On the problem concerning the modification of the exchange rate in the conversion of convertible bonds into shares, after the reduction of the share capital due to losses, pursuant to Art. 2420 bis, section 6, Civil Code

1. – The author of these lines resumes discussion, after the essay published in *Riv. dir. civ.*, 1983, II, 485, on this problem which has not yet found a solution, let alone satisfactory from case law and to which legal literature has given an unsatisfactory answer, with wide consensus, but unjustified in my opinion.

It is substantiated in the question of what meaning to give to article 2420 bis, section6, which literally reads: « In the cases of capital increase, by means of allocation of reserve and reduction of capital for losses, the exchange rate is modified in proportion to the proportion of the increase or reduction ».

Dominant legal literature (1) maintains that in the case in which the share capital is reduced due to losses and with it the nominal value of the shares in circulation, the owner of the convertible bonds also undergoes the consequences of the reduction and receives the same quantity of shares promised at the time, with a nominal value reduced due to the losses.

On the contrary, in that study written so long ago, this writer maintained with conviction the theory that the convertible bondholder, who has not yet requested conversion, bearing in mind section four, is entitled to receive the different greater quantity of shares with a reduced nominal value, the product of which with the latter is equal to the nominal value of the convertible bonds in his possession. In practice, if, following the reduction of the share capital due to losses, the share capital is halved and with it the

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(1) In this sense: BUONOCORE, *Le obbligazioni convertibili in azioni nella legge di riforma*, in *Giur. comm.*, 1974. I, 724; R. CAVALLO BORGIA, *Le obbligazioni convertibili in azioni*, Milan, 1978, p. 166 ff., note 77; B. COLUSSI, *Problemi delle obbligazioni convertibili in azioni*, in *Riv. dir. civ.*, 1974. I. 606; F. FERRARA, *Gli imprenditori e le società*, Milan, 1974, p. 560; R. NOBILI-M. VITALE, *La riforma delle società per azioni*, Milan, 1974. pp. 254 ff., F. FAZZUTTI, *Obbligazioni convertibili e modifica del rapporto di cambio*, in *Giur. comm.*, 1977, I, 928.

nominal value of the shares in circulation, the bondholder creditor will receive a double quantity of the shares with the nominal value halved.

This solution has remained isolated and has not been followed by the authors who have subsequently dealt with the subject without, moreover, adding any convincing element in support of the dominant opinion (2).

We are returning to this subject here, convinced that the dominant opinion is contrary to the literal and logical interpretation of the rule under examination and the further reflections that show how the opinion put forward in the past represents the strictest application of the law.

2. – Article 2420 bis, section 1, Civil Code, established that the Extraordinary Meeting that decided on the issue of the bonds convertible into shares, « determines the rate of exchange and the conditions and subsequent section two adds that it decides on the increase of the share capital for an amount corresponding to the nominal value of the shares to be attributed in conversion ».

Section five also provides that the company cannot reduce the surplus capital.

Section six, as seen, prescribes that « in the event of reduction due to losses », the exchange rate is modified, in proportion to the extent of the reduction ».

The exchange rate and the conditions for conversion decided by the Meeting that issued them are shown specifically by the certificate of the convertible bond, as in possession of the convertible creditor.

The dominant legal literature, which on the other hand want to assign to the convertible bond the same number of shares, but with a reduced nominal value, is translated into the modification *in peius* of the conversion rate originally decided by the Meeting and promised to creditors. That is, it reverses the provision of the last part of section six, where it lays down that the rate of conversion must be modified « in proportion to the extent of the reduction ».

The modification of the rate must be inversely proportional to the reduction due to losses and the company is obliged to distribute that quantity of shares with the reduced value due to losses, the product of which is equal to the value of the stake it was entitled to originally.

The holder of the convertible bonds is entitled to have, in the exchange rate, a stake which has a nominal value equal to that of the bonds as originally promised.

The company has no right not to fulfil the obligation it contracted.

The capital increase, decided at the time of the issue of the convertible bonds, in accordance with section three, is insensitive to the reduction, be-

(2) P. Casella, *Le obbligazioni convertibili in azioni*, Milan, 1983, p. 140 ff.

cause it is only future and virtual. unlike that existing and circulating of the shareholders, therefore, susceptible to the reduction.

The convertible bondholder therefore has the right to receive that quantity of shares with the nominal value, fixed when the reduction was decided, which corresponds to the nominal value of the bonds, in his possession and which he will change into shares.

Those of a different opinion are making a great confusion between the circulation share capital, in the possession of the shareholders after the reduction due to losses and that which results from the decision to increase the share capital in accordance with article 2420 bis section 3, which is virtual and only for the holders of the convertible bonds.

Moreover, the holders of the circulating shares are directly or indirectly chargeable, as a source of appointment of the company management, for the operating choices, which have given rise to the losses.

Dominant literature that wants to subject the convertible bonds to the losses as well, on condition that the right of conversion has not been exercised before the resolution of reduction, must be rejected on the basis of the contents of section six, which provides literally « that the exchange rate is modified in proportion to the extent of the reduction ».

This is, therefore, a modification of the exchange rate in favour of the bondholders and more specifically of a modification that is inversely proportional to the reduction for losses which was decided and must weigh only on the shareholders.

The opposite dominant opinion attributes to the literal contents of the rule the opposite meaning, not of a modification but of keeping the merely quantitative ratio of the shares with the halved nominal value of the convertible bonds.

The company, with the resolution to issue the convertible bonds and increase the capital reserved for the creditors, has taken on the commitment and is obliged to give them shares for a certain value and ensure for them a conversion rate such as to exhaust the entire capital increase reserved exclusively for the bondholders.

The capital increase decided, in accordance with section three, cannot, on the other hand, be revoked or modified to the detriment of the convertible creditors because it is part of the Articles of Association of the company and is mentioned as a commitment on the circulating certificate of the bond security, as a commitment of the issuing company bearing in mind section seven of article 2420 bis.

A distinction must be made between the capital of a company that is existing and circulating after the decision of reduction, the future increase reserved to the bondholders and the circulating shares from those that are only of future issue.

3. – Our legal literature repeatedly states the argument that, if the intention is to protect the bondholder from losses, in the modification of the exchange rate, as we have shown, the convertible bondholder would be advantaged by the losses of the company with an upheaval of the ratio between the shareholder and himself.

The theory is unfounded. The bondholder has no advantage from losses but is only protected because the losses are not attributable to him, not even directly.

Those who think otherwise would give an advantage against every logic from the losses to the shareholders who are collectively responsible for the operating decisions of the directors they have appointed to the detriment of the bondholders.

Is it perhaps fair that the holder of the shares in circulation takes advantage of the losses of the company for which he is indirectly responsible, at the expense of the company and the convertible creditor?

The company is certainly bound to guarantee to the bondholder the stake corresponding to the right of conversion assured with the decision of issue and therefore to fulfil it. However, it also has its own interest to keep the perspective of the flow of the capital increase in accordance with article 2420 bis, section 2, Civil Code, reserved for the convertible creditors.

This interest is all the more significant the greater the losses, as is the case that reduce the capital to zero.

The dominant opinion ends up by protecting the interests of the shareholders against every logic to the detriment of the company and its survival and the convertible bondholders.

It codifies the principle that the company fails to fulfil the obligations contracted with the decision of issue, with its own damage with respect to the bondholders.

The fact that only the shareholders undergo the reduction due to losses, as well as for the reason show, is because it is a consequence of the incidence of their risk.

Why should the decision of reduction due to losses be extended to the capital increase, which does not yet exist and therefore for the time being only virtual and why ask the convertible bondholder to support it although he is extraneous to the legal affairs of the company. He is not advantaged but only protected fro the losses that otherwise would make his credit inconvertible.

This is a mere consequence of the decision of issue and the capital increase to which the modification of the Articles of Association of the company and the mention of the obligation on the bond certificate correspond.

The dominant opinion, opposed here, ends up by violating the dual limit of the net equity and the respect of the nominal value.

A fundamental argument that reinforces the opinion maintained here is given by the provision of article 2412 Civil Code.

It provides that not only the company, which has issued the obligations, cannot reduce the share capital except in proportion to the reimbursed bonds, but also « in the case of reductions due to losses, the legal reserve must continue to be calculated, on the basis of the value of the share capital existing at the time of issue ».

This is until the « amount of the share capital and the legal reserve are equal to the amount of the bonds in circulations ».

Reading this rule does not appear to legitimize the equivalent opinion in literature.

Lastly, the circumstance that a reduction of the capital cannot even be decided that were deemed surplus is another subject due to the non-modifiability of the exchange rate in *peius* for the bond.

4. – The advocates of the opinion opposed here, justify it at last with the argument that the convertible bondholders would, in accordance with article 2420 bis, section six, benefit from any capital increase that were ordered therefore, according to reasons of symmetry, they would take part in the losses, in the exchange rate, if they were to convert their credit instruments into shares.

The provision must be understood as referred to the normal hypothesis that the increase is for allocation to the reserves.

This takes place in particular when the reserves are allocated to cover losses.

This argument reinforces the opposing conclusion maintained by the writer, in the sense that the convertible creditor is protected from the consequences of a use of the reserves to cover losses, on the shareholder's instructions.

Even where the capital increase were provided « due to allocation of the reserves » not to cover the losses, the extension of the benefit to the convertible bondholders aims to protect them from decisions of the shareholders that would be detrimental to their interests.

The reserves are not available to the detriment of the convertible bondholders because they also belong to the latter virtually.

The rule materializes the equity situation of the company at the time of the issue of the bond and like article 2412 Civil Code protects the convertible creditor from a deterioration in the conditions of conversion which is decided by the shareholder, as according to article 2420 bis, section five, Civil Code.

This protection of the bondholder's interests is in line with all the guarantees for its rights and interests, including by articles 2413, 2414 and 2415 ff. of the Civil Code.

This set of rules from the Civil Code has the purpose of protecting the convertible bondholder from shareholders' decisions to his detriment.

The protection offered moreover, meets the fact that the bondholder, even non-convertible, in accordance with article 2413 Civil Code has the right to obtain the guarantees contemplated and to benefit from the power of the meeting of the bondholders, laid down by articles 2415 ff. Civil Code.

The power conferred on the bondholders, who hold one twentieth of the securities issued and not reimbursed, to call the bondholder's meeting allows them to be able to prevent and block any resolution to their detriment that that might be adopted by the shareholders.

The theory according to which the convertible bondholder, protected from education due to losses, obviously applies, with all the more reason in the case of reducing the share capital to zero due to losses.

Lastly, it must be said that what has been stated is valid only for the convertible bondholder who has not requested and obtained in advance the conversion before the decision to reduce the reserves due to losses were adopted.

He now becomes a shareholder like all the others and over him there hangs the risk of resolutions for the reduction of capital, which is not for the bondholder who has not converted his credit instruments into shares.

3. – Lastly, some may object that our legislator, with this discipline could have excessively penalized the shareholder and rewarded the bondholders.

Leaving aside the chargeability, even indirect, to the shareholders of the losses following on the management implemented by the directors they chose and, in any case, from the logic of the risk on the circulating shares. it is not correct to hypothesize it against the bondholders.

Our coordination grants the shareholders, protecting their interests of the bondholders as well, the remedy provided by article 2447 Civil Code.

Under this rule, in the event of losses in excess of one-third of the share capital and in the hypothesis that this drops below the legal limit, the Directors must « call the Meeting without delay to pass resolution on the reduction of capital and *its simultaneous increase* ».

Beyond this specific hypothesis, with general bearing, in the sense that the shareholder who wants to keep his share in capital at the amount it was on the issue of the bonds and not undergo the modification in *peius* in favour of the convertible creditors, he can have recourse to a refund of capital to absorb the losses.

This is to be considered for the shareholders only, of simultaneous with the reduction.

In conclusion, the convertible bondholder, as he does not suffer the losses, he cannot benefit from the increase or refund of the capital, that could be deliberated and performed by the shareholders to cover them.

Also by the author on the same subject:

– «*Modifica del rapporto di cambio delle obbligazioni convertibili e riduzione per perdite del capitale sociale*», in Rivista del diritto civile, 1983, II, p. 485 and in L'Espressione monetaria nella responsabilità civile, Cedam, 1994 p. 463.