

Dual class stock unifications and shareholders' expropriation[#]

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Abstract

An increasing number of firms with dual class shares are deciding to unify their shares around the world. Though the return to “one share one vote” is usually considered good news, the unification can give rise to a wealth transfer between the two classes of shares, especially in the presence of high voting premia. This paper develops a model that quantifies the wealth effects on the two classes of shares depending on the type of unification, the voting premium and the equity structure. The model shows that voting shareholders can be substantially harmed by a 1:1 unification in the presence of high voting premia. The model predictions are then tested and validated on Italian unifications, characterized by the presence of a majority shareholder, high value of voting rights and no form of compensation for voting shareholders. Unifications can be a form of expropriation of minority voting shareholders, as confirmed by five case studies where majority shareholders hedge or even take advantage of such operations by engaging in the following activities some months before the unification decision: buying relevant blocks of nv-shares, selling voting shares or approving stock option plans on nv-shares. At the stock unification announcement the price of a voting share in the five case studies dropped by a minimum of -4.26% , to a maximum of -10.41% , consistent with the assertion that dual class unifications expropriate minority-voting shareholders to the benefit of the controlling shareholders.

Dual class stock unifications and shareholders' expropriation

1. Introduction

The pioneering works of Grossman and Hart (1988) and Harris and Raviv (1988) support the optimality of “one share-one vote” in a variety of contexts. In general, amendments to “one share-one vote” rule are regarded as entrenching managers, and by reverse logic, reversions from multiple to single class of shares, so called *stock unifications*, are regarded as generally beneficial to non-controlling shareholders. In fact, institutions, as the Tel Aviv Stock Exchange, as well as public-owned corporations around the world, as the German SAP or the Italian Alitalia, have recently taken important decisions against the contemporary listing of two different classes of shares.

Several recent studies have documented a trend towards a “one share-one vote” equity structure in Canada (Amaoko-Adu, and Smith, 2001) and in Israel (Lauser and Lauterbach, 2003). In Continental Europe, non-voting or limited voting shares are rarely used in Belgium, Portugal and Spain, while they are common in Italy, Germany, Switzerland and northern Europe (Faccio and Lang, 2002). A recent trend in stock unifications has been reported in Germany by Dittman and Ulbricht (2003), while Pajuste (2003) provides evidence on the determinants of 108 unifications in seven European countries (Denmark, Finland, Germany, Italy, Norway, Sweden and Switzerland).

A stock unification (especially through a typical one-to-one conversion) causes a dilution in the value of the voting rights of the voting shareholders, and favors non-voting shareholders by increasing their voting control. In some countries, this effect has been taken into consideration in the structure of the unification. In Israel, 52% of unifications have assigned voting shareholders new voting shares to compensate their voting dilution (Hauser and Lauterbach, 2003). In the UK, Ang and Megginson (1989) report that in 45 of the 49 stock unifications in their sample, voting shareholders received an extraordinary dividend equal on average to 12 % of the voting share's stock price.

While extant literature has focused on the determinants of returns surrounding stock unifications, a shortcoming of existing studies is that they have generally not examined the overall wealth effects on the two classes of shares. In particular, the literature has focused on the differential valuations of voting and non-voting shares, and has ignored the possibility of wealth transfers among controlling and non-controlling voting shareholders. The main contribution of this paper is to show that a dual class unification can be a form of expropriation of minority voting shareholders, in the presence of a majority shareholder system, high voting premia and no regulation. A simple model is developed to show that most unifications harm voting shareholders the higher the percentage of nv-shares relative to total equity and the larger the price discount at which they are traded. The Italian setting, contemporary characterized by a high price differential between the two classes of shares (Zingales 1994, Dick and Zingales 2004, Nenova 2003) and no compensation for voting shareholders, is the one where a stock unification produces the most relevant and opposite effect on the different classes of shareholders. The subsequent analysis of five specific stock unifications shows that a few months before the unification announcement the majority shareholder engages in the following activities: approves stock option plans on nv-shares, and sells voting shares. Both the controlling shareholders' behavior and the sharp drop of the voting share price at the announcement (-5% to -10%) confirm the model prediction that dual class unifications can be a form of shareholder wealth expropriation. Such a new form of "tunneling" adds to the broad list highlighted by Johnson et al. (2000) and appears to be not prosecuted by the Italian regulator.

The rest of the paper is structured as follows. Section 2 discusses related literature. Section 3 describes the institutional background, the main reasons for Italian stock unifications, and the types of stock unifications. The model is presented in section 4. Section 5 analyzes some case studies, which support the expropriation argument. Section 6 provides conclusions.

2. Related literature

While the creation of a second class of shares has been widely studied, the same cannot be said for stock unifications. From the theoretical point of view, the creation of a second class

of shares is part of the debate on optimal equity structure, successfully analyzed by Grossman and Hart (1988), Harris and Raviv (1988), Zingales (1991) and Burkart et al. (1998). The empirical evidence on the effects of the creation of a second inferior class of shares through different issuing techniques is mixed. A positive market reaction has been found by Partch (1987) and Cornett and Vetsuypens (1989) on US data, by Ang and Megginson (1989) in UK, Liljebloom and Rydqvist (1992) in Sweden, Zingales (1991) in Italy. Negative excess returns have been found by Jarrell and Poulsen (1988) and Hanson and Song (1995) in US, Jog and Riding (1986) in Canada.

On the contrary, few papers examined the abolition of dual class equity structures, probably because is a relatively recent phenomenon.

In the UK, Ang and Megginson (1989) report that 49 of 152 companies with restricted voting shares in the 1955-1982 period decided to extend full voting rights to restricted voting shareholders. In 45 of the 49 operations voting shareholders received an extraordinary dividend equal, on average, to 12.3% of the voting share stock price as a form of compensation for their surrender of special voting privileges.

In Canada, Ben Amoako-Adu and Smith (2001) study changes in capitalization and control of dual class firms before and after IPOs. They find 56 cases of stock unifications in the 1979-1998 period. They report three main reasons for the re-capitalization into a single class of shares: a debt restructuring plan that required elimination of dual class shares; facilitating the sale of a control block and avoidance of coattail provisions¹; increasing liquidity and institutional investor appeal, especially before a seasoned equity offering.

In Israel, Hauser and Lauterbach (2003) analyze 84 stock unifications between 1990 and 2000 after a new regulation banned new issues of inferior voting shares at the Tel Aviv Stock Exchange. The typical Israel dual class shares structure sees a superior voting class (one share one vote) and an inferior voting class (five shares one vote). All stock unifications transformed inferior voting shares into superior voting ones. In 55% of their sample (46 out of

¹ Coattail provisions are meant to provide equal treatment to all classes of shareholders upon a takeover involving an acquisition of at least 50% of the superior voting shares of a dual class company. Since August 1987, a coattail provision has been a listing requirement on the Toronto Stock Exchange under TSX Policy 624(l).

84 cases) voting shareholders were compensated for the loss in voting power through a new issue of superior voting shares distributed to superior vote shareholders free of charge. From such compensation the authors infer the value of a voting right and found: the price of votes in unifications (as compensation for the vote dilution) is similar to the market price of votes; family-controlled firms sell votes at higher prices; both stock classes respond positively to the unification announcement in a subsample of 44 observations where an event study is run.

Dittman and Ulbricht (2004) using logit analysis based on 29 stock unifications in Germany find that the probability of abolishing a dual class structure is higher for (i) firms that issue new equity in the same calendar year; (ii) larger firms; (iii) firms with a high proportion of voting shares; and (iv) firms where the largest block of voting shares is small. They interpret the strong correlation between a stock unification and subsequent equity offering as indicative of the presence of growth opportunities. In 29 of the 37 stock unifications from their 1990-2001 sample, Dittman and Ulbricht (2003) found an average abnormal return in the five days around the announcement (day -4 to day +1) of 9.9% for nv-shares, 3.9% for voting shares, and 5.4% for the overall firms' market capitalization. Unfortunately, they do not report the magnitude of the voting premia in their sample.

A very recent paper by Pajuste (2003) estimates a logit regression on the determinants of stock unifications for a sample of 108 observations from seven European countries (Denmark, Finland, Germany, Italy, Norway, Sweden and Switzerland) from 1996 through 2002. Pajuste finds that the probability of a stock unification is positively related with new equity issues, the number of acquisitions, and growth opportunities, and negatively related with a high voting premium. These results are interpreted as if the main goal of a stock unification is to raise the company's share price. The number of Italian unifications in Pajuste's sample is twelve. By contrast, our sample contains 26 stock unifications from the same period, 13 of which were coercive, i. e. nv-shares were forced to convert into voting shares. Pajuste's sample includes only the latter; that is, only those companies that made a coercive unification. If the economic reasons underlying the decision to make a 100% or a 90% stock unification are the same, companies making a non-coercive or a coercive stock unification should belong to the same sample.

As mentioned earlier, existing papers on stock unification do not examine the wealth effects of such operations but focus instead on the determinants of the return to a “one share-one vote” equity structure. This paper focuses on the different wealth effects originated by a stock unification. Italian unifications, characterized by one of the highest voting premium and no form of compensation for voting shareholders, is provides a powerful setting to examine the wealth effects of unifications on different classes of shareholders. Our simple model presented in section 4 and case studies presented in section 5 are consistent with the hypothesis that Italian stock unifications adversely affect the welfare of non-controlling shareholders. Ironically, such unifications have been warmly endorsed by the financial press².

3. Italian non-voting shares, reasons and types of DCUs

3.1 Italian non-voting shares

Italian listed companies can issue non-voting shares for up to 50 percent of their equity capital. Non-voting shares do not have any voting rights but the law which introduced them (L. 216/1974) set some minimum privileges (these can be increased by amending the corporate charter).

- A minimum dividend equal to five percent of par value.
- If a dividend is paid to voting shares, the dividend to non-voting shares has to be greater by an amount equal to two percent of the par value or more.
- In case dividends are not paid because of accounting losses, when dividends are paid again non-voting shares have the right to receive up to two past unpaid minimum dividends in addition to the dividend of the current year.
- When accounting losses have cancelled out the company’s equity, only voting shareholders must put new equity in the company.

² For example, Il Sole 24 Ore financial newspaper commented the CIR unification announcement as a “market friendly” operation, completely ignoring that voting shares dropped by about 9% around the announcement date, that the CIR board approved three different stock options plans on non voting shares some months before the

- In case of bankruptcy, non-voting shares have prior claim on the company's assets

The new Italian financial code introduced in 1998 (D. lgs 58/1998) modified the legal framework governing non-voting shares. The major changes are the following:

- Corporate charters are free to define the rights of non-voting shares and no minimum rights are imposed by law. Notwithstanding such a provision, in June 2002 all listed non-voting shares enjoyed the minimum rights set by the earlier institutional code.
- When voting shares propose to vote on proposals deemed harmful to non-voting shareholders, the decision must be approved by a special meeting of non-voting shareholders (as per rule 216) and at least 20% of the non-voting shares must be favorable to the decision. However, according to the judicial interpretation and precedent, actual harm is excluded if it is not a violation of an existing right.

Overall, the new financial code has improved minority shareholders' rights, for e.g., as measured by La Porta et al. (1998), whose protection index improved from below to above the continental European average.

Notwithstanding the higher dividends they get, non-voting shares are usually traded at a deep discount from the voting shares' stock price. This is due to the high value of the voting right, which has recently been measured as 29,4 percent or 36,9% of the firm's total market capitalization, when it has been respectively computed either from the price difference between voting and non-voting shares in 1997 (Nenova, 2003) or inferred from the higher price paid for controlling block of shares in the 1990-2000 period (Dick and Zingales, 2004).

3.2 International reasons for stock unifications

We now address some of the reasons underlying a recent surge in stock unifications. We believe there are some common international factors while some others characterized only

announcement and that the controlling majority shareholder had sold voting shares and bought non-voting shares few months before the announcement.

Italian unifications. We now describe the former and then pass to the latter.

Internationalization of the shareholders base and “one share-one vote” preference

One of the main reasons driving companies’ decisions to unify their shares is probably the increasing internationalization of the investors’ base together with the institutional investors’ preference for a “one share-one vote” equity structure. According to Amaoko-Adu and Smith (1995), direct institutional pressure towards a more desirable “one share-one vote” structure is one of the main reasons underlying Canadian unifications. In Israel, Hauser and Lauterbach (2002) report that the unification trend was triggered by the Stock Exchange’s decision to ban any new issue of limited voting stock in 1990. Italian issuers became aware of the difficulty in issuing new nv-shares after August 1998, when Parmalat had to cancel a \$500 million nv-shares issue targeting US investors due to adverse market reaction.³

This attempt to create new nv-shares is the last made by an Italian blue chip. The new awareness that stock market would reject the creation of new nv-shares may have favored the conversion of the existing ones (almost like in Israel), especially when their percentage on the equity capital was so limited so that they were not determinant to achieve a greater separation of ownership and control.

Increase of the voting shares’ market capitalization and liquidity in order to enter or remain in a major stock index

In order to be included in one of the most important domestic or international stock indexes, the two most common criteria are the common stock’s market capitalization and turnover. Since a dual class unification would increase both parameters, it helps companies in reaching such a goal. In fact, the inclusion in a stock index would increase the investors’ base, the stock liquidity and therefore firm’s value, as found for the S&P 500 by Dhillon and Johnson (1991) and Beneish and Whaley (1996).

³ The Financial Times described the failed offering in an article titled “Tired to milk cows, tried with shareholders”.

3.3 Italian specific reasons for stock unifications

Sharp decrease in interest rates and corresponding higher cost of non-voting shares

In the aftermath of the European Monetary Union in 1999, Italian interest rates plunged in order to align with the EMU average. Unlike other past interest rate drops, this sharp decrease (more than 5% in 1998-1999 and 8% at the current level) was structural, and affected the relative costs of debt and equity capital. The minimum dividend based on the par value of nv-shares resulted in dividend yields that often exceeded the company cost of debt, especially in the wake of market-wide depressed stock prices (as in 2001 and 2002) and large discounts on non-voting shares relative to voting shares. The higher dividend yield on nv-shares may have favored some unification decisions. For example, Cofide decided to convert nv-shares into voting shares in December 2001 when nv-shares were trading below par, assuring a minimum legal dividend yield equal to 5.7%.

Besides, Italian firms, as most continental European firms, adopt the rights offering method in equity offerings, involving a longer execution period and an issue price below market price⁴. We believe that the issue of new nv-shares at prices below depressed market quotes could bind the company to pay an excessive minimum yield and provide an incentive for unification *prior* to the rights offering. This is probably the reason underlying at least one recent Italian stock unification (IFIL 2003). Such incentives are also consistent with the significant correlation between unifications and equity offerings found by Dittman and Ulbricht (2003) for the German unifications.

Unifications as a mean to raise equity from minority shareholders and take advantage of anomalous voting premia

When a non-voting share is traded at a high discount relative to the voting share, a dual class unification can be structured such that nv-shareholders pay a cash premium to participate in a 1:1 conversion. When the majority shareholder does not own nv-shares, such an operation is equivalent to raising new equity capital with no financial involvement of the majority

⁴ On average 42,1% of market price in the 1980-1994 period, (Bigelli, 1998).

shareholder but a dilution of his control. For example, the Italian mobile phone company TIM proposed a unification where nv-shares (quoted at €5.96 at the time of the announcement) could convert to voting shares (€11.45) by paying a €3.70 cash premium. TIM was able to raise €5 billions as part of this unification (incidentally an amount that was sufficient to finance the entire investment in third generation mobile technology for TIM). After the unification, TIM's controlling block was diluted to 56%, down from 60% prior to the unification. In 2003-2004 a TIM non-voting share has been worth almost as a voting share and non voting shareholders who converted their shares and kept them in their portfolio regret of having paid €3.70 for a worthless voting right.

New Italian takeover discipline and lower percentages of voting blocks needed to exercise a safe control

Italian takeover regulation introduced in 1998 has reduced the threshold necessary to exercise control in two ways. First, when a bidder buys more than 30% of votes he must launch a tender offer on *all* voting shares. Second, the quorum to control extraordinary shareholders' meetings is now 66.67% of voting shares (down from XX%). This means that a 34% voting block can stop any extraordinary meeting decision and thwarting a hostile takeover. Because of this new regulation, some unifications, which would have significantly diluted the controlling voting block, could now take place without threatening the controlling shareholder. For example, the Cofide unification diluted the majority shareholder block (Carlo De Benedetti & Figli S.a.p.a.) to 34.7%, down from 43.2%.

Unifications made by Italian privatized companies

The 1992 CIPE directives on future Italian privatization stated that future privatized dual class companies “*will favor solutions which allow conversion of non-voting share into voting...*”. Five of the 42 Italian unifications made in the 1982-2003 period have been made by privatized companies (Credit, Comit, Alitalia, Bnl, Finmeccanica), which followed the above guidelines.

Unifications and insider trading

For a controlling shareholder, buying nv-shares at a discount prior to the unification announcement provides an opportunity to gain by selling them after the unification. In at least five of 42 Italian unifications (Finpart, Cir, Alleanza, Ras, Banca Finnat), the majority shareholder had bought a block of nv-shares a few months before the announcement of the unification. In section 5, we provide details on these five unifications, highlighting the expropriation of nv-shareholders. The existing literature on dual class unifications has not examined the role of insider trading in these events.

3.3 Types of Italian stock unifications

From the introduction of non-voting shares (1974) through the end of 2003, there have been 43 stock unifications, 29 of which took place after 1998, as shown by Figure 1.⁵ At the end of 2003, only 40 listed companies out of 268 (15% of the total) deviate from a “one share-one vote” equity structure, compared with 78 companies in 1996 (31% of the total). The percentage of non-voting shares’ market capitalization has dropped from 15% in 1990 to 3.5% at the end of 2003; nv-shares collectively represent about €17 billion in aggregate value at the beginning of 2004. Fifty-five percent of nv-share value is represented by one company, Telecom Italia, the major Italian phone company.

Italian stock unifications have been structured in several different ways. For example, a distinction must be made between coercive and voluntary or non-coercive unifications. Coercive unifications must be approved by the non-voting shareholders. It is not always the case that nv-shareholders prefer a conversion to voting shares. For e.g., when non-voting shares are traded at almost the same price as voting shares, but have the right to higher and safer dividends, nv-shareholders have sometimes claimed that a coercive unification involved an expropriation of their dividend privileges and have taken the decision to court. The necessary approval by the nv-shareholders meeting not always works as a safeguard of nv-shareholders’ rights, as controlling shareholders often own relevant blocks of nv-shares.

⁵ Stock unifications were found by using “Indici e Dati” by Mediobanca and Il Sole 24 Ore Cd-Roms.

Notwithstanding such evident conflict of interests, majority voting shareholders can also vote in the non-voting shareholders' meeting, where a stake as small as 20% of nv-shares can provide control.

In our sample of 43 stock unifications, 17 were coercive and 26 non-coercive or voluntary. In the 26 voluntary unifications the average percentage of nv-shareholders who opted to convert was 86.6% (median 91.4%). Below we describe other stylized facts associated with Italian stock unifications.

- a) *1:1 coercive (17 obs.):* one non-voting share must be converted into a voting share without any additional payment⁶;
- b) *1:1 non-coercive (9 obs.):* one non-voting share can be converted into one voting share without any additional payment;
- c) *1:1 with a cash payment (7 obs.):* one non-voting share can be converted into a voting share by paying an amount lower than the price differential. None of these seven unifications have been made as coercive because of the cash payment required⁷.
- d) *1:1 plus a cash refund (1 obs.):* one non-voting share can be converted into one voting share and receive a cash payment⁸.
- e) *1:1 and conversion limit (3 obs):* one non-voting share can be converted into one voting share up to a conversion limit of 10% of the nv-shares owned.
- f) *y voting shares for x nv shares (2 obs.):* x nv-shares can or must be converted into y voting shares ($x > y$ whenever nv-shares are traded at a discount).
- g) *Option to choose between a conversion through y voting shares for x nv-shares and a 1:1 conversion with a cash payment (1 obs):* in one case nv-shareholders could choose between converting x nv-shares into y voting shares or convert 1 nv-share into 1 voting share with an additional payment.

⁶ According to Dittman and Ulbricht (2003), these are also the typical terms of German stock unifications.

⁷ In German unifications, Dittman and Ulbricht (2003) report two cases in which the required payment was equal to 2/3 of the price differential. None of the seven Italian unifications had such provision and all required a fixed amount (obviously lower than the price differential) # I don't get what should be changed...#.

⁸ These anomalous terms were fixed only in only one unification (SNIA 2002), when non-voting shares were traded at a premium on the voting shares.

4. Wealth effects of a stock unification: a theoretical model

A simple 1:1 conversion gives rise to a remarkable appreciation of non-voting shares when voting shares quote at a relevant higher price but also to a reduction in the voting shares' market price caused by the vote dilution. The size of such dilution should depend on the number of the converted nv-shares compared to the existing voting ones. Less obvious are the several effects of unifications on voting and nv-shares when the conversion is not coercive, only a percentage of nv-shareholders accepts the proposal, a cash payment is required and the conversion ratio is set as y voting shares for x nv-shares. That is the reason why a model is hereafter developed so that the effect on the two classes of shares of the most common kinds of unifications (types a, b, c, or f) can be estimated.

The model takes into consideration only two classes of shares, though it could be easily expanded to a third class. The time before the announcement of the operation is defined as t_0 , while t_1 is the situation after the class unification, assuming no other effect will influence stock prices.

The simple framework described by Manne (1964) is adopted, and the value of a nv-share before the unification announcement is therefore defined as the present value of its expected future dividends, i.e. what we will call *Investment Segment* ($IS_{nv,0}$). The voting share is defined as the sum of its *Investment Segment* ($IS_{v,0}$) and its *Vote Segment* (VS_0). The voting share's *Investment Segment* is lower than the nv-share's *Investment Segment* as nv-shares are entitled to higher dividends by the company charter.

The voting shares' *Investment Segment* can be expressed as:

$$IS_{v,0} = IS_{nv,0} - \Delta IS$$

where ΔIS , is the difference in the investment segment of the nv-shares and voting shares.

Abstracting from risk considerations, ΔIS can be proxied by the present value of a perpetuity whose cash flow is the legal or statutory extra dividend payable to the nv-share, that is:

$$\Delta IS = \frac{M\% \cdot PV}{rf}$$

where $M\%$ = extra dividend payable to nv-shares as a percentage of their par value;

PV = par value;

Rf = long-term risk-free rate.

The *Vote Segment* of the voting shares can now be determined as the difference between the price of a voting share and its *Investment Segment*:

$$VS_0 = P_{v,0} - IS_{v,0}$$

It is now possible to split the company's total market capitalization into two parts representing the total value of the *Investment Segments* and the total value of the *Vote Segments*:

$$TIS_0 = IS_{nv,0} \cdot N_{nv,0} + IS_{v,0} \cdot N_{v,0}$$

$$TVS_0 = VS_0 \cdot N_{v,0}$$

Where:

TIS_0 = Total Investment Segments before the unification announcement;

TVS_0 = Total Vote Segments before the unification announcement;

$N_{nv,0}$ = number of non-voting shares before the unification announcement;

$N_{v,0}$ = number of voting shares before the unification announcement.

We now define the stock unification characteristics:

x = the number of non-voting shares to submit in order to have y voting shares, if the unification offer a swap of x nv-shares into y voting shares;

C = the cash additional payment required from each nv-share to accept the unification;

Q = acceptance rate, i.e. the percentage of nv-shares expected to convert their shares when the unification is not coercive.

The market value of the company's equity after the operation (V_1) can be simply expressed as the sum of the market capitalization before the unification announcement (V_0) and the increase in the market capitalization due to the required additional payments (ΔV):

$$V_1 = V_0 + \Delta V$$

The increase in the company's market capitalization (ΔV) can be defined as the amount of the cash payments to the company net of some residual costs expressed as a percentage of the total amount raised ($R\%$). Given the unification characteristics and the estimate of the acceptance rate (Q) in non-coercive unification (usually close to 90%), the capitalization's increase can be expressed as:

$$\Delta V = N_{nv,0} \cdot Q \cdot C \cdot (1 - R\%)$$

The residual component can take into consideration both transaction costs for the operation and the quota of the new funds that are expected to finance the majority shareholders' perquisites. Since such resources will not pertain to minority shareholders they should not be reflected in the increase of the company's market capitalization. The model assumes that unification would not affect the overall firm's equity value except in case additional cash payments are paid in, and focuses on the wealth effects between the two classes of shares. In practice dual class unifications could rise firm's value through an increase in the stock's liquidity, the inclusion in a major stock index and a lower deviation from the "one share-one vote".

In order to determine the value of the *Voting Segment* after the unification, we first have to estimate the value of the *Total Vote Segments* after the unification (TVS_1). If cash payments are not required, the market capitalization remains the same and we can assume that the value

of the *Total Vote Segments* is unchanged⁹. If cash payments are required, market capitalization increases and the *Total Vote Segments (TVS)* should rise as well. We assume that *TVS* is an increasing function of market capitalization.

$$\Delta TVS = f'(\Delta V)$$

The post operation *Total Vote Segment (TVS₁)* and *Total Investment Segments (TIS₁)* are obtained as follows.

$$TVS_1 = TVS_0 + \Delta TVS$$

$$TIS_1 = V_1 - TVS_1$$

The number of voting shares after the unification ($N_{v,1}$) will equal the pre-unification number ($N_{v,0}$) plus the expected number of nv-shares submitted for conversion ($N_{nv,0} \cdot Q$) times the eventual conversion ratio (y/x) when the unification is not coercive:

$$N_{ord,1} = N_{ord,0} + N_{rc,0} \cdot Q \cdot y/x$$

In coercive unifications the number of post operation nv-shares ($N_{rc,1}$) will equal to zero, while in non-coercive unifications it will be equal to the pre-operation number ($N_{rc,0}$) times the percentage of unsubmitted shares ($1-Q$):

$$N_{rc,1} = N_{rc,0} \cdot (1 - Q)$$

Nv-shares still outstanding after a voluntary unification, being entitled to higher dividends, will have a higher *Investment Segment* than voting shares. The *Investment Segment* of the voting shares is obtained as the post-operation *Total Investment Segment* less the extra *Investment Segments (ΔIS)* value of the post-unification nv-shares. The residual amount can then be divided by the post-operation overall number of shares to obtain the *Investment Segment* value of the voting shares:

⁹ This would in general not be true if the unification gave rise to a different ownership structure and to a higher or lower probability of a takeover. However, Italian unifications in practice have not changed the control exercised by the dominant pre-unification shareholder.

$$IS_{v,1} = \frac{TIS_1 - \Delta IS \cdot N_{nv,1}}{N_{v,1} + N_{nv,1}}$$

The post-unification equilibrium prices for both the voting and nv-shares is determined as follows:

$$P_{v,1} = VS_1 + IS_{nv,1}$$

$$P_{nv,1} = IS_{nv,1} = IS_{v,1} + \Delta IS$$

Substituting from earlier equations, we get:

$$\begin{aligned} P_{v,1} &= \frac{V_1 - TVS_1 - N_{nv,1} \cdot \Delta IS}{N_{v,1} + N_{nv,1}} + \frac{TVS_1}{N_{v,1}} \\ &= \frac{(V_0 + \Delta V) - [TVS_0 + f'(\Delta V)] - N_{nv,1} \cdot \Delta IS}{N_{v,0} + N_{nv,0} \cdot y/x \cdot Q + N_{nv,0} \cdot (1-Q)} + \frac{TVS_0 + f'(\Delta V)}{N_{v,0} + N_{nv,0} \cdot y/x \cdot Q} \end{aligned}$$

The two components in the above expression are respectively the value of the *Investment Segment* and the *Vote Segment* of a voting share after the unification.

The new *Investment Segment* of a voting share is obtained as the ratio of the new *Total Investment Segments* pertaining to all shares and the new number of outstanding shares. The numerator is obtained as the new market capitalization minus the new *Total Vote Segments* and minus the present value of the extra dividends payable to remaining nv-shares.

The new *Vote Segment* is obtained as the ratio between the new *Total Vote Segments* and the new number of voting shares, where the numerator is given by the previous *Total Vote Segment* (TVS_0) plus its eventual increase due to a higher market capitalization when cash payments are required.

Table 2 shows the model's predictions of a 1:1 non-coercive unification on three classes of shareholders: voting; non-voting who accept the unification proposal; non-voting who reject the proposal and keep their shares. We assume a 90% acceptance rate and a value of the differential *Investment Segment* (ΔIS) equal to 20% of the nv-share market value¹⁰. The effects are simulated for several different levels of price discounts of a nv-share compared to

a voting share and different percentages of the company's equity represented by nv-shares. The simulated returns show a negative wealth effect for voting shares due to the *Vote Segment's* dilution which becomes more relevant for higher values of voting rights (higher price discounts of nv-shares) and the percentage of nv-shares on the company's equity. When nv-shares represent only a small fraction of the firm's equity, the *Vote Segment's* dilution is negligible and the return on the converted nv-shares depends only on the discount at which they are traded. For example, when nv-shares are traded at a 50% discount and represent only 1% of the total outstanding shares, a 1:1 unification would appreciate nv-shares by almost 100% (99.10%) while voting shares would drop by only -0.45%. With the same market conditions and nv-shares representing 50% of the outstanding equity the dilution of the voting right would be much higher: voting shares would drop as much as -23.92% and nv-shares would appreciate by a lower +52.16% to the new equilibrium price of a voting share.

Voluntary unifications should produce some effects also on nv-shares which do not adhere to the conversion offer. In fact, when a relevant part of the existing nv-shares is converted into voting equity, there will be a small but positive increase of the "basic" investment segment of all shares. This is due to the fact that a lower part of the firm's free cash flows (and therefore of the *Total Investment Segments*) will have to be reserved to the extra dividends payable only to nv-shares. The greater residual part of the *Total Investment Segments* will then be split on the same number of shares, therefore originating a higher value of the "basic" *Investment Segment*. Non-converted nv-shares will then have a higher "basic" *Investment segment* and the same privilege on future dividends as before. The positive effect on non-converted nv-shares will be more relevant for higher fractions of nv-shares on the firm's equity, greater extra dividends granted to nv-shares and higher percentages of converted nv-shares. However, the positive effect is not very big in size. In the supposed conditions (a *ΔIS* equal to 20% of the nv-shares' market price and an acceptance rate equal to 90%), when nv-shares represented 50% of the outstanding equity the best positive effect reaches +9.00%.

¹⁰ Which roughly correspond to the median acceptance rate and average market conditions for non-voting shares in Italian DCUs.

When a 1:1 non-coercive unification is made by requiring an additional payment the increase of the post-operation “basic” *Investment Segment* may be quite relevant and produce a remarkable revaluation of the stock price of non converted nv-shares. Voting shares are also positively affected and this partially offsets the negative wealth effect due to the dilution of the voting right. If we simulate the same market conditions as before and we assume that the required cash payment is equal to half of the price discount between a non-voting and a voting share¹¹ we should observe: a lower favorable effect on converted voting shares (+25.13% versus +52.16%); a more favorable effect on non-converted nv-shares (+22.50% versus +9.00%); a lower negative effect on voting shares (-12.43% versus -23.92%).

5. Stock unifications, shareholders’ expropriation and “insider trading”

When nv-shares trade at a large discount relative to voting shares, as it is often the case for the Italian companies, a unification is one of the few extraordinary operations whose effect is certain at least on one class of share. In fact, if the negative effect on the voting shares can sometimes be negligible, the revaluation of the nv-shares at the announcement is granted whenever the offer implies a conversion premium. A relevant conversion premium is always offered for two reasons: so that the offer will be accepted in voluntary unifications; to ease the approval by the nv-shareholders’ meeting in coercive unifications. Whenever voting shares trade at a premium, a relevant conversion premium or a 1:1 unification expropriate voting shareholders as their *Voting Segment* gets diluted. As anticipated, the majority-voting shareholder would not be affected if he buys an equal or greater stake of nv-shares before the unification announcement.

Non-voting shares are bearer shares and it is therefore difficult to know who owns them before the unification. Nonetheless, I’m able to show at least five cases in which the majority shareholder bought relevant blocks of nv-shares some months before the unification announcement. Since 7 of the 43 Italian unifications were made in the process of privatization of state-controlled companies, these five cases (over 36) represent about 15% of the total.

¹¹ In the simulations I also assume that the total amount of cash raised will entirely increase the firm’s market capitalization.

More over, these 5 cases are the only we are able to document, as nv-shares are bearer shares and majority shareholders could hide their trading on non-voting shares if they wanted to. As an example, we can refer to the 2001 1:1 coercive unification made by Cofide, a holding company controlled by the De Benedetti family. From “Il Corriere della Sera” newspaper on April 14th, 2002 we get to know that “*at the conversion date (in March 2002), nearly 70% of nv-shares were hold by Intermobiliare Fiduciaria, a fiduciary company belonging to a group close to De Benedetti, who is a board member of the Intermobiliare Bank*”. The unrequired disclosure of relevant stakes of nv-shares do not let us know who was in possess of 70% of the nv-shares before the operation announcement.

Such opportunistic behavior of the majority shareholder in Italian unifications has driven the attention of the Italian Security and Exchange Commission (Consob), which in an official communication on March 22nd 2001 stated: “*In recent years we have observed a significant increase of extraordinary operations involving nv-shares issued by listed companies followed by their delisting. Such operations are sometimes decided by the same issuer (mergers, unifications) and some other times by the controlling shareholders of the listed companies (through public offerings)*”. In order to help investors to take correct investment decisions, “*the Italian regulator therefore asks the controlling shareholders to communicate publicly, in the ways and times indicated by art. 66 of rule 11971/1999, the execution of trades on nv-shares made by anyone belonging to the controlling group, if, thanks to the above trades, the controlling group ends up owning nv-shares representing a fraction of the firm’s equity greater than 2%, 5%, 7.5%, 10% and subsequent multiples of 5% or the same group reduces its stake below the above thresholds.*”

We have to point out that the above declaration of relevant blocks of nv-shares owned by the controlling group recommended by the Italian regulator is not mandatory and can be ignored. Besides, in some of the hereafter reported unifications the Italian regulator open an insider trading file only relative to the anomalous trading activity surrounding the unification announcement date. No file has been opened on the majority shareholder’ trading activity on non-voting shares made few months before the unification announcement as there were non

chance to prove that the unification decision had already been decided when the trading took place.

5.1 Fin.part coercive 1 :1 unification

Fin.part is a small financial company whose major assets are in the textile industry. The Fin.Part case study is the typical example of how a stock unification can entail an expropriation of minority shareholder rights.

The Fin.part unification is announced by the board on January 24th 2000 and reported on “Il Sole 24 Ore” newspaper on January 25th, 2000. The operation was enforcing a coercive 1:1 conversion of non-voting and preferred shares¹² into voting ones. Since both preferred and nv-shares were traded at a deep discount from the voting shares and they represented about 40% of total equity, a stock unification would have depressed the voting shares’ stock price. We find that Miravan Luxemburg, a company based in Luxemburg, controlled by the same Fin.part controlling shareholders, In July 1999 (6 months before the unification announcement) had launched a voluntary tender offer on 100% of preferred and nv-shares. About 66% and 59% of preferred and nv-shareholders tendered their shares.

From the tender offer prospectus we know that 54% of Miravan Luxemburg was controlled by Valcor and Valcor was controlled, through some companies, by two Italian industrial families. Valcor was controlling Fin.part through the direct and indirect control of 33.3% of the voting shares (12.06% of which directly and 22% through Miravan Luxemburg). In other words, the controlling shareholders (Valcor), through a controlled company (Miravan Lux.) tried to buy all the preferred and nv-shares by a tender offer and six months later converted them in the more valuable voting shares in a 1:1 coercive unification.

The investment in preferred and nv-shares has obviously outperformed that on voting shares. Since the majority shareholders, after the tender offer, had accumulated a greater stake of preferred and nv-shares (66% and 59%) than voting shares (33%), the revaluation of the two inferior voting classes more than offset the devaluation of his block of voting shares. The

¹² Italian preferred shares are different from US ones. In fact, they are like voting shares (they are entitled to higher dividends) but can vote in the extraordinary meetings.

unification allowed the majority shareholder to earn abnormal net returns. The same cannot be said for the minority voting-shareholders, who collectively suffered a decline in the value of their shares following the unification announcement. In the three-day window (two days before the announcement through the publication day in financial newspapers), the price of voting shares declined by -10% while the price of the non-voting (as well as preferred) shares rose by 29% (24% for preferreds). The stock price changes for the three classes of shares around the unification announcement date are shown in Figure 2.

Interestingly, the weekly news journal of the Italian Security and Exchange Commission,¹³ shows that an insider trading file had been opened to look into the anomalous price movement of the Fin.part preferred and nv-shares in the days prior to the dual-class unification announcement date.

5.2 Banca Finnat Euramerica coercive 1:1 unification

Banca Finnat Euramerica is a small Italian bank with interests mainly in private banking. On September 23rd 2003 its board launched a coercive 1:1 unification, whose details were reported on a company press release.¹⁴ The pre-announcement voting and non-voting stock price were respectively €0.3572 and €0.2920. Nv-shares represented 40% of the company's total equity. After the unification announcement, voting shares' stock price dropped to €0.3358 (-6% decline) while nv-shares' stock price rose to €0.3269 (+12% change). The company press release also reported that the majority shareholder, the Nattino Family, directly and indirectly owned 81.71% of nv-shares. The same press release states that "*the operation aims to simplify the company's equity structure and all shareholders will benefit.*" In reality, the *Voting Segment's* dilution made minority voting-shareholders suffer a loss (-4.26%) while nv-shareholders saw their shares rise by +14.63%. Figure 3 shows the behavior of the two classes of shares in a 40-day window around the announcement date. Since the majority shareholder owned almost all nv-shares before the unification, the Banca Finnat

¹³ "Notiziario settimanale Consob" as of November 27th 2000.

¹⁴ Still available (on January 22nd, 2004) at the following website: http://www.finnat.it/download/pdf/cs_230903.pdf.

Case is illustrative of how a stock unification can lead to a significant expropriation of minority voting shareholders.

5.3 Cir coercive 1:1 unification

CIR is a mid-cap financial company in the second tier of a pyramidal group controlled by the De Benedetti family. CIR's controlling company is Cofide (another financial listed company). The CIR unification has been one of the clearest examples of market abuse before a favorable unification. After the company had bought back non-voting shares in the past and cancelled out the corresponding equity on November 1998 and November 1999, on September 13th 2000 the board proposes a 1:1 coercive unification, which was approved on October 27th. Non-voting shares represented 22.5% of the firm's equity.

Three days before the announcement voting and non-voting stock prices were respectively closed at €4.256 and €3.497. In the two days preceding the announcement date, the voting shares started declining, while nv-shares experienced an appreciation, accompanied by abnormally high trading volumes. On the announcement day, the voting shares price closed at €3.886 (decline of -8.69%) while nv-shares' stock price closed at €3.807 (up 8.86%). Figure 4 shows the behavior of the stock prices of the two classes of shares around the announcement date (day -20 to day + 20). Not only had the majority shareholder bought nv-shares in advance of the unification announcement, but the board had actually assigned stock option plans on nv-shares before the unification.

A year prior to the unification (in 1999), a stock option plan based on non-voting shares was approved by the board at CIR. The first exercise date was set on December 22nd 1999, followed by additional exercise dates on March 31st, June 30th, September 30th, and December 31st through the end of 2003. All board members exercised their stock options on the first exercise date, i.e. December 22nd 1999. The CEO (a member of the controlling family) exercised his stock options for 2 million shares on that date. On March 7th, 2000, six months before the unification announcement, the board approved a new stock option plan based on nv-shares. The stock market decline in April 2000 (the collapse of the Internet bubble) meant

that these new options remained underwater¹⁵. As noted above, Cir is controlled by another financial company, Cofide, which is controlled by the De Benedetti family. During the months of April and May 2000, Cofide had bought CIR nv-shares and sold CIR voting shares.¹⁶

On June 26th 2001 the Italian Security and Exchange Commission opened an insider-trading file in relation with the CIR nv-shares for the period preceding September 13th 2000, the unification announcement date.

5.4 R.a.s. 1999 voluntary 1:1 unification with additional payment

R.a.s., the second Italian insurance company, has carried out two voluntary unifications: in 1994 and in 1999. In September 2002, R.a.s eventually decided to launch a buyback of all outstanding nv-shares and cancel them.¹⁷

As far as the second unification is concerned, the R.a.s. controlling shareholder, Allianz A.G., had increased the percentage of nv-shares in its possession a few months before the unification announcement. *Il Sole 24 Ore* dated July 30th1998 reported that Allianz (who owns 51% of R.a.s. voting shares) increased its stake of R.a.s. nv-shares to 43% of all nv-shares over the preceding month. Nearly eight months after, precisely on March 25th 1999, the R.a.s. board announced a voluntary 1:1 unification with a required cash payment equal to €1.059. The declared reasons were the following: “...in order to increase the security’s liquidity and market capitalization and be therefore included in the main market indexes”. Two days before the announcement, voting shares were traded at 10 euros while nv-shares at €7.29. Given these market prices, the discount at which nv-shares were traded equaled 27%, and the required cash payment was set at about 39% of the price differential between the two classes of shares (€1.059/€2.1). After the announcement of the unification, voting shares’ were traded at €9.33 (decline of –6.70%) and nv-shares at €8 (up 10.4%). The market price behavior of the two classes of shares in the 40 days around the announcement date is shown

¹⁵ CIR is a financial company and at that time was valued especially for its internet and media participations.

¹⁶ September 14th 2000, *Il Sole 24 Ore*.

¹⁷ R.a.s nv-shares are still listed but they now represents only 0.2% of R.a.s. total equity.

in Figure 5. More than 95% of nv-shareholders accepted the offer to convert to voting shares. *Il Sole 24 Ore* dated September 21st 2000 reported that the Italian Security and Exchange Commission has opened a file on insider trading on R.a.s nv-shares in the 10 days preceding the unification announcement.

5.5 Alleanza coercive 1:1 unification

Alleanza Assicurazioni is the largest Italian life insurance company and is controlled by Generali, the first Italian insurance company and one of the largest in Europe. On September 25th, 2001 Generali declared that its group had increased ownership of Alleanza nv-shares shares to 6.0%. On October 1st 2001 another Generali press release stated that its nv-shares stake had been further increased to 7.8%. Just 44 days after, on November 13th, 2001, Alleanza's board announced a 1:1 coercive unification of 131,608,000 nv-shares (representing approximately 6.4% of the total equity of Alleanza). Before the announcement, the market price for the voting and nv-shares was €12.196 and €9.527. After the announcement, the voting shares' stock price dropped to €11.563 (a decline of -5.2%) while the nv-shares rose to €11.389 (up 19.5%). Figure 6 shows the behavior of the two classes of shares in a 40-day window around the announcement date.

The unification was approved in December by both the voting and non-voting shareholders. Before the approval, Generali kept increasing its stake in Alleanza nv-shares, ending up with 10.25% of nv-shares. Since the additional nv-shares were purchased after the unification announcement, and shareholder approval would be a given, it seems that Generali's actions were designed to mitigate the dilutive effects of the unification on Generali's voting control.¹⁸

6. Conclusions

Dual class unifications present a puzzle – their announcements are associated with price increases for nv-shares, and price declines for voting shares. Why do voting shareholders

¹⁸ The post unification percentage of Alleanza voting shares owned by Generali dropped to 47.3% (from 54.3%).

agree to such unifications? In this paper, we present a model showing the price effect of unifications on voting as well as nv-shares. Our main conclusion is that unifications, while appearing to be favoring non-controlling shareholders, are a lot more complex in execution. Using a sample as well as case studies of Italian unifications, we provide prima facie evidence that unifications have been used by controlling shareholders to transfer wealth from non-controlling voting shareholders to themselves by purchasing nv-shares ahead of the unification announcement.

Recent international literature on dual class unifications have tried to find the main factors underlying the increasing international trend. The most broadly accepted are the internationalization of the shareholder base and “one share-one vote” preference; the increase of the voting shares’ market capitalization and liquidity in order to enter or remain in a major stock index. We also suggest that the decision to return to a single class of stock can be driven by some domestic unique factors as: a sharp decrease in interest rates and corresponding higher cost of non-voting shares’ minimum yield; an opportunity to raise equity from nv-shareholders when an additional payment is required; an opportunity for insider trading ahead of unification announcements and an expropriation of minority voting shareholders. Other factors that have encouraged unifications are changes in voting blocks needed to maintain control, and new takeover discipline.

The model developed in the paper shows that most unifications harm voting shareholders, as the dilution in the value of a voting right increases the higher is the percentage of the nv-shares on the firm’s equity and the larger is the price discount at which they are traded. In other countries such kind of expropriation has often been compensated either by an extraordinary dividend (Ang and Megginson, 1989, UK) or by assigning new voting shares to voting shareholders (Hauser and Lauterbach, 2003, Israel). In Italy, where the price differential between voting and nv-shares is one of the highest in the world (Nenova 2003, Dick and Zingales 2002), voting shareholders have not received any explicit compensation. The Italian setting is therefore optimal to study the expropriation effect of a stock unification. The model predictions that a stock unification can be a form of expropriation of minority voting shareholders are confirmed by the analysis of five case studies where the majority

voting shareholders hedge or even take advantage of such unifications by engaging in the following activities: buying relevant blocks of nv-shares, selling voting shares or approving stock option plans on nv-shares. At the stock unification announcement the price of a voting share in the five case studies dropped by an average of seven percent. Such dual class unifications expropriated minority-voting shareholders to the benefit of the controlling shareholder. The Italian Security Exchange Commission has opened several files of alleged insider trading in relation to the above operations but they are referred only to the anomalous volumes observed in the few days before the unification announcement dates. This kind of dual class unifications seems to be another legal form of shareholders' expropriation.

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Figure 1. Yearly distribution of Italian stock unifications. The examined period goes from their introduction (1974) till present (2003).

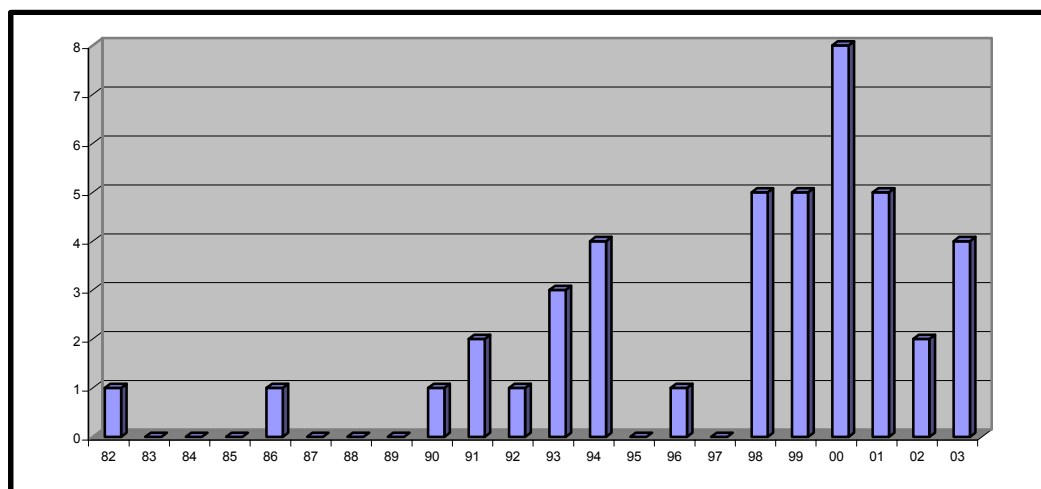


Table 1. Types of Italian stock unification (1974-2003)

Types of unifications	#	% Total
a) 1:1 coercive	17	39,53%
b) 1:1 non coercive	9	20,93%
c) 1:1 with a cash payment	7	16,28%
d) 1:1 plus a cash refund	1	2,33%
e) 1:1 and conversion limit	3	6,98%
f) y voting shares for x nv shares	2	4,65%
g) Choice between c) and f) methods	4	9,30%
Total	43	100,00%

Table 2. Wealth effects of a voluntary 1:1 unification on the different classes of shares. We assume a 90% acceptance rate and a value of the difference in Investment Segment (ΔIS) equal to 20% of the nv-share market value. The effects are simulated for several different levels of the price discounts of a nv-share compared to a voting share before the operation and different percentages of the company's equity represented by nv-shares.

Different classes of shares	$(P_{nv} - P_v) / P_v$ (%)	% of nv-shares on the company's equity				
		1.00%	10.00%	25.00%	33.33%	50.00%
Converted nv-shares	50%	99.10%	90.89%	76.81%	68.76%	52.16%
Voting shares		-0.45%	-4.55%	-11.60%	-15.62%	-23.92%
Not converted nv-shares		0.18%	1.80%	4.50%	6.00%	9.00%
Converted nv-shares	40%	66.07%	60.59%	51.19%	45.80%	34.69%
Voting shares		-0.36%	-3.65%	-9.29%	-12.52%	-19.18%
Not converted nv-shares		0.15%	1.50%	3.75%	5.00%	7.50%
Converted nv-shares	30%	42.47%	38.95%	32.89%	29.41%	22.22%
Voting shares		-0.27%	-2.74%	-6.98%	-9.41%	-14.45%
Not converted nv-shares		0.13%	1.29%	3.21%	4.29%	6.43%
Converted nv-shares	20%	24.77%	22.72%	19.16%	17.11%	12.86%
Voting shares		-0.18%	-1.83%	-4.67%	-6.31%	-9.71%
Not converted nv-shares		0.11%	1.12%	2.81%	3.75%	5.62%
Converted nv-shares	10%	11.01%	10.09%	8.48%	7.55%	5.58%
Voting shares		-0.09%	-0.92%	-2.37%	-3.21%	-4.97%
Not converted nv-shares		0.10%	1.00%	2.50%	3.33%	5.00%

Figure 2. Fin.Part total volume, voting, non-voting and preferred stock price around the unification announcement date.

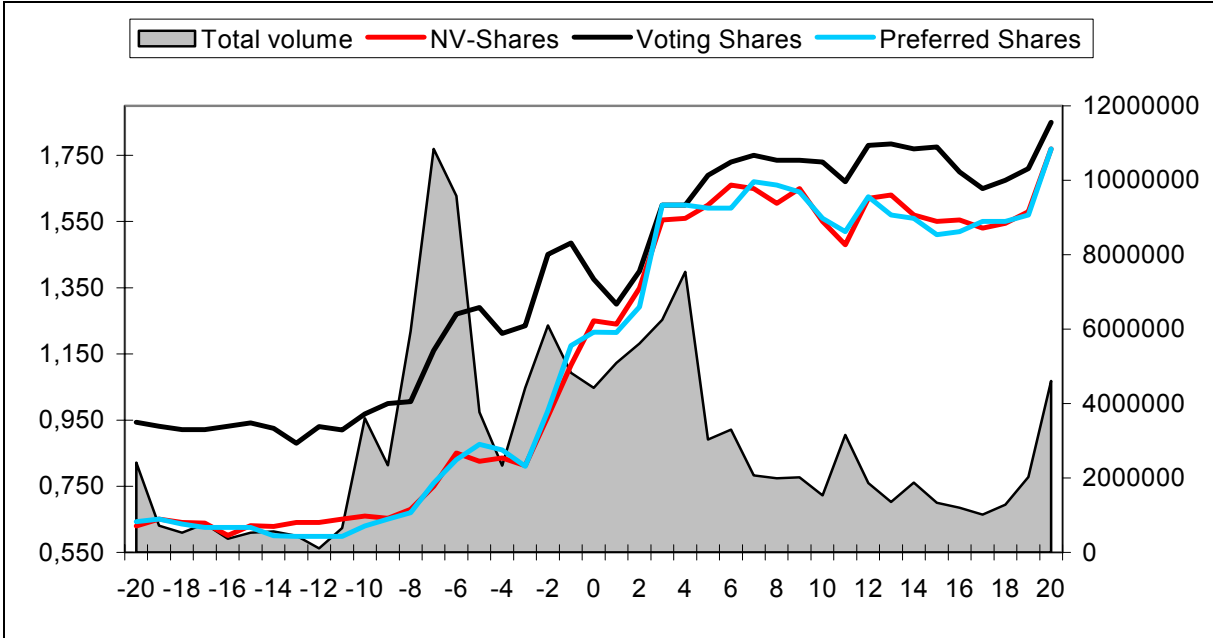


Figura 3. Banca Finnat total volume, voting and non-voting stock price around the unification announcement date.

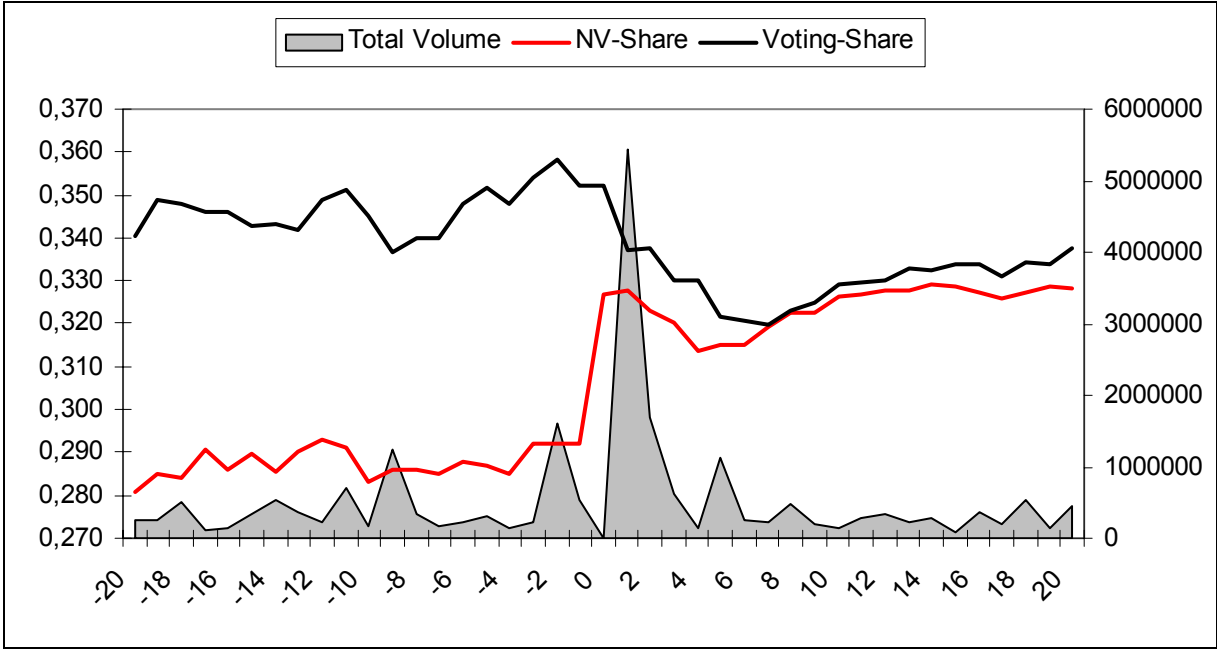


Figura 4. CIR voting and non-voting stock price around the unification announcement date.

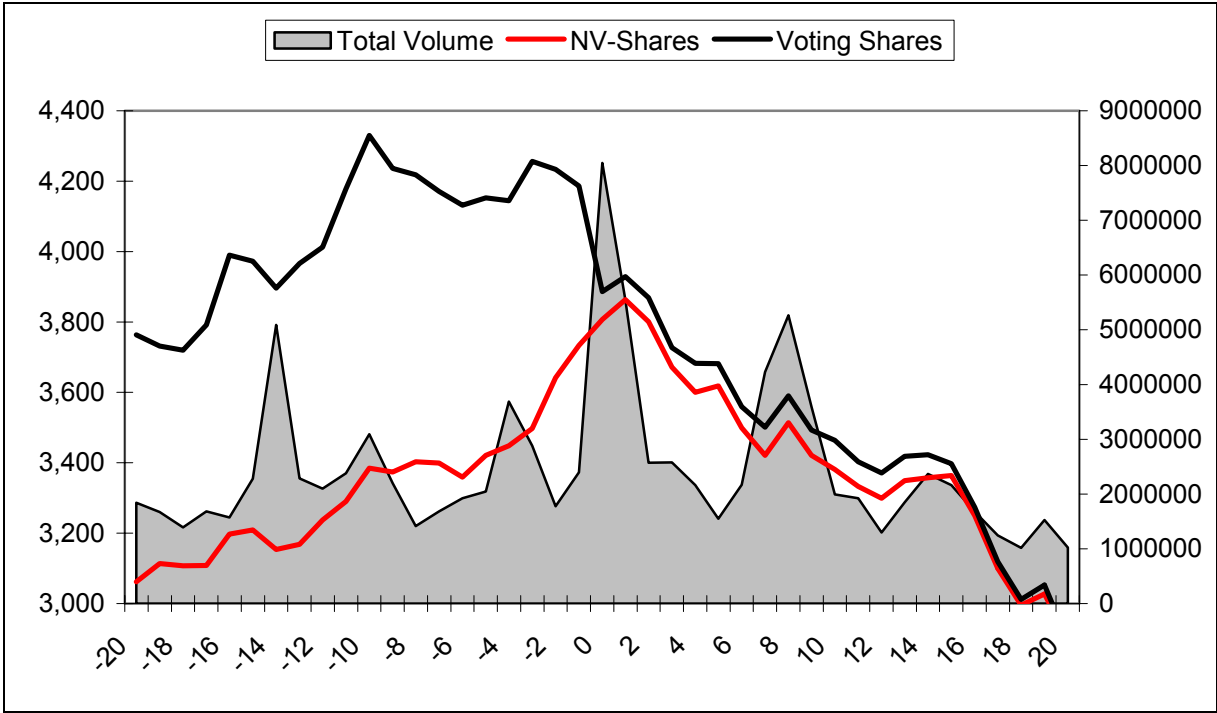


Figura 5. Ras total volume, voting and non-voting stock price around the unification announcement date.

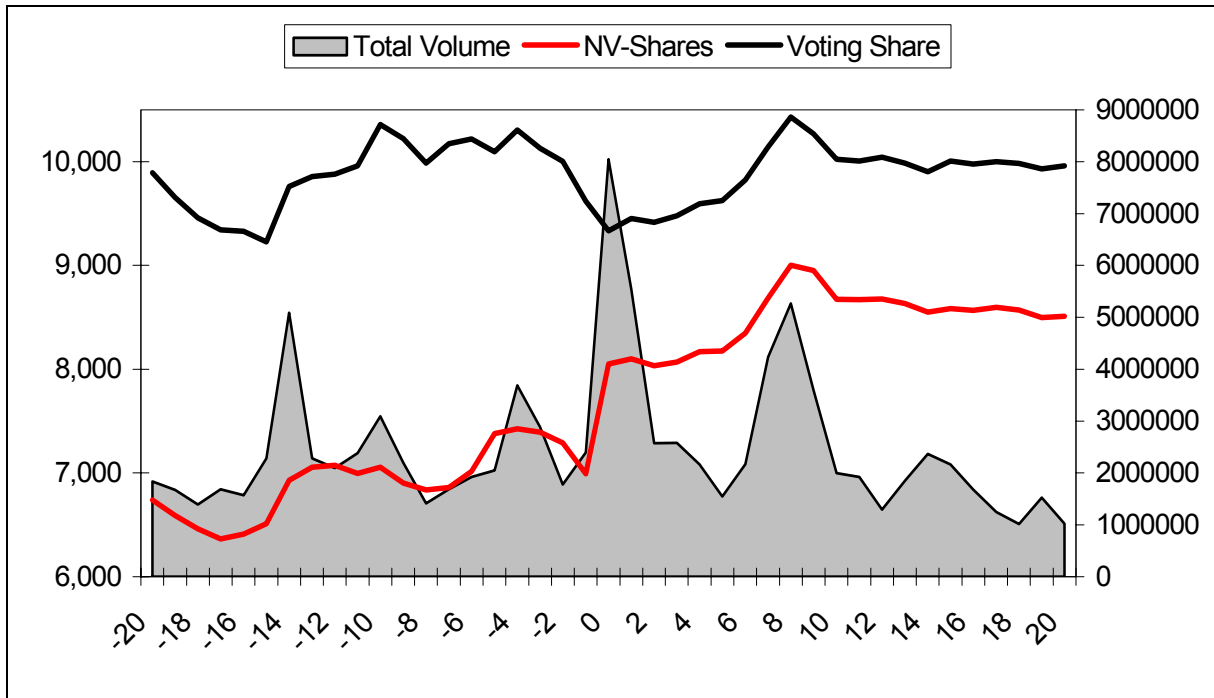


Figura 6. Alleanza total volume, voting and non-voting stock price around the unification announcement date.

