sup>43</sup> whilst simultaneously abstaining from tracing any “war trench system” between arti-

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*these services can expect to be paid reasonably well for their contributions, but of course this means that they may become financially dependent on the company to a greater or less extent. Is it realistic to expect NEDs to be “independent”, and to supervise executive management? Equally, is it realistic to expect companies to appoint and pay fees to individuals who have little to offer apart from independence and policing role?”.*

<sup>40</sup> R Smerdon, *A Practical Guide to Corporate Governance* (3rd edn Thomson/Sweet&Maxwell, London 2007) at 123,124; L Roach, ‘Equitable Life and Non-Executive Directors: Clarification from the High Court’ (2005) *Company Lawyer* 253,254; Id., ‘An Equitable Solution for Non-Executive Directors?’ (2006) *International Company and Commercial Law Review* 117 ff.

See also, from a non-doctrinal perspective and in terms of news comments, J Rossiter, ‘Equitable Life Abandons Negligence Claim’ (*Evening Standard*, 2nd December 2005); R Fletcher, ‘Former Equitable Life Directors Sell Properties to their Wives’ (*Timesonline*, 17th April 2005); Equitable Life (Press Release), ‘Litigation against Former Directors and Ernst & Young’ on [http://www.equitable.co.uk/content/content\\_11.htm](http://www.equitable.co.uk/content/content_11.htm), retrieved on 6th September 2009.

<sup>41</sup> R Smerdon, *A Practical Guide to Corporate Governance*, cit. at 126.

<sup>42</sup> In line with the *desiderata* of the Law Commission (see Law Commission No 261, para 5.20, p 52).

<sup>43</sup> For clarity sake, it is worth citing the proper wording of section 174 of the CA 2006:

*“The care, skill and diligence that would be exercised by a reasonably diligent person with-*

(a) *The general knowledge, skill and experience that may be reasonably be expected of a person carrying out the functions carried out by the director in relations to the company, and*

(b) *The general knowledge, skill and experience that the director has.”*

From an international point of observation and in Italian, critical comments relating to this new duty of the members of the board of directors have been expressed more recently in P de Gioia-Carabellese, ‘I Doveri dei “Members” del “Board of Directors” e le Relative Responsabilità in Regno Unito alla luce del nuovo *Companies Act 2006*’ (2009) *Le Società* 784, 798.

official categories (“executive” versus “non-executive”). Such evidence may therefore yield unerring proclamations that *Re City Equitable Fire Insurance Co* might be a relic of a past era!

Last but not least (although the relevant topics are dissected *funditus* henceforth),<sup>44</sup> the comparative analysis conducted in this work could lead one to conclude that it would be logically incorrect to postulate any category of non-executive directors, also for the sake of protecting the minorities’ shareholders.

#### 4.2. *The Raison d’Être (if any) of Non-Executive Directors in the Soft Legislation*

As to listed companies, an attempt to conceptually mould non-executive directors may be found in the Combined Code on Corporate Governance.<sup>45–46</sup> The Code<sup>47</sup> prescribes, first of all, that in listed companies (A.3. Main Principle)

<sup>44</sup> See Parts 6 and 7 *infra*.

<sup>45</sup> Financial Reporting Council, *The Combined Code on Corporate Governance* (June 2008), in [http://www.frc.org.uk/documents/pagemanager/frc/Combined\\_Code\\_June\\_2008/Combined%20Code%20Web%20Optimized%20June%202008\(2\).pdf](http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_June_2008/Combined%20Code%20Web%20Optimized%20June%202008(2).pdf).

<sup>46</sup> A history of the development in the UK of both the Codes and the numerous Reports (Cadbury, Greenbury, Hampel) in the corporate governance is encompassed by R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 1,7. A concise “history” of the Reports may be read in J Dine & M Koutsias, *Palgrave Macmillan Law Masters Company Law* (7th edn Palgrave Macmillan, London 2009) at 151,153. The latest “episode” of this tragicomic “tv series” might be represented by the Walker Report, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (16 July 2009) in [http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956f9ed6cb8ae5277dbec35c233bab54a5b/walker\\_review\\_consultation\\_160709.pdf](http://www.audit-committee-institute.be/dbfetch/52616e646f6d4956f9ed6cb8ae5277dbec35c233bab54a5b/walker_review_consultation_160709.pdf). The Walker Report appears to place emphasis on the “board size, composition and qualification” of the “NED”. However, the proposed approach still fails addressing the root of the problem, that is to say, the liability of the NED within the general concept of their duties set forth under statute. The Walker Report, with limited reference to banks and financial institutions, affirms that a differentiation under statute between liabilities of NEDs and Executive directors would not be required; namely, “new statutory provision through amendments of CA 2006 would be unlikely to contribute positively to such improvements and could impede them through promoting compliance with specific rules rather than strengthening an overall culture of good governance.” (Walker Report, cit. 38).

However, the same “Walker Report”, in contradiction with these conclusions, affirms that “[...] the core separation between the role of the executive and non-executive board member is well-entrenched if not always well-understood. [...]” (“Walker Report” cit. 33). In reality, it could be argued that, if a separation of the roles between the two figures does exist, then either the liability should be clearly defined under statute or the “Italian job” (i.e. convergence of the non-executive directors towards an autonomous body; see Part 6 below) should be better pursued. The statement, therefore, seems to be contradictory.

<sup>47</sup> The Listing Rule 9.8.6(5) prescribes that companies registered in the UK with a primary listing in the UK must disclose in their annual report the extent to which they have complied with the Combined Code in the previous 12 months and to give the reason for any non-compliance. The Listing Rules might be endowed with a sort of enforcement by virtue section 73A of the Financial Services and Markets Act 2000 (FSMA 2000); however, they do not represent “law” *stricto sensu*.

Incidentally, the UK mercantile environment seems to be traditionally reliant on the principle of trust and, as a result, on the belief that few rules, not legally binding because merely conventional, may be nonetheless efficacious through the mere moral suasion. This system is opposite to the continental one,



*“The board [of directors] should include a balance of executive and non-executive directors (and in particular independent non executive directors) such that no individual or small group of individuals can dominate the board’s decision taking.”*

The above provision is echoed in Provision A.3.2 whereby, for listed companies above the FTSE 350, at least half the board, excluding the chairman, should comprise of non-executive directors determined by said board to be independent whereas, for smaller listed companies, the suggested minimal threshold of non-executive directors should be two.<sup>48</sup>

In addition to this, the Code specifies that the board itself, rather than an external body or authority, shall assess the independence of a director.<sup>49</sup> In detail, Section A.3.1. specifies that:

*“The board should determine whether a director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances [...]”.*

In performing such a self-assessment, the board should acknowledge either the relationships or the circumstances existing between the directors and each company concerned (see again Code Provision A.3.1)<sup>50</sup>. However it is noteworthy, from a

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where rules, usually abundant, are hinged upon legal sources (rather than the mere conventional ones); as a result, every violation of each binding provision rules sparks off a coercive sanction against the wrongdoer, well beyond the tenuous moral suasion. See P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditori sull’Asse Roma-Londra’ cit. *passim*.

<sup>48</sup> See again R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 137. The Combined Code commented on this textbook is that of 2006.

<sup>49</sup> Namely:

*“The board should identify in the annual report each non-executive director it considers to be independent.”*

This self-assessment is correctly viewed as a weakness by R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 136.

<sup>50</sup> More specifically, if the director:

- “has been an employee of the company or group within the last five years”;
- “has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company”;
- “has received or received additional remuneration from the company apart from a director’s fee, participates in the company’s share option or a performance-related pay scheme, or is a member of the company’s pension scheme”;
- “has close family ties with any of the company’s advisers, directors or senior employees”;
- “holds cross-directorships or has significant links with other directors through involvement in the other companies or bodies”;
- “represents a significant shareholder: or

legal perspective, that such relationships and circumstances represent mere rebuttable presumptions (in other words, *presumptions iuris tantum* rather than *iuris and de iure*), as the board, despite such necessary acknowledgements and given the tenor of the Code, could nonetheless deem as duly met the requisite of independence for the director concerned, particularly if “*it determines that [he] is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.*”<sup>51</sup> In such a scenario, the concept of “independence” takes on quite a ‘loose’ connotation, as its evaluation is fundamentally left to the discretion of the board.

Equally important is the Code’s attempt to define the duties of non-executive directors. In so doing, not only does the Code dramatically fail to ingratiate itself to the interpreter, but it also inexplicably ingenerates hermeneutical confusion within its own main statements.<sup>52</sup> As an insightful prelude then to a more comprehensive analysis under section 4.3 below), the framework in question, deviating markedly from the aforementioned recent legal interpretations, specifies that, for non-executive directors, the time devoted to the company’s affairs “*is likely to be significantly less [...] than for an executive director*”. In addition to this, “*the detailed knowledge and experience of a company’s affairs that could reasonably be expected for a non executive director will generally be less than for an executive director.*” (sic!)<sup>53</sup>

Following a non-dissimilar reasoning, para 1 concludes that “[t]hese matters may be relevant in assessing the knowledge, skill and experience which may reasonably be expected of a non-executive director and therefore the care, skill and diligence that a non-executive director may be expected to exercise.

#### 4.3. “Non-Executive Directors: A Critical Perspective

Propelled by a combined reading of both the ultimate aforementioned provisions in company legislation and the latest rulings in the same matter, the following critical views can be feasibly expressed:

- a. As it is “artificially” stated (by the Code) and/or assumed (by the Scholars) that non-executive directors dedicate less time to the management of the company than their executive colleagues, the former appear to generously benefit from a “mitigation” of liability; in other words and per absurd, their liability for potential maladministration, if held accountable by a shareholder, might be viewed

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– “has served on the board for more than nine years from the date of the first election”.

See, for the further circumstances affecting the principle of independence, R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 137.

<sup>51</sup> A.3.1 of the Combined Code.

<sup>52</sup> In this respect see eloquently Schedule B of the Combined Code.

<sup>53</sup> As to the aspect at stake, the tenor of the Combined Code even contrasts previous legal stances, such as the Derek Higgs report published in January 2003 (<http://www.berr.gov.uk/bbf/corp-governance/higgs-tyson/page23342.html>). In this report, which should have inspired the same Combined Code, the role of the non-executive directors is intended to cover four areas: strategy; performance; risk; people. In this respect, see *amplius* A Dignam & J Lowry, cit. at 395.



with leniency at a judicial level, given their possible protestations, paradoxically supported by the tenor of the Combined Code, that they were “allowed to dedicate less time to the management of the company”.<sup>54</sup> The absurdity of the provision is that, for listed companies, where investors seek and indeed expect transparent investment protection, the door has been left ajar for certain directors (i.e. of non-executive status), to evade liability and seek refuge in the glimmering light of “immunity” held steadfastly at the end of a long tunnel of litigation by the Combined Code (but not by the legislation).<sup>55</sup>

- b. In addition to the potential “mitigation” of liability, the specific duties which non-executive directors are required to discharge, according to the Code, are somewhat ambiguous. It may have found greater consistency in methodically spelling out the specific tasks by which said directors are bound during their ‘limited devotion’ to company activities. By contrast, the Code, on the assumption that<sup>56</sup> “[...] *the detailed knowledge and experience of a company’s affairs that could reasonably be expected of a non-executive director will generally be less than for an executive director*”, paves the way for this limited involvement to theoretically lead one (a judge!?) to adopt a more benign evaluation of the care, skill and diligence expected of non-executive directors.<sup>57</sup> Even more worryingly, an assertion that “*the knowledge and experience [...] expected of a non-executive director will generally be less than for an executive director*” drives a coach and horses through the diametrical philosophy underpinning Sect. 174 of the *CA 2006*, where full care and dedication is expected of all the directors.<sup>58</sup>
- c. From a methodological perspective, such perspectives arising out of a reading of the Code are highly arguable, as they are not the result of legislative provisions of law – rather they constitute a mere “non-rigid set of rules”.<sup>59</sup>
- d. As to the requisite of independence stipulated by the Code,<sup>60</sup> the requirement that a non-executive director should be singled out as independent (and deemed as such) among his colleagues,<sup>61</sup> albeit conceptually creditable (a non-executive

<sup>54</sup> Again Schedule B of the Code.

<sup>55</sup> Such a view is not shared by those that – probably tautologically – tend to express unfettered enthusiastic endorsement of the philosophy of the Code. E.g. J Birds & Others, *Boyle & Birds’ Company Law* (Jordans, Bristol 2009) at 602, at footnotes 86, namely the statement:

*“It is thought that the provisions of the combined Code on Corporate Governance [...] may also be a useful guide, at least as concerns the non-executive directors of listed companies.”*

<sup>56</sup> Schedule B (Guidance on liability of non-executive directors: care, skill and diligence), p 24.

<sup>57</sup> An attempt to corroborate such a theory is connected to the case *Equitable Life Assurance Society*. In this controversy, one of the non-executive directors, Mr Martin, sued by the company for negligence, wrote to the financial Times (15th March, 2004) arguing that, in discharging his duties, he was not expected to be a “bloodhound”, rather a “watchdog” that, after receiving an answer from the other directors, could not go further in his investigations. See also R Smerdon, *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 124.

<sup>58</sup> *Supra* dissected.

<sup>59</sup> See the Combined Code, July 2008, Preamble, page 1.

<sup>60</sup> See Parts 4.1 and 4.2 *supra*.

<sup>61</sup> See again the above referred Provision A.3.1, particularly the passage where it is prescribed that “*The board [of directors] should include a balance of executive and non-executive directors (and in*

director can certainly also be independent – and usually he is!), fails to address the distinct possibility that an executive director could also fulfil an “independent” role.<sup>62</sup>

### 5. Are Non-executive Directors an Illusionary Category?

A critical summary of the matter must acknowledge the category of the non-executive director, as moulded by the Code, to contain some fallacious elements for the reason that, instead of enhancing investor protection, it might paradoxically deprive them of significant legal prerogatives, particularly in the context of watertight litigation brought forward in cases of alleged mismanagement.<sup>63</sup> It is not so unrealistic to imagine<sup>64</sup> that the non-executive directors concerned (*ergo*, those sued for the alleged violation of their duty of care and diligence) may attempt to get away with it (*ergo*, to reject or reduce their degree of liability) exclusively on the basis that they were not “fully dedicated”.

In addition to this, the category of the non-executive director appears inconsistent with the same contemporaneous legislative apparatus, where a clear distinction between “executive” and “non-executive” is lacking and all directors are therefore expected and required to assume responsibility, jointly and severally, for any violation of their duties.<sup>65</sup> As previously emphasised, the category in question could now be a “relic” of a bygone era, “buried” by the legislator thanks to the new criterion of the duty of care, skill and diligence mapped out by Sect. 174(1) and 174(2).

Furthermore, and independently of the state-of-the-art legislation (which is in itself self-explanatory), the same jurisprudence has more recently rejected such a characterization,<sup>66</sup> although admittedly a certain degree of acquiescence continues

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*particular independent non executive directors) such that no individual or small group of individuals can dominate the board's decision taking.*” [emphasis not per original text].

In other words and through an interpretation of the Combined Code, there should be an ideal 50% of executive and non-executive directors and, among the latter, each listed company should take pain to select those being “independent”.

<sup>62</sup> Again, to be an executive and to be independent represent two different ontological categories. A director is executive or not according to whether he employs full time in the company. The same is independent or not according to whether he is autonomous or, conversely, expression of the majority shareholders.

<sup>63</sup> See above *amplius* Part 4, particularly 4.3.

<sup>64</sup> *Equitable Life Assurance Society v. Bowley and others* and particularly the “legal trench” erected by the non-executive directors sued for mismanagement. See above Part 4, particularly 4.1.

<sup>65</sup> Hermeneutically, the tenor of Sect. 170 (“*The general duties in sections 171 to 177 are owed by a director of a company to the company*”) is clear and imposes the observance of each duty to each director, whether or not conventionally qualified as executive.

<sup>66</sup> *Dorchester Finance Co Ltd v. Stebbing* [1989] BCLC 498 and, even more, *Re D'Jan of London Ltd* [1994] 1 B.C.L.C. 561, cited *supra* as to non-listed companies. As far as listed companies are concerned, see *Equitable Life Assurance Society v. Bowley and others*, *cit.*

nonetheless (albeit through tautologies, rather than through an apodictic reasoning) to be fuelled by certain scholars.<sup>67</sup>

Finally, beyond these legal explanations, and by way of mere logical reasoning, in the context of a theoretical legal system a category of non-executive directors must be shaped in such a way as to define, constructively, the parameters of their responsibilities and areas of liability,<sup>68</sup> (if) different from those covering the executive directors.<sup>69</sup> Alternatively, it may be desirable not to intervene at all in the relevant discipline. Unfortunately, by all accounts it seems that the choice adopted by soft legislation in the UK favours the latter!

## 6. Directors and Auditors in the Italian Legal System; A Comparative Analysis

The moral suasion, dear to the British legal system, has lacked the necessary allure to seduce the jurists in continental Europe. A paradigm befitting of this different approach exists within the Italian jurisdiction, particularly the rules governing its Civil Code and aimed at regulating the matter of auditing activities.

### 6.1. Italian Systems of Corporate Governance

As a necessary prelude to this analysis, it is worth mentioning that the Italian corporate governance, as a result of the reform passed by Legislative Decree n. 17th January 2003, no. 6 (the so called Company Law Reform),<sup>70</sup> proves to be quite flexible, as it permits each company, according to its own organizational and economic strategies, to opt for one of three different typologies of corporate governance, specified in its own by-laws. This system came about as the result of a deregulation process of the regime of the joint stock companies (*società per azioni*), propounded by the Italian parliament in 2001 and culminating in the empowerment bestowed on the government to adopt detailed norms in the matter in accordance with the principles specified in the framework.<sup>71</sup>

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<sup>67</sup> See *supra* Part 4.1, particularly footnote 28.

<sup>68</sup> See Part 6 (particularly 6.3) *infra*, as to the liability of the statutory auditors in Italy.

<sup>69</sup> For instance, by specifying among their duties the audit.

<sup>70</sup> Amended by Legislative Decree 6th February 2004, no. 37 (*Correttivo riforma delle società*, “Amending Provisions of the Reform of the Companies”), and further on amended by Legislative Decree 28th December 2004, no. 310 (*Nuovo correttivo riforma delle società*, “New Amending Provisions to the Reform of the Companies”).

<sup>71</sup> *Ex multis*, See G Ferrarini, ‘A View from Italy’ in K J Hopt & others (eds), *Corporate Governance in Context* (Oxford University Press, Oxford 2005) at 48.

### 6.1.a. *The “Classical” Italian System of Corporate Governance*

If a mode of corporate governance is unspecified in the by-laws, the system adopted shall automatically adhere to the standard one, based on a board of directors (*Consiglio di Amministrazione*) and a board of statutory auditors (*Collegio Sindacale*).<sup>72</sup>

### 6.1.b. *The Two-Tier System*

On the other hand, a given company may decide against the “classical” system and select one where the by-laws permit management and supervision to be carried out by a management board and a supervisory board respectively.<sup>73</sup> The latter will end up being a body of composite nature, endowed both with the powers typically bestowed on the shareholders’ meeting and those conferred on the board of statutory auditors. In terms of legal terminology, this system is referred to as “two-tier”.<sup>74</sup>

### 6.1.c. *One-Tier System*

The third alternative system of governance is commonly defined as “one-tier”. Derived essentially from British inspiration,<sup>75</sup> it allows the company to arrange for a board of directors and a subsequent committee within (the *Comitato per il controllo sulla gestione*, the committee for management supervision). In this case, given the tenor of art. 2409-*sexiesdecies*, CC, although “[t]he management of the business is under the exclusive responsibility of the board of directors”, the supervision of the company shall be entrusted to the committee made up of directors (at least one third of the members of the board of directors), therefore fulfilling the independence requirements set out for statutory auditors.<sup>76</sup>

### 6.1.d. *Duties and Liabilities of the Directors in Italy*

It is outwith the scope of this work to delve too deeply into the principles which underpin the duties of the directors in Italy beyond noting that said directors are unequivocally jointly and severally liable, as enunciated by statute:<sup>77</sup>

*“The directors shall fulfill the duties imposed upon them by law and by the by-laws with the diligence required by the nature of the office and their specific capabilities. They are jointly and severally liable to the company for damages*

<sup>72</sup> N Abriani & Others, *Diritto delle Società. Manuale Breve* (3rd edn Giuffrè Editore, Milano 2006) at 213.

<sup>73</sup> This system is of clear Germanic inspiration. See G Ferrarini, cit. at 49.

<sup>74</sup> N Abriani & Others, *Diritto delle Società. Manuale Breve*, cit. at 213

<sup>75</sup> As regards this aspect, Italian scholars usually stress the alleged “Anglo-Saxon” origins of this system. See among others, V Allegri & Others, *Diritto Commerciale* (5th edn Monduzzi Editore, Bologna 2005) at 195,263, particularly 198. On this point see better the stances of P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditors sull’Asse Roma-Londra’ cit. at 1567, particularly footnote 84.

<sup>76</sup> Specified better under Art. 2409-*septiesdecies*, CC. See again, *inter alia*, N Abriani & Others, *Diritto delle Società. Manuale Breve*, loc. ult. cit. at 213.

<sup>77</sup> Art. 2392, CC.

*deriving from the non-observance of such duties, except for functions vested solely in the executive committee or materially vested in one or more directors.”*

The ambit of liability extends to omissions, particularly in cases where a member of the board, being aware of prejudicial facts, did not do all within his power to prevent said facts from occurring or to eliminate or reduce their harmful consequences.<sup>78</sup>

Exemption from liability, either for acts or omission, is dependant solely on the director, so long as he is without fault, ensuring his grievances are promptly recorded in the minutes and resolutions kept by the board of directors and, just as swiftly, given in written notice to the chairman of the board of statutory auditors.<sup>79</sup> In any case, it becomes obvious even from a rudimentary reading of these provisions (particularly, the line “*the diligence required by the nature of the office and their specific capabilities*”) that the Italian legislation has adopted, for a long time,<sup>80</sup> a clear-cut approach to the area of “care, skill and diligence”, to semantically put it in the terminology of Sect. 174 of the *CA 2006*. The diligence is not that expected of the *pater familias* (in other words the layman)<sup>81</sup>, rather of an “agent” specifically appointed for the tasks that he is required to discharge,<sup>82</sup> irrespective of the “general knowledge, skill and experience that the director has”. Therefore, revealingly, the Italian paradigm of corporate liabilities, in terms of care, bears a striking resemblance to the objective-subjective one, more recently adopted in the UK.<sup>83</sup> At the risk of over-elaborating, a subtle exegesis would lead one to conclude in even more accurate terms that the directors’ care in Italy is a “prevalingly objective one”. This reasoning is hinged on the fact that the administrator is traditionally bound by a duty of particular care (that of the agent). However, specific subjective qualities inherent in the directors could be exceptionally taken into account – particularly at a judicial level – as constituting mitigating circumstances for his liability.<sup>84</sup>

<sup>78</sup> Art. 2392(2), CC. See *ex plurimis* GF Campobasso, *Manuale di Diritto Commerciale* (4th edn UTET, Torino 2007) at 262. The Author takes pain to note that, because this would be a liability due to the non-delegated director omitting to prevent or impede the harmful conduct of the delegated directors, the liability of the former would result in being a liability for *culpa in vigilando*, with the consequence that, if compelled to reimburse the damages, he would be vested with a recourse action against the latter.

<sup>79</sup> Art. 2392(3), CC.

<sup>80</sup> Namely since the enactment of the CC, (AD) 1942.

<sup>81</sup> The “father of the family”.

<sup>82</sup> G Visentini, ‘La Diligenza come Criterio di Responsabilità dell’Amministratore’ in V Afferni & G Visintini (eds), *Principi Civilistici nella Riforma del Diritto Societario* (Giuffrè, Milano 2005) at 99, 107.

<sup>83</sup> The “objective-subjective test” under the Companies Act 2006 is synthesized by PL Davies, Gower and Davies, *Principles of Modern Company Law*, cit. at 488, 495.

<sup>84</sup> See *inter alios* N Abriani & Others, *Diritto delle Società. Manuale Breve* (Giuffrè, Milano 2006) at 226:

*“Il livello di diligenza dovuto sarà tanto più elevato al crescere della dimensione e della complessità dell’impresa gestita, tenendosi conto delle capacità individuali. A semplice titolo di esempio, l’erronea valutazione delle conseguenze di un contratto potrà produrre conseguenze diverse per un amministratore laureato in chimica e nominato in funzione delle sue specifiche competenze*

Moreover, the Italian system does not engage in any attempt to define the non-executive director, nor does the associated literature indulge so much in its ontological categorization. Rather, what carries weight under Italian statute is a possible (but not imperative) definition of delegated directors as opposed to the non-delegated ones.<sup>85-86</sup> Distinctive of such a typology of directors is their organizational role within the company, particularly their role in ensuring that the organizational, administrative and accounting structure is suitably conducive to the nature and size of the undertaking and, at intervals set by by-laws or, in any case, at least every six months, they report to the board of directors and the board of statutory auditors on the general

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*nel campo produttivo, rispetto a quelle che produrrà per un avvocato, nominato nel consiglio per le sue specifiche competenze in materia contrattuale. Si tratta di un parametro di diligenza come detto stringente, che mira alla crescita della professionalità di chi gestisce la società e a far sparire il malcostume delle cariche ricoperte con distrazione e disinteresse.”*

(The level of required diligence shall be even higher according to the dimension and complexity of the managed company, by taking into account the individual capacities. Merely for explanatory purposes, the erroneous assessment of the consequences of a contract shall produce different consequences in respect of a director graduated in chemistry and appointed in connection of his specific competences in the field of the production, in comparison to the consequences that it [the erroneous assessment] shall produce against a lawyer, appointed to the Board [of Directors] because of his specific competences in the matter of the contracts. The paradigm of diligence is a very strict one and is aimed to improve the professionalism of those in charge of the company and to make disappear the malpractice of posts discharged with disinterest and distraction)

<sup>85</sup> See also P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-Executive e Auditori sull’Asse Roma-Londra’ cit. at 1568. Art. 2381(2), CC, clearly provides that:

*“If the by-laws or the shareholders’ meeting allow so, the board of directors may delegate its functions to an executive committee consisting of some of its members, or to one or more of its members.”*

Doctrinally, see V Salafia, ‘Amministratori senza Deleghe fra Vecchio e Nuovo Diritto Societario’ (2006) *Le Società* (3) 290, 294. The Author correctly emphasises that:

*“Il trattamento della responsabilità degli amministratori senza deleghe nei confronti della società e dei terzi è meno generico di quello proprio del vecchio art. 2392 c.c., nel quale se ne prevedeva il solidale coinvolgimento nella responsabilità, che veniva collegata alla omissione della dovuta vigilanza sull’andamento della gestione oppure all’omesso impedimento di atti pregiudizievoli, dei quali fossero a conoscenza, oppure ancora all’omesso intervento per attenuarne o eliminarne le conseguenze dannose.”*

(The way the liabilities of the non-executive directors against the company and third parties are dealt with [as a result of the Reform] is less generic than that provided under the previous art. 2392, CC, where it was set forth a principle of joint involvement with the liabilities, that used to be connected to the negligence in the due supervision on the general management, or to the omitted impediment of prejudicial conducts, of which they were aware, or finally to the omitted intervention aimed at attenuating or eliminating the relevant damages).

*Contra:* G Visentini, ‘La Diligenza come Criterio di Responsabilità dell’Amministratore’ in V Afferni & G Visentini (eds), *Principi Civilistici nella Riforma del Diritto Societario* (Giuffrè, Milano 2005) at 99,107. The A. places emphasis on the fact that, although the new text arising out of the company reform does not mention any more the word “agent”, in actual term the innovation is merely semantic. The controversial paradigm of the “diligence of the agent” has been replaced with a more neutral criterion; however, according to the A. this does not add anything more to what, in the matter, already held by the jurisprudence and propounded by the prevailing scholars. (G Visentini, *ibid.*, at 107)

<sup>86</sup> Cfr G Ferri, *Manuale di Diritto Commerciale* (12th edn UTET, Torino 2006) at 352, 353.

In this respect, the A. correctly emphasises than, within the “two-tier system”, the management board may nonetheless delegate powers to one or more members singularly; however, the delegation cannot be in any case joint, this taking into account the tenor of art. 2409-novies(1).



course of business and the foreseeable chain of events, as well as recording the most significant transactions, by size and nature, carried out by the company and its subsidiaries.<sup>87</sup> Despite this, the provisions of law are uncompromising in stipulating that certain core functions cannot be delegated in any way and must remain consigned to the entire board.<sup>88</sup> Even more remarkably, any delegation which does occur is required to be transparent<sup>89</sup> and shall not, in any circumstances, be a justification for the non-delegated director to escape liability, as he is required to act only after having filtered all due information.<sup>90</sup> For this reason, non-delegated directors in Italy maintain a “concurrent competence” which they end up sharing with the delegated ones, for the reason that the delegation does not confer new powers, rather it bestows the delegated powers also on the delegated directors.<sup>91</sup>

<sup>87</sup> Art. 2381(5), CC. For comments, see particularly F Bonelli, *Gli Amministratori di S.p.a.* (Giuffrè, Milano 2004) at 53,54. In the past and before the company reform occurred in 2003, the duties to which non-delegated directors were subject, were even more accentuated in Italy, because all the directors were responsible for the verification of the general course of the business (namely, *il generale andamento della gestione*). See Art. 2392(2) in the wording existing before such a reform. Therefore, it was common to affirm that this liability was an “objective-vicarious” one (F Bonelli, *ibid.* At 53).

This Author places emphasis on the fact that:

“La diversificazione [...] degli organi delegati rispetto a quelli dei consiglieri senza deleghe, determinerà una maggiore estensione della responsabilità dei primi rispetto a quella dei secondi, in conformità al loro diverso ruolo, ai loro diversi poteri e alla loro diversa retribuzione. Insomma, la riforma del 2003 ha preso atto del dato di fatto, noto a tutti della sostanziale diversità tra consigliere delegato e consiglieri deleganti. [...]”

<sup>88</sup> Art. 2381(4). *Exempli gratia*: the drafting of the balance sheet, entitlement conferred on the board by the by-laws to increase the sharecapital and to issue bonds convertible in shares, the drafting of the project of merger or demerger, duties entrusted with the board in case of mandatory decrease of the share-capital because of losses. See GF Campobasso, *ibid.* At 258.

<sup>89</sup> F Galgano, ‘Le Nuove Società di Capitali e Cooperative’ in Galgano (ed), *Trattato di Diritto Commerciale e Diritto Pubblico dell’Economia*, vol XIX, I (CEDAM, Padova 2004) at 268; even more, O Cagnasso, ‘Brevi Note in tema di Delega del Potere Gestorio nelle Società di Capitali’ (2003) *Le Società* 802, according to whom the delegation would be invalid if devoid of any subject.

Such an interpretation appears to be corroborated by the sheer tenor of Art. 2381(3), CC, providing that “[t]he board of directors sets the contents, restrictions and terms for the exercise of the power delegated [...]”

<sup>90</sup> Art. 2381(6), CC. In addition to this, each director may request the delegated persons and bodies to provide information relating to the management of the company at a board’s meeting. In this respect, among authors it is correctly spelled out that the silence of the non-delegated directors as to the information received by the delegated ones shall be tantamount to an approval, with all the necessary consequences in terms of assessment of liabilities (see V Salafia, ‘Profili di Responsabilità degli Amministratori di Società di Capitali’ (2005) *Le Società* (11) 1333,1339, particularly at 1335.

<sup>91</sup> S Ambrosini, ‘L’amministrazione e i Controlli nella Società per Azioni’ in S Ambrosini (ed), *La Riforma delle Società. Profili della Nuova Disciplina* (Giappichelli, Torino 2003) at 63; P Morandi, ‘Commentary to Art. 2381’ in A Maffei Alberti (ed), *Il Nuovo Diritto delle Società. Vol I* (CEDAM, Padova 2005) at 664, 684.

Judicially, albeit with reference to controversies arisen out before the company reform, see Corte d’Appello Milano 21/01/1994, (1994) *Le Società* 923; Tribunale Milano 17/03/1986, (1986) *Le Società* 619.

See also F Di Sabato, *Diritto delle Società* (2nd edn Giuffrè, Milano 2005) *passim*, particularly at 339. In a convincing way, it is remarked that:

Exclusive to listed companies, “independent directors” are alluded to, albeit at a mere non-legislative level. To elaborate, a specific framework, promoted more than a decade ago under the aegis of the Italian stock-market – the so called *Codice di autodisciplina delle società quotate*, which listed companies are invited (but not compelled) to adopt<sup>92</sup> – suggests that an adequate number of directors be independent and, furthermore, that such a requisite be verified from time to time by the same board. In this respect, it is worth noting that the categorization of the “independent director” does not impact upon his degree of liability, as, on the one hand, the relevant source is a non-legislative one while, on the other, the independent director is nonetheless a “full” director (executive, albeit subsisting contiguous to a peculiar relationship with the company, that is to say, the independence).

### 6.2. *The Mandatory Role of the Board of Statutory Auditors*

Regardless of any previous indication to the contrary, whatever the system of corporate governance adopted by an Italian company,<sup>93</sup> the auditing activity and the specific body in charge of it seem to represent solid foundations on which the structure of each corporate entity is built from a legal perspective.

Firstly, in every Italian public company limited by shares (either listed or non-listed) as well as in any private limited liability company,<sup>94</sup> a statutory board of audi-

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*“Il dovere di vigilanza, in particolare, è un mero dovere di attenzione alle più rilevanti vicende della società, che fa carico agli amministratori, esista oppure no un “organo” delegato. Esso si specifica in un diritto-dovere di “informazione” e in un diritto-dovere di istruzione” sui singoli atti ogni volta che, in base alla diligenza del mandatario, vi è motivo di ritenere che l’interesse sociale possa venire compromesso [..].”*

<sup>92</sup> More recently, Art. 124-bis, CFA, more clearly provides that each Italian listed company with shared quoted in securities markets either in Italy or in another country of the European Union will annually communicate to the market information relating to whether they adhere to codes of conducts promoted by the market company or by other associations. In Italy the system is commonly summarised with the maxim “either comply or explain”.

The “Codice di autodisciplina delle società quotate”, also referred to the “Codice Preda”, in its first version, has been commented by P de Gioia-Carabellese, ‘Codice di Autodisciplina elaborato dal Comitato per la Corporate Governance delle Società Quotate’ (2000) *Le Società* (10) 107,119, as well as by M De Mari, ‘Il Codice di Autodisciplina delle Società Quotate in Materia di Corporate Governance’ (2000) *Rivista di Diritto Privato* 141 ff. As to the second version comments may be read in M De Mari, ‘Corporate Governance e Nuovo Codice di Autodisciplina delle Società Quotate’ (2003) *Rivista di Diritto Privato* 541 ff, as well as in G Presti, ‘Tutela del Risparmio e Codice di Autodisciplina delle Società Quotate’ (2006) *Analisi Giuridica dell’Economia* (1) 47 ff.

The latest version of the Codice (2006) is critically referred to by M Stella Richter jr, ‘Il Nuovo Codice di Autodisciplina delle Società Quotate e le Novità Legislative in materia di Autoregolamentazione’ (2007) *Rivista del Diritto Commerciale* 149, 163.

<sup>93</sup> Doctrinally, it is adumbrated (G Ferrarini, cit. at 49) that:

*“The possibility to choose between three different systems is intended to be a substitute for regular competition, as the choice, for example, of the unitary board might work functionally as a (partial) equivalent to the choice of UK law.”*

<sup>94</sup> This is a typology of company which, *mutatis mutandis*, could be conceptually associated to the private limited company of British “footprint”.



tors (or alternatively, a committee, in the case of a one-tier system) shall always be required.<sup>95</sup>

In this context, it is worth highlighting the clear-cut definition of the duties conferred upon the members of the board of statutory auditors,<sup>96</sup> provided by the Italian legislation under Art. 2403, CC:

*“The Board of statutory auditors controls the observance of the law and the by-laws, the observance of principles of proper management and, in particular, the adequacy of the company’s organisational, administrative and accounting structure and the actual operation of the company.”*

Secondly, the CC takes pain to deliberate in detail over both the competence and independence that each auditor is obliged to comply with.

As to the former, Art. 2397, para 2, specifies that:

*“At least one acting member and one substitute shall be selected among those listed in the Register of Auditors kept at the Ministry of Justice. The other members, if they are not listed in the said Register, shall be selected from persons registered with the professional rolls specified by decree of the Minister of Justice, or among full university professors of economic or legal courses.”*

In other words, because the core duties which the body in question is required to discharge are of a profoundly technical nature, the relevant tenure shall be reserved to persons with specific competence, rather than to *quisque de populo*. In this respect, all auditors shall be selected *de minimis* from amongst those persons registered with certain professional roles specified by decree of the Ministry of Justice; incidentally, the roles referred to, are those grouping specific professional categories, such as qualified lawyers and qualified accountants, in addition to university lecturers in the subjects of law and/or economics. Furthermore, at least one ordinary member of the “board” and at least one substitute member must be appointed from amongst those enrolled with the Register of the Auditors (kept by the Ministry of Justice) which is exclusively accessible only to those endowed with a high level of skill in accountancy, illustrated by the taking (and passing) of an accountancy exam.

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<sup>95</sup> It is worth noting that, for private limited-liability companies, the appointment of statutory auditors is left to the discretion of the bylaws. However, the appointment is mandatory “if the capital is not below the minimum provided with respect to limited by share companies” (art. 2477, CC). Incidentally, the minimum share capital for a limited by share company is Euro 120,000 (art. 2327, CC). V Buonocore (ed), *Manuale di diritto commerciale* (6th edn Giappichelli, 2007 Torino) *passim*; GF Campobasso, *Manuale di diritto commerciale*, cit. at 250, 287.

<sup>96</sup> Or alternatively, of the Committee, in the case of one-tier system of corporate governance.

As to the requisite of independence, such a board shall not be subjected to the discretion of the company, rather, in accordance with that defined by the legislator at Art. 2399, CC.<sup>97</sup>

### 6.3. *The External Auditor*

In Italy, not only is the auditing system overseen by a specific internal board charged with the regulatory audit of the company, legislation also demands the inclusion of an additional external auditor whose task is exclusively focused on the verification of company accounts.<sup>98</sup>

More specifically, Art. 2409-*bis*, CC, prescribes the following:

*“Auditing of the company’s accounts is carried out by auditor or auditing firm enrolled in the special register kept by the Minister of Justice.”*

The register at stake is that in which accountants, having passed a specific technical exam, are enrolled.

As to the functional scope outlining the job of said auditor, according to the Italian legislation, the specifics are detailed in Art. 2409-*ter*, CC, namely:

*“The auditor or the firm entrusted with auditing:*

- a) Verifies, during the financial year and at least on a quarterly basis that company’s accounts are kept properly and the transactions are properly reported in the accounting records;*
- b) Verifies that the accounts, and the consolidated accounts when drawn up, correspond to the results of the accounting records and verifications carried out and that they comply with the relevant law provisions;*
- c) Issues an opinion on the accounts and the consolidated accounts, if drawn*

<sup>97</sup> More specifically such a provision states the following:

*“The following may not be elected to the office of statutory auditor and, if effected, shall forfeit their office:*

- a) Those who are in the conditions provided by article 2382;*
- b) The spouse, the relatives by blood or marriage up to the fourth degree of the directors of the company, the directors, the spouse, the relatives by blood or marriage up to the fourth degree of the directors of the company’s subsidiaries, of its parent companies and of companies under common control;*
- c) Those who are connected with the company or its subsidiaries or its parent companies or companies under common control with the company by an employment relationship or an ongoing remunerated relationship of services or works, or by other relationships of economic nature which prejudice their independence”*

<sup>98</sup> In this respect, for a more in-depth analysis, let me refer to my work – P. de Gioia-Carabellese, ‘Commentary to Artt. 2409-*bis*, 2409-*ter*, 2409-*quater* of the Italian Civil Code’ in G Schiano di Pepe & G Fauceglia (eds), *Manuale delle Società per Azioni* (UTET, Torino 2007) at 929, 970, as well as to V Vitalone, ‘Commentary to Art. 2409-*sexies* of the Italian Civil Code’ in G Schiano di Pepe, cit. at 971, 975.

*up, with a specific report.”*

Quite interestingly, the two “protagonists” – that is to say, the internal and external auditors – traditionally coexist within those Italian companies limited by shares, each one assuming control over independent, albeit sometimes overlapping, duties (as previously mentioned); however, in specific limited cases,<sup>99</sup> the external auditor will not be required at all, as in certain circumstances the board of statutory auditors will extend its capacity to include the auditing of accounts, notwithstanding its obligations in the field of the regulatory audit.<sup>100</sup>

### **7. Italian System of Audit as to Listed Companies and Companies “Resorting to Capital Market”**

In addition to the general rules regulating the activities of non-listed companies, the Italian legislation also governs over the auditing of listed companies. In this case, the relevant source of law is not the CC, but rather a specific piece of legislation aimed at exclusively overseeing this typology of company.<sup>101</sup>

To elaborate, the distinction between a “regulatory audit” and an accounting one is relatively more accentuated in the listed company than in non-listed companies; in fact, the legislator clearly requires the two categories of audit to be bestowed respectively on two separate bodies, namely the board of statutory auditors for the regulatory audit and an external auditing firm for the audit of the accounts.

A thorough analysis of the listed companies’ audit in the Italian legislative scenario is outwith the parameters of this work.<sup>102</sup> However, it will suffice to acknowledge that the duties, by which an auditing firm is bound, as to the performance of the auditing of listed company accounts, is neatly summarised under Art. 155 of the CFA: more specifically:

*“Auditing firms entered in the special register referred to in Article 161<sup>103</sup> shall verify:*

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<sup>99</sup> Art. 2409-bis(3). It is fundamentally the case of companies “which do not resort to capital markets and are not required to draw up consolidated accounts”.

<sup>100</sup> Also according to Art. 2409-bis(3), “[i]n such case the board of statutory auditors shall consist of auditors entered in the register kept at the Ministry of Justice.”

<sup>101</sup> The Legislative Decree no. 58 of 14th February 1998 and following amendments. (so called Consolidated Finance Act, henceforth also the CFA).

<sup>102</sup> However also in this case, more ample analysis is available in P de Gioia-Carabellese, loc. ult. cit.

<sup>103</sup> Art. 161 prescribes that Consob (the Italian supervisory authority on the financial markets) “shall keep a special register of auditing firms authorized to perform the activities referred to in Articles 155 and 158”. The same authority (see para 2 of the same article) “shall enter auditing firms in the special register after verifying that they satisfy the requirements referred to in Article 6(1) of Legislative Decree 88/1992 and the requirement of technical adequacy.”

- a) *During the financial year, that companies' accounts are kept properly and their transactions reported correctly in the accounting records;*  
 b) *That companies' annual accounts and consolidated accounts correspond to the results of the accounting records and tests performed and that they comply with the relevant statutory and regulatory provisions."*

Paragraph 2 of the same continues to stipulate that:

*"Auditing firms may obtain documents and information serving to carry out the audit from the company's directors and may carry out examinations, inspections and controls; they shall inform Consob and the board of auditors without delay of any facts deemed to be censurable."*

Finally, the third para specifies that:

*"Auditing firms shall record information on their activity in a special book kept at the registered office of the companies that engaged them, according to the criteria and procedures laid down by Consob in a regulation. The third para of Article 2421 of the Civil Code shall apply."<sup>104</sup>*

For sake of the integrity of this analysis, it is worth mentioning that, in the same Italian system, companies resorting to capital market forces (albeit not listed)<sup>105</sup> shall comply with a rigorous system of audit more akin to that relating to listed companies, than to non-listed ones. In other words, the auditing shall be performed by an auditing firm enrolled with the register of auditors, which, for this specific purpose, shall observe the discipline of auditing set forth for companies whose shares are listed on regulated markets.

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<sup>104</sup> As to the specific technicalities of these tasks, it is worth mentioning the following articles of the CFA: 156 (Auditors report), 157 (Effects of audit opinions on the accounts), 158 (Proposals for increases in capital, mergers, spin-offs and the distribution of interim dividends), 159 (Conferment and revocation of the engagement), 160 (Incompatibility). Extensive comments relating to Art. 155, CFA, are encompassed by the analysis in P Balzarini, 'Commentary to Art. 155' in P Marchetti & LA Bianchi (eds), *La Disciplina delle Società Quotate, Vol. II* (Giuffrè, Milano 1999) at 1799, 1819.

<sup>105</sup> The definition of the category is rather subtle: however, in this respect sect. 2325-bis, CC, comes to a help by stating that:

*"Companies whose shares are listed on regulated markets or distributed among the public to a relevant extent are deemed companies resorting to capital markets."*

Among Italian scholars, see *ex plurimis*, F Di Sabato, *Diritto delle Società* (2nd edn Giuffrè, Milano 2005) at 188,189.

## 8. Summary of the Italian System of Corporate Management and Audit

To summarise then, the impact of the Italian corporate legislation, as regards non-listed companies:

- a. The category of the non-executive director is quite extraneous to the Italian corporate governance, particularly in the way the same – without accounting for the tautologies and contradictions emphasised *supra*<sup>106</sup> – is traditionally moulded by British literature; indeed, the two distinct categories of delegated and non-delegated directors are acknowledged under Italian statute, but crucially, in this case, specific duties and liabilities are clearly defined;
- b. Such legislation defines a separate body overseeing the audit of a public limited company (*i.e.* a company limited by shares) as well as of a private limited company, albeit in the latter case allowing for exceptions;
- c. This body, due to its peculiar composition (incorporating exclusively qualified professionals),<sup>107</sup> is potentially in a position to effectively discharge a full range of auditing duties, firstly pertaining to the running of the company from an organisational perspective, but also in terms of its accountancy; in this respect, the mandatory presence in each board of statutory auditors of qualified accountants more than suffices for such a purpose.
- d. The presence of a separate body overseeing the audit of the company in its fullness (*i.e.* that concerning not only the management but also the accounts), is conducive to specific liabilities which the auditors may incur and thereupon owe to, *vis-à-vis* (i) the company,<sup>108</sup> (ii) the shareholders, albeit indirectly on behalf of the company through a derivative suit,<sup>109</sup> (iii) the company creditors and, last but not least, (iv) the shareholders (directly rather than through a derivative suit) or third parties.<sup>110</sup> In this respect, Art. 2407, CC, sets forth the principle according to which:

*“Statutory auditors shall fulfil their duties with the professional capability and care required by the nature of their office; they shall be liable for the truthful-*

<sup>106</sup> See particularly Part 6 *supra*.

<sup>107</sup> As already mentioned *supra* in Part 6, particularly 6.3.

<sup>108</sup> Art. 2392, CC, headed “*Liability of company*”.

According to this provision:

*“The directors shall fulfill the duties imposed upon them by law and by the by-laws with the diligence required by the nature of the office and their specific liabilities. They are jointly and severally liable to the company for damages deriving from the observance of such duties, except for functions vested in the executive committee or materially vested in one or more directors.”*

<sup>109</sup> Art. 2393-bis.

*“The company action for liability may be brought also by shareholders representing at least one fifth of the company capital or the other fraction of capital – in any case not to exceed one third – set forth by the by-laws.”*

<sup>110</sup> Art. 2395, CC. However, this action is unanimously considered as an extra-contractual actions, rather than a contractual one, as those mentioned under artt. 2392, 2393-bis, 2394.

*ness of their statements and shall keep facts and documents of which they have knowledge because of their office confidential”.*

Perhaps even more persuasively, the following excerpt assesses the degree of their liability, specifically the principle according to which:

*“They are jointly and severally liable with the directors for actions or omissions by the latter, where a damage would have not occurred had they supervised pursuant to the duties of their office.”*

The concept at stake epitomised in a nutshell by the Latin maxim *culpa in vigilando*, i.e. the liability arising out of a failure in inspection, rather than from a procedural error;

- e. Moreover, the board of statutory auditors existing in Italy functions as an important “filter” between the shareholders and the respective company. In this respect, the provision of Art. 2408, CC, allows any shareholder to file a complaint to the board of statutory auditors with regard to facts deemed “censurable”. *De minimis*, the board will be obligated to address such a complaint in its annual report to the shareholders’ meeting.<sup>111</sup> However, should said complaint be lodged by shareholders representing at least one twentieth of the company’s share capital (or one fiftieth in the case of companies resorting to the capital market), para 2 subsequently prescribes that:

*“[T]he board of statutory auditors shall investigate on the facts set forth in the complaint without delay and submit its findings and recommendations, if any, to the shareholders’ meeting; [...]”*

- f. Finally, and referring back to the previous point, any potential argument that a separate body in charge of the auditing might, as a consequence of its somewhat ‘peripheral’ status, be disarticulated from the very activities it is charged with auditing (the resolutions of the board of directors) can easily be neutralized by simply reminding oneself of the specific rules requiring the members of the *Collegio Sindacale* to play an active role in the running of the company. Further addressing this aspect, the legislation is adamant in stipulating the mandatory presence of the auditors in meetings held by the

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<sup>111</sup> Art. 2408(1), CC.

board of directors,<sup>112</sup> in addition to those prescribing the *Collegio Sindacale* to meet, autonomously, at least every ninety days.<sup>113-114</sup>

## 9. Advantages of Certain Aspects of the Italian Corporate Legislation

The analysis conducted in the previous Chapter might help postulate, from a comparative law perspective, that in the Italian system the role of the auditors tends not to be commingled with that of the directors, regardless of the system of governance adopted (therefore also in the one-tier management system). To elaborate, the director is, by definition, an “executive”, overseeing the management of the company, given the fact that liabilities are extended jointly and severally to all members of the board. In addition to not being influenced by the rather nebulous figure of the non-executive director, the Italian legislative system, reflecting the same authorities, tends to adhere to a concept of regulatory audit, entrusted with a specific group of professionals – the board of statutory auditors. This board, with its criteria of duties and liabilities (from a quantitative point of view, not dissimilar from those of the directors),<sup>115</sup> clearly emphasising the duty to supervise, would appear to be better equipped to cope with its natural functions; that is to say, a regulatory audit of the company, as opposed to an accounting one, conferred on an external auditing firm.

## 10. Possible Improvements of the UK Corporate Legislation

In dissecting two contrasting jurisdictions, it is invariably problematic, not to say pretentious, to propose any transnational adaptation of a legal concept, particularly

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<sup>112</sup> In this respect, Art. 2405(1) and (2), CC, prescribes that:

*“The statutory auditors shall attend the meetings of the board of directors, shareholders’ meetings and executive committee meetings.*

*Statutory auditors who, without justified reason, fail to attend shareholders’ meetings or two consecutive meetings of the board of directors or of the executive committee during a financial year forfeit their office.”*

<sup>113</sup> Art. 2404(1), prescribing that:

*“The board of statutory auditors shall meet at least every ninety days. The meeting may also take place by means of telecommunication, if the by-laws so permit and indicate the relevant procedure.”*

<sup>114</sup> The same Art. 2402, CC, at the following para 2, providing that:

*“A statutory auditor who, without justified reason, fails to attend two board meetings during a financial year, forfeits his office.”*

<sup>115</sup> Judicially, this view is constantly endorsed by the Supreme Court (*ex multis*, Cassazione, n. 2624 of 2000) as well as by the lower Italian courts (*e.g.* Milano Tribunal, 17/01/2007 in (2007) *Il Merito* (7–8) 47 ff; Como Tribunal, 16/06/2001 in (2002) *Giurisprudenza italiana* 568 ff.)

so when taking into account the plausible “rejection” to which any implantation of an organ into a different “organism” may conceivably give rise.<sup>116</sup>

That said, a certain degree of criticism must be expressed with regard to the current legal scenario in UK corporate governance.

Firstly, the rules enshrined in the *CA 2006* (governing over the audit) are beset by a rather laconic air, particularly if attention is paid to the dearth, within British corporate legislation, of any form of regulatory audit – a staple ingredient of other jurisdictions.

Of no less importance, particularly in listed companies, the non-executive directors currently reside on the margin of the corporate governance, with their role, functions and liabilities legislatively unidentified and ontologically unsubstantiated.

Thirdly, the same soft legislation, with its plethora of reports (and, in certain cases, inconsistent provisions) – reports that, like clockwork, diachronically follow the “bloody” and financially excruciating aftermath of a financial crises – perennially prove to be inefficacious in providing the investor with any adequate legal protection, which is, incidentally, the primary purpose of corporate governance.<sup>117</sup>

Ideally, (i) a company, particularly if a public one, might require the presence of a separate body formed on a mandatory basis (and at the behest of a legislative framework rather than communicated through “codes” devoid of any binding capacity), given the fact that a “contradictor” of the board of directors may create a rather more reflective environment for the decisional process. (ii) In addition to this, such a “board”,<sup>118</sup> as a body in charge of specific functions, could be better equipped to discharge such duties, given its practical latitude to focus on specific, determined functions, in contrast to the incumbent “independent directors” who are hampered by an ambiguous sense of mission. (iii) Finally, and beyond the topic of the audit, it is undeniable that the corporate governance debate in the UK can no longer refrain from adopting convincing Draconian measures towards the category of the non-executive directors – a case strengthened further in light of the principles enshrined in the *CA 2006*.

Notwithstanding any requisite caution, it is possible to declare that the example of the Italian system of corporate governance, currently arranging for a mandatory supervisory body for both public and private companies,<sup>119</sup> might be a feasible comparator.

<sup>116</sup> It is well known the reluctance towards this form of approach. *Ex plurimis*, P Legrand, ‘European Legal Systems are not Converging’ (2006) 45 *International Comparative Law Quarterly* 52, 81; Id., ‘Against a European Civil Code’ (1997) *The Modern Law Review* 44, 63.

<sup>117</sup> Eloquently, according to R La Porta, F Lopez de Silanes, A Shleifer & R Vishny, ‘Investor Protection and Corporate Governance’ (2000) *Journal of Financial Economics* 58, “*Corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders*”.

<sup>118</sup> More realistically, such a Board could result in being the same “Committee” that, in the Italian legislation, is currently prescribed on mandatory basis in case of one-tier system of corporate governance.

<sup>119</sup> However, so long as they satisfy a minimum requisite of capital.



From a legal perspective, the presence of a body of mandatory auditors overseeing the managerial-legal audit and positioned at the pinnacle of the corporate organisation, parallel to (but not commingled with) the directors, does not appear detrimental to the expedition of decision-making within the entity concerned. It is furthermore a moot point to remember that said auditors would not have a power of “veto”, nor would “their say” be a requisite condition upon which any resolution of the board of directors relies on for validity. Such a role,<sup>120</sup> fulfilled within each company by professionals of qualifying competence, could provide significant protection not only for the minority shareholders, but also for the consumer<sup>121</sup> and the taxpayer.<sup>122</sup>

As to the methodology whereby the set-up of these prospective new rules should occur, the best criterion would appear to be that based on the legislative rules (in this respect, the “slogan” should ideally be “laconic provisions of law and clear responsibilities”), rather than the soft-legislation.<sup>123</sup> On the other hand, such a solution (primary legislation rather than mere framework of semi-legislative rank) should not be perceived to be an anti-liberal approach, as, in reality, it goes markedly beyond the well trodden debate, dear to economists, between minority protection<sup>124</sup> and “contractarianism”.<sup>125-126</sup>

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<sup>120</sup> In this respect, the metaphor utilized by R Smerdon, (Id. *A Practical Guide to Corporate Governance* (Thomson/Sweet & Maxwell, London 2007) at 126) to define the proper role of the non-executive directors, namely the “terrier”, rather than “watchdog”, is not inappropriate.

<sup>121</sup> An example may help. In the current scenario, if a non-listed company decided to market defective products – not meeting criteria of safety, therefore with a potential damage for the health of several consumers in the UK – through a “dodgy” agreement with a contractor outside EU, as long as consumers are not actually damaged and denounce the facts, the “con” will probably remain undetected at corporate level (needless to say, it is assumed in this simulation that all the directors are complicit in the crime). In fact, the auditors (accountants, by definition) are merely requested to verify the accounts of the company but not also the merit, including the legality, of the activities of a company. And in this case, because the deal at stake is certainly lucrative, seemingly no objection would be raised in terms of accounts. By contrast, in a scenario where professionals, who are members of a separate corporate body (the board of the statutory auditors) and take part in the meeting of the board of directors, they would be required to immediately challenge the deal, because such auditors would be not simply in charge to check the financial statements of the company but also to make sure that laws and regulations are observed. See P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditori sull’Asse Roma-Londra’ cit. at 1573, particularly footnote 127.

<sup>122</sup> Stability of the business and its progressive growth may mean creation of jobs. Fast and wild growth, with no respect of the rules, in a context of a risky behaviour, may mean in the long run foreclosure of the same entrepreneurial activity and redundancies, with consequent costs of relocation and requalification.

<sup>123</sup> In such a provocative way, P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditori sull’Asse Roma-Londra’ cit. at 1573.

<sup>124</sup> R La Porta, F Lopez de Silanes, A Shleifer & R Vishny, ‘Investor Protection and Corporate Governance’ cit. 3,4.

<sup>125</sup> See in this respect the view of F Easterbrook & DR Fischel, *The Economic Structure of Corporate Law* (Harvard University Press, Harvard 1996) *passim*, particularly at 101.

<sup>126</sup> For more recent descriptions as regard the “ancient” debate, see L E Talbot, *Critical Company Law* (Routledge-Cavendish, Oxon 2008) at 193, 198;

In fact, in a fast-growing environment of white-collar criminals “sprouting” at an exponential rate, a legislative framework, endowed with its “armoury” of persuasive sanctions, appears to be a feasible system which could allow for the implementation of a *substratum* of corporate democracy; by contrast, the current “ambience”, where so many (often contradictory) rules<sup>127</sup> are furnished with mere moral suasion and do not originate from legitimate constitutional bodies, probably reflects either a past era or a perennial utopia.

In practice, the financial scandals that, over the last two years, have battered the “shores” of the UK financial institutions give credence to the argument that the trust may be inadequate in the fight to preserve the market and maintain self-regulation – an arena where rules tend to be devoid of sanctions in cases of wrongdoing does not adequately dissuade the impostors.<sup>128</sup>

Taken from a different meta-legal angle of observation, the proposed intervention within British legislation, aimed at closing the current loophole in this specific matter, would find support in the form of investors’ confidence. On the other hand, any scepticism which would not hesitate to arise, as to an alleged over-invasive presence of the mandatory supervisory board, with the potential harm it could impart on small businesses, must be roundly dismissed. In this respect, it will suffice to consider the enormous stimulus which the business would undeniably reap in the long run as a result of prospective greater stability; secondly, and more empirically, the same costs entailed in the presence of mandatory auditors in each company cannot be exaggerated – a rudimentary glance over the same figures extracted from jurisdictions where the system has been in place for a long time bears testament to this.<sup>129</sup>

In conclusion, is everything to be “binned” in terms of the UK corporate governance? The answer is an unequivocal no. From a practical perspective, the continental hyper-protective legislative frameworks (particularly, as analysed in this article, the Italian one), with its multifarious safeguards (and therefore, with an accompanying potential array of controversies), may provide an interesting model *in British quoted companies*, by definition of big dimensions. In other words, in such companies the emphasis typically placed by the Italian legislation upon both the contrasting bodies in charge of the audit of the company and on the dual typology of audit (both accounting and regulatory) might favourably impact on the degree of investor confidence. By contrast, in a “chiastic logic”, as to *non-quoted listed companies*, the current Brit-

<sup>127</sup> In an even more mischievous way, the documents and/or frameworks at stake are offered to the “masses” of the investors as ostensive, albeit non-seeming, “Codes.”

<sup>128</sup> The Italian system, albeit far from being immune from financial scandals, at least may boast symbolic achievements in term of sanctions against directors and auditors for maladministration. In the notorious “Parmalat scandal”, the maladministration of the directors, with the complicity of both auditors – regulatory and financial – and banks, has recently seen a court (Milan Tribunal, 18th December 2008) issue a ruling stating the liability of all the parties concerned. See for first comments:

<http://www.adusbef.lombardia.it/Investimenti/PARMALAT/parmalat-la-sentenza-di-milano-aggiotaggio.html>; [http://www.asca.it/news-PARMALAT\\_SENTENZA\\_DI\\_1\\*\\_GRADO\\_A\\_5\\_ANNI\\_DAL\\_CRAC\\_CHE\\_HA\\_BRUCIATO\\_11\\_MLD-798162-ORA-.html](http://www.asca.it/news-PARMALAT_SENTENZA_DI_1*_GRADO_A_5_ANNI_DAL_CRAC_CHE_HA_BRUCIATO_11_MLD-798162-ORA-.html).

<sup>129</sup> In an Italian non-listed company with returns amounting to Euro 50,000,000.00, the overall annual emoluments for the entire board of statutory directors do not usually exceed Euro 50,000.00.

ish corporate legislation in the matter of both governance and supervision (where the need for the certainty of law takes precedence over the exaggerated search for the ideal of justice) might provide an interesting insight for the “Roman legislator”<sup>130</sup> in an attempt to define a more flexible corporate model, where the decision process is not “suffocated” by unnecessary safeguards and therefore the neutralization of any shape of excessive litigation might improve the difficult conditions of doing business in Italy.<sup>131</sup>

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<sup>130</sup> Seemingly, this would end up being a precious “tip” not simply for the Italian legislator, but also for the continental one, broadly considered.

<sup>131</sup> P de Gioia-Carabellese, ‘Corporate Governance, Amministratori Non-executive e Auditors sull’Asse Roma-Londra’ cit. at 1573, 1574.