

Financial Scandals and the Role of Private Enforcement: The Parmalat Case

Law Working Paper N° 40/2005

May 2005

Guido Ferrarini

University of Genoa, Centre for Law and Finance
and ECGI

Paolo Giudici

Free University of Bozen and Centre for Law and
Finance

© Guido Ferrarini and Paolo Giudici 2005. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
<http://ssrn.com/abstract=730403>

www.ecgi.org/wp

ECGI Working Paper Series in Law

Financial Scandals and the Role of Private Enforcement: The Parmalat Case

Working Paper N° 40/2005

May 2005

Guido Ferrarini

Paolo Giudici

This Working Paper is based upon a draft prepared for the EU Corporate Law Making Conference (Cambridge, October 29-30, 2004) organized by Harvard Law School and the Swiss Federal Institute of Technology (ETH Zurich).

The authors are grateful to Gerard Hertig, Mark Roe, Donald Langevoort, and other conference participants for helpful comments. Drafts of this paper were also presented at the Yale Law School Alumni Meeting on October 8-10, 2004; at a meeting of the Associazione Via Isonzo held in Milan on October 10, 2004; and at a seminar at the Institute of Law and Finance (ILF), University of Frankfurt, on January 18, 2005. The authors are grateful to Theodore Baums, Andreas Cahn, Carmine Di Noia, Jon Macey, Katharina Pistor and other seminar participants for helpful suggestions. Special thanks to Bruno Cova (General Counsel of Parmalat's Extraordinary Administration), Lucie Courteau and Justin Rainey. The authors acknowledge research assistance by Liliana Emer, Gian Giacomo Peruzzo and Andrea Zanoni.

This paper is part of a research project cofinanced by the "MIUR – Ministero dell'Istruzione, dell'Università e della Ricerca", the University of Genoa and the Free University of Bozen.

© Guido Ferrarini and Paolo Giudici 2005. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Coming shortly after the Enron and WorldCom scams, the Parmalat scandal offers a good opportunity to compare failures on both sides of the Atlantic. In this paper, we start by tracing Parmalat's history and describe the frauds and the criminal proceedings and civil actions that followed the company's collapse both in Italy and the US. We then focus on Parmalat's governance and gatekeepers, and argue that gatekeepers are substantially undeterred in Italy because of poor enforcement rather than legislative black holes. In fact, law on books, in particular the civil law concerning auditors, is even more severe than common law. We subsequently analyse the causes of under-enforcement and the reasons why Parmalat generated litigation in the US rather than Italy. Drawing from economic analysis, we explain the role of private enforcement and consider the benefits of class actions. In this respect, we emphasize the importance of discovery and pleading rules. We also find that the interplay between public and private enforcement is missing in Italy and argue, by way of conclusion, that US securities regulation was transplanted into Continental Europe without sufficient modernisation as to civil procedure in the area of mass claims and complex litigation.

Keywords: corporate fraud, corporate scandals, Enron, Parmalat, directors, board of director, statutory auditors, audit firms, auditor's liability, gatekeepers, underwriters, financial intermediaries, analysts, insider trading, mandatory takeovers, Consob, law enforcement, public v. private enforcement, regulation, class actions, discovery, contingency fees, civil procedure

JEL Classifications: K22, K23, K41, K42

Guido Ferrarini
Università degli Studi di Genova – Law School
Via Balbi 22
Genoa 16126, Italy
phone: +39-0102099894; fax: +39-010-2099890
e-mail: guido.ferrarini@giuri.unige.it

Paolo Giudici *

Libera Università di Bolzano/Freie Universität Bozen - School of Economics and Management
Via Sernesi/Sernesistraße 1
39100 Bolzano/Bozen
Italy
Phone : +39-0471-013140 , fax : +39-0471-013009
e-mail: paolo.giudici@unibz.it

* Corresponding author

I. INTRODUCTION

The Parmalat scandal has been described by the SEC as “one of largest and most brazen corporate financial frauds in history.”¹ Coming soon after the Enron and WorldCom scams, it offers a good opportunity to compare failures on both sides of the Atlantic. The Parmalat case epitomizes the most important problem traditionally associated with Continental European governance structures, namely a controlling shareholder that exploits the company rather than monitoring its managers. Parmalat’s governance structure was openly deficient, unlike Enron’s, which apparently was well-designed. In spite of this deficiency, Parmalat enjoyed an investment grade credit rating and was able to borrow increasing amounts of capital from investors. With the benefits of hindsight one could be tempted to argue that capital markets were inefficient because they did not take into proper consideration Parmalat governance’s flaws. However, a more plausible assertion would be that they discounted the perceived risk and heavily relied on gatekeepers.²

Thus, once again, as in all sudden financial collapses of recent times, it is to gatekeepers that attention is turned. Two large networks of auditors (Grant Thornton International and Deloitte Touche Tohmatsu) failed to detect the frauds. Grant Thornton’s Italian partners are also suspected of having orchestrated them. Some first-ranking international banks allegedly assisted Parmalat senior managers in structuring and executing complex financial transactions aimed at concealing Parmalat’s true situation. In the face of due diligence reviews and top-firms’ legal opinions, the market was never openly warned. As Professor John Coffee pointed out with reference to Enron, it seems clear that Parmalat is another tale of the corporate governance deficiencies of undeterred gatekeepers.³

¹ Securities and Exchange Commission v. Parmalat Finanziaria S.p.A., Case No. 03 CV 10266 (PKC) (S.D.N.Y.), Accounting and Auditing Enforcement Release No. 1936 / December 30, 2003.

² We will extend this argument in this article: see *infra* section III.

³ John C. Coffee Jr., *Understanding Enron: “It’s the Gatekeepers, Stupid,”* 57 Bus. Law. 1403 (2002). See also John C. Coffee Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, G. Ferrarini – K. Hopt – J. Winter – E. Wymeersch (eds.), *Reforming Company and Takeover Law in Europe*, Oxford University

As we show, Italian substantive rules cannot be blamed for what happened. Indeed, we argue in this article that the existing Italian substantive rules that were in place during Parmalat's last decade were sufficient and, somewhat surprisingly, were even more severe than those in the US. If gatekeepers were undeterred, do not blame Italian substantive rules, blame enforcement.

When enforcement is discussed in Continental Europe, this typically means public enforcement. Indeed, the scandal affected a country that heavily relies on public enforcement and basically dislikes the whole concept of private vindication of the public interest. Yet, the Italian capital markets watchdog (Consob) only started its investigations after the market had signalled, in late 2002-early 2003, that something was wrong at Parmalat. The market knew something that Consob did not. Thus, the Parmalat scandal should discourage any view that more regulation and public supervision of markets can prevent major frauds. The reaction both at Italian and European levels, nevertheless, is in the direction of more regulation and public enforcement, even though the idea of a European public regulator equivalent to the SEC seems not to be a priority on the EU's agenda.

However, the Italian public learned from the mass-media shortly after Parmalat's collapse that civil actions were being launched, at a speed unthinkable for Italy, by class-action lawyers in the US, and that those actions could also involve unsuspecting Italian investors. Class actions were no longer an ingredient of a John Grisham novel. This news gave impetus to a discussion (ill-conceived) concerning the introduction of class-action mechanisms in Italy, conducted in the mass-media and at a political level as a side-issue of the main topic concerning new regulation in response to the scandal. Indeed we assert (strange as it may sound in a study devoted to one of the most significant criminal scandals in Europe's recent history) that the whole framework of civil procedure is one of the main problems in Italy. In reaching this conclusion we also rely on the pattern of litigation that has followed the Parmalat collapse. It confirms both Lord Denning's dictum that "[a]s a moth is drawn to the light, so is a litigant drawn to the United States"⁴ and the modern trends of litigation in the mass tort⁵ and antitrust areas, which led to the recent US Supreme

Press, 2004, 455, and also published in 84 B.U.L. Rev. 301 (2004).

⁴ *Smith Kline & French Lab. Ltd v. Block*, [1983] 2 All ER 72, 74 (C.A.). This passage is quoted by Paul Carrington, *The American Tradition of Private Law Enforcement*, 5 German Law Journal 1413, 1420 (2004).

⁵ One of the most remarkable examples being the action brought by the Republic of India against the Union Carbide Corporation for the Bhopal tragedy in 1984: see Paul Carrington, *supra* note 4, at 1420.

Court decision in the *Hoffmann La Roche v. Empagran* case.⁶ Indeed, whenever it has been possible, both Parmalat's Extraordinary Commissioner (Mr Bondi, who acts on behalf of the company and its creditors) and investors have brought civil actions in the US, escaping the jurisdiction of Italian courts. We argue that this pattern cannot be understood if it is considered simply as a form of "forum shopping" based on the search for the most convenient substantive rules, because it is mainly motivated by the array of weapons that US civil procedure offers plaintiffs in complex cases regarding collective interests. Accordingly, drawing from similar conclusions reached by one of us with reference to the problem of cartel private enforcement in Europe, we argue that the balance between public and private enforcement must be reconsidered and that the whole framework of civil procedure has to be reviewed in Italy. As far as possible, cyclical bursts of criminal proceedings needs to be replaced by the continuous, low level pressure of private suits, in order to keep deterrence working on a day-by-day basis.

While advocating the modernisation of civil procedure in continental Europe along the US model, we do not claim that US law and regulation in the securities area are in all respects superior to their homologues in Europe. The fact that serious financial scandals recently plagued US capital markets may be taken as evidence of deficiencies affecting also US corporate law and securities regulation and their enforcement. As we note below, the limits of law and enforcement concerning auditors and gatekeepers in general presumably contributed to the recent wave of corporate frauds in the US and no doubt determined a substantial amount of re-regulation through legislative reforms. Yet, the Italian and European experiences show deficiencies as to private enforcement which materially contributed to the recent scandals in Europe and led the aggrieved investors (and Parmalat's Extraordinary Administrator) to seek relief in US courts. Therefore, the reference to US institutions in the area of private enforcement, like class actions and discovery rules, appears justified despite the failures of US law recently shown by Enron and similar scandals. As we argue in this paper, the design of substantive rules needs to be balanced by appropriate enforcement mechanisms: in Italy the substantive rules concerning gatekeepers, while reflecting high standards of behavior, are not matched by rules of civil procedures that offer an appropriate setting for mass claims and complex litigation.

We proceed as follows.

⁶ In *Hoffmann La Roche v. Empagran* the US Supreme Court limited the subject jurisdiction of US antitrust law, holding that it is not reasonable to apply it to a price-fixing conduct that affects both customers outside and within the United States, when the adverse foreign effect is independent from any domestic adverse effect: 124 S. Ct. 2359.

In Section II we briefly trace Parmalat's history from its rise in the late sixties to its collapse in December 2003, considering how the information concerning Parmalat's problems surfaced in the market in the period between December 2002 – February 2003, and how it was officially disclosed in the following part of that year. We shortly describe the frauds, the criminal proceedings that followed the collapse, and the civil actions that have been brought in the US by investors (through the class action mechanism) and Parmalat's Extraordinary Commissioner. Section III is devoted to Parmalat's governance and gatekeepers. In particular, we show that gatekeepers in Italy are substantially undeterred, not because of substantive rules, but because of poor enforcement. Law on books, as we point out with reference to auditors, is even more severe than common law. Section IV considers the causes of under-enforcement and the reason why the Parmalat case is generating litigation in the US and not in Italy (or in Europe). Drawing from the law and economics literature we explain why deterrence must rely also on private enforcement and consider the advantages, from a European perspective, of class actions. We emphasize the role of discovery rules and their interplay with pleading rules. In the light of our analysis we explain the total absence of derivative actions in Italy. Finally, we turn to the interplay between public and private enforcement, to show that this interplay is missing and that the most significant junction between private gatekeepers and the public watchdog is totally ill-suited in Italy, because the public watchdog relies too much on the wrong gatekeeper. Our conclusions are radical. We argue that Continental Europe in general and Italy in particular have transplanted US securities regulation, as well as US antitrust, and are now transplanting US-style corporate governance, without any serious attempt to modernize a civil procedure that is ill-suited for investors (or consumers) protection. A big-bang is needed but, sadly, it is not on the political agenda (except for an ill-conceived debate on class actions). Indeed, the political agenda is entirely devoted to drawing a regulatory response to the scandal that could stand comparison with the Sarbanes-Oxley Act.

II. A SHORT HISTORY OF PARMALAT

1. *Parmalat*

Calisto Tanzi was the heir to a dynasty of food traders based in Collecchio, Parma. At the end of the nineteen sixties Mr Tanzi entered the milk market, taking advantage of the continuous packaging process developed by Tetra Pak,⁷ and Parmalat started its expansion into the dairy

⁷ For references to Tetra Pak's competitive advantage in the packaging of liquid and semi-liquid foods see the EC Commission decision in *Elopak Italia Srl v Tetra Pak* (no. 2), 24 July 1991, (1992) O.J. L72/1, at par. 11 ff.

industry. During the seventies the Parmalat trademark became popular thanks to high-profile sponsorship in the world of sport. In the same decade, Parmalat started its penetration of Latin American markets. The eighties was a period of further expansion: Parmalat consolidated its position as a world leader in the dairy market and extended into other food markets, such as bakery products, tomato sauces, fruit juices. Mr Tanzi became very well known for his Catholic fervour and his political connections with Christian Democrats leaders. In particular, he was considered to be a close friend of Ciriaco De Mita, the powerful leader of the ruling Christian Democrat party during the eighties. Parmalat built one of its factories in Nusco, a small town in southern Italy whose principal claim to fame is that it is Mr De Mita's home town.

Allegedly the influence of politicians is one of the reasons why Mr Tanzi ventured into the TV market during the eighties. Odeon TV, the channel he bought through a family shield, recorded terrible results and was sold in 1989 to a company of the Sasea Group managed by Mr Florio Fiorini.⁸ Odeon TV went bankrupt and Tanzi, who had guaranteed Odeon TV debts, had to pay out huge amounts of money. During the criminal investigations into the Parmalat collapse it came to light that this money was actually provided by Parmalat.⁹ This was probably one of the first large cases in which Parmalat money was used to cover Mr Tanzi's debts in other business areas.

Following the TV fiasco, at the end of the eighties Parmalat was a large international group in financial turmoil. Through a complex financial transaction, Coloniale s.r.l. (the Tanzi family's company holding Parmalat's shares) used its controlling stake as non-cash consideration in the raising of capital of a listed company, Finanziaria Centro Nord, which was to become Parmalat Finanziaria. Through the financial transaction, Coloniale kept a controlling stake of around 51 per cent in Parmalat Finanziaria, which became the listed holding of a group formed by 58 companies, of which 33 based outside Italy, with a group turnover of around ITL 1,100 billion (Euros 560

⁸ Mr Fiorini was later to become famous worldwide because he was an associate of Mr Parretti, who was at the centre of the Hollywood studio Metro-Goldwyn-Mayer saga. Mr Fiorini and Mr Parretti were the dominant figures of the Swiss Sasea group of companies, which were vehicles of massive frauds and collapsed in 1992, with a financial scandal that, amongst other things, rocked Credit Lyonnais's lending policy. Some accounts of the scandal can be read in the UK case *Sasea Finance Ltd (in liquidation) v. KPMG (formerly KPMG Peat Marwick McLintock)* [2000] 1 All ER 676, [2000] 1 BCLC 236.

⁹ Fausto Tonna's confessions to the prosecutor, mentioned by Gabriele Franzini, *Il crac Parmalat*, Roma: Editori Riuniti, 2004, 25, and by Gabriele Capolino – Fabrizio Massaro – Paolo Panerai, *Parmalat. La grande Truffa*, Milano: Milano Finanza, 2004, 41.

million). The most significant of these companies was Parmalat S.p.A., the main operating company.

In the nineties, the Parmalat Group (herebelow, “Parmalat”) launched a new international acquisition campaign, which was particularly intense in South America. The group turnover was ITL 4,300 billion (Euros 2.4 billion) in 1995 and ITL 5,464 billion (Euros 2.8 billion) in 1996. Around 45 per cent of the turnover was generated in Latin America. The multinational group was a lucrative client for investment banks, Chase Manhattan Bank in particular. The group became very active on the capital market, issuing waves of bonds on the Euromarket.

In the meantime Parmalat had diversified into football, buying Parma Calcio (Parma’s soccer club), the well-known Brazilian club Palmeiras, and a Chilean club named Audax Italiano. The group started a massive sponsorship plan in Latin America. Parma Calcio was handed to Mr Tanzi’s son Stefano, who became the club’s president in 1996. One of Mr Tanzi’s main rivals in the dairy-product market – Sergio Cragnotti – was also involved in the football market. A former manager of the Ferruzzi Group who had been involved in the criminal proceedings that followed the collapse of the Ferruzzi family’s empire,¹⁰ Cragnotti was the main shareholder and manager of Cirio, as well as owner of Lazio, one of Rome’s two football clubs. Cirio was to go bankrupt in 2003, in a financial scandal involving banks accused of having covered their debt exposure by dumping Cirio bonds onto retail investors.¹¹

Mr Tanzi also entered the tourism market in the nineties. Through many transactions and acquisitions, the tourism firm of the Tanzi family, HIT, reached a turnover of ITL 1,000 billion (Euros 550 million), generating a mountain of losses and debt. Stefania, Calisto Tanzi’s daughter, was in charge of the business.

At the end of the decade the Parmalat Group was still expanding. Between 1998 and 2000 it purchased around 25 companies. Amongst them, in 1999 Parmalat bought Eurolat, the dairy business of the Cirio group, in a deal that is now under investigation also in consideration of the role played by Banca di Roma, a bank heavily involved in the Cirio financial crisis.

¹⁰ The Ferruzzi Group went bankrupt in 1993, with a criminal and political scandal that led its CEO Mr Raul Gardini to commit suicide. The Group became insolvent in 1993 and was successfully restructured by a five bank committee: Alessandro Penati – Luigi Zingales, *Efficiency and Distribution in Financial Restructuring: The Case of the Ferruzzi Group*, The Center for Research in Security Prices Working Paper No. 466, 1997.

¹¹ For a review of the Cirio scandal see Marco Onado, *I risparmiatori e la Cirio: ovvero, pelati alla meta. Storie di ordinaria spoliazione di azionisti e obbligazionisti*, 3 Mercato Concorrenza Regole 499 (2003).

The trend continued at the beginning of the new millennium. Parmalat was continuously issuing bonds. In November 2000 Standard and Poor's rated Parmalat with a BBB- grade (the lower level of investment grade). Following the problems experienced by Latin American economies (with Argentina's default in December 2001)¹² and the default of the fellow food manufacturer Cirio in November 2002, Parmalat's cost of capital increased. Yet the group was still pursuing its apparent strategy of holding a huge amount of cash to be used in mergers and acquisitions whilst financing its cash needs through bonds.¹³

At the end of 2002 Parmalat Finanziaria S.p.A. was the listed holding of a multinational food group made up of more than 200 companies spread around 50 countries. The group was a world leader in the markets of milk, dairy products and beverages. It operated 139 industrial plants and totalled more than 36,000 employees,¹⁴ with a consolidated turnover of Euros 7.6 billion.¹⁵ Parmalat Finanziaria was still controlled by Coloniale S.p.A., the instrument of the Tanzi family that held around 51 per cent of the share capital.¹⁶ Parmalat's 2002 last quarterly report showed Euros 3.35 billion in cash and equivalents; Parmalat Group's assets amounted to Euros 10 billion and its liabilities Euros 7.17 billion. Amongst these liabilities was Euros 1.5 billion in bond debt, launched through 31 different issues. At the beginning of 2003 Parmalat was back on the Mib30 index, the index of the 30 largest Italian companies in terms of market capitalisation.

2. *The collapse*

The most distinctive feature of Parmalat's financial reports was the concurrent high level of cash and debt. Its disclosure policy was characterised by its management's opaque and arrogant approach towards analysts and investors,¹⁷ similar to Enron's.¹⁸ However, Parmalat was not a

¹² The problems raised by Argentina's default in the Italian market are discussed by Consob, *Audizione informale sulla diffusione in Italia di obbligazioni pubbliche argentine*, 27 April 2004, in www.consob.it

¹³ See next paragraph.

¹⁴ Report of the Chairman of Consob to the Parliamentary Commission, 27 January 2004.

¹⁵ Report of the Governor of the Bank of Italy to the Parliamentary Commission, 27 January 2004, at 10.

¹⁶ Consob's website, 30 June 2003.

¹⁷ See *infra* in this paragraph.

“faith” stock.¹⁹

In October 2002 the group launched a bond issue of 150 million with Banca Akros and UBM acting as lead underwriters, and in November a new bond issue by Parmalat Soparfi²⁰ followed, with a value of Euros 200 million and Morgan Stanley Limited acting as the only bookrunner.²¹ These issues alerted the market. In a report dated 6 December 2002 and titled “Putting a Focus on Debt”, Unicredit Banca Mobiliare’s (UBM’s) analysts recommended “accumulate” but wrote:

“As for the debt refinancing issue, we argue that, post-Cirio and owing to the higher risk perception following the instability in South America, refinancing expiring debt at a reasonable cost has become harder. Moreover the Group has shown no intention to use its Euros 3.3 billion cash pile. This point would need to be accurately assessed with the management, which, however, continues to remain unapproachable”.²²

Parmalat management’s arrogance was a recurring theme in the reports. A Merrill Lynch report of the previous day had a much more straightforward tone. The report, titled “The Straws That Break the Camel’s Back”, downgraded Parmalat from “buy” to “sell”. The analyst wrote:

“The key issue which continues to perplex us is why the group continues to tap the market for relatively small, yet often quite complex debt issues, when its cash pile continues to rise.”²³

¹⁸ For accounts of Enron’s opaque financial statements and arrogance, see William W. Bratton, *Does Corporate Law Protect the Interests of Shareholders and Other Stakeholders: Enron and the Dark Side of Shareholder Value*, 76 Tul. L. Rev. 1275, 1281 (2002).

¹⁹ Asset managers considered Enron a “faith” stock: William W. Bratton, *supra* note 18, at 1340, and Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. Chi. L. Rev. 1233, 1236 (2002).

²⁰ Parmalat’s Luxembourg subsidiary.

²¹ Parmalat’s press release, 14 November 2002.

²² UBM, *Putting a Focus on Debt*, 6 December 2002, posted in the Italian Stock Exchange website.

²³ Merrill Lynch, *The Straws That Break The Camel’s Back*, 5 December 2002, at 8, posted on the Italian Stock Exchange website (www.borsaitalia.it).

Indeed, the analyst's estimate was that Parmalat's raising money on a BBB - credit rating compared to an implied rate on cash and equivalent of 5.2% had generated a 90bp loss on the spread.²⁴ Thus, the first conclusion was that

“the group is *prima facie* losing money by running a high level of total debt and total cash.”²⁵

The second conclusion was that problems could be hidden:

“this need for re-financing raises questions as to the underlying cash generation of the group.”²⁶

All the other analysts remained apparently unconcerned. For instance, Euromobiliare's report dated 23 January 2003 referred to a “Debt Mountain ... Under Control” and defended Parmalat's strategy on tax considerations. The unconcerned analysts considered the strategy to be theoretically sound, even though they had no clear picture of how it could work, since Parmalat did not disclose sufficient information and the group structure was terribly complex.²⁷

Notwithstanding analysts' apparent support, the market became more suspicious of Parmalat's behaviour, clearly evidenced by rumours concerning a new bond issue at unfavourable conditions in February 2003, which hit the company. As an analyst wrote in March 2003,

“November 2002-February 2003 period saw Parmalat's price fall by 45%, following the announcement of bond issues (...). In our view, market speculation on debt sustainability and accounting procedures, strongly denied by a company press release, combined with poorly-timed group

²⁴ *Ibidem*, at 5.

²⁵ *Ibidem*, at 9.

²⁶ *Ibidem*, at 1.

²⁷ On the failure of institutional investors and securities analysts to understand structured transactions even when these transactions are duly disclosed see Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity*, 2004 U. Ill. L. Rev. 1. On the information overload issue, Troy A. Paredes, *After the Sarbanes-Oxley Act: the Future Disclosure System: Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. U. L. Q. 417 (2003).

communication, accentuated the market reaction.”²⁸

The new issue was officially cancelled.

On 6 March 2003 “Assogestioni”, the Italian asset management association, wrote a letter to Parmalat, Consob and Borsa Italiana, denouncing the lack of transparency of the group. As a reaction, Parmalat organized a meeting in Milan on 10 April 2003, during which Mr Tanzi announced that the Group’s CFO, Mr Tonna, had resigned and that a new CFO, Mr Ferraris, was in charge. The market reacted positively and the price soared after the February downturn. In the meantime Parmalat denounced market manipulation and related abuses concerning its stock to Consob, the Italian watchdog, also mentioning that Lehman Brothers and other investment banks were asserting in private talks with clients that Parmalat’s reports were false. Consob started to investigate.

Parmalat’s new CFO, Mr Ferraris, had assured that it would have used only cash to repay the Group debt. However, in June it was discovered that Parmalat, assisted by Morgan Stanley, had privately placed a new bond, wholly undersigned by Nextra, the asset manager of Banca Intesa group. The real amount of all pending bonds was still a mystery. When questioned, Parmalat replied that it had bought back some of its own bonds, but numbers did not match, as an Italian newspaper reported on 7 July 2003.²⁹ Following the article, Consob forced the company to be more explicit, but at this stage any communication was raising more problems than it solved. The watchdog started to put strong pressure on Parmalat Finanziaria’s statutory auditors and external auditors, Deloitte. The latter after the summer and with reference to second quarter financial statements informed that it could not give a “fairness opinion” of the true value of Parmalat’s open ended mutual fund Epicurum, recorded as cash equivalent by Parmalat Finanziaria for a book value of Euros 497 million; Deloitte also disclosed the existence of a complex currency swap transaction with the fund. On October 31 Consob wrote a letter to Parmalat, to their statutory auditors and to their external auditors, requesting more information. Parmalat replied that the participation in Epicurum would have been sold immediately. In the meantime, another discovery was made, i.e. the existence of an unreported complex contract between a Swiss subsidiary (Geslat) and a company constituted by Citigroup and named *Buconero*, the Italian equivalent of Black Hole. This

²⁸ UBS Warburg, 4 March 2003, posted on the Italian Stock Exchange website.

²⁹ Affari e Finanza, La Repubblica, mentioned by Gabriele Franzini, *supra* note 9.

news caused an uproar in the market.

On 8 December 2003 Parmalat informed the market that Epicurum was unable to liquidate Parmalat's interest. The same day a bond was expiring and Parmalat declared that it could not pay it. S&P downgraded Parmalat's bonds to junk bond status. The next day, during a desperate attempt to sell the company to American investors, Mr Tanzi admitted in private that the company's records were false. On December 11 the share price collapsed. Consob asked Grant Thornton, the auditor of a Cayman Islands company named Bonlat, which held a bank account with Bank of America where all Euros 3.95 billion of Parmalat's group cash was supposedly deposited, to investigate whether Parmalat's statement concerning the bank account was true. Bank of America replied that the document confirming the bank account was a forgery. In the meantime Parmalat's management completed the destruction of the relevant company's documentation and hardware containing evidence of the fraud. Criminal investigations started. On the 27 December 2003 Parmalat S.p.A. was declared insolvent. The same day Mr Tanzi was jailed. On the 8 January 2004 it was the turn of Parmalat Finanziaria: the group's insolvency procedure started and Mr Enrico Bondi, a renowned manager, was appointed as Extraordinary Commissioner.

From 5 December 2002 to the 17 November 2003, only one analyst (from Merrill Lynch) had issued sell recommendations, amongst those posting reports on the Italian Stock Exchange' website.

With the benefit of hindsight, Parmalat reveals some features common to firms that have faced catastrophic financial failures: massive growth (a 'nova effect', as Geoffrey Miller writes), questionable accounting and accountants, poor underlying performance, political connections, a dominating shareholder, complex corporate structures and operational mystery.³⁰ In contrast with other bankrupt firms, however, Parmalat's governance structures did not appear to be well-designed or state-of-the-art.³¹

3. *The fraud and the criminal proceedings*

The managers (and, in particular, Mr Tonna, the most deeply involved) immediately cooperated with prosecutors when in jail. They explained what had happened. Basically, all Parmalat's financial statements had been false for a long time, even though it is not yet clear from

³⁰ Geoffrey P. Miller, *Catastrophic Financial Failures: Enron and More*, 89 Cornell L. Rev. 423 (2004).

³¹ See *infra*, par. 7. Geoffrey P. Miller, *supra* note 30, at 451, observes that collapsed firms usually had well designed or even state-of-the-art corporate governance structures.

exactly when. Both the bad performance of the core business and the exceptional cash amount siphoned-off by the Tanzi family during the years, also in connection with the terrible results of the tourism business and the other activities of the Tanzi family (e.g. the football business), had created a mountain of debt that went out of control.

Indeed, the first analysis shows that from 1990 up to the collapse, the Parmalat Group consumed Euros 14.2 billion of financial resources, generating an operating income of Euros 1.1 billion; Euros 13.2 billion was advanced by banks. The figure also includes Euros 5.3 billion in interest and fees. Around 80 per cent of bank finance was provided by non-Italian groups. Euros 3.8 billion was used for acquisitions. Euros 2.3 billion was used for unknown, unreported transactions.³²

As far as the technical means used to conceive the fraud, they were extremely basic. Parmalat hid losses, overstated assets or recorded non-existent assets, understated its debt, and diverted company cash to Tanzi family members.³³

In order to hide losses, Parmalat had used various wholly-owned entities, amongst which the most significant was Bonlat, the Cayman island waste basket of the Group in its final 5 years, and the holder of the Bank of America's false account. Uncollectible receivables were transferred from the operating companies to these nominee entities, where their real value was hidden. Fictitious trades and financial transactions were organized to offset losses of operating subsidiaries and to inflate assets and incomes. Securitization schemes based on false trade receivables and duplicate invoices were recurrently used to finance the group.

Parmalat understated its debt through different fraudulent schemes. It recorded non-existent repurchases of bonds. It sold receivables falsely described as non recourse, in order to remove the liabilities from the records. It mischaracterized debt or, simply, did not record it.

Funds were diverted to Tanzi family members and their private companies. A recurrent scheme was to record the payments as receivables and then move the false receivables through the web of the offshore entities in order to blur their true nature. Allegedly, the Tanzi family also channelled repayments for quantity discounts made by Tetra Pak at the end of each year into a bank account held by a company wholly controlled by the family. The funds were used by the family as

³² Giuseppe Oddo, *Il cappio delle commissioni*, Il Sole 24 Ore, 21 July 2004, quoting the Extraordinary Commissioner's report.

³³ See SEC, First Amended Complaint, 27 July 2004.

spending money. In order to understand the dimension of this misappropriation, it is worth noting that Parmalat was Tetra-Pak's third largest customer world wide. The Extraordinary Commissioner of Parmalat has alleged that for the period from 1995 to 2003 the discount payments reached an average of around USD 15 million per year.

Needless to say, some of the gatekeepers helped management. The role of the auditors and Parmalat's lawyer attracted immediate attention after the collapse, and they were immediately arrested.

Prior to 1995, Mr Maurizio Bianchi and Mr Lorenzo Penca were providing auditing services to Parmalat's companies through Hodgson Landau Brand S.a.S.. In 1995 they moved to Grant Thornton, Parmalat's principal auditor since 1990. Under Italian Law, every nine years auditors must rotate. It is alleged that both men knew well all the frauds and were concerned that Deloitte, the new auditor, could discover them at the start of its term. Accordingly, they suggested the constitution of a Cayman Islands company, Bonlat, with the contribution of the fictitious assets of other offshore companies (mainly Zilpa and Curcastle). Grant Thornton would continue to audit Bonlat as secondary accountant of the group. Indeed it was Grant Thornton that established Bonlat.³⁴ Bonlat became the group's principal waste basket and Mr Bianchi and Mr Penca helped Parmalat's managers to conceal the losses and the debt until the end of 2003. The two men are to appear in January 2005 before the Criminal Court of Milan in a fast-track procedure ("giudizio abbreviato") typically asked for by defendants with little chance of success who at best can hope for a reduced conviction. This special procedure is part of the criminal proceedings started in Milan concerning market abuses, false financial reports and obstacles placed in the way of the watchdog's inquiry. These proceedings concern 27 defendants, amongst which Parmalat's management and statutory auditors,³⁵ partners of the audit firms and bankers, the audit firms and some banks.³⁶ With

³⁴ *Parmalat: Thornton registrò Bonlat*, Ansa/Bloomberg, 13 January 2004, interview with Ian Johnson, partner of Grant Thornton.

³⁵ About statutory auditors see *infra*, par. 13.

³⁶ Giuseppe Oddo, *Parmalat, indagini alla svolta*, Il Sole 24 Ore, 7 December 2004, 33. Both the audit firms and the banks are involved because they are subject to special administrative fines (which in fact have a quasi-criminal nature) in the course of the criminal proceedings concerning their partners, managers, employees, under the D. Lgs. (Legislative Decree) of 8 June 2001 no. 231, a law that has created two types of corporate liability: the first in the form of vicarious liability; the second in the form organisational fault (see James Gobert – Maurice Punch, *Rethinking Corporate Crime*, Butterworths LexisNexis, 2003, 108-113).

regards to the bankruptcy criminal offences, the investigation seems to be nearing an end and the trial phase of the Parma proceedings is expected to start in 2005. Also these investigations involve Parmalat's managers, statutory auditors, partners of the audit firms and bankers, the audit firms and some banks.

Parmalat's lawyer, Mr Zini, was a Milan based attorney who had worked in the well-known law firm of Pavia Ansaldo and established, in 2000, his own law firm, Zini & Associates. The latter was basically a Parmalat captive, since the large majority of its turnover was generated by the dairy group. Allegedly, Zini was the legal mind behind Parmalat's complex web of companies and transactions. He became known to the mass-media during the group's final month as the legal representative of the infamous Epicurum fund, held by Bonlat. He also was immediately jailed after the collapse. He is facing charges in the Milan trial and is the subject of investigation in Parma.

4. Civil actions

The Parmalat scandal is generating a flurry of civil litigation.

In early January 2004, US class action lawyers sued a group of defendants amongst which Tanzi, Tonna, Zini, and the auditors. The news that only a few days after Parmalat's insolvency a class action had been started in the US, allied to rumours that Italian investors might benefit from it, fuelled the debate concerning the introduction of class action-like mechanisms in Italian civil procedure. In the same period the SEC brought an action against Parmalat. The action was settled at the end of July 2004. Parmalat's Commissioner agreed to comply with extensive provisions concerning corporate governance and shareholder participation, which were also an important part of its restructuring plan in Italy, as well as cooperating with the SEC investigation in the Parmalat case.

In August 2004 Parmalat's Commissioner sued in the US Grant Thornton US and Italy as well as the Swiss Association of Deloitte Touche Tohmatsu, and members and affiliated firms (Deloitte & Touche USA LLP, Deloitte & Touche LLP and Deloitte & Touche S.p.A.). The Commissioner pointed out that the international affiliations and relationships of Grant Thornton and Deloitte were a core issue of the audit services they sold to Parmalat and therefore that as members of an integrated network they are to be held liable for damages as agents or joint venturers. The Commissioner held that both networks failed to properly audit Parmalat's companies and their related party transactions.

Later in the US the Commissioner started an action against Citigroup, its subsidiary Citibank and other subsidiaries, and a further action against Bank of America. The Commissioner alleges that Citigroup structured Parmalat's securitization program knowing that Parmalat's management was using the program to artificially increase Parmalat's cash flow by double counting its receivables,

and that Citigroup structured many equity investments (amongst which the infamous Buconero transactions) that actually were disguised loans. The latter charge was also brought separately against Bank of America.³⁷

In October 2004 asset managers acting as lead-plaintiffs filed a class action in the US against the two banks, the auditors and former management, in an action based on similar arguments as those presented by Parmalat and aimed at redressing damages suffered by investors and, particularly, by those investors that had sold Parmalat's shares and bonds and could not therefore take advantage of the Commissioner's actions.

In Italy more than 7000 investors joined as civil claimants the criminal trial that started in Milan in October 2004. Such a number was unprecedented in Italy and highlighted the differences existing between class action mechanisms and individual participation to legal proceedings. Also Parmalat and Consob joined the proceedings as civil claimants against the individual defendants. Consob's position is, in particular, controversial, because the securities watchdog's right to claim damages as a civil party acting on behalf of investors is far from clear under Italian law.

As far as we know, no other liability actions have been started in Italy. There are civil proceedings started by the Commissioner before the Court of Parma, but they seek to nullify under insolvency law transactions entered into by the banks and the company prior to its insolvency declaration.

5. *Political reactions to the Parmalat scandal in Italy and in the EU*

The Parmalat scandal is the subject of political debate concerning the distribution of powers amongst Italian supervisors. The Bank of Italy was attacked for not having screened Parmalat's issues on the bond market under Article 129 of the Consolidated Banking Law. It was also criticised for failing to discover the true nature of the information provided by Parmalat regarding its debt, given that the Bank of Italy manages the so called "Centrale Rischi", a data bank that classifies bank debts. The Governor of the Bank of Italy replied that the banking supervisor has no power to screen bond issues and to evaluate the financial soundness of industrial groups and that the data classified in the "Centrale Rischi" have limited informational value when a large part of the group

³⁷ Citigroup, as well as Bank of America, has been involved in the US financial scandals. For a review see James A. Fanto, *Subtle Hazard Revisited. The Corruption of a Financial Holding Company by a Corporate Client's Inner Circle*, 70 Brooklin L. Rev. 7, 20 ff. (2004).

finance comes from foreign lenders.³⁸ Consob, the capital markets supervisor, claimed that access to the data of the “Centrale Rischi” would have provided essential information and required more resources and more powers to conduct investigations and to sanction wrongdoers.³⁹

Parliament created a joint committee for the analysis of the Parmalat collapse and the drafting of a new law concerning capital markets, a sort of Italian Sarbanes-Oxley Act. After almost a year, no legislation has been produced. In particular, the debate concerning the distribution of powers between the Bank of Italy and Consob is ongoing. A side-issue of the Parmalat scandal is the political debate concerning class actions, as it did not go unnoticed that investors took action in the US, whereas in Italy nothing happened until the criminal trial in Milan had begun. This debate has been presented in the Italian mass-media and sometimes also in Italian law journals as a panacea for all the problems affecting investors’ protection under Italian civil procedure.⁴⁰ Needless to say, the class action mechanism can offer an explanation to investors’ actions that have been brought in the US, but cannot explain why also Parmalat acted in the US and did not seek to fight against Grant Thornton, Deloitte, Citigroup and Bank of America in its local jurisdiction. Thus, the Italian political debate is misconceived and will not lead to any significant advance in the solution of the problems affecting Italian civil justice.

At the European level, following the European Parliament resolution on corporate governance and supervision of financial services (concerning the Parmalat case) dated 12 February 2004,⁴¹ the EC Commission adopted on the 27 September 2004 a communication addressed to the Council and the European Parliament. The communication points out that transparency, supervision and oversight have to be improved, especially as far as tax havens are concerned, and law

³⁸ Report of the Governor of the Bank of Italy, *supra* note 15.

³⁹ Report of the Chairman of Consob, *supra* note 14.

⁴⁰ For some references cf. Alessandro De Nicola, *Lotta di “class”*, *Il Sole 24 Ore*, 17 March 2004; Id., *Se Roma fa la balia*, 20 October 2004 (against the introduction of class action mechanisms in Italian law, mentioning the critics to the instrument coming from the US); Andrea Zoppini, *Tutela dei consumatori – I limiti della class action approvata dalla Camera*, *Il Sole 24 Ore*, 28 July 2004 (in favour of class actions, but criticizing a draft of law debated by the Italian Parliament); Andrea Giussani – Andrea Zoppini, *Tutela del risparmio e mercati finanziari: una ricetta italiana per la “class action”*, 27 *Guida al Diritto* 11 (2004) (favourable to the introduction of class action as an instrument to aggregate small claims that otherwise would not go to court).

⁴¹ http://www.europa.eu.int/eur-lex/en/com/cnc/2004/com2004_0611en01.pdf

enforcement has to be strengthened through increased cooperation amongst agencies and public prosecutors. The Communication stresses the need for further regulation concerning auditors, corporate advisors, analysts and rating agencies, and money-laundering. Private enforcement is not at issue in the communication.⁴²

6. *Market effects of the Parmalat scandal*

In the wake of the Parmalat scandal, Consob launched a wide-ranging investigation concerning bond issues. Listed companies were required to provide additional information, auditors adopted a stricter approach and some cases of insolvency were probably accelerated.

The effect of the Parmalat scam on the bond market has been quite significant. According to a report from Fitch Ratings, the number of Italian companies accessing the bond market is collapsed. More than half of the overall amount of new issues relates to two single companies, Telecom Italia, the telecommunications operator, and Autostrade, the motorway operator.⁴³ These two issuers complied with best international market practices and were able to issue bonds notwithstanding the financial scandals. Other companies exited the market and turned their attention back to the loan market.⁴⁴

III. CORPORATE GOVERNANCE AND GATEKEEPERS

A. THE BOARD OF DIRECTORS

7. *Parmalat's board*

The Milan Stock Exchange's listing rules require listed companies to illustrate their corporate governance system. Those companies that have decided not to follow the Corporate

⁴² The Parmalat scandal has also influenced the Commission in the drafting of the proposal for a directive on statutory audits of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC (http://europa.eu.int/comm/internal_market/auditing/officialdocs_en.htm). On its side, the International Organization of Securities Commissions (IOSCO) established a task force in February 2004 addressed at coordinating a response to the financial frauds. See IOSCO's website at <http://www.iosco.org/news>.

⁴³ One of us is independent director of both companies.

⁴⁴ We have drawn this information from newspaper coverage of the Fitch Report. See Ivar Simensen, *The Spectre of Parmalat still haunts market Italian Bonds*, Financial Times London Edition, 10 December 2004.

Governance Code's recommendations, issued by Borsa Italiana in 1999 and amended in 2002, have to justify this choice. The Code recommends the appointment of independent directors, a concept which is loosely defined and frequently misunderstood in practice.

If Enron's board "was a splendid board on paper, fourteen members, only two insiders,"⁴⁵ Parmalat's board was basically the opposite. In its first report, dated 2001, Parmalat declared that four out of its thirteen directors were independent, but did not mention the relevant names. It gave the names in 2002. As far as 2003 is concerned, amongst Parmalat's thirteen directors, eight were executives: they were Calisto Tanzi (CEO) and his son Stefano, his brother Giovanni, his nephew Paola Visconti, the company's CFO Fausto Tonna and the top managers Luciano Del Soldato, Alberto Ferraris and Francesco Giuffredi. The CFO was also a member of the three-member audit committee. The other committee members were Mr Francesco Giuffredi (another executive) and Mr Luciano Silingardi. Amongst the five non executive directors, three were qualified as independent directors by the report. The most significant was Luciano Silingardi. He and Tanzi had been close friends since school and Silingardi had been Tanzi's accountant before being appointed, through Tanzi's and his own political connections, president of Cassa di Risparmio di Parma (the local bank that was to be one of Parmalat's most reliable banking partners) and, later on, of the foundation that controls the bank. The other two independents were Mr Paolo Sciumè, allegedly one of Tanzi's lawyers and a member of many boards, amongst which Mediolanum,⁴⁶ and Mr Enrico Barachini, he also a member of many boards, amongst which the boards of two subsidiaries of the Banca Popolare di Lodi group, another significant banking partner of Parmalat.⁴⁷

The situation was similar as far as previous boards were concerned. It is clear that during Parmalat's history non executive directors had never supervised managers. One should ask why they did not have enough incentives to monitor. There are probably many answers. At least one of the three directors who were qualified as independent by Parmalat was not truly so. They accepted procedures that were clearly inadequate (recall Mr Tonna's role as member of the audit committee). The complexities of the group's structure and finance required a great amount of work and financial

⁴⁵ Jeffrey N. Gordon, *supra* note 19, at 1242.

⁴⁶ Mediolanum's main shareholder was at the time (and still is) the present Prime Minister of Italy, Mr. Silvio Berlusconi (information published in Consob's data base at: www.consob.it).

⁴⁷ Directors disclose their appointments following the Italian Stock Exchange's corporate governance code (Article 1.3).

understanding, and they were not prepared to dig into Parmalat’s intricate business. They probably relied on Mr Tanzi. One could still wonder why they were not afraid of lawsuits. US commentators discuss the role of lawsuits on corporate governance. It is hotly debated whether or not shareholders’ derivative actions and securities class actions are incentives to proper management. The issue is complicated by D&O insurance, which in any case protects directors’ pockets. However, Italy offers a completely different scenario. Basically, Italy has no significant cases of lawsuits against the directors of a solvent company and, more important, virtually no cases of securities suits against a solvent company and its directors. Accordingly, D&O insurance is an unimportant issue both in academia and in the real world;⁴⁸ it is even still debated whether directors’ civil liability is absolute or not.⁴⁹ Directors face lawsuits only from bankruptcy receivers and usually protect well in advance their assets against the enforcement of a negative court decision, thereby obtaining a very favourable position when a settlement is discussed. Criminal investigations are not effective and sanctions are probably inadequate. In short, unless the company goes bust, there is nothing the directors should be afraid of. Thus, Parmalat’s story (like Enron’s) is about gatekeepers.

Yet, probably the most interesting question is whether or not the market was discounting Parmalat’s poor governance. We will briefly deal with this matter further on in this paper.⁵⁰

B. EXTERNAL AUDITORS

8. *Gatekeepers’ role*

The term “gatekeeper” is used to refer to outside professionals who provide verification or certification services to investors.⁵¹ Before the financial scandals that culminated in the Enron case,

⁴⁸ One writer has recently covered the issue: Franco Bonelli, *L’art. 129 Legge Draghi: l’azione sociale di responsabilità esercitata dalla minoranza dei soci, e l’assicurazione contro i rischi incorsi nella gestione*, F. Bonelli et al. (eds), *La riforma delle società quotate*, Milano: Giuffrè, 1998, 151.

⁴⁹ Umberto Tombari, *L’assicurazione della responsabilità civile degli amministratori di società per azioni*, I Banca borsa titoli credito 180 (1999). On absolute liability see Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 Yale L.J. 857, 876-887 (1984).

⁵⁰ See *infra*, par. 15 and par. 18.

⁵¹ John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 304 and 308. On the role of

it was believed that market incentives could be sufficient to lead gatekeepers to screen against fraud and improper disclosure by their clients. A classic example of how market forces should have worked was offered by auditors, by far the most important gatekeepers. Auditors are reputational intermediaries that receive a far smaller benefit than do their clients from the operations they certify. Since they share none of the gains of fraud (or just a small fraction of it) and are exposed to a large fraction of the risk (in the form of reputation disruption and also legal liability), they have all the proper incentives to efficiently monitor their clients and stop or denounce wrongdoings. Accordingly, they are easier to deter than their clients.⁵² One of the best known judicial expressions of this straightforward belief in market efficiency was Frank Easterbrook's position in the *DiLeo v. Ernst Young* case.⁵³

The fact that auditors as well as other gatekeepers are paid by their clients was not an actual issue for the paradigm, for two related reasons. First, it was thought there is no price a gatekeeper can accept for the disruption of its reputation. Second, firms face significant costs when they fire a gatekeeper (think once again of an auditor), because the market interprets the decision as a signal of hidden problems within the firm. Accordingly, gatekeepers can credibly offer a collective service to investors and creditors even though they are paid by companies.

The belief was severely hit by the American corporate scandals.

9. *Corporate governance problems within the audit organization*

During the 1990s the big auditing firms learned how to use auditing services as an entry-

gatekeepers, cf. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. Econ. & Org. 53 (1986). Professor Kraakman's definition of gatekeepers is broader than Professor Coffee's: John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 308-309.

⁵² John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 308; Reinier H. Kraakman, *supra* note 49, at 891.

⁵³ *DiLeo*, 901 F.2d at 629. For a classic statement of this position see also Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary?*, 17 J. Legal Stud. 295, 312 (1988). For an intermediate course that considers too heavy-handed gatekeepers' liability regime and, at the same time, ineffective the private contractual solutions that Professor Goldberg considers as the best approach towards gatekeepers, see Stephen Choi, *Market Lessons for Gatekeepers*, 92 Nw. U.L. Rev. 916 (1998), proposing a "self-tailored liability system." Professor Choi has developed this proposed framework: see *infra* note 56 and 63.

point into the more lucrative market of consulting services.⁵⁴ Auditing companies became involved in tax planning services, management services, corporate finance services, legal services. For instance, it is well known that in Europe the Big Five tried to enter into the lucrative transactional legal business that was starting to be dominated by London firms and, to a lesser extent, by U.S. law firms that had decided to go global. Prior to its own collapse following Enron's insolvency, Andersen's affiliated law firm had successfully gained a position in the Italian legal market. Just to offer an example, it was the legal advisor of a huge securitization concerning State-owned real estates.⁵⁵

The involvement in non-audit services offered audited companies a weapon. They could now discipline their auditors in a way that could remain undetectable, through the threat of the reduction of the non-audit services. Clients were in a position to adopt an effective "tit-for-tat" strategy,⁵⁶ to which auditors were exposed because of agency problems concerning their partners' incentives.⁵⁷ Partners' fees are related to the overall volume of revenues that their clients generate. Accordingly, partners do not want to make their clients unhappy, because in the short term this would affect their earnings. Enron generated 1 per cent of Arthur Andersen's whole turnover, but was the main client of David Duncan, the Houston partner of the auditing firm, who accepted a lowering of the auditing standards and thus of Andersen's reputational asset in order to protect and increase his own revenues. In such situations corporate governance within the audit firm becomes crucial. When internal control is not effective, the problem can be disruptive, as it was for Andersen.⁵⁸ Thus, the usual corporate governance problem is simply shifted from the issuer to the gatekeeper.⁵⁹ With reference to auditors, some scholars also point out that the limited liability

⁵⁴ John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 321.

⁵⁵ The "SCIP" securitization program.

⁵⁶ See Jeffrey N. Gordon, *supra* note 19; John C. Coffee Jr., *supra* note 3; William W. Bratton, *supra* note 18; Stephen J. Choi – Jill E. Fisch, *How To Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 Yale L. J. 269, 293 (2003).

⁵⁷ Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 Wash. U. L. Q. 491, 500 (2001), considering in particular underwriters and independent auditors.

⁵⁸ See Jeffrey N. Gordon, *supra* note 19; John C. Coffee Jr., *Understanding Enron*, *supra* note 3.

⁵⁹ Jonathan Macey – Hillary A. Sale, *Observations on the Role of the Commodification, Independence, and*

structure of auditing companies had impaired the previous monitoring role of partners, typical of a regime of vicarious liability for each other's professional negligence.⁶⁰ In a world where “equity-based compensation constituted approximately two thirds of the median annual compensation of chief executives of large public corporations” and where managers had large incentives to “inflate the stock price of their company through premature revenue recognition or other classic earning management techniques”, corporate managers had significant incentives to lure auditors' partners or to discipline them by means of stick-and-carrot strategies affecting non-audit services.⁶¹

Yet, one could still question why rational auditors put their clients in a position where the latter could condition the quality of the formers' original core business. Apart from behavioral biases affecting auditors, it is suggested that the market bubble had a role. Indeed, euphoric investors do not rely upon the collective services offered by gatekeepers as cautious investors do.⁶² Thus, in an overconfident growing market the value of reputation (an asset that generates revenues that are collectively paid by investors and firms' creditors through the audited firm) decreases and the value of consulting services offered to the firm increases. In short, the Enron case and the following scandals indicate that a corporate governance problem led gatekeepers to relax their professional standards.⁶³

The story is not yet complete. If reputation was not enough to keep gatekeepers on the right track, in theory legal liability should still have had some deterrence effect. As Professors Coffee and Partnoy in particular have pointed out, however, auditors and other gatekeepers experienced in the

Governance in the Accounting Industry, 48 Villanova L. Rev. 1167 (2003). As the two authors point out at 180, “Andersen suffered an internal corporate governance failure of epic proportions.”

⁶⁰ Jonathan Macey – Hillary A. Sale, *supra* note 59, at 1170-1172, 1180-1181.

⁶¹ John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 327-328.

⁶² John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3, at 323-324.

⁶³ For a general review of institutional failures concerning security market intermediary institutions see Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 Berkeley Bus. L. J. 1 (2004). In the Enron case the US global office of Arthur Andersen drew affiliates underwater. In the Parmalat case it remains to be seen whether local shielding will be able to resist the Commissioner's action and, at the same time, to protect the reputation of Grant Thornton's and Deloitte's global trademarks. In this case, corporate shielding would offer another argument about the corporate governance problem of international auditors, since it would become clear that, in a catastrophic scenario, reputation is effectively at stake only when the US offices are in trouble.

US a progressive reduction of civil liability risk during the 1990s, because of new statutes (e.g. the Private Securities Litigation Reform Act of 1995 – PSLRA – and the Securities Litigation Uniform Standard Act of 1998 – SLUSA) and new judicial trends (e.g. the Supreme Court’s decisions in the *Lampf*, *Pleva* and in the *Central Bank of Denver* cases) that decreased the exposure to securities class actions. Indeed, in the wake of the financial scandals one of the most provocative issues in the US legal academic arena seems to be the one concerning gatekeepers’ liability, an issue that has not been touched by the Sarbanes-Oxley Act. Auditors are the most significant targets of this debate,⁶⁴ which cannot ignore the fact that the audit market is concentrated: the “Big Four” – Deloitte & Touche, Price Waterhouse Coopers (PCW), Ernst & Young and KPMG – audit the majority of listed companies worldwide.⁶⁵

10. Auditors and Parmalat

Grant Thornton (GT) was Parmalat’s auditor through the first-half of 1999. According to Italian law, auditors are appointed for three years and can be re-appointed twice. After nine years, they have to be changed. As we have written, in 1998 the duty to appoint new auditors created a big problem to both GT and Parmalat, which feared that the new auditors could discover the true purpose of the offshore entities. Allegedly, Mr Bianchi and Mr Penca used the GT network to create a new shield, the infamous Bonlat, that could be certified by GT, acting as secondary auditor, with the new auditor acting as primary auditor. Accordingly, if the primary auditor was not too strict, Bonlat could be used as a waste basket that was out of the primary auditor’s direct control. Should such accusations be confirmed by the courts, it would be clear that GT’s internal controls were totally lacking. Consob has already cancelled the company through which GT operated in Italy (Grant Thornton s.p.a., renamed Italaudit s.p.a. following the Parmalat scandal) from the register of the certified auditors (entitled to audit listed companies),⁶⁶ after having ascertained that the Italian

⁶⁴ See Frank Partnoy, *Barbarians at the Gatekeepers?*, *supra* note 57; John C. Coffee Jr., *Gatekeeper Failure and Reform*, *supra* note 3; Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U.L. Rev. 365 (2004); John C. Coffee Jr., *Partnoy’s Complaint: A Response*, 84 B.U.L. Rev. 377 (2004); Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statement Insurance Alternative to Auditor Liability*, 52 UCLA L. Rev. 413 (2004); Assaf Hamdani, *Gatekeeper Liability*, 77 S. Cal. L. Rev. 53 (2003); Peter B. Oh, *Gatekeeping*, 29 Iowa J. Corp. L. 735 (2004).

⁶⁵ The Economist, *Called to account – The future of auditing*, 20 November 2004.

⁶⁶ See *infra* note 83.

entity of the GT network did not follow adequate audit procedures.⁶⁷ In 2002 GT audited on a mandatory basis 15 listed companies (amongst which Parmalat and Cirio) and financial intermediaries. In particular, GT audited Cirio's first quarter 2002 consolidated financial report and Mr Bianchi was the partner in charge of the audit.⁶⁸ Since Cirio's default became apparent in November 2002, no doubt someone linked Cirio to Parmalat through the GT connection. Perhaps it was chance, but the first serious warning to the market concerning Parmalat's financial situation occurred in December 2002.⁶⁹ Needless to say, since GT is not in the top league of auditing services, it would be interesting to know how much of GT's income was generated by Parmalat and if and how the Parmalat scandal will affect the GT trademark. As far as we know, there are no publicly available data on the issue, at least in Italy.⁷⁰

The Italian member firm of Deloitte Touche Tohmatsu (Deloitte & Touche S.p.A.), the world's no. 2 accounting firm, was appointed as Parmalat's primary auditor in 1999. Deloitte Touche Tohmatsu had been already involved in consulting services for Parmalat. For instance, it is reported that the appraisal concerning a controversial transaction announced in December 1999 and involving Parmalat's main Brazilian unit had been prepared by Deloitte's corporate finance arm many months earlier, i.e. in July 1998. Some evidence shows that Deloitte's network was involved in non-audit services to Parmalat even after Deloitte's appointment in 1999. Another transaction investigated because of Deloitte's apparent lax attitude concerns the member office in Malta and, particularly, a large intercompany loan between Parmalat Capital Finance Ltd., a special purpose vehicle controlling Bonlat, and the latter.⁷¹ Indeed the Maltese registered office of Parmalat Capital Finance was Deloitte's office. The related party transaction between Parmalat Capital Finance and

⁶⁷ Consob, decision no. 14671 dated 28 July 2004 (www.consob.it).

⁶⁸ Therefore, it would be interesting to explore whether an "illicit market" in "pliable gatekeeping" was in place. Illicit markets in gatekeeping are discussed by Renier Kraakman, *supra* note 51, at 66-68.

⁶⁹ See *supra* par. 2.

⁷⁰ However, in December 2004 GT "reported full-year global revenues of USD 2.1bn - an increase of 12 per cent compared with 2003" (Andrew Parker, *Revenue growth at Grant Thornton. News Digest*, Financial Times, London Edition 1, 14 December 2004).

⁷¹ Bloomberg News, 16 March 2004.

Bonlat would appear to be just one of many.⁷²

Deloitte's story with Parmalat raises some issues that seem to be similar to the ones raised by the Enron affair. Allegedly, a Brazilian auditor who was unconvinced by information provided by the Italian parent was removed from the Parmalat account thanks to heavy lobbying in Deloitte's US global headquarters by the Italian Deloitte member firm.⁷³ The Commissioner Dr Bondi alleges that the Italian firm acted in the same way in other similar situations.

Deloitte's firm in Luxembourg audited Parmalat Soparfi SA. Financial information services have reported that Deloitte "wrote in three separate reports that the unit's directors hadn't supplied enough evidence to support book values they put on stakes held in two other Parmalat units."⁷⁴ With the benefit of hindsight it seems that the problem could have offered an early warning about Parmalat's management attitude.

For a five-year period Deloitte certified Parmalat's statements. It is not clear whether it was the market turmoil that started in February 2003 to force Deloitte to take more care, or the action of the Italian watchdog that followed the incredible complaint lodged by Parmalat in March 2003. It seems clear, however, that Deloitte had never asked GT to explain how the existence of the huge cash pile held by Bonlat in the New York account had been checked.

Deloitte were also the auditors of Cirio and had audited that company's 2001 statements, those impugned by Consob in January 2003.⁷⁵

11. Do Italian rules facilitate audit failures?

According to some areas of the media GT and Deloitte's failures can be put down to lax Italian auditing rules. We do not agree. The issue is one of enforcement, not substantive rules.⁷⁶

⁷² Parmalat's press release dated 29 July 2004.

⁷³ Fred Kapner, *Parmalat probe focuses on Deloitte's Italian office*, Financial Times, London Edition 1, 10 April 2004.

⁷⁴ Bloomberg News, 10 February 2004.

⁷⁵ With its decision no. 14488 dated 25 March 2004 Consob disqualified for a two-year period Mr Stefano Baudo, Deloitte's partner in charge of Cirio (www.consob.it).

⁷⁶ For an overview of the main issues discussed at an international level with reference to auditor standards see Werner F. Ebke, *Corporate Governance and Auditor Independence: The Battle of the Private Versus the Public*

a. Primary supervisor liability

A common view about the Parmalat scandal holds that it was caused also by lax Italian rules concerning the relationship between the primary auditor and secondary auditor. However, there were national auditing standards reflecting the international ones that govern the situation⁷⁷ and at least one very significant court case in which the primary auditor has been considered liable because of the lack of controls over the activity of the secondary auditor. The case was decided by the Milan Tribunal the 21 October 1999 and concerned, amongst other issues, the liability of the Ferruzzi group's primary auditor (Price Waterhouse S.p.A.) in connection with reports certified by a secondary auditor not directly appointed by the primary auditor.⁷⁸ The Court applied the national auditing standards and held that the primary auditor cannot accept without criticism the work of the secondary auditor and certify the consolidated accounts, but has a duty (when it decides to avail itself of the secondary auditor's work) to check the procedures followed by the secondary auditor and to access the documentation used by the latter. Accordingly, the emphasis on relaxed Italian auditing standards is misplaced.

b. Independence

As far as independence is concerned, Italian rules are very strict. Auditing companies must have an exclusive activity in order to be recorded by Consob in the register of auditors entitled to certify listed companies' financial reports (Article 6 Legislative Decree no. 88/92, referred to by article 161 Consolidated Financial Services Act, "CFSA"). Any provision in the company's statute concerning non-audit services makes the company non eligible. The sole advisory service that the registered auditor can offer concerns the accounting systems ("organizzazione contabile") of the audited company.

The appointed auditor must be independent (articles 160 – 162 CFSA). Before hiring the auditor, the shareholders' meeting must receive the statutory auditors' opinion (article 159

Interest, G. Ferrarini – K. Hopt – J. Winter – E. Wymeersch (eds.), *Reforming Company and Takeover Law in Europe*, Oxford University Press, 2004, 507.

⁷⁷ The Italian auditing standards basically incorporate the International Standards on Auditing (ISAs) and International Standards on Assurance Engagements (ISAEs) issued by IAASB, available at www.ifac.org.

⁷⁸ *Infra* note 100.

CFSA).⁷⁹ Consob's rule provides that this opinion must expressly consider the independence issue. This system gives responsibility for the hiring and the compensation of the auditor to the shareholders' meeting, creating a situation, in companies dominated by a controlling shareholder (as Parmalat was), similar to the one that existed before the SOA in US public companies, in which the auditors were appointed by management.

Supervision of independence after hiring is in the hands of Consob. The watchdog can ask for information, inspect the business premises of the auditor and ask for information to partners, directors, statutory auditors, CEO of the audited company. It can also indicate the auditing principles to be followed by registered auditors. When "serious" breaches of the rules are ascertained, the public supervisor can order the auditor not to use the services of the involved partner for a period of up to 2 years, or order the auditor to decline new appointments for a period of 1 year. When breaches of rules are "particularly serious" or the auditor has lost the prerequisite required in order to be recorded in the register (exclusive statutory objects and technical qualification), Consob may cancel the name of the auditor from the registry. Accordingly, disqualification is the main administrative remedy (Article 163 CFSA).

As usual, the problem arises when rules are to be enforced. In order to circumvent independence criteria, international auditors have organized their activity through a network of companies that are formally independent from the auditing entity but are actually linked through participation agreements. Italian scholars and practitioners never really challenged these participation agreements as serious impediments to independence.⁸⁰ Consob followed this pattern and never launched an attack on the non-audit services offered by the auditors' networks, in spite of the fact that auditors openly market themselves as global multifunctional brands.

Moreover, it is clear that the watchdog supervision on auditors was very lax due to a lack of resources. More generally, owing to a detection policy that was too heavily dependent on statutory

⁷⁹ Statutory auditors are the members of an internal board of auditors which until the recent reform of Italian company law was mandatory. See Guido Ferrarini – Paolo Giudici – Mario Stella Richter, *Italian Company Law Reform: Real Progress?*, K. Hopt - E. Wymeersch (eds.), *Company Law and Corporate Governance in Europe*, Kluwer, forthcoming.

⁸⁰ See Paola Balzarini, *Commento all'art. 161 TUF*, P. Marchetti – L.A. Bianchi (eds.), *La disciplina delle società quotate*, II; Milano: Giuffrè, 1999, 1898, 1901.

auditors' complaints,⁸¹ Consob never followed a proactive law enforcement approach,⁸² but always punished auditors after a problem in the audited companies had arisen.⁸³

c. Liability rules

Probably the most striking difference between the US and Continental Europe concerns the level of private enforcement. Italy is no exception. Yet, the “law on books” is, once again, very strict. There are no doubts whatsoever that auditors are liable for damages.

Prior to the February 2004 amendment to the Consolidated Financial Services Act, this conclusion could be drawn from the civil law of obligations and, even though implicitly, from Article 164 CFSA, stating that: “the persons responsible for an audit and the employees who performed the audit shall be liable, jointly and severally with the auditing firm, for injury to the hiring company and third parties as a result of non-fulfilment of their duties or illicit actions”. The rule recognizes a civil liability of the auditing firm towards the audited firm, its creditors and investors, posing a regime of joint liability with individual auditors and employees.

The new Article 164 (1) as amended in February 2004 explicitly foresees liability towards the audited firm and the creditors, through a combined reference to Articles 2407 and 2394-bis Civil Code: the insolvency liquidator and the extraordinary commissioner of a large insolvent company (like Parmalat) are entitled to bring actions against the directors, the statutory auditors and the audit firm, cumulating both the company's and the creditors' actions.

⁸¹ See *infra* par. 16.

⁸² On the role of regulators as proactive enforcers see Katharina Pistor – Chenggang Xu, *Incomplete Law*, 35 N.Y.U.J. Int'l L. & Pol. 931, 963-964 (2003); Id., *Law Enforcement Under Incomplete Law: Theory and Evidence from Financial Market Regulation*, London School of Economics and Political Science, working paper No. Te/02/332, 2002. On SEC's failures to act as a proactive enforcer see John R. Kroger, *Enron, Fraud and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. Colo. L. Rev. 57 (2005), who writes at 64: “We also need to improve the SEC's ability to proactively investigate and uncover widespread and systematic securities violations before millions of investors are harmed, instead of waiting to investigate until the problems have exploded publicly in the headlines of the *Wall Street Journal*.”

⁸³ Italaudit S.p.A. (previously Grant Thornton S.p.A.) was cancelled from the Registry on the 28 July 2004 (Consob's resolution No. 14671). Mr Bianchi was disqualified for the audit services rendered to Cirio in 2002 with Consob decision no. 14480 dated 23 March 2004. Two days later it was Mr Baudo's turn for the audit services rendered by Deloitte to Cirio in 2001 (Consob decision no. 14488 dated 25 March 2004).

As noted, this liability regime can also be inferred by general rules concerning contractual obligations and tort. More specifically, as for the nature of the auditing firm's liability, it clearly is contractual when the company is suing. It must be pointed out that Italian scholars hold that the auditors cannot raise defences of *in pari delicto*, contributory negligence or fault, and unclean hands, because the auditors' function is to monitor the managers through the auditing processes: a party whose duty is to monitor cannot escape liability by asserting that the monitored party concurred in the damage, since the gatekeeper was rewarded in order to prevent managers' misbehaviour.⁸⁴ The only court decision that dealt with the issue also rejected these kinds of defences.⁸⁵ The rationale is probably clearer if one recalls that under Italian law auditors are appointed by shareholders:⁸⁶ also under Italian law, therefore, one can assert – as the House of Lords did in *Caparo Industries Plc v Dickman* – that auditors' reports are intended to enable shareholders to question the management of the company.⁸⁷

Auditors are also liable towards creditors and investors. The nature of this liability is discussed in the legal literature, as a part of the wide debate concerning the nature of prospectus liability and, more in general, liability for pure economic loss.⁸⁸

The main differences between a contractual action and an action in tort concern time limitation and burden of proof. If the action is in tort, the plaintiff has to show that the auditor intended to cause damages or at least was in culpa, while if the action is contractual the onus is on

⁸⁴ Mario Bussoletti, *Le società di revisione*, Milano: Giuffrè, 1985, 352; Adriano Rossi, *Revisione contabile e certificazione obbligatoria*, Milano: Giuffrè, 1985, 192; Daniela Casadei, *La responsabilità della società di revisione*, Milano: Giuffrè, 2000, 149. A different view is expressed by Paolo Montalenti, *La società quotata*, Padova: Cedam, 2004, 316, who considers applicable standards of comparative negligence, imputing to the company the managers' wrongdoings.

⁸⁵ Turin Tribunal, 18 settembre 1993, I.F.C. Istituto Fiduciario Centrale c. KPMG, *Giur. it.* I/2 1994, 655.

⁸⁶ *Supra*, par. 11.b.

⁸⁷ *Caparo Industries plc v Dickman and others*, [1990] 2 AC 605.

⁸⁸ See Giuseppe Portale, *Informazione societaria e responsabilità degli intermediari*, in *L'informazione societaria*, Atti del Convegno di Venezia, Milano: Giuffrè, 1982, II, 1169; Guido Ferrarini, *La responsabilità da prospetto. Informazione societaria e tutela degli investitori*, Milano: Giuffrè, 1986, 49; Id., *Sollecitazione del risparmio e quotazione in borsa*, in G. E. Colombo - G. B. Portale (eds.), *Trattato delle società per azioni*, Torino: Utet, 10**, 1993, 289 ff.; Carlo Castronovo, *La nuova responsabilità civile*, Milano: Giuffrè, 1997, 203 ff.

the auditor to escape liability through a due diligence defence (even though some scholars assert that when the contract concerns duties and not specific results, the burden of proof lies on the plaintiff's shoulders).⁸⁹ Under both regimes of liability, auditors are jointly and severally liable with companies, directors and statutory auditors, depending on which party claims damages. If it is the company (typically, through its liquidator or insolvency trustee) or the creditor to claim damages, the negligent audit firm is jointly and severally liable with negligent directors and statutory auditors. If it is the investor to claim damages, also the company can be held liable, since towards innocent third parties the directors acted on behalf of the company, which accordingly is responsible for their misstatements.⁹⁰

The framework that we have depicted is very strict. These are severe liability rules indeed, even more so than those applied in the US, where the “imputation” defences that we have mentioned are routinely invoked and can be effective.⁹¹ As far as investors' protection is concerned, they are also more severe than the ones adopted under common-law, where the problem of proximity between the auditor and the investor⁹² is treated in a way that may appear narrow viewed from Italy, where in contrast tort liability for pure economic loss is admitted by scholars and courts adopting more relaxed standards. Thus, Italian rules are very favourable to plaintiffs. Parmalat's action in the US against the auditors cannot be understood by mere reference to law on books, because Italian substantive rules governing auditors' liability are severe.⁹³

⁸⁹ For references cf. Eugenio Barcellona, *Responsabilità da informazione al mercato: il caso dei revisori legali dei conti*, Torino: Giappichelli, 2003, 20-21.

⁹⁰ Cassation Court, 14 January 1987, no. 183, II Dir. Fall. 319 (1987), asserting that the shareholder is not a third-party and cannot sue the company together with the directors under Article 2395 Civil Code; Rome Tribunal, 27 August 2004, not yet published.

⁹¹ For a recent overview cf. Richard P. Swanson, *Theories of Liability*, American Law Institute – American Bar Association Continuing Legal Education ALI – ABA Course of Study, 2004.

⁹² In England one of the leading cases is *Caparo Industries plc v Dickman and others*, [1990] 2 AC 605; in the US the leading case is *Ultramares Corp. v. Touche*, 255 N.Y. 170, 174 n.e. 441 (1931). For recent overviews cf. Anita Anand – Niamh Moloney, *Reform of the Audit Process and the Role of Shareholder Voice: Transatlantic Perspectives*, EBOR 5 (2004), 223, at 247; Christian Witting, *Justifying Liability to Third Parties for Negligent Misstatements*, Oxf. J. Leg. Stud. 2000.20 (615); Richard P. Swanson, *supra* note 91.

⁹³ Since Parmalat's action against Deloitte and Grant Thornton in the US cannot be explained on the grounds

d. Private enforcement

Case analysis of the published court decisions shows that any discussion concerning the legal risk associated with the auditing profession in Italy (and thereby the level of deterrence) misses the target if it relies upon law on books. The first published decision concerning auditors' liability is dated 1992. Law journals report, as far as we know, six cases concerning auditor liability, for a total of eleven published decisions. These cases can be classified as follows.

Two cases concern actions by purchasers of controlling stakes claiming that the price paid in an acquisition was overvalued because of financial misstatements or omissions that the auditor should have detected (*BPM Leasing v KPMG*)⁹⁴ or claiming that the auditor's appraisal of the true equity value of the target company was wrong (*Carraro v Arthur Andersen*).⁹⁵ In the acquisition context we find also the unsuccessful claim against the auditor of a controlling shareholder that had sold the shares at a certain price but, later on, had to give back part of the price as it was discovered that some receivables were in fact not recoverable (*Efim v Coopers & Lybrand*)⁹⁶ and, more interestingly, the successful claim of a company that had sued its auditors, directors and statutory auditors because it had entered into a null and void contract as a result of which it had paid consultancy fees. In this case (*Alumix v Reconta Ernst & Young*), the court held that the company would have not paid the illegal fees had the auditors properly screened the relevant contract.⁹⁷

of liability rules, one could still wonder whether Italy offered a less friendly environment as to the Extraordinary Commissioner's claim that the audit firms of the network are to be considered agents one for the other (or joint venturers with one another) in their auditing of Parmalat entities. Even though a comparison between the chances of success in the US (if any) with the chances of success in Italy (if any) would require a thorough investigation of legal doctrines that is beyond the scope of this article, our general impression is that a claim of this nature might be attempted also under Italian law, despite the absence of precedents on the issue. Needless to say, the establishment of a network liability would affect the governance of auditor networks. If the actions against parent companies and networks in the US are successful, audit networks will have to reflect on their governance systems and possibly adopt more transparent group structures.

⁹⁴ Milan Tribunal, 18 June 1992, *Banca Popolare di Milano, Bipiemme Leasing v. KPMG*, *Giur. it.*, 1993, I, II, c. 1.

⁹⁵ Cassation Court, 18 July 2002, n. 10403, *Arthur Andersen v. Carraro*, *Foro it.*, 2003, 1, 2147; Milan Court of Appeal, 7 July 1998, *Carraro v. Arthur Andersen, Soc.*, 10/1998, 1171.

⁹⁶ Milan Tribunal, 18 October 1999, *Efim v. Coopers & Librand*, *Giur. it.*, 2000, 570.

⁹⁷ Rome Tribunal, 26 April 1999, *Alumix v. Reconta Ernst & Young, Soc.*, 10/1999, 1232.

Potential defences of *in pari delicto*, contributory negligence or fault, and unclean hands, were not considered by the decision. As far as creditors' actions are concerned, in the *I.F.C.* case the liquidator of an insolvent financial intermediary successfully recovered damages suffered by the bankrupt intermediary's investors and creditors.⁹⁸ The typical situation of US securities litigation appears in the last case, the *FIN.GE.M.* case, regarding the successful action of a sophisticated investor who had bought on the market Ferfin's shares (Ferfin was a listed company of the bankrupt Ferruzzi Group)⁹⁹ relying on the information contained in the prospectus, whose financial statements were audited by Price Waterhouse.¹⁰⁰

Needless to say, the numbers are striking. Maybe there are some unreported cases. Clearly there have been settled cases. Nevertheless, it seems evident that private enforcement of auditor liability is very weak, unless one optimistically believes that reputational incentives are so strong in Italy as to make private litigation unimportant.

12. Administrative and criminal sanctions

We have mentioned Consob's powers as far as administrative sanctions ('disqualification') are concerned. Needless to say, auditors can also commit criminal offences, when they wilfully state false information in order to enrich themselves and with the specific intention of deceiving the readers (Article 2624 Civil Code). The prison term can vary, up to a maximum of 4 years. However, imprisonment terms are usually very short, and the auditor would in any event benefit from the large array of alternative criminal sanctions aimed at avoiding imprisonment.

C. STATUTORY AUDITORS

13. The collegio sindacale

In Italian joint-stock companies ("società per azioni" – spa) a board of statutory auditors (*collegio sindacale*) is foreseen with monitoring tasks (Articles 2397 ff.). Traditionally, the board of auditors was entrusted with the audit of the company's accounts. However, the board of auditors

⁹⁸ Turin Tribunal, 18 September 1993, *I.F.C. Istituto Fiduciario Centrale v. KPMG*, *Giur. it.*, 1994, I, 2, c. 655; Turin Court of Appeal, 30 May 1995, *KPMG v. I.F.C. Istituto Fiduciario Centrale*, *Giur. comm.*, 1996, II, 492.

⁹⁹ *Supra* note 10.

¹⁰⁰ Milan Tribunal, 21 October 1999, *FIN.GE.M. v. Price Waterhouse and other defendants*, *Giur.it.*, 2000, 554.

has never been efficient in discovering mismanagement and frauds, a task which was subsequently transferred to outside auditors leaving to statutory auditors general monitoring duties. The traditional view in Italy is that statutory auditors are usually complacent because they are appointed by controlling shareholders. In a corporate governance system characterized by concentrated ownership, in which managers are often the company's controlling shareholders and directors are in general closely related to them, statutory auditors are appointed on the basis of friendship with controlling shareholders or professional ties. Usually statutory auditors are professional accountants ("commercialisti," who in the Italian tradition are experts in accounting, tax and company law matters). Indeed, firms often appoint as auditor the controlling shareholder's personal professional accountant, or a professional accountant the managers worked with in the past or still work with, or a partner of a professional firm offering its services to the management. This professional is appointed as chairman of the board and informally indicates the two other professionals to be appointed as members of the board. Thus, the board approaches problems with a consultant's rather than a monitor's attitude.

14. Statutory auditors in Italian listed companies

In order to strengthen the controls of listed companies, the auditing activity was passed on to external auditors in 1975.¹⁰¹ After the reform concerning listed companies that took place in 1998 (Consolidated Financial Securities Act – CFSA), statutory auditors' monitoring functions are limited to two areas. Firstly, they supervise the company's compliance with the relevant laws and statutes. Secondly, they monitor the management of the company, with particular regard to the compliance with standards of good management and the adequacy and functioning of the company's organisational and management structure (Article 2403 (1)). Needless to say, this monitoring role is still affected by the fact that statutory auditors are appointed by controlling shareholders. In order to limit the inherently complacent attitude of statutory boards, the CFSA mandated that listed companies introduce clauses in their articles of association that enable minority shareholders to appoint a statutory auditor (Article 148.2 CFSA). The introduction of this right was obviously a source of considerable debate. The law clearly wanted to offer minority shareholders an

¹⁰¹ The company law reform extends a similar regime to non-listed companies by subjecting their accounts to the audit of either an individual registered auditor or a registered auditing company; however, in the case of non-listed companies which do not publish consolidated accounts the articles of association can reserve the audit of the accounts to the board of statutory auditors provided that its members are all registered auditors (Article 2409-bis).

access to boards in order to prevent the establishment of lax auditing procedures by statutory auditors. One could also suspect that one purpose was to provide minority shareholders with access to relevant information. Companies complained that a minority shareholder with no significant stake in the company could have appointed an inexperienced or malevolent statutory auditor, thereby creating an atmosphere of distrust and conflict in the board room. Scholars and courts accommodated both arguments, holding that the rule is addressed to institutional shareholders and minority shareholders possessing a significant stake in the company. Therefore all Italian listed companies have inserted a threshold in their articles of association, allowing minority shareholders to appoint a statutory auditor only if they represent a significant percentage (usually, from 0.5 to 5%) of the voting rights.

15. Funds and the minorities' statutory auditor in Parmalat

Something strange happened in Parmalat. As noted by many commentators, Italian fund management firms have been curiously untouched by Parmalat's insolvency, in contrast with foreign asset managers.¹⁰² Moreover, only eight out of one hundred and sixty six pension funds were invested in Parmalat at the time of its collapse.¹⁰³ Clearly the national asset managers had spotted problems.¹⁰⁴ The role of the auditor appointed by the minority shareholders could help to explain the circumstance.

Parmalat's articles allowed minority shareholders representing at least 3% of the voting rights to appoint a statutory auditor. In 1999 institutional investors were successful in appointing a statutory auditor to Parmalat's board. However, at the end of her three-year term in 2002 the minority appointed auditor informed the institutional investors that she was not available for re-appointment. It is rumoured that her decision was construed by the industry as an alarm signal. As a consequence, many funds sold Parmalat shares and thus at the general meeting of 2002 institutional investors were not able to reach the required threshold and therefore could not appoint a statutory auditor for the minority shareholders.

¹⁰² Funds International, *Parmalat collapse leaves most scars on US fund managers*, 31 October 2004.

¹⁰³ Commissione di Vigilanza sui Fondi Pensione (COVIP), Report of the Chairman to the Parliamentary Commission, 29 January 2004 (at <http://www.covip.it>).

¹⁰⁴ This is not COVIP's explanation, by the way. COVIP's chairman explains the circumstance praising the regulatory constraints concerning pension funds' investments: see *supra* note 103.

If confirmed, this account would add credibility to the idea that well before the end of 2002 information concerning Parmalat's problems was buried in the market.

16. Adverse Selection At Work

We have outlined that in Italy statutory auditors are generally considered unreliable gatekeepers because they are often professionals appointed by controlling shareholders and are often complacent figures rather than investigative ones. Lack of independence exposes them to “tit-for-tat strategies” similar to the ones analyzed with reference to external auditors.

However, there are two further issues that make the Italian corporate governance structures peculiar. First, statutory auditors do not fit the “market incentives” account of the gatekeepers' role. It is worth recalling that the traditional market theory of gatekeepers was based on the following reasoning: any gatekeeper can be easily deterred because she shares none of the gains of fraud (or just a small fraction of it) and is exposed to a large fraction of the risk (in the form of reputation disruption and also legal liability). Accordingly, she has all the incentives to efficiently monitor the company and stop or denounce wrongdoings, even though it is the company that pays her. Of course, the theory assumes that the gatekeeper enjoys a wide reputation and has at least some assets pledged, in form of company capital or partners' unlimited liability. However, a statutory auditor has only his own personal assets, which can be easily covered in order to make any negative judgment difficult to enforce.¹⁰⁵ Most important, his reputation is usually limited to a restricted circle of persons, among which usually are the shareholders and managers who appoint him. Accordingly, the reputation argument can be reversed. The statutory auditor builds up his own reputation among a small social circle that appreciates professional skills and cooperative behaviour more than the inquisitive side of an independent and effective gatekeeper. In short, adverse selection is at work as far as statutory auditors are concerned.

Second, the Italian financial watchdog (Consob) has publicly stated that it heavily relies on statutory auditors to detect frauds and launch investigations.¹⁰⁶ Clearly Consob's reliance on

¹⁰⁵ On the judgement-proof problem, see Steven Shavell, *Foundations of Economic Analysis of Law*, Cambridge: Belknap Press of Harvard University Press, 2004, 230.

¹⁰⁶ The Report of the Chairman of Consob to the Parliamentary Commission, *supra* note 14 states as follows: “In this institutional setting it is to be pointed out that the relevant rules, included in the Consolidated Financial Services Act of 1998, assign a fundamental role to internal corporate governance, primarily to the board of statutory auditors. This body is bound to timely disclose to Consob the wrongdoings found in the company's management and to report on

statutory auditors as its “eyes and ears” in market supervision is a passive approach that relies on the wrong detectives, so ultimately eroding the quality of public enforcement. This passive approach is based on a very narrow reading of the law emphasizing that statutory auditors have a duty to whistle-blow to Consob on all corporate wrongdoings found in their monitoring activities. However, a different interpretation of the law would be preferable, assigning to the Securities Commission a proactive role with limited reliance on statutory auditors, who should rather be subject to intense scrutiny by Consob as to the performance of their monitoring duties.

D. OTHER GATEKEEPERS

17. Investment banks and universal banks

Other gatekeepers are underwriters and other financial intermediaries whose services are used to gain reputation, attorneys, analysts. The arguments offered to explain why auditors’ reputation is not enough to grant efficient auditing services can be extended to other reputational intermediaries. Incentives concerning career advancement within banks and large law firms create an agency problem, which can be exacerbated by a euphoric bull market. In the absence of efficient internal controls and effective deterrence, reputation is no longer an asset to be preserved at any cost.

Underwriters can be held liable if the prospectus contains a material misrepresentation or omission and a due diligence defence cannot be established. In the first Italian case concerning prospectus liability, the underwriting bank was held liable for not having conducted reasonable investigation of the accuracy of the prospectus drafted by the issuer in connection with a bond placement.¹⁰⁷ However, this case is today still the only significant decision on the issue. Again, deterrence through private enforcement is virtually absent in Italy.¹⁰⁸ Parmalat’s Commissioner

the meetings and the enquiries made, transmitting all relevant documents. The underlying philosophy of the Consolidated Financial Services Act is that the internal monitoring body of the company is better placed than a third party to timely spot possible wrongdoings of the managers and report the same to public authorities such as Consob and public prosecutors.”

¹⁰⁷ See Milan Trib., 11 January 1988, II Giur. Comm. 585 (1988); Milan Court of Appeal, 2 February 1990, II Banca borsa 734 (1990); Guido Ferrarini, *Sollecitazione del risparmio e quotazione in borsa*, G.E. Colombo – G.B. Portale (eds.), *Trattato delle società per azioni*, 10**, Torino: Utet, 1993, 289.

¹⁰⁸ Usually underwriters also take the role of sponsors in the listing of a company. The rules of the Italian Stock Exchange demand companies to use a financial intermediary in the process of listing. The financial intermediary

actions against the bankrupt company's investment bankers are the first massive civil action against investment bankers as gatekeepers concerning an Italian group. It is no coincidence, however, that the most significant actions taken by Parmalat's Extraordinary Commissioner started in the US against Citigroup and Bank of America.

In the recent Italian financial scandals banks have been under attack, in the media and in the courts, for the breach of rules of conduct governing their activity as investment brokers. Allegedly, banks advised their clients to buy Cirio bonds, knowing that the proceeds would be used, as agreed with the issuer, to repay the food group's bank loans. Moreover, many banks advised their clients to buy high interest bonds, such as those issued by Argentina, Cirio or Parmalat, which were not suitable to their clients' portfolios. The public uproar, the activism of consumer associations that fuelled investors' litigation (even though not comparable to US class-action litigation), and investigations carried out by the capital markets supervisor and criminal prosecutors forced the most exposed banks to open settlement discussions with their clients. This situation shows another typical pattern of the Italian (and probably European) enforcement system. When great cases explode, criminal prosecutors step in and investigations end up in the hands of criminal judges. The Ferruzzi case created a huge criminal investigation at the beginning of the 1990s. The Cirio and the Parmalat cases did the same in the new decade. As we have noted, no significant civil litigation lies in the middle of the cyclical explosion of criminal scandals and the ensuing response on the part of the politicians.

18. Attorneys and analysts

Transactional attorneys are routinely involved in financial transactions and securities placements. In Italy most of the important players are the Italian offices or affiliates of top London or US law firms. They are usually involved in due diligence, transactional engineering, drafting of prospectuses and contracts, compliance. They are very well paid for their role, "as if" liability were attached to the gatekeeper's position they take. However, no single case concerning attorney liability in financial market transactions has yet been published.

As far as analysts are concerned, Consob's regulation affects research disclosure.¹⁰⁹

has to take responsibility in connection with the company's compliance to listing rules and corporate information rules. As yet there is not a single case concerning sponsor's liability.

¹⁰⁹ It is arguable whether an analyst's civil liability can be established in tort, and under what conditions: Alberto Mazzoni, *Osservazioni in tema di responsabilità civile degli analisti finanziari*, 1 *Analisi giuridica dell'economia* 209 (2002).

Analysts' reports prepared for general circulation have to be posted in the stock exchange's website.¹¹⁰ As we noted, one analyst only posted negative reports from 5 December 2002 to 17 November 2003.¹¹¹ Nevertheless no investigations comparable to those conducted by the Attorney General of the State of New York Eliot Spitzer have been launched after the Parmalat affair: Italy has not benefited from any competition among regulators in this field.¹¹² Analysts' behaviour in the Parmalat case raises many questions. A thorough investigation would be needed in order to understand whether the "buy" and "hold" recommendations were motivated by conflicts of interest. Indeed there is also a serious possibility that the market was already discounting Parmalat's poor governance, as analysts' reports took into consideration Parmalat's opaque management and financial structure. In defence of the unconcerned analysts that continued to issue "buy" or "hold" recommendations, one could point out that there was a large valuation gap between Parmalat and its competitors and, as a consequence, Parmalat seemed to be cheap. Further research in this area is needed.¹¹³

19. Another example of weak enforcement of capital markets law: the SCI case

We think that the numbers of published cases concerning gatekeepers' liability offer evidence of a weak level of enforcement, even if one takes into consideration the size of the financial market involved. Though not relating to gatekeepers, one further example can be added to the picture regarding private enforcement in securities markets. The first case concerning civil

¹¹⁰ Article 69 Consob Regulation no. 11522/1998.

¹¹¹ See *supra*, par. 2.

¹¹² For an example of beneficial competition among regulators see *infra*, par. 20. The competition between Spitzer and the SEC has been analyzed by Jonathan Macey, *The U.S. Experience: Wall Street in Turmoil: State-Federal Relations in U.S. Regulation of Corporations and Market Post-Eliot Spitzer*, paper for the symposium "Changes of Governance in Europe, Japan, and the U.S. Corporations, State Markets, and Intermediaries, Berlin, 9-11 September 2004. See also John R. Kroger, *supra* note 82, at 65, writing that "Spitzer is successful, and the SEC is not, because Spitzer is able to gather intelligence about market problems in an effective manner and then prioritize and attack those problems swiftly."

¹¹³ Analysts have been the target of much debate after the Enron collapse: amongst the others, John R. Kroger, *supra* note 82, at 38-45 (discussing analysts' debacle with reference to Enron) and 55-56 (commenting the wake of litigation affecting analysts after Enron); Jonathan R. Macey, *Efficient Capital Markets, Corporate Disclosure, and Enron*, 89 Cornell L. Rev. 394 (2004); Stephen J. Choi – Jill E. Fisch, *supra* note 56.

liability arising from insider trading has only been recently decided in Italy. It involved a group of banks that were negotiating, as large creditors, the rescue of a small listed company on the edge of insolvency. When negotiations came to a halt the banks, separately and massively, sold their shares before any information had been passed onto the market. The Court held them liable for damages in tort. However, damages were not calculated using a “fraud-on-the-market” theory, but adopting “fairness” criteria more favourable to the defendants.¹¹⁴ Damages are another area where European courts are very prudent.

20. *The Sai-Fondiaria saga*

An account of the poor record in the enforcement of Italian capital market law would not be complete without any reference to the Sai-Fondiaria saga, a well known case of elusion of mandatory takeover rules that started in summer 2001. At the beginning of 2002 Sai, a large insurance company, was stuck in a situation where it had promised (acting in concert with Mediobanca) to buy a large stake in Fondiaria, another large insurance company, but could not purchase the shares because this would have triggered mandatory takeover rules (pursuant to Articles 106 and 109 CFSA). In order to elude the problem, Sai and Mediobanca used five intermediaries (among which JP Morgan and Commerzbank), which bought the stake that Sai should have purchased. The five intermediaries claimed to have acted independently, i.e. not in concert, notwithstanding the large premium they were paying on the shares; in spite of these declarations, they were immediately and ironically renamed “The White Knights” by the financial press.¹¹⁵ Following the White Knights’ intervention, Consob received many complaints but succinctly dismissed them without any further investigation, asserting that there was no evidence of a running action in concert between Sai (and its five White Knights) and Mediobanca. After this decision Sai’s and Fondiaria’s shareholders agreed a merger and soon after Sai bought the White Knights’ stake in Fondiaria. As a consequence the antitrust authority opened a proceeding in order to ascertain whether the concentration would create a dominant position in the insurance market, taking into consideration Mediobanca’s influence over Sai, Fondiaria and Generali. Two days later an inspection was ordered in the offices of Mediobanca, Premafin (Sai’s controlling shareholder),

¹¹⁴ Milan Tribunal, 14 February 2004, *Matteini v. Intesa, Unicredit and other banks*, Foro it. 1567 (I/2004).

¹¹⁵ Giuseppe Oddo - Riccardo Sabbatini, *Fondiaria, Sai trova un tris di acquirenti*, Il Sole 24 Ore, 3 February 2002, in an article starting as follows: “Non uno ma ben tre cavalieri bianchi sono giunti in soccorso della Sai” (Not one, but three white knights arrived to help Sai).

Sai, Fondiaria, Generali, Compagnia Fiduciaria Nazionale and Interbanca. The existence of secret, unwritten agreements was confirmed by the inspectors.¹¹⁶

The Sai-Fondiaria case is another tale of poor enforcement. Fondiaria's minority shareholders had to rely on complaints lodged to the financial supervisor, who did not take any active role. If it had not been for another agency, the antitrust authority, the elusion would have remained undisclosed. Up to now only a few large Fondiaria blockholders are suing the concerting parties, claiming damages suffered because of the elusion of the mandatory rules.¹¹⁷ In the absence of any class-action mechanisms, dispersed shareholders' rights have not been taken to courts.

IV. VINDICATING THE PUBLIC INTEREST: ENFORCEMENT IN THE EUROPEAN CONTEXT

21. *The current Italian discussion concerning class actions*

In the wake of recent financial scandals and an antitrust case involving a massive cartel in the motor insurance market,¹¹⁸ the Italian public has discovered that it is difficult to deter substantial wrongdoings through private actions, in the absence of effective aggregation mechanisms. Existing (ineffective) mechanisms are based on the role of consumer associations, which have no standing in actions to recover damages and can only obtain cease or desist orders to protect consumers' interests. The news that only a few days after Parmalat's insolvency a class action had been started in the US against individuals and investment banks, as well as rumours that Italian investors might be positively affected by it, gave a strong impulse to the debate concerning the introduction of class action-like mechanisms in Italian civil procedure.

Indeed, an insolvency procedure such as that of Parmalat is probably the only mechanism of collective action in Italian private law, since the liquidator, as we have already pointed out, is entitled to sue the gatekeepers in order to get compensation for the company's and creditors' losses. It is clear that the collective action of an insolvency liquidator usually comes too late, and not all the liquidators adopt the aggressive approach Mr Bondi is meritoriously following: after all, also

¹¹⁶ In a scenario completely re-shaped by the results of the antitrust watchdog analysis, an administrative court declared the Consob's decision to be null and void and ordered Consob to re-evaluate the case. For further details see Consiglio di Stato, 13 May 2003, no. 4142, Giur. It. 2107 (2004), with comment of Eva Desana, *Opa obbligatoria "da concerto occulto": alcune osservazioni a margine della vicenda Sai-Fondiaria*.

¹¹⁷ *Vertenze tra ex soci Fondiaria*, Il Sole 24 Ore, 18 December 2004.

¹¹⁸ See Paolo Giudici, *Private Antitrust Law Enforcement in Italy*, 1 Comp. L. Rev. 61 (2004).

liquidators are public servants and may face problems of incentives.

The dominant impression concerning Italy is that private enforcement is under-developed because courts are extremely slow and inefficient.¹¹⁹ This is undoubtedly true, but it is not the only reason why securities law, as well as antitrust law and consumer protection law, are under-enforced. The motor insurance case in antitrust and the Parmalat case in capital market law show that it is essential for a modern civil liability system to be able to vindicate collective interests, otherwise under-enforcement creates incentives to adopt socially inefficient behaviours such as horizontal cartels and market frauds. As we will point out, however, even American style class actions would not change the pattern of Italian private enforcement. Private enforcement cannot be ameliorated without revolutionary changes to the whole civil procedure system, since the current Italian system is simply not suited to disputes concerning the protection of investors' diffuse interests.

Since one of the most striking differences between the US and European scandals concerns the pattern of litigation, the problem of private enforcement in Italy (and Europe) needs to be set in context.¹²⁰

22. *The interplay between private and public enforcement: theory*

From a welfare economics perspective, where civil remedies are not seen in terms of compensation and corrective justice, liability systems and government regulations have to establish optimal levels of deterrence. The dimensions of legal intervention are different. Professor Shavell has classified the methods of legal intervention using three fundamental dimensions: (i) time of intervention (intervention before acts are committed, after acts but before harm, after harm); (ii) form of intervention (i.e. sanctions); (iii) parties entitled to bring actions (public v. private enforcement).¹²¹ Needless to say, these dimensions are closely connected.

As far as securities frauds are concerned, non monetary fines (e.g. imprisonment) are needed

¹¹⁹ For a recent investigation see Daniela Marchesi, *Litiganti, avvocati e magistrati. Diritto ed economia del processo civile*, Bologna: Il Mulino, 2003. With reference to corporate courts it has been pointed out that Italian judges have a formalist approach, do not possess basic notions of corporate finance, accounting and business administration, do not have experience in handling complex cases and, moreover, have a deferential attitude towards corporate insiders: Luca Enriques, *Do Corporate Law Judges Matters? Some Evidence From Milan*, 3 Ebor 765 (2002).

¹²⁰ One of us has investigated the issue with reference to antitrust enforcement; the following paragraphs draw from Paolo Giudici, *supra* note 118.

¹²¹ Steven Shavell, *supra* note 105, at 572-575.

because, moral considerations apart, the level of the private benefits that can be achieved through fraud is so high that civil suits cannot be sufficient to deter the violator, since his assets will never be sufficient to redress the social cost of his action.

In order to prevent fraud, mandatory disclosure is also needed. A system of mandatory disclosure has to rely on a public enforcer, able to intervene when a company is seeking to hide information and able to “verify the veracity of the number disclosed”, an action that “a private intermediary can only do ... through a lawsuit, an avenue which is very slow and expensive”¹²² (assuming that discovery mechanisms are effective). Monetary civil fines (administrative fines, in Continental Europe) are also usually associated with public enforcement of mandatory disclosure.

In theoretical terms some scholars argue that public enforcement offers two advantages. First, it allows better control in setting the optimal monetary or non-monetary sanction in accordance with the theory of deterrence, because a single public enforcer can take into proper consideration social cost and the probability of detection when deciding punishment. Damages awarded in private litigation can be unrelated both to the social cost and the *ex-ante* probability of detection of the violation, and when used together with administrative or criminal fines may alter the optimal (even though purely theoretical) level of deterrence. Second, public enforcers usually have stronger investigative powers and are equipped to discover information that private parties cannot disclose. This aspect is not only related to the need to control interferences in private life, but also to the economies of scale and scope that can be necessary to create an efficient system of identification and apprehension of violators.¹²³

However, as far as the first point is concerned, no public body can realistically calculate on a case-by-case basis the social cost of wrongdoings; and it is in any event impossible to assert *ex ante* the probability of detection if the actual level of diffusion of wrongdoing is unknown. In such a situation, there are at least three strong arguments against a system that relies entirely on the public enforcement of law. First, in the real world public agencies are not usually the most efficient enforcers because they cannot have access to the widespread information that private parties naturally possess.¹²⁴ As we have seen, the Parmalat story is a case in point. Second, they lack

¹²² Luigi Zingales, *The Costs and Benefits of Financial Market Regulation, Regulation*, ECGI - Law Working Paper No. 21/2004.

¹²³ Steven Shavell, *supra* note 105, at 580-581.

¹²⁴ Steven Shavell, *supra* note 105, at 578-579.

adequate financial resources to investigate all potential wrongdoers and to pursue all pending investigations with the same unrestricted vigour.¹²⁵ Third, the public agency can face agency costs in the same form of auditors and other gatekeepers, because the public servant could be “amenable to payoffs”, as Professor Easterbrook has written.¹²⁶ The “revolving door” between public and private jobs, i.e. the incentive to be not too harsh with some wrongdoers in view of potential future employment with them in the private sector,¹²⁷ and political influence are very easy examples of the nature of these payoffs, if one does not want to mention bribery, the extreme form of payoff.¹²⁸

¹²⁵ In favour of private attorneys general it is argued, for instance, that they ensure enforcement as they are “not wholly dependent on the current attitudes of public enforcers”: John C. Coffee Jr., *Rescuing the Private Attorney General: Why the Model of Lawyer as Bounty Hunter Is Not Working*, 42 Md. L. Rev. 215, 227 (1983); Trevor Morrison, *Private and Attorneys General and the First Amendment*, Cornell Law School Research Paper No. 04-017, 20 ff., reviewing the arguments in favour and against private attorneys general.

¹²⁶ With reference to the public prosecutor in antitrust cases, Professor Easterbrook writes: “Unable to capture the benefits of his work, he would tend to shirk. He might seek to maximize something other than allocative efficiency. He also would be amenable to payoffs, perhaps in the indirect form of future employment (the ‘revolving door’ between public and private jobs) or support for future political campaign.” Frank Easterbrook, *Detrebling Antitrust Damage*, J. Law & Ec. 445, 454 (1985). See also Edward L. Glaeser - Daniel Philip Kessler – Anne Morrison Piehl, *What Do Prosecutors Maximize? An Analysis of the Federalization of Drug Crimes*, (December 1998 - revised November 1999), Stanford Law John M. Olin Working Paper No. 170.

¹²⁷ Doubts concerning the existence of such an “agency problem” affecting regulators have been recently raised by Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience*, (November 2004). Georgetown Public Law Research Paper No. 624582. Professor Langevoort argues as follows: “Two problems, however, make this problematic. First, the broad consensus among officials needed for significant action makes it hard for one or a handful of officials to push policy in the direction of a particular interest. Second, the dominating strategy for opportunistic officials may be instead to create some new body of regulation that is dense and difficult to interpret or apply, and upon departure claim the rents associated with expert informational advantage.”

¹²⁸ Edward Glaeser – Simon Johnson – Andrei Shleifer, *Coase Versus the Coasians*, Quart. J. Econ. 116-3, 853 (2001), adopt a different approach and reach different conclusions, asserting that regulators are more aggressive enforcers than courts; however, in their analysis the authors “focus on the inquisitorial legal system of civil law countries, where the judge must himself undertake an investigation into the facts of the situation and the law” (at 856). Generally speaking, this preliminary assumption is wrong as far as private enforcement is concerned, since also in the so called “inquisitorial legal systems” facts have to be submitted to the Court by the litigants. Indeed all the emphasis on the differences existing between adversary and inquisitorial models is, as a well known specialist of the field has

For all these reasons private parties are provided with economic incentives to report wrongdoings, in the form of damages, restitution, bounties or any other form of monetary reward whatsoever.¹²⁹ Accordingly, even though the private incentive to bring suit remains “fundamentally misaligned with the social optimal incentive to do so, and the deviation between them could be in either direction”,¹³⁰ it is nonetheless advisable to have a certain level of private enforcement pressure. If one wants to add to these arguments considerations of corrective justice, it is clear that the issue is not whether or not private actions should have a role in securities law enforcement. Rather, the problem is, in effect, that of reaching a balance between private and public enforcement and creating formal or informal effective mechanisms for coordinating the roles of the two institutional frameworks (litigation and regulation), as is usual in fields where there is a cumulative effect of both.¹³¹

23. Class actions

In civil procedure law the most significant device to aggregate damaged parties is the class suit. When private interests are widespread, the violator could avoid costs because each victim’s injury is too small to warrant suit.¹³² If each victim’s injury is significant, independent actions create duplicative litigation. The main regulatory instrument that can be used to aggregate victims’ interests and create economies of litigation scale, thereby enforcing mass claims through the

written, “meaningless”: Michele Taruffo, *Sui confini*, Bologna: Il Mulino, 2002, 80.

¹²⁹ Steven Shavell, *supra* note 105, at 578-579; Reinier Kraakman, *supra* note 51, at 60-61. It must be noted that civil law countries such as Italy have never adopted *qui tam* legislation or citizen-suit provisions, enlisting citizens in law enforcement (on the subject, from a US perspective, Ben DePoorter – Jef De Mot, *Whistle Blowing*, George Mason University School of Law, wp No. 04/56, 2004). Accordingly, in countries like Italy private incentives are always in the form of damages. Usually the right to claim damages is associated to violations of public regulation specifically constructed (in order to grant the action) as instruments to protect private interests also.

¹³⁰ Steven Shavell, *supra* note 105, at 391.

¹³¹ W. Kip Viscusi, *Regulation through Litigation*, Washington D.C.: Brookings Inst., 2002, 3. For a recent analysis of the interplay and overlap of SEC public enforcement proceedings and private enforcement of securities regulation cf. James D. Cox - Randall S. Thomas (with the Assistance of Dana Kiku), *Sec Enforcement Euristic: An Empirical Inquiry*, 53 *Duke L.J.* 737 (2003).

¹³² Fleming James Jr. – Geoffrey C. Hazard Jr. – John Leubsdorf, *Civil Procedure*, New York: Foundation Press, 2001, 643.

liability mechanism and the action of private parties is the class suit. Since class actions require lawyers to find potential cases and launch expensive, complex multi-parties suits, and attorneys compete to be vested with the right to prosecute all the aggregate claims, the class suit is by definition a lawyer-driven litigation. That creates, once again, a well studied agency problem: an attorney's interest can conflict with those of his or her clients. "The lawyer for the class will be tempted to offer to settle with the defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant, provided the sum of the two figures is less than the defendant's net expected loss from going to trial."¹³³

Securities litigation class actions faced, in the 1990s, strong criticism. Securities class suits were perceived to be "epidemic" and too frequently based on "frivolous" claims aimed at coercing companies to settle in order to avoid disproportionate legal costs, especially in the form of discovery costs. "The increasing disenchantment for much of the public with the class action (and possibly with private enforcement of law in general)"¹³⁴ led to the PSLRA,¹³⁵ designed to curtail class actions in securities litigation. A rich body of empirical research is now investigating the actual effects of the PLSRA on securities litigation.¹³⁶ Nevertheless, class actions still exist and are increasing in the wake of the corporate scandals, notwithstanding the PSLRA and the many proposals to repeal it.¹³⁷

From a European perspective it must be noted that the US debate concerning the defects of the class action mechanisms and the pros and cons of the PSLRA tends to develop its arguments from a situation where class action exists: the issue is how to control their defects and, particularly,

¹³³ Richard Posner, *Economic Analysis of Law*, New York: Aspen Publishers, 2003, 6th edition, 586.

¹³⁴ Richard W. Jennings – Harold Marsh Jr. – John C. Coffee Jr. – Joel Seligmann, *Securities Regulation. Cases and Materials*, 8th edition, Westbury, NY: Foundation Press, 1998, 1250.

¹³⁵ *See supra*, par. 9.

¹³⁶ Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?* (June 2004), UC Berkeley Public Law Research Paper No. 558285; USC CLEO Research Paper No. C04-11; USC Law School, Olin Research Paper No. 04-16.

¹³⁷ For a discussion see Adam C. Pritchard, *Should Congress Repeal Securities Class Action Reform?*, 471 Policy Analysis 1 (2003).

the agency problem created by the attorney-class relationship.¹³⁸ As far as we know, nobody has seriously suggested the repeal of class actions. Indeed, a liability system cannot operate when there are mass damages and there is no effective aggregating device, because it leads to under-deterrence unless a very efficient public alternative is at work. However, an efficient public enforcement system cannot exist because of the three problems we have pointed out. Italy is a case in point. The result is strong under-enforcement. This conclusion is supported by empirical research concerning the control premium of transactions in Italy, which show that private benefits of control are very high and correlate this fact with a weak legal system that, as we have shown, is not weak in substance, but in enforcement.¹³⁹ The introduction of class action-like mechanisms is deemed to be a forced step to improve the liability system in many European countries. England has recently enacted new instruments that permit the pooling of separate claims against one defendant,¹⁴⁰ and in Germany it is debated how to introduce class action devices.¹⁴¹

24. Further advantages of class actions: breaking down social networks

We would like to advance a further argument in favour of class actions.

It is well known that economic systems with low enforcement of legal rights tend to survive

¹³⁸ Jonhatan Macey – Geoffrey Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1 (1991).

¹³⁹ Rafael La Porta - Florencio Lopez-de-Silanes – Andrei Shleifer – Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. Fin. 1131 (1997); Andrei Shleifer - Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737 (1997); Rafael La Porta – Florencio Lopez-de-Silanes – Andrei Shleifer – Robert W. Vishny, *Law and Finance*, 106 Journal of Political Economy 1113 (1998); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. Fin. 471 (1999); Rafael La Porta – Florencio Lopez-de-Silanes – Andrei Shleifer, *What Works in Securities Law?*, Harvard University (2004) available at http://post.economics.harvard.edu/faculty/shleifer/papers/securities_0907.pdf (last access: 25 January 2005); Simon Djankov – Rafael La Porta – Florencio Lopez-de-Silanes – Andrei Shleifer, *Courts*, 118 Quarterly Journal of Economics 453 (2003).

¹⁴⁰ For references see Bernard Black – Brian Cheffins, *Outside Director Liability Across Countries*, Stanford Law School, wp n. 266, at 26-27, and at footnote 132.

¹⁴¹ See the Federal Government proposal of law at <http://www.bmj.bund.de/media/archive/798.pdf> On the issue see also Theodor Baums - Kenneth E. Scott, *Taking Shareholder Protection Seriously? Corporate Governance in the United States and Germany* (November 2003), Stanford Law and Economics Olin Working Paper No. 272; ECGI - Law Working Paper No. 17/2003.

thanks to social networks.¹⁴² Conversely, strong social networks may limit the adoption of liability rules for dispute resolution and, hence, limit the positive externalities related to the development of a rule of law. We think that the literature on class actions no longer considers the positive effect that class action grants as an instrument to break down social networks that usually, in small financial markets, hinder law enforcement. In a market where collective interest cannot be aggregated, only large creditors or blockholders can seriously face the cost of litigation in order to recover damages. However, large creditors and blockholders are usually members of a social and professional network that would have to sue members of their own club, a choice that can have a negative outcome in a repeated game. It is common experience in a country like Italy to see economic actors not enforcing their rights in order to avoid peer entanglement and the deterioration of some of their “club relationships.”

When lawyers are vested with the power to drive litigation, interpersonal links between plaintiff and defendant could be more easily broken and the rule of law could be more easily established.

25. Attorneys' fees

Contingency fees are deemed to be essential to the development of the entrepreneurial lawyer, who is the driving force of private enforcement, especially in the case of mass tort claims enforced through class suits.¹⁴³ The point is relevant, even though it seems to be over-emphasized (at least when it refers to well-grounded actions).¹⁴⁴ Contingency fees are probably necessary; however, they are not sufficient to ignite more effective forms of private enforcement.

Under the “American Rule”, applied in the US, a prevailing plaintiff does not normally recover from the loser its litigation expenses. However, the plaintiff can enter into a contingent fee

¹⁴² See, also for further references, Avinash K. Dixit, *Lawlessness and Economics. Alternative Modes of Governance*, Princeton – Oxford: Princeton University Press, 2004, 12-14; Ethan Bueno de Mesquita – Matthew Stephenson, *Legal Institutions and the Structure of Informal Networks*, Harvard Law School, Discussion Paper No. 419, 04/2003; Eric A. Posner, *Law and Social Norms*, Cambridge – London: Harvard Univ. Press., 2000; Douglass C. North, *Institutions, Institutional Changes and Economic Performance*, Cambridge: Cambridge University Press, 1990, 13; Robert C. Ellickson, *Order Without Law: How Neighbours Settle Disputes*, Cambridge, Mass.: Harvard University Press, 1994 (Reprint Edition).

¹⁴³ Luigi Zingales, *supra* note 122.

¹⁴⁴ See Luigi Zingales, *supra* note 122.

arrangement with its lawyer, by means of which in case of defeat he is liable for nothing but court costs and the lawyer's out of pocket disbursements; if he wins or settles, his lawyer takes a significant fraction of the recovery (usually one third).¹⁴⁵ Accordingly, lawyers can finance plaintiffs' actions. It must be noted that, under a contingency fee arrangement, redress of damages is never complete because the lawyer takes part of the recovery and the loser does not contribute.

European countries usually adopt the "English rule", i.e. the rule under which a prevailing party recovers her attorney's fees from the loser. Under this rule, the plaintiff's attorney could in theory still finance the action, with the loser paying the final sum. In this situation, however, the final sum cannot be negotiated in advance by the plaintiff and her lawyer, because it is a cost that the loser has to face. Accordingly, it is regulated by the law and fixed by the court. If the regulation and the court were able to take into consideration all the costs faced by the plaintiff's lawyer in terms of monitoring, identification of the case, financing of the case through her work etc., and the plaintiff's lawyer were allowed to renounce any advanced payment of fees before the case is ended, the "English rule" could also be more effective than the "American rule", for the loser would pay an amount of money closer to the social cost of his action (redress plus damaged party's legal expenses). Once again, the problem is in the application of the rule, not in its nature or quality. The English rule fails because its effectiveness depends on a form of public enforcement. Indeed, the regulator and the court have no information about the true costs of the plaintiff's attorney. Paternalism embedded in the European culture also influences the outcome. Italian courts quite often shift away from a rigid application of the rule and do not require the losing defendant to pay the actual amount of a plaintiff's litigation costs. A rule adopted to offer full redress to the damaged party ends up chilling lawyers' activism as "general private attorneys."

Not all claims, however, have crystal-clear chances of success at the start of the civil action. The English rule is clearly unfavourable to risk adverse plaintiffs, as it puts on the party – and not on her more informed lawyer – the risk of a negative outcome. From an Italian perspective, however, it has to be observed that courts, which do not apply rigidly the English rule, quite often do not require the losing plaintiff to pay the defendant's litigation costs (or the full amount) when the plaintiff's action had some grounds and the defendant has "deep pockets". Thus, the chilling effect of the English rule on risk adverse plaintiffs is not to be overemphasized in Italy.

¹⁴⁵ Fleming James Jr. – Geoffrey C. Hazard Jr. – John Leubsdorf, *supra* note 132, at 51.

26. Access to information: discovery rules

In order to start any enforcement action, information is needed. If a private party is directly involved in a deal, as in a standard breach of contract situation, she probably possesses relevant information. If an investor wants to start actions against a gatekeeper on the basis of a very preliminary set of information, things obviously become more complex.

Civil procedure law approaches the problem of access to information in various ways. The most radical approaches are no discovery and broad discovery. English Civil Procedure Rules 1998 (CPR 1998) and US Federal Rules of Civil Procedure (FRCP) allow extensive recourse to discovery.¹⁴⁶ The broadest range of discovery measures is offered by Rule 26 Federal Rules Civil Procedure (FRCP) in the US Federal system.¹⁴⁷ Even after the recent amendments aimed at containing discovery,¹⁴⁸ they can still impress, if not shock, any continental European lawyer. Parties can not only access documents held by their opponents, but they can also inspect offices with detective-like powers that are simply inconceivable in continental Europe (at least, as far as Italy, Germany and France are concerned). The discovery phase is the core of litigation and, as Professor Hazard has pointed out, “a procedural institution perhaps of virtually constitutional foundation.”¹⁴⁹ Since roughly 95% of all civil cases are resolved without trial, pre-trial discovery is ‘the trial.’¹⁵⁰

It is highlighted in the American literature that certain types of claims such as discrimination

¹⁴⁶ English compulsory disclosure rules are analyzed by Paul Matthews, *Disclosure*, London: Sweet & Maxwell, 2001, who briefly covers the main differences between England and the United States at 10-11.

¹⁴⁷ Rolf Stürner, *Transnational Civil Procedure: Discovery and Sanctions Against Non-Compliance*, 4 Rev. Dr. Unif. 871 (2001).

¹⁴⁸ Richard L. Marcus, *The 2000 Amendments to the Discovery Rules*, Fed. Cts. L. Rev. 1, (2001) <http://www.fclr.org/>; Rowe, *A Square Peg in a Round Hole? The 2000 Limitation on the Scope of Federal Civil Discovery*, 69 Tenn. L. Rev. 13 (2001); Jeffrey W. Stempel, *Politics and Sociology in Federal Civil Rulemaking: Errors of Scope*, 52 Ala. L. Rev. 529 (2001); Jeffrey W. Stempel – David F. Herr, *Applying Amended Rule 26 (B) (1) in Litigation: The New Scope of Discovery*, 199 F.R.D. 396 (2001).

¹⁴⁹ Geoffrey Hazard Jr., *From Whom No Secrets Are Kept*, 76 Tex. L. Rev. 1665, 1694 (1998).

¹⁵⁰ Michele Taruffo, *supra* note 128, at 80.

claims would not have been possible without broad discovery granted to plaintiffs.¹⁵¹ Cases where discovery is also an essential tool in the hands of plaintiffs are negligence torts, product liability claims, environmental degradation cases, antitrust and securities regulation cases.¹⁵²

Italian procedural rules allow broad discovery in a very limited and defined set of marginal cases. When reading a book on Italian civil procedure it may appear that access to the documents held by the other party can be obtained through a court order. The problem is that the party does not know exactly what documents his opponent has, and the court cannot grant any disclosure order unless a document is specifically indicated. Moreover, if the party obliged to discover the document does not comply, the court can only consider this issue when deciding on the merits. The same is true for German and French laws. Hence, discovery is virtually absent. Given the lack of efficient discovery rules, investor action against mass wrongdoings is virtually impossible in Italy as it is in the rest of Europe, unless information is gathered by public authorities.¹⁵³

27. *Interplay between pleading rules and discovery rules*

The information situation at the beginning of the “game” is also influenced by the pleading rules. Basically, two different systems of pleading exist: “fact pleading” and “notice pleading”. As has been noted, “fact pleading requires a full statement of all material facts from the beginning of the pleading process; notice pleading requires only that the party against which the pleading is directed is given notice of the nature of the claim”.¹⁵⁴ Needless to say, the former system assumes that the plaintiff is in possession of all relevant information, while the latter expects that litigation is

¹⁵¹ Richard L. Marcus, *Discovery Containment Redux*, 39 B.C. L. Rev. 747, 751 (1998).

¹⁵² Jeffrey W. Stempel, *supra* note 148, at 603 ff.

¹⁵³ The role of discovery in private litigation is stressed by many articles in the European literature on private antitrust enforcement: see Paolo Giudici, *supra* note 118; Ernst-Joachim Mestmäcker, *The Commission’s Modernization of Competition Policy: A Challenge to the Community’s Constitutional Order*, 1 Ebor 401, 424 (2000). In the Italian literature on civil procedure law the analysis of discovery rules has been conducted by Professor Dondi. See Angelo Dondi, *Effettività dei provvedimenti istruttori del giudice civile*, Padova: Cedam, 1985; Angelo Dondi, *Questioni di efficienza della fase preparatoria nel processo civile statunitense (e prospettive italiane di riforma)*, Riv. Dir. Proc. Civ., 161 (2003). For a general review concerning Civil Law countries see Kuo-Chang Huang, *Introducing Discovery into Civil Law*, Durham, NC: Carolina Academic Press, 2003.

¹⁵⁴ L.J. Priestley, *Transnational Civil Procedure, - Fact Pleading v. Notice Pleading: its Significance in the Development of Evidence*, 4 Rev. Dr. Unif. 841, 842 (2001).

also a way of discovering and accessing information.¹⁵⁵ The US Federal and English systems are based on notice pleading. Civil law is generally based on fact pleading mechanisms.

Common law and civil code systems are on opposing ends of the spectrum as far as pleading and discovery are concerned. It could be argued that this difference is based on opposite conceptions of what private civil litigation is about. Many American scholars assert that in common law jurisdictions the promotion of justice is seen as a value at stake, whereas this is not true in civil law jurisdictions.¹⁵⁶ This assertion is contested by leading comparativists.¹⁵⁷ Nevertheless, it is clear that, at least in the US, the process enhances the vindication of the public interest in a more effective way than in civil law countries.¹⁵⁸ In the absence of fact pleading and discovery rules, in Europe any serious hope that investor claims could take a significant role in the enforcement of securities law is ungrounded.¹⁵⁹

¹⁵⁵ “Imposing on a plaintiff a requirement that the claim be articulated in detail means that only claimants who have access to such detail are in a position to state a claim”: Fleming James Jr. – Geoffrey C. Hazard Jr. – John Leubsdorf, *supra* note 132, at 181.

¹⁵⁶ Stephen N. Subrin, *Fishing Expeditions Allowed: The Historical Background of the 1938 Federal Discovery Rules*, 39 B. C. L. Rev. 691 (1998); Kevin M. Clermont – Emily Sherwin, *A Comparative View of Standards of Proof*, 50 Am. J. Comp. L. 243 (2003), arguing that the search of truth characterizes the American process. This view seems not be shared by leading comparativists.

¹⁵⁷ Professor Taruffo does not think that the American civil procedure is especially oriented to the search of truth: see Michele Taruffo, *Rethinking the Standards of Proof*, 51 Am. J. Comp. L. 659 (2003), criticising the article of Kevin M. Clermont and Emily Sherwin. Since discovery is one of the core issues of the debate, Professor Taruffo argues (at 676) that “one may wonder whether the American discovery, with its well known abuses, is really aimed at the search of truth or if its real purpose is not that of exerting pressures on the adverse party in order to achieve a forced settlement or of fishing for evidence that is needed to set up a case, although such evidence will not be presented at trial.” In his fundamental book on justice, Professor Damaska debates how discovery could fit a pure conflict-solving process (i.e. purely adjudicative): Mirjan R. Damaska, *The Faces of Justice and State Authority. A Comparative Approach to the Legal Process*, New Haven and London: Yale Univ. Press, 1986, 131-134. He does not suggest that the search of truth lies at the heart of discovery rules.

¹⁵⁸ Mauro Cappelletti, *The Judicial Process in Comparative Perspective*, Oxford: Clarendon Press, 1989, *passim*; Hein Kotz, *Civil Justice Systems in Europe and the United States*, 13 Duke J. Comp. & Int'l L. 61 (2003).

¹⁵⁹ Needless to say, introduction of discovery would raise litigation costs and, in “loser pays” systems (i.e. systems adopting the “English Rule”), that would considerably increase the risk to a plaintiff in initiating a private

28. *Derivative actions*

In a highly publicized attempt to develop private enforcement as a tool to influence companies' corporate governance, the CFSA introduced in 1998 derivative suits by minority shareholders into Italian law (Article 129 CFSA).¹⁶⁰ Many problems affected the new system, which has been recently introduced as a standard rule (Article 2393-bis) also in the general law of joint-stock companies (“società per azioni”). However, the most significant hindrance is probably the lack of discovery. In the absence of any instrument allowing the plaintiff to access information in the hands of the defendant company, and with “fact pleading” rules still governing plaintiffs' actions, derivative actions have had no effect on Italian corporate governance. As far as we know, there are no significant cases of suits started by minority shareholders in a derivative suit context up to now. Accordingly, derivative suits have not changed the pattern of a legal system where managers (appointed by controlling shareholders or controlling coalitions) are sued by insolvency liquidators only. Needless to say, liquidators do possess all relevant information needed to sue managers, since they have access to all the company's documents.

There was the hope that the statutory auditor appointed by minority shareholders would have helped in the diffusion of information needed to start legal proceedings, but that simply did not happen.

Of course, there are further explanations concerning the lack of derivative actions. An obvious explanation lies in the absence of incentives to establish lawyer-driven actions. Another explanation regards the size of Italian listed companies.¹⁶¹ In any event, we think that the absence of discovery rules is the most significant weakness of Italian derivative suits, and the reason why they will never be really effective in monitoring ex post managers' and controlling shareholders' conducts.

attorney general lawsuit against large firms with deep pockets, whereas in the US the defendant is not reimbursed by the plaintiff for the cost of the defendant's lawyers (see Richard L. Marcus – Martin H. Redish – Edward F. Sherman, *Civil Procedure. A Modern Approach*, St. Paul, Minn.: West Group, 2002, 100-106; Fleming James Jr. – Geoffrey C. Hazard Jr. – John Leubsdorf, *supra* note 132, at 48-53). From an Italian perspective, however, the difference between the English Rule and the American Rule should not be overemphasized for the reasons mentioned at par. 25.

¹⁶⁰ This move is discussed by Luca Enriques, *supra* note 119, at 780.

¹⁶¹ Stephen J. Choi, *The Evidence on Securities Class Actions* (April 7, 2004), UC Berkeley Public Law Research Paper No. 528145

29. *Interplay between public and private enforcement in Italy*

It must be noted that class actions and discovery rules are not the only institutional designs that could be framed to sort out the problems of collective action and access to information. Theoretically, an alternative institutional design could be to have a public agency vested with the power to investigate and make (autonomously or before a court) a factual finding in favour of private parties seeking individual redress before civil courts.¹⁶² In such a system, the public enforcer would create economies of scale and scope, and the general problem of access to information by the agency would be resolved as private parties would have strong incentives to report. Otherwise, a “partie civile” mechanism could be foreseen in administrative actions conducted by the agency, following the model of criminal proceedings in some Continental European countries, like France and Italy.¹⁶³

The Italian law system (as well those of the other countries in Continental Europe, as the antitrust experience shows) is unfriendly to this interplay between public and private enforcement; moreover, problems affecting public watchdogs’ incentives are always ready to resurface.

(a) *Incentives to report.* - Incentives granted to private parties to report wrongdoings are low. The watchdog receives many complaints every year, but the vast majority are too vague to establish an action without launching a specific investigation. In complex matters investors have to seek professional advice to draft a readable, persuasive complaint. However, professional advice is costly. Moreover, the investor has no costless control of the administrative proceeding. If the authority decides not to pursue a case, the complainant should seek judicial review of the decision. As usual, however, cost issues chill any attempt to pursue the matter any longer. Since the watchdog faces funding problems and cannot investigate all potential cases, the watchdog has to select cases. Case selection can be contaminated by the usual corporate governance problem, which a private attorney would not face at this stage. Moreover, as we have noted, the Italian watchdog case selection policy is affected by a misplaced reliance on the cooperative approach of statutory auditors. In some cases, viz Sai-Fondiaria, there have also been suspicions of political interference in the sphere of the independent agency.

(b) *Role of the authority’s factual finding.* – Italian public action is not equivalent to

¹⁶² For similar institutional designs, even though in the course of a completely different analysis, see Mirjan R. Damaska, *supra* note 157, at 160-164.

¹⁶³ Mauro Cappelletti, *supra* note 158, at 287-288.

discovery. Consob and the Bank of Italy do not provide a private investor with information needed to offer evidence concerning his own claim. A special rule concerning confidential information acquired in the course of public enforcement actions forces investors to use only the general factual findings mentioned in the final decision taken by the Authority, thereby denying access to any further information that could help in establishing a case against a wrongdoer. A well-known case concerned the Sai-Fondiaria affair, where Consob's decision denying the existence of a duty to launch a compulsory takeover bid was motivated so succinctly that investors could not understand the evidentiary basis of the decision.¹⁶⁴ Even though the watchdog pursues the case and offers in its administrative decision sufficient evidentiary basis for an independent civil action by the damaged party, the factual findings contained in the public authority's decision can be considered by the civil court, but are not sufficient evidence. In theory, the investor should be able to offer independent evidence of the asserted facts, an insurmountable burden of proof in the absence of discovery rules, even though sometimes courts relax the burden of proof requirements.¹⁶⁵

All these problems show that the system is not designed to offer a real interplay between public and private enforcement. In any event, when accessible information is sufficient to establish a *prima facie* case against the wrongdoers, duplicative litigation would be nevertheless unavoidable, in the absence of class action mechanisms; legal costs would also be too high to justify an independent legal action, because lawyers are not entitled to renounce to partial, advanced payment of their fees and the "English rule" is not strictly applied (and, in any event, it cannot be effectively applied).

30. Criminal prosecutions

Finally, we briefly consider criminal proceedings. When private parties join criminal proceedings as investors are currently doing in the Parmalat case, they can benefit from the evidence offered by the prosecutors and can minimize the burden of persuading the court (a burden

¹⁶⁴ *Supra* note 116.

¹⁶⁵ Standards of proof in Italy, as in many civilian countries, are sometimes oblivious both in civil and in criminal litigation. As far as civil litigation is concerned, see Michele Taruffo, *supra* note 157. In criminal law the principle that proof must be beyond a reasonable doubt has been stressed, with reference to causation, in a recent case by Cassation Court, Joint Meeting (Sezioni Unite), 11 September 2002 no. 30328, *Riv. it. dir. e proc. pen.*, 2002, 1133 ff., commented by Federico Stella, *Etica e razionalità del processo penale nella recente sentenza sulla causalità delle Sezioni Unite della Suprema Corte di Cassazione*, 3 *Riv. it. dir. e proc. pen.* 767 (2002).

that in any event stays with the prosecutor). The absence of the weapons that we have briefly analyzed (class actions, discovery rules, notice pleading) becomes less important in damage claims for economic loss lodged in criminal proceedings. This explains why the Milan criminal proceedings have gathered a considerable bundle of civil claims. However, civil claimants' compensation depends on conviction. In criminal actions the standard of proof is different, because proof beyond a reasonable doubt is required, whereas in civil cases proof-standards are more relaxed - even though, at least in Italy, they are usually stricter than the standard of preponderance of the evidence.¹⁶⁶ It must also be considered that gatekeepers can be liable under civil law for frauds committed by managers and yet be innocent under criminal law as their negligent behaviour does not necessarily amount to crime. In short, the Parmalat case is special and one should not indulge in the belief that criminal law offers sufficient deterrence against market frauds. In fact, public enforcement in Europe is increasingly dissatisfied with criminal enforcement and adopts models of administrative enforcement, as has always been the case for antitrust in Europe.

V. CONCLUSION

The Parmalat scandal raises the well known gatekeepers' problem with respect to auditors, lawyers and financial intermediaries. It also confirms the low level of law enforcement in Italy, which might typify Continental Europe as a whole. Yet, the problem does not lie with the substantive rules concerning corporate governance and gatekeepers' standards of behaviour. The Italian system has been influenced by corporate governance debates and has sought to respond to the demands of modernization by acting on substantive rules. The problem is that there was no serious effort to reshape the enforcement system. The result is under-enforcement.

Europe's unfriendly approach to private enforcement of collective interests has to be reconsidered. An astonished Italian public learned from the mass-media shortly after Parmalat's collapse that civil actions were being launched, at a speed unthinkable for Italy, and in the United States, by a public agency (SEC) and by class-action lawyers. Similarly, Parmalat's reorganization procedure brought its three main legal suits in the US, one against Citigroup, the other against Grant Thornton and Deloitte, the third against Bank of America, claiming large amounts of money. On the

¹⁶⁶ In a newspaper article, Professor Federico Stella has pointed out that criminal prosecutions are a weak instrument for the vindication of widespread economic interests, since the burden of proof in criminal proceedings has to be beyond any reasonable doubt; accordingly, the author has pointed out that, in order to be effective in the vindication of the public interest, civil procedure has to rely on a standard of preponderance of evidence: Federico Stella, *Quando l'azione civile tutela più del processo penale*, Corriere della Sera, 6 February 2004.

contrary, in Italy the vindication of the public interest, driven by a liquidator with the highest reputation who is doing an excellent job, is currently in the hands of criminal and civil courts which are ill-equipped to deal with complex litigation concerning capital market frauds and masses of claimants seeking to recover damages.

As a result, global issuers and gatekeepers are mainly exposed to the US private enforcement system with its plaintiff-friendly weaponry: class actions and entrepreneurial lawyers, notice pleading rules and aggressive discovery. The efficient US private enforcement system (as well as “intra-brand” competition in the form of the SEC v Eliot Spitzer rivalry), forces public enforcers to be faster and more reactive than their European counterparts. We conclude that Italy (Europe) has to upgrade and re-balance its public and private enforcement mechanisms in order to increase deterrence and weaken the role of secretive practices, political accountability, and social networks. It is clear that private enforcement cannot be improved without revolutionary changes to the whole civil procedure system, since the present system is ill-suited for disputes concerning the protection of diffuse interests. Moreover, formal and effective mechanisms for coordinating the roles of the two institutional frameworks (litigation and regulation) have to be created. In the meantime, the US will exercise an increasing role in the public and private enforcement of securities laws also with respect to foreign global issuers.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities*.

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

ECGI Working Paper Series in Law

Editorial Board

Editor Guido Ferrarini, Professor of Law, University of Genova & ECGI

Consulting Editors

Theodor Baums, Director of the Institute for Banking Law,
Johann Wolfgang Goethe University, Frankfurt & ECGI

Paul Davies, Cassel Professor of Commercial Law,
London School of Economics and Political Science & ECGI

Henry B Hansmann, Sam Harris Professor of Law, Yale Law
School & ECGI

Klaus J. Hopt, Director, Max Planck Institute for Foreign Private
and Private International Law & ECGI

Roberta Romano, Allen Duffy/Class of 1960 Professor of Law,
Yale Law School & ECGI

Eddy Wymeersch, Professor of Commercial Law, University
of Ghent & ECGI

Editorial Assistant : Karina Huberman, ECGI, ECARES, Université Libre De Bruxelles

Financial assistance for the services of the editorial assistant of these series is provided by the European Commission through its RTN Programme on European Corporate Governance Training Network (Contract no. MRTN-CT-2004-504799).

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (www.ecgi.org/wp) or SSRN:

| | |
|-----------------------------|---|
| Finance Paper Series | http://www.ssrn.com/link/ECGI-Fin.html |
|-----------------------------|---|

| | |
|-------------------------|---|
| Law Paper Series | http://www.ssrn.com/link/ECGI-Law.html |
|-------------------------|---|