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Additional Report Required For Leveraged Buy-Outs?

On 5 April 2011, the Milan Council of Notaries published its *Massima* 118 ("**Precept 118**"), and in doing so has effectively ended a longstanding debate associated with LBOs of unlisted companies. Precept 118 addresses transactions in which shares in neither the purchaser nor the target are listed or held to a material degree by the general public, and comments as to whether a merger scheme drawn up in connection with such a leveraged buy-out requires the preparation of a report from an auditor.

Such a report is now always required, according to the Milan Council of Notaries, except in the largely theoretical case where both companies are not joint stock companies, but rather are limited liability companies without shares (*società a responsabilità limitata*), and have not appointed a board of statutory auditors.

Key issues

- **Changes to article 2501-*bis*, fifth paragraph, of the Civil Code**
- **The debate, and the Milan Council of Notaries' position**
- **Only one report required; content of report**
- **The precept's force, and effects**

Changes to article 2501-*bis*, fifth paragraph, of the Civil Code

Article 2501-*bis*, fifth paragraph, of the Civil Code specifically governs corporate mergers where one company has borrowed to acquire control of the other. Until April 2010, it provided that the merger scheme drawn up by the board of directors and submitted to the shareholders' meeting for approval had to be accompanied by a report from *"the audit firm appointed to carry out the mandatory audit of the accounts"*, either of the target or the purchaser.

It was widely thought that the report had to be prepared only if the target or the purchaser was required to have its accounts audited (meaning, broadly speaking, that the shares of at least one of the companies were listed, or held to a material degree by the general public). In the more common case in which the target company was not under such an obligation, and was being merged with a newly-incorporated vehicle which borrowed to acquire control (and also was not subject to such an obligation), no such report was required.

In April 2010,[1] the fifth paragraph of article 2501-*bis* was amended, and the words "*the audit firm appointed to carry out the mandatory audit of the accounts*" were replaced by "*the person appointed to audit the accounts*", of the target or the purchaser.

The debate, and the Milan Council of Notaries' position

This amendment to the law generated a debate as to the scope of application of the amended provision.

One side of this debate interpreted the amended provision literally, arguing that a firm or individual that had been appointed to audit the target's accounts would be required to prepare a report to accompany the merger

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[1] To be exact, the change was introduced by article 37(31) of Legislative Decree No. 39 of 27 January 2010, issued by virtue of the power delegated under the primary legislation, Law No. 88 of 7 July 2009, in implementation of Directive 2006/43/EC, on statutory audits of annual accounts and consolidated accounts. It came into force on 7 April 2010.

scheme, even where the company was not under a statutory obligation to have its accounts audited.

The other side, following a more conservative approach, observed that the literal interpretation would effectively have altered the statutory arrangements arising from the 2003 reform of company law and would have expanded the scope of the obligation beyond the authority granted under the primary legislation . Neither EU's Directive 2006/43/EC (in implementation of which the amendments were made), nor Law 88 of 7 July 2009 (which formed the basis for the secondary legislation) had indicated any such intent.

Debate around a second issue also arose, among those who favoured a literal interpretation of the new rules, as to whether a report would be necessary where the company had appointed a board of statutory auditors to audit the accounts (as permitted by article 2409-*bis*, second paragraph, of the Civil Code for those companies not required to prepare consolidated accounts). Some thought that, even where a literal interpretation was preferred, the report was not necessary if the board of statutory auditors had been appointed to audit the accounts, as that board is considered an internal body of the company, and thus not a different person. Others, nevertheless, gave little weight to such semantic niceties, and believe that the obligation to draw up a report also extends to a board of statutory auditors.

The Milan Council of Notaries, in its Precept 118, supports the literal interpretation of the new terms of article 2501-*bis*, fifth paragraph, of the Civil Code. In the Council's view, extending the scope of the legislation's application is "consistent with an intention to make use of external auditors, if appointed, to allow more penetrating disclosure and oversight in potentially risky transactions such as those governed by article 2501-*bis* of the Civil Code."

According to the Milan Council of Notaries, the report is necessary not only in those cases in which the target and/or the purchaser has a statutory obligation to have its accounts audited, but also when one or both of the companies has decided voluntarily to have its accounts audited either by an external audit firm or individual auditor, and ,for reasons of consistency, where the board of statutory auditors has been appointed to audit the accounts (in such circumstances, the members of the board must all be registered auditors).

In short, such a report is now always required, according to the Milan Council of Notaries, except in the largely theoretical case where both companies are not joint stock companies, but rather are limited liability companies without shares (*società a responsabilità limitata*), and have not appointed a board of statutory auditors.

Only one report required; content of report

The Milan Council of Notaries also stated that where both companies are required to prepare a report, one single report will be sufficient. The companies' administrative bodies may instruct, at their discretion, the auditors of either company to draw up the report.

The auditor's duty is to verify the accounting information underlying the transaction and in particular the business programme contained in the directors' report.

Precept's force, and conclusions

What force does Precept 118 have?

Precept 118 is above all an interpretation, albeit one that carries great authority. As such, it might be thought to be merely one additional contribution to the commentary on the subject thus far. It was however drawn up by the Commission for Uniform Principles on Corporate Matters, which was set up by the Milan Council of Notaries to provide guidance on questions of interpretation, and to articulate those principles to which notaries should adhere when called to advise on whether particular corporate documentation is suitable for registration (including, for these purposes, the minutes of the extraordinary general meeting that must be called to approve the merger scheme).

While notaries remain free to interpret the legislation as they see fit, it is highly probable that the publication of Precept 118 will lead the vast majority to opt for a literal interpretation of article 2501-*bis*, fifth paragraph, and to refuse to draw up and register the minutes of such extraordinary general meetings where the merger scheme lodged with the register of companies is not accompanied by a report from the audit firm or individual auditor appointed to audit on a voluntary basis, or from the board of statutory auditors.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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