SHAREHOLDERS' COALITIONS AND CONTROL CONTESTABILITY: THE CASE OF ITALIAN VOTING TRUST AGREEMENTS

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Abstract

Since ownership structures characterized by the presence of multiple large shareholders are extremely common around the world, the effects of having such a controlling structure are receiving increasing attention in literature. More than one third of Italian listed companies are controlled by coalitions of shareholders bound together by agreements called "voting trusts" which represent an interesting opportunity to study the consequences of having multiple large shareholders who share the control of firms. We perform an event-study on voting trust announcements (2004-2006), showing significant abnormal returns in both the event day and the following day. The sign of this cumulative reaction is negative for announcements of new/renewed trusts and positive in the cases of trust terminations. These findings are consistent with the "entrenchment effect" hypothesis linking the ownership structure and the firm value. As a general result, the presence of multiple large shareholders tied within a voting trust, by curbing the company's contestability is reflected in a lower valuation of the firm.

Keywords: ownership structure, multiple large shareholders, voting trust agreements, firm value

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1. Introduction

The effects of ownership structures on the value of firms have been a central item in the scholars' agenda since the Seventies, when Jensen and Meckling (1976) identified large shareholders who have both strong incentives and power to discipline the management, as a medium to increase firm value. While the positive incentive effects of large ownership (mainly of managers) have been researched extensively, much less work has been done on the costs – in terms of lower firm valuation – associated with the presence of large investors. Fama and Jensen (1983), DeAngelo and DeAngelo (1985), and Barclay and Holderness (1989) argue that increased insider ownership concentration permits managerial consumption of perquisites and "entrenchment" of incumbent management by reducing the probability of bidding by outside agents, thus reducing firm value.

Stulz (1988) develops a theoretical model, formalising the costs of large shareholders and entrenchment, which predicts a concave relationship between managerial ownership and firm value. In this model, as managerial ownership and control increase, the negative effect on firm value associated with the entrenchment of manager-owners starts to exceed the incentive benefits of managerial

ownership. As a consequence, the entrenchment costs of managerial ownership, in terms of a lower firm value, relate to managers' ability to block value-enhancing takeover or to make them more costly to the bidder.

Empirically, the contribution by Mork et al. (1986) and McConnell and Servaes (1990) support the Stulz's theoretical model, finding an inverse U-shaped relationship between managerial equity ownership and firm valuation for a sample of US firms.

Slovin and Sushka (1993) adopt a different methodological approach in order to ascertain the existence of entrenchment effects due to insiders' ownership. In the "most macabre" event study ever performed within the finance literature, they analyse the market reaction to announcements of deaths of insiders who own at least 5 percent of firm shares. They find significant positive abnormal returns to the announcements of insider block-holders' deaths. Moreover, they show that for a large portion of firms in the sample, the disposition of the deceased's shareholdings leads to a reduction in the control group block and to subsequent corporate control bids. That article is broadly consistent with the Stulz's (1988) propositions, supporting the hypothesis that the firm value is positively related with its openness to the market for corporate control

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while, on the contrary, is negatively affected by ownership structures in which a substantial portion of shares is held by insiders.

Substantial empirical work has shown that ownership around the world is typically concentrated in hands of a small number of large shareholders (e.g., La Porta et al,. 1999; Barca and Becht, 2001). As a consequence, the research focus has shifted from the traditional conflict of interest between managers and dispersed shareholders towards an agency conflict (especially in terms of downright expropriation, self-dealing or collusion with management) between large controlling shareholders and minority shareholders. This conflict is exacerbated when in addition there is substantial separation between voting rights and cash-flow rights, as is common in both continental Europe (Faccio and Lang, 2002; Laeven and Levine, 2006) and Asia (Claessens et al., 2002). Many authors have argued that such an arrangement is particular vulnerable to self-dealing by the controlling shareholder (Zingales, 1994; Burkart et al., 1997; La Porta et al., 1998; Wolfenzon, 1998; Bebchuk et al., 2000).

The theoretical literature on multiple large shareholders is well developed. Zwiebel (1995) assumes that blocks can confer to their holders partial benefits of control, and, as a consequence, on one hand holders of small blocks will join together and form coalitions, while on the other large investors will "create their own space", i.e. by taking a large stake in a firm and thereby deterring other big blockholders; Pagano and Roell (1998) suggest that in concentrated ownership settings, the presence of other large shareholders help mitigate agency costs by monitoring the controlling shareholder; Bennedsen and Wolfenzon (2000) point out that the coalition formation improves firm performance since no individual shareholder is able to take any action without the consent of other shareholders; Gomes and Novaes (2005) show that bargaining problems among multiple controlling shareholders may prevent inefficient investment decisions that harm minority shareholders, but, at the same time, those bargaining problems may block efficient investment decisions.

Still, empirical evidence, to date, on the effect of ownership structures with multiple large shareholders on firm performance has been relatively limited. Lehman and Weigand (2000) report that the presence of a strong second largest shareholder enhances profitability in German listed companies. Faccio et al. (2001) test the effect of multiple large shareholders' structures on dividends. They find that the presence of multiple large shareholders dampens expropriation in Europe (due to monitoring), but exacerbates it in Asia (due to collusion). For Italy, Volpin (2002) provides evidence that valuation is higher when control is to some extent contestable as in the case in which a voting syndicate controls the firm. Finally, Maury and Pajuste (2005) using a

sample of Finnish listed firms show that a more equal distribution of the votes among large blockholders has a positive effect on firm value. This result is particularly strong in family-controlled firms suggesting that families are more prone to private benefit extraction if they are not monitored by another strong blockholder.

Laeven and Levine (2006), studying a sample of European publicly listed companies, find that multiple large shareholders (defined as those having at least 10% of the shares) are relatively common (34% of the sample); moreover, the market value of companies with limited "dispersion" of shareholders (measured as the distance between the first and the second largest shareholder) is higher, signalling a positive effect of either more contestable power or of monitoring by the second largest shareholder, but this effect is weakened with better shareholder protection increased if shareholders' types differ.

This paper extends the findings of Gianfrate (2007) by investigating the existence of entrenchment effects in Italian companies controlled through a voting trust. In particular, we follow, on the one hand, the reasoning line proposed by Stulz (1998) about the relation between insider ownership and market for corporate control, and, on the other hand, the insights emerging from the literature about the separation between ownership and control (Bebchuk et al., 2000). We therefore attempt to merge these reasoning lines in order to assess how the voting trusts' functioning, which implies a certain degree of closeness to the market for corporate control, actually affects firm value.

2. Italian Voting Trusts

According to Bianchi and Bianco (2006), almost 34.5% of Italian listed companies (meaning 47% of total Italian stock-market capitalization) in 2005 were controlled by coalitions of shareholders. These shareholders are usually kept together by explicit agreements to vote together, which are called voting trusts or voting syndicates ("*patti di sindacato*"). These agreements are publicly announced on national newspapers, must be communicated to CONSOB (the Italian Security and Exchange Authority), last for a fixed number of years (usually three) and can be renewed.

The members of a typical Italian voting trust just bind themselves to vote in a certain way within shareholders' meetings and/or within corporate board's meetings. Hence, the content of this kind of trusts varies widely ranging from agreements on voting together on a single specific issue to more complex agreements where the members statue the decisional criteria (i.e. *per capita*, unanimously, super-majority) to be adopted in order to determine how the members of the trust should vote on relevant corporate issues.

Moreover, Italian voting trusts are generally complemented by explicit constraints related to the

possibility of selling the shares owned by trust's members. The content of such covenants can be declined in various ways ranging from the simple prohibition of the selling to the articulation of *pre-emption-rights* among the trust's members. Thus, the content of such agreements could vary significantly but they usually contain the following articles:

- *Pre-emption rights* that confer precedence to the parties in buying other members' stakes at "fair" value in case syndicated shareholders should wish to exit the trust;

- *Provisions of control* which consist in the explicit designation of the rights and duties of the trust's members in the management of the company, and requirements of prior unanimous or majority consent (in the case of "*patti di consultazione*" a simple consultation among trust's members is required) for relevant decisions such as the declaration of any dividend, the approval of business plans or M&A transactions, the disposal of corporate assets, the issuance of shares, etc.;

- *Restrictions on the transfer of shares* when the shareholders commit not to sell, pledge, or charge their shares except with the prior written consent of all other trust's members;

- *Right of first refusal:* a shareholder offered to sell her shares to an outside investor at some price is required to offer his shares to the other shareholders at the same price. If the other shareholders decline, the first shareholder is free to sell her shares to the outside investor;

- *Election of directors and/or members of the board of statutory auditors*: explicit agreement on the number, role (i.e., chairman and vice-chairman of the board of directors) and board seats allocation among trust's members;

- *Call/put options* when trust's members are granted put options on the shares, in part or in whole, held by the other members, at a strike price that is typically equal to "fair" value (the reverse in the case of call options);

- *Valuation*: the 'fair' value of the shares is generally determined by an external expert (usually an investment bank), or it is based on a previously agreed valuation formula;

- *Drag-along rights*: in case a trust's member sells his stake to an outside investor, drag-along rights grant the investor the right to buy out the other members' stakes at the same price and on the same terms as the first shareholder's stake;

- *Tag-along rights*: in case a trust's member sells his stake to an outside investor, tag-along rights grant the other members the right to require the outside investor to buy their stakes at the same price and on the same terms as the first shareholder's stake. Tag-along rights can be viewed as conditional put options granted all shareholders;

- *Dispute resolution and arbitration*: The shareholders agree to follow a specified procedure to resolve disputes. The procedure may specify the appointment of an arbitrator.

Gianfrate (2007) studies a sample of 74 voting trust agreements showing that the gathering of large shareholders in a voting trust determines the binding of the majority of voting rights, allowing, in particular, the largest shareholder to exercise both the majority of board rights and, usually, the direct management of the controlled company. The other shareholders involved within the trust obtain, at least, the right to appoint some board directors and/or the members of the board of statutory auditors presumably in order to monitor the largest shareholder in charge of the company's direct control.

Volpin (2002) investigates the determinants of executive turnover and firm valuation as a function of ownership and control structures in Italy, showing that the presence of a voting trust actually increases the sensitivity of turnover to performance (after a 10% decrease in earnings, executive turnover is 7% more likely if the firm is controlled through a voting trust than otherwise). Furthermore, he points out that firm value (measured as Tobin's Q) is significantly larger when control is partially contestable as in the case in which a voting trust controls the firm.

Indeed, Volpin shows that the control obtained through a voting trust agreement is more efficient in comparison with the situation where the control is fully in the hands of a single controlling shareholder. Then, if the voting trust control structure has more beneficial effects when compared with the single controlling shareholder one, the question to be addressed remains whether, in absolute terms, voting trusts are an efficient governance mechanism.

3. Voting Trusts and the Market for Corporate Control: a Stylized Model

Bianchi and Bianco (2006) suggest that Italian shareholders' coalitions, especially in the form of voting trusts, ensure to the members (considered as a whole) a concentration of voting rights sufficient to maintain the control of the companies, in the sense that such trusts perform a function similar to that of pyramidal ownership structures. This implies that those coalitions might reproduce the separation between ownership and control usually performed by pyramids, cross-ownership and issuance of shares with different (or no) voting rights.

Bebchuk et al., (2000) highlight the potentially large agency costs that the separation between ownership and control involves. In particular, they demonstrate that the agency cost imposed by controlling shareholders who have a small minority of the cash-flow rights in their companies can be an order of magnitude larger than those imposed by controlling shareholders who hold a majority of the cash-flow rights. This is because, as the size of cash-flow rights held decreases, the size of agency costs increases, not linearly, but rather at a sharply increasing rate.

The most important decision that can impose significant agency costs on firms where a separation between ownership and control has been attained, is represented by transfers of control (Bebchuk et al., 2000).

Thus, following Bebchuk (1994), we propose a formalization of the corporate control transactions in order to evaluate the agency costs generated when there is a separation between cash-flow and voting rights obtained by enacting a voting trust among large enough shareholders.

The model considers an initial controller I owning a fraction α of company's cash-flow rights. Under the control exerted by I, the value of the company is V_I which consists of sum of cash-flow C_I and private benefits of control B_I. Under a potential new controller, N, the corresponding values would be, respectively, V_N, C_N, and B_N. The a transfer of control from I to N will be efficient if and only if

$$V_I = C_I + B_I < V_N = C_N + B_N.$$

In particular, under the "equal opportunity rule" system of mandatory bid, which implies that non-controlling shareholders are entitled to participate in a transfer of control on the same terms as the controller (Bebchuk, 1994), the initial controller I will sell his control stake if and only if

$$\alpha\, V_N > \alpha\, C_I + B_I,$$

meaning that the transfer of control takes place only if the sum of his cash-flow right portion and the private benefits he is able to extract is less than the portion of the value – that basically means price – the potential new controller will attribute to the control of the firm.

The key point of this model relies on the fact that, since α can be as small as desired, the decision of controller I to sell the firm will depend much less on V_I and V_N, the values of the firm in the hands of I and N, than on the relative sizes of B_I and B_N, the private benefits of I and N.

Extending this model to the voting trust mechanism, we are able to show how the separation between cash-flow and control rights obtained through a voting trust, affects the market for corporate control of companies held by such a device.

If that firm is controlled by the voting trust T, then its value is

$$V_T = C_T + B_T$$

consisting of the sum of cash-flow C_T expected by the firm under the control of the trust and private benefits of control B_T extracted by the trust.

Assuming that the trust is composed of n members who own, as a whole, the fraction α of the total cash-flow rights of the firm (C_T), then each i-member of the trust owns the fraction α_i of the cash-flow such as

$$\sum_{i=1}^{n} \alpha_i = \alpha.$$

The trust is able to extract the private benefits of control B_T which are shared only among trust's members and not with shareholders outside the trust – this descends from the definition itself of private benefits of control – allocating to each member the fraction β_i (such as $\sum_{i=1}^{n} \beta_i = 1$) of B_T.

Finally, we assume for sake of simplicity that only two states of the world exist: one in which the trust works and one in which the trust is not able to work effectively at all (e.g. the members cannot reach an agreement on major decisions). Hence, the extraction of the private benefits of control is assumed to be allowed if and only if the trust does fully work. We capture this idea stating that private benefits of control B_T are a function of trust effectiveness λ which assumes alternatively the value 1 when the trust works, and 0 otherwise.

In this setting, the value of the stake for the i-member of the trust is V_{Ti} defined as

$$V_{Ti} = \alpha_i\, C_T + \lambda\, \beta_i\, B_T, \text{ such as } \sum_{i=1}^{n} V_{Ti} = V_T.$$

the i-member of the trust will sell her stake to the potential new controller N if and only if

$$\alpha_i\, V_N > V_{Ti}.$$

It is worth noting that while the presence of the fraction α_i still implies (as in the general case) that the lower the stake held by the i-member of the trust, the more the decision to sell depends upon the relative sizes of private benefits of control of B_I and B_N, rather than upon the values of the firm V_T and V_N. Moreover, in this model, the decision to sell is dramatically determined by the allocation of private benefits of control (β_i) and, naturally, by the effectiveness of the trust itself.

When the trust works well, the extraction of private benefits is allowed, and λ is equal to 1. Thus, the last expression becomes

$$V_N > (\alpha_i\, C_T + \lambda\, \beta_i\, B_T)/\, \alpha_i.$$

Conversely, if λ is equal to zero - meaning that the trust's members are unable to extract the private benefits of control - then previous expression becomes

$$\alpha_i\, V_N > V_{Ti} = \alpha_i\, C_T.$$

This result implies the intuitive idea that if the i-member of the trust could not enjoy his portion of private benefits of control (e.g. he is rejected from the trust), then he should value his stake no more than the attached fractional claim on the company's cash flow. If this condition is respected for each member of the controlling trust, also the dispersed minority shareholders (who value their shares only

on the basis of their expected cash-flow portion) should sell their shares if and only if

$$(1-\alpha) \ V_N > (1-\alpha) \ C_T.$$

It follows that if a potential buyer who assigns to the entire company (or to a single stake in it) a value which is higher than the total cash-flow generated by the firm under the control of the voting trust, then he will succeed in buying the company. (In particular, the new controller is willing to pay something more then the cash-flow rights currently generated by the firm, because he expects to improve the cash-flows due to a superior management of the firm after the takeover, and/or she conjectures to be able to extract more private benefits of control from the company than the voting trusts currently does).

Coming back to the main objective of this paper, from the illustration of this simple model, we are able to draw the hypotheses to be tested in the empirical analysis. Since both the establishing of new trusts aimed to control a listed company as well as the renewal of existing trusts, represent a way of insulating (at least, to a certain extent) the firm from the market for corporate control, thus avoiding a range of efficient transactions (from the market point of view), then at the announcement of such events a negative response from the market is expected.

Conversely, when the termination of a voting trust is announced, and, as a consequence, the company's openness to potential bids increases, a stock upside should follow.

4. Evidence from voting trusts announcements

Following Gianfrate (2007), we obtain the announcements regarding Italian listed companies controlled by voting trusts from the database *Radiocor/IlSole24Ore*, an Italian financial news agency. We examine the period 2004 through 2006, searching for records about the establishment of new trusts, as well as the renewal or termination of existing ones. We discard, from the sample, the announcements containing other relevant financial information (e.g. announcements regarding earnings, CEO turnover, acquisitions) conveyed to the market together with the information about the trust. We finally find 32 events which we group into two separate sub-samples. The first one includes 21 announcements related to new voting trusts or to the renewals of existing ones. The other sub-sample contains 11 announcements which are referred to the termination of voting trusts.

We find an average two-days (0,1) excess return equal to -1.46% for the "New/Renewal" announcements, and a +6.56% for the "Termination" cases.

Table 1. Cumulative Average Abnormal Returns (0,1) for Voting Trusts' Announcements

	Announcements	Mean	Median	Standard Deviation	Min	Max	*t*-statistic
New/Renewal	*21*	-1.46%	-0.83%	2.10%	-6.57%	2.46%	-3.18*
Termination	*11*	6.56%	4.60%	6.21%	-0.71%	17.30%	3.50*

* significance at 5% level (two-tailed test)

The sign of the market reaction at the announcements is negative for the newly established o renewed trusts, and is positive when the termination of a voting trust is announced.

Though the announcements' sample is limited, those findings suggest that the market considers unfavourably – in terms of firm value - the ownership situations where the control over companies is cooperatively shared among large shareholders.

5. Conclusions

This paper is aimed at illustrating the relation between ownership structures based on multiple large shareholders and control contestability by analysing the case of Italian voting trust agreements.

We formalize a simple model which shows how the separation between ownership and control attained through voting trusts, affects the dynamics of the market for corporate control of firms held by such agreements. In particular, the rationale of such shareholders' agreements is assumed to be the insulation of the controlled company from potential control contests.

We test the insights coming from the model by applying an event-study analysis on a sample of voting trusts' announcements. We find statistically significant abnormal returns in both the event day and the following day. The sign of this cumulate reaction is negative for announcements of new/renewed trusts and positive in the cases of trusts' termination. This finding is consistent with previous findings by Gianfrate (2007) and confirms

the presence of an entrenchment effect linking the ownership structure and the firm value: as a general result, the presence of multiple large shareholders, tied within a voting trust which curbs the company's contestability, is reflected in a lower valuation of the firm.

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