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RECENT CORPORATE FAILURES: SOME REFLECTIONS ON LEGAL AND REGULATORY ISSUES[1]

1. Introduction

On 27 December 2003, Parmalat, an Italian food company, was declared insolvent, the result of the largest accounting fraud in European corporate history. Taking either an international or an historical perspective, this is perhaps the most prominent example of corporate malfeasance to date. The case has been quickly dubbed "Europe's Enron", suggesting that the same corporate scandals happened in USA in the last three years may be also in Europe. This follows an earlier insolvency of another big Italian listed company ("Cirio"), which presented a lot of similarities, and other corporate scandals happened in Europe in the last months.

This note reviews some important issues and assesses what lessons could be learnt from it. It focuses on legal issues relating to corporate governance of listed companies and to banks' activity in capital markets.

The rest of the note is organised as follows: Section 2 reviews some of the possible legal and regulatory issues to be further assessed; Section 3 makes a preliminary analysis of the selected issues. Section 4 identifies some preliminary suggestions for improvement of the current European framework for further EFMLG work.

2. Selected legal issues identified in the recent corporate scandals

The recent Parmalat insolvency and, before it, the Cirio case seem to be two of the most remarkable insolvencies and fraud scandals in Europe of the last years.

Both of them were remarkable not only for the big amount of indebtedness, but for the impact they had on investors' confidence on capital markets. In fact, both companies had issued high amount of corporate bonds, which at the end were largely in the hands of retail investors.

In the **Annex 1** the main events of the two insolvencies are summarised.

The main issues raised by the recent corporate scandals in Italy are concerning false accounting, insufficient disclosure and the provision of misleading information to investors.

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More specifically, the cases call into question legal problems related to banks' activity in capital markets, which show potential liabilities of banks when providing investment services to a client company. Although the cases must be seen in the framework of the applicable Italian laws and regulations, the preliminary analysis conducted in the Section 3 shows that such problems could be relevant also in other jurisdictions, as current and future Community directives do not clearly solve them.

Summing up, the following issues have been identified and are analysed in the note.

Section 3 identifies the following issues related to the obligations andliability of banks in the provision of investment services:

1. the role of the banks in private offerings of corporate bonds and the application of disclosure duties to them;
2. the legal risks of banks as underwriters;
3. the conflicts of interests of banks doing capital markets activity;
4. the problems related to the disclosure of internal information;
5. the need for further harmonisation of the companies' limits to raise funds from the market.

The EFMLG's members are invited to consider whether the Group should work on the legal issues identified by the note. An ad-hoc subgroup could be set-up on selected legal issues.

3. Obligations and liability of banks in the provision of investment services

3.1 General considerations

As also highlighted by the President of Consob ("Commissione Nazionale per le Societa' e la Borsa", the Italian securities and companies regulator and supervisor) in his report to the Italian parliamentary commissions on 20 January 2004, the main aspects in the evolution of the financial and banking sector in Italy in the last few years are the following.

1. The financial market has evolved from a bank-oriented system to a market-oriented system. While in a bank-oriented system corporations have recourse to banking facilities in order to finance their business needs, in a market-oriented system corporations finance themselves on the capital market.
2. A bank-oriented system is characterised by more prudence and stability, while a market-oriented system is characterised by more growth opportunities but also by more instability and by the possibility of corporations to reach high degrees of leverage and debt through bonds issues, which are not controlled by banks and by their interest to recover their credits.

3. In a bank-oriented system the enterprise risk is borne by the corporate shareholders and by the banks, while it is only indirectly borne by the individuals, who place their earnings in bank deposits. In a market-oriented system the enterprise risk is shifted directly to the individual investors who, instead of placing their earnings in non profitable bank accounts or in low profit government securities, make investments in corporate securities or in mutual funds.

These considerations are applicable, mutatis mutandis, to all the European Member States. The introduction of the Euro as common currency in the Euro-area and the process of integration in financial markets have made it easier for companies to issue bonds to be placed in other countries or listed in foreign regulated markets, and for individuals to invest in securities issued in other countries. Therefore, the market for corporate bonds tends to be a truly European one, even if some barriers related to the heterogeneous tax environment, to administrative costs, infrastructures, credit assessment and legal environment still remain.[2]

With the increase of such market, new legal and regulatory issues emerge. More specifically, the corporate scandals highlight important legal issues related to the involvement of banks in bond placement and more generally to the provision of investment services to corporate entities.

3.2 Public and private offerings of corporate bonds. The role of banks and the duty of disclosure to the public

3.2.1 The legal issues

In both cases, described in Annex 1, there were many issues of bonds under the lead of banks for institutional investors only. Then the bonds were listed on the Luxembourg stock exchange and then placed by banks to retail investors.

As further examined in **Annex 2**, Italian law provides that any offer of securities to the public requires the previous publication of a prospectus, to be authorised and controlled by Consob. However, the provisions mandating the publication of a prospectus do not apply in cases of private placements, which occur in case of offers addressed only to professional investors, or to a limited number of subjects, or for a limited amount.

A possible legal problem arises when such securities are subsequently sold to retail investors, either in the grey market [3] or in the ordinary banking activity of trading.

In this case the rules on transparency and on the obligation to previously publish a prospectus do not apply and the investor who buys the securities does not receive the degree of information he would receive in a public offering. However, the authorised intermediaries that re-sell the securities to investors

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[2] See European Central Bank, The Euro Bond Market, July 2001.

[3] The so-called "grey market" indicates the period, which starts from the announcement of the issue of securities until the settlement date. In the grey market professional investors already have the possibility to buy the securities from the members of the underwriting syndicate and to re-negotiate them with retail investors. See Banca d'Italia, Lo sviluppo del mercato obbligazionario per le imprese italiane, Economic Bullettin No 41, November 2003, at 16.

have to comply with the general conduct of business rules for investment services as established by the law and by the implementing Consob regulation.

An issue that is actually under investigation by the Italian authorities, is whether this structure (foreign private placement – individual trading in Italy) allowed the issuer and the underwriters to carry out an offering of securities to the public by circumventing the obligation to publish a prospectus and the subjection to Consob supervision. There is therefore a problem of possible legal liability for banks.

It is noted that a preliminary analysis shows that in other European jurisdictions the subsequent sale by banks of the initially privately placed bonds to more than a defined number of clients would be considered as a "public offer" which, as a rule, requires the preparation of a prospectus.

3.2.2 Community rules of relevance

The two main legal aspects, already highlighted above, concern the placement of the securities (to the public or privately), and the trading in the secondary market with retail investors.

These two aspects are regulated by two different EU Directives. The placement phase is regulated by the recent Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (the "Prospectus Directive"). The trading activity of bonds to retail investors is subject to the rules of the Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (the "ISD"), which will be repealed soon by the directive on financial instruments markets ("FIM")[4].

The new Prospectus Directive

The new Prospectus Directive, which will have to be implemented by the Member States not later than 1 July 2005, has been hailed as a major step towards the integration of the European financial markets: in particular, it introduces a new "single-passport" procedure, which replaces the current mutual recognition procedure, a new EU-wide definition of "offer to the public", with specific exemptions for non-public offers and common disclosure standards.

The Prospectus Directive contains some provisions which are related to the above-mentioned aspects.

Article 3 establishes the obligation to publish a prospectus in any case of offer of securities to the public[5]. There are however some important exemptions in cases of private placement (Article 3, Paragraph 2, which includes, among others, the offer of securities to qualified investors, the offer of securities to fewer than 100 natural or legal persons per Member State other than qualified investors and specific cases of whole sale offers of securities).

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[4] On 28 November 2003 the EU Council adopted a common position. It is currently awaiting European Parliament's second reading.

[5] An "Offer of securities to the public" is defined as "a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities. *This definition shall also be applicable to the placing of securities through financial intermediaries.*" (Article 2, Paragraph 1, letter (d)).

The same rule states that “any subsequent resale of securities which were previously the subject of one or more of the types of offer mentioned in this paragraph shall be regarded as a separate offer” for the evaluation of the occurrence of a public offer. Furthermore, it provides that “The placement of securities through financial intermediaries shall be subject to publication of a prospectus if none of the conditions (a) to (e)[6] are met for the final placement”[7].

As already pointed out, the above-mentioned rules address issues which were not subject to specific regulation by the previous Directives.

However, as regards the sequence private placement – resale to retail investors, by means of which the Cirio and Parmalat bonds were sold, it is unclear whether the Prospectus Directive makes a substantial improvement.

It seems in fact that it does not give clear rules for the situation in which an intermediary places securities solely to qualified investors, being therefore exempted from the obligation to publish a prospectus, and thereafter resells the bonds individually to retail investors. The subsequent individual re-sales would however still be subject to the rules of the Investment Services Directive.

The Investment Services Directive

The directive 93/22/EEC will be modified soon by the directive on financial instruments markets (“FIM”).

The FIM introduces a number of obligations on the intermediary as regards conduct of business when providing investment services to clients. As regards the case in which a bank sells financial instruments to investors, it is subject to the rules listed by Article 19 (i.e. duty to ask the client about his knowledge and experience and to assess if the product is appropriate to him and to warn him if it is the case).

However, Article 19.6 provides that the above-mentioned “Know your customer rule” does not apply when providing investment services that only consist of execution and/or the reception and transmission of client orders with or without ancillary services to their clients, where all the following conditions are met:

(a) the above services relate to shares admitted to trading on a regulated market, money market instruments, bonds or other forms of securitised debt (excluding those bonds or securitised debt that embed a derivative), UCITS and other non-complex financial instruments;

(b) the service is provided at the initiative of the client or potential client;

(c) the client or potential client has been clearly informed that in the provision of this service the investment firm is not required to assess the suitability of the instrument or service provided or

[6] Conditions (a) to (e) of Article 3 Paragraph 2 of the Prospectus Directive list the exemptions to the obligation to publish a prospectus.

[7] In addition, Article 3, Paragraph 3 of the Prospectus Directive confirms the obligation, already established by the Directive 2001/34/EC on listing particulars, to publish a prospectus in any case of admission of securities to trading on a regulated market situated or operating in a Member State.

offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules; this warning may be provided in a standardised format;

(d) the investment firm complies with its obligations under Article 18 (i.e. conflicts of interests rules).

Therefore, according to Article 19.6 there is a wide exemption from conduct of business rules for so called "execution-only services". The application of such exemption is further widened by the interpretation of the concept of client's initiative given in the recitals: according to recital 29 "A service can be considered to be provided at the initiative of the client notwithstanding that the client demands it on the basis of any communication containing a promotion or offer of financial instruments made by any means that by its very nature is general and addressed to the public or a larger group or category of clients or potential clients."

Again, it is crucial to see how these provisions will be implemented by the Commission in Level 2 acts, as provided by Article 19.10 of the FIM.

3.2.3 A comparison with the USA

A preliminary analysis of USA securities statutes and regulations shows that, similarly to the provisions of the Prospectus Directive, some specific rules were enacted in order to provide exemptions from the general obligation to file a registration statement in case of securities offerings (Article 5 of the 1933 Securities Act). Said exemptions generally apply for limited offerings, such as private placements. However relevant rules provide specific limits to the public resale of securities acquired in limited offerings without a prospectus registered with the SEC.

The US system clearly distinguishes public offerings and private placements (which are specifically regulated); in case of private placement the securities are considered as "restricted" (also by labelling the securities certificates and imposing holding periods) and any further non-exempted sale of restricted securities requires the filing of a registration statement including a prospectus. The sequence private placement – resale to retail investors, which is lawful in the EU and Italian legal frameworks, and which permitted the sale of Cirio and Parmalat bonds to thousands of investors, is thus not allowed in the US system. However, a private placement still has some extent of flexibility, as Rule 144, Rule 144A and other US securities regulations permit further re-sales among specific subjects, such as qualified investment buyers, and other limited and regulated re-sales.

3.3 The legal risk of the banks as underwriters

Banks are responsible in their individual trading of securities with retail investors in case of violation of the investment services rules. A different topic of discussion is whether they can be considered liable for their activity as underwriters in the (public or private) placement of securities.

In the above-mentioned Italian cases, a problem of possible liability of the issues' underwriters was raised. However, such issues were managed by a number of international banks. This fact, together with the circumstance that most of the issues were made by foreign and off-shore companies, created a number of legal problems.

A look to the European legal framework does not help to solve the problem. To this regard, the new Prospectus Directive supplies a general rule on the "Responsibility attaching to the prospectus" (Article 6). Said Article provides that the "responsibility for the information given in a prospectus attaches at least to the issuer or its administrative, management or supervisory bodies, the offeror, the person asking for admission to trading on a regulated market or the guarantor, as the case may be."

While the Member States can implement in a more restrictive way the Article, the latter does not supply a clear provision as regards the potential liability of the underwriters or of the lead underwriter of the securities. In Italy, for instance, Article 5 of Consob regulation No 11971 of 1999 on securities issuers, provides for the liability of the lead underwriter on the formal compliance of the prospectus and on the completeness of the information contained therein.

Besides the above-mentioned Italian rules, a recent case by the Court of Appeal of Brussels, 8 March 2002[8], stated the tort liability of the lead banks of a syndicate for the firm commitment of a public placement of Euro-bonds. The Court of Appeal established that the lead underwriting bank which decides to associate its name to a Euro-bond issue (namely of a Canadian insurance company, subsequently declared insolvent) must also verify, during the preparatory stages of the issue, the reliability of the information contained in the prospectus and in general of the information communicated by the issuer regarding its financial situation and solvency, as this affects the issuer's capacity to repay its debts. On the other hand, the Court held that no statutory, regulatory or customary Belgian provision establishes an obligation by the banks to carry out a due diligence, meaning a personal and independent verification of the issuer's solvency.

By contrast, it has to be noted that in the United States, the 1933 Securities Act is extensive and detailed in attaching liability for material omissions or mistakes in prospectuses for sales based on prospectuses containing false or misleading information. Among other, the 1933 Securities Act establishes the liability of the issuer's representatives, as well as of the underwriters and of the experts, including the accountants, who certified parts of the prospectus.

3.4 Banks and conflicts of interests

3.4.1 General considerations

Where there exists a financial system characterised by "universal banks", i.e. banks are allowed to provide investment services in addition of lending activity, the existence of conflict of interests is somehow structural. In fact, the same banks may have different relationships with the same legal entity as lender, underwriter of its issues, placing the bonds to the public, etc. The concept of universal banks is one of the most fundamental ones in European banking legislation, as opposed to the US situation (although this difference has been recently mitigated). Being this the starting point, it must be seen as European laws tackle the issue.

[8] See Cour d'appel de Bruxelles, 8 March 2002, Droit bancaire et financier – Bank-en financieel Recht – Vol. 66, No IV, 07/08-2002, at 234.

As there is a general tendency in Europe towards a more frequent recourse of companies to capital markets in addition to the traditional banking lending, the issue seems to be of high relevance for all banks.

It may be a problem for a bank to manage such conflicts of interest in a way that satisfies regulatory requirements and avoids any legal or reputational risk. The problem is further exacerbated by the presence of conflict of interests within the banking group, as the latter may include asset management companies and participation to joint ventures with industrial companies. In addition, banks may have shares in operators of regulated markets or manage themselves trading systems. An additional problem relates to the "commission bias": bank staff and agents might be encouraged to sell products with the highest profitability for the banks. This calls for greater transparency on the fees perceived by the banks especially when selling complex financial products to their clients.

In recent corporate scandals, banks have been accused of having consciously arranged and placed bonds of corporate entities with the intention to get repayment of their debt towards them, although being aware of financial difficulties of such entities. Although such allegations are currently under investigation by national competent authorities, it seems helpful to review Community regulation to see if they give a clear guidance to banks' behaviour in order to avoid any legal liability.

3.4.2 Community rules of relevance

Community law provides some rules in order to tackle such situations. However, it must be seen whether they are clear and unambiguous.

The current directive 93/22/EEC on investment services (ISD) provides very general rules as regards conflicts of interest[9], in practice leaving the matter to the Member States' discretion.

The new FIM directive is more detailed on this point[10].

First of all, the new discipline gives a very wide definition of them, which includes "conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.[11]"

Furthermore, the FIM provides a number of obligations on the investment firms. They are required to:

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[9] Article 11, directive 93/22/EEC: "Member States shall draw up rules of conduct which investment firms shall observe at all times. Such rules must implement at least the principles set out in the following indents and must be applied in such a way as to take account of the professional nature of the person for whom the service is provided. (…) These principles shall ensure that an investment firm:
— acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market,
— acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market, (…)
— tries to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated."

[10] The draft directive is still under scrutiny by the European Parliament, and some amendments concern essential articles of the proposal. Here reference is made to the Council common position approved on 4 December 2003.

[11] Article 18.1 FIM.

1. take all reasonable steps to identify conflicts of interest;
2. operate organisational and administrative arrangements with a view to taking all reasonable step designed to prevent conflict of interest from adversely affecting the interests of its clients (Article 13.3);
3. where organisational or administrative arrangements made by the investment firm in accordance with Article 13.3 to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, to clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

It is important to underline that the new rules on one hand prescribe the need to adopt "arrangements" to prevent the conflict of interests, but, on the other hand, do not expressly oblige the firm to abstain from the transaction where such conflict may emerge. However, the firm has a duty to disclose the existence of the conflict of interest to the client.

However, the definition of some important elements of the new discipline is to be done by Level 2 measures, to be adopted by the Commission on the basis of the advice given by CESR. According to article 18.3, the implementing measures will:

(a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;

(b) establish appropriate criteria for determining the types of conflict of interest whose existence may damage the interests of the clients or potential clients of the investment firm.

The rules enacted at level 2 will be crucial for the future of banking activity in the capital markets.

On 20 January 2004 the Commission published a set of "Provisional mandates to CESR for technical advice on possible implementing measures concerning the future directive on financial instruments markets", including the above-mentioned Article 18. The CESR has already started to work on it and it will launch a public consultation on its preliminary advice on March/June 2004.

3.5 Banks providing credit and investment services to the same entity – the disclosure of internal information

When lending to a company, a bank is subject to specific duty of confidentiality. However, what if it becomes also subject to duty of disclosure provided by securities law? This could be the case, for instance, if the same bank is also involved in the issuance of bonds of the same entity.

Of course, there are cases in which the rules on conflicts of interest have to be applied: in fact the bank, as lender, may have an interest that the financial situation of the company be improved by raising funds through the issuance of bonds. Furthermore, a question may be posed about the duty of the bank to give full disclosure of the information on the company to investors to whom it sells the bonds where a conflict of interest is not identifiable (e.g. when providing execution-only services).

Community law does not seem to fully address such problem.[12] Banking directives do not deal with banking secrecy, which is a matter regulated by law or case law.

In some cases, the rules contained in the new Market Abuse Directive will apply and will prohibit the disclosure of inside information by the bank.

3.6 Limits to the issuance of debt securities by (listed) companies

Another debated issue is the fact that the limits actually fixed by the Italian Civil Code on bond indebtedness by companies did not work in order to avoid insolvency. In fact, issues were made by foreign companies (sometimes off-shore), with the parent company's guarantee.

How could this be improved? Could more extensive limits or controls on bond indebtedness, also at a consolidate level and considering also guarantees be feasible? Could further harmonization at the European level be reached on this issue, considering the extended presence of European groups?

[12] The note does not address the problems related to the application of privacy law.