

Do Differences in Corporate Governance Standards in Cross-Border Mergers and Acquisitions create synergy value?

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1. Introduction

Cross-border merger and acquisition (M&A) activity has increased significantly over the last 15 years. Expansion through cross-border acquisitions enables companies to exploit differences in tax systems and to capture rents resulting from market inefficiencies, such as national controls over labour and resources markets. An additional source of takeover value in cross-border M&As may be induced by improvements in the governance of the bidding and target firms as a result of spillovers of corporate governance standards between the two firms. We hypothesize that the scope for potential improvements in corporate governance is even greater in cross-border M&As, as the difference between the bidder and target quality of corporate governance is amplified by the significant variation in national corporate governance standards. Therefore, our main question is: *Do differences in the quality of corporate governance standards between the bidder and target countries explain part of the expected value creation in cross-border takeovers?* In other words, is there a valuation effect of cross-border spillover of corporate governance standards (and more specifically of investor protection)?

2. Spillover effects

Why would we expect such a spillover valuation effect for corporate governance? In international law, a full takeover leads to a change in the nationality of the target firm such that the acquirer's corporate governance regulation will apply to the combined company, in effect replacing the target cor-

porate governance. When the bidder is subject to better corporate governance regulation than the target, the acquisition may result in an improvement in corporate governance (e.g. enhanced shareholder orientation) in the target. If this improvement is expected to generate value, the abnormal share price returns of both the bidder and target should reflect such value creation. We call this hy-

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hypothesis the *positive spillover by law hypothesis*. ‘Positive’ refers to the corporate governance improvement for the target as a result of the full takeover by the bidder. In other words, the better the corporate governance of the bidder, the higher the returns to the bidder and target firms from the takeover. Likewise, we define the *negative spillover by law hypothesis*: when the bidder governance standards are below those of the target, the abnormal returns will be lower as the governance standards of the target will now be less strict.

The *negative spillover by law* effect is expected between a bidder in a country with low investor protection and a target in a country with stricter corporate governance regulation, as the poor investor protection induced by the bidder may lessen the quality of corporate governance of the target. This could reduce the value of the target’s assets in the hands of the bidder.

3. Bootstrapping

For the negative spillover effect, there is an alternative hypothesis: bidders can abide by the stricter regulation that the target is subject to. We call this the *bootstrapping hypothesis*: bidders voluntarily bootstrap their corporate governance regulation to a higher level. As such, firms can contract privately on the optimal level of investor protection. If the bidder shareholders intend to pursue such bootstrapping to a higher level of corporate

governance, the value of the merged firm may actually increase which will also be reflected in the bidder share price at the takeover announcement. Bootstrapping may occur in both full and partial acquisitions, but the valuation effect may be stronger in partial takeovers whereby a stake of less than 100% of the voting rights is acquired and the target still remains listed on its national stock exchange. The bootstrapping valuation effect may also be stronger in takeovers with all-equity offers or mixed bids as (some of) the target shareholders will then remain involved with the merged company and may actively resist managerial actions reflecting a reduced shareholder orientation.

4. Full and partial takeovers

International law prescribes that the *positive spillover by law* effect is to take place in a full takeover, which leads to a change in the target firm’s nationality. Nonetheless, partial takeovers may also lead to a similar spillover effect, which we call the *spillover by control hypothesis*. Although the target firm is not fully absorbed by the bidder in a partial acquisition, the bidder may still impose its own corporate governance standards on the target, provided that the bidder standards are stricter than the target’s. In contrast, if the bidder standards are less strict than the target’s, the bidder has to comply (locally) with the target corporate governance law and the listing regulations (in case the target remains listed on a national stock exchange).

5. Conclusion

The main conclusion from our analysis is that the *positive spillover by law hypothesis* is supported whereas the *negative spillover by law hypothesis* is not. The bidder and target takeover announcement returns are positive when the former’s governance standards are stricter than the latter’s. This implies that the stricter governance imposed on the target is expected to lead to value creation, possibly to an increased focus on shareholder value and a reduction in managerial private benefits of control. In contrast, when the bidder corporate governance standards are less strict than the target’s, neither the bidder’s nor the target’s returns are lower. While this evidence goes against the negative spillover

Bibliography

This policy brief is based on Martynova and Renneboog (2008), *Spillover effects of corporate governance standards in cross-border mergers and acquisitions*, Journal of Corporate Finance, forthcoming.

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by law hypothesis, it does not contradict our *bootstrapping hypothesis*: it seems that poor-governance bidders bootstrap to the better-governance regime of the target, experiencing a share price increase. Importantly, the effect is only valid for partial acquisitions, in other words deals which still involve some of the target shareholders (who did not sell out) and in which the target firm remains listed on the stock exchange in the country of the target.

The *spillover by control hypothesis* holds when the differences between the bidder and target governance regulation have a positive effect on anticipated gains of partial takeovers. The spillover effect from a bidder from a country with stronger shareholder protection on the target explains part of the value creation expected at the announcement of the partial takeover. The potential benefits from the improvement of the target corporate governance are shared by both the bidding and target firms' shareholders: both the bidder and target returns increase. Our results are robust with respect to several model specifications that control for potential endogeneity problems.

Our results also support the view that national corporate governance regulation has a significant impact on the flow of cross-border takeovers. In particular, we find that firms from countries with weak corporate governance regulation are more likely to invest abroad rather than domestically. We also find that bidders are more likely to acquire firms abroad if minority shareholder protection in their home country is strong. This result is in line with the argument that strong protection of minority shareholders makes corporate takeovers costly and hence forces companies to look for potential M&A targets abroad, in countries with weaker (minority) shareholder protection. Strong creditor protection in the home country also has a positive effect on international takeover activity.

Finally, most of our other results on the effect of the relative transaction size, free cash flow, hostility, means of payment, diversification strategies, stock-price run-up, differences in economic development, geographical closeness and language relatedness of the bidder and target, the level of corruption,

Further reading

This policy brief is based on research carried out within the NEWGOV project no. 21 on "Towards New Corporate Governance Regimes in Europe". Over the past decade, corporate governance has attracted significant attention in the corporate and financial world as well as in academic circles. Still, whereas the Anglo-American governance paradigm has been well developed, research on the Continental European framework has been lagging, mainly due to lack of high quality data. The adoption of legal disclosure requirements by most European countries at different times throughout the 1990s on, e.g., ownership structures and managerial remuneration, enables us now to investigate the relative merits and deficits of particular corporate governance systems. The lack of research that takes the specific context of European governance structures into account, has abated the quality of auto-regulation and of legislative initiatives on the national and European level.

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and other characteristics are in line with the findings in the earlier literature.

This paper contributes to the literature in two ways.

First, we answer the question *how or through which channels cross-border mergers and acquisitions generate value*. Our results reveal that the improvement in the target shareholder protection has a positive effect on takeover synergy irrespective of the type of takeover. Our results thus reveal that governance-related takeover synergies may not only arise from a *spillover by law* effect but also from *spillover by control* and *bootstrapping* effects.

The second contribution is that our analysis is based on new corporate governance indices. Our *country-level indices* are more elaborate than the indices developed by La Porta, Lopez-de-Silanes, Shleifer and Vishny and employed in the studies mentioned

above. With the help of 150 corporate lawyers from 32 European countries, we have created a corporate governance database that comprises the main changes in corporate governance regulation in all European countries over the last 15 years. For each country, we quantify corporate law, stock exchange regulation and corporate practices, and measure their effectiveness in mitigating the conflicts of interest between the various corporate constituencies: management, ma-

majority and minority shareholders, and creditors. Our indices reveal that corporate governance regulation has been substantially reformed in virtually every European country since the early 1990s. Therefore, it is important to note that, in contrast to previous studies, all legal indices employed in this paper are time-varying and reflect changes in the legal environment. A description of the indices can be found in the box below.

Corporate Governance Standards Indices

To measure the quality of corporate governance standards in the countries of the bidder and target firms we construct a number of indices. With the help of 150 corporate lawyers from 32 European countries, we have created a corporate governance database comprising the main aspects of, and changes in, corporate governance regulation in all European countries (including Central and Eastern Europe) since 1990. For each country, we quantify the regulation mitigating the conflicts of interests between the main corporate constituencies: management versus shareholders, majority versus minority shareholders, and creditors versus shareholders. We construct the following three indices (see also Martynova and Renneboog, 2007b).

- (i) The *shareholder rights* index is based on shareholders' ability to curb managerial opportunistic behaviour. The index measures the degree of *shareholder orientation* of a national regulation. The index increases with the number and quality of legal provisions that provide shareholders with effective power to appoint and dismiss the board of directors and to control most of the important corporate decisions on, for instance, equity issues or anti-takeover measures. We also take into account the regulatory provisions that ensure that the board of directors acts as an independent body operating on behalf of all shareholders and monitors top management. Provisions that address the quality of information on the management and the frequency of disclosure of accounting information are also considered. A higher index score represents a greater likelihood that management acts in the interest of shareholders and hence reflects better corporate governance standards with respect to shareholder protection.
- (ii) The *minority shareholder protection* index hinges on the regulatory provisions that increase the relative power of the minority shareholders in the presence of strong majority shareholders. In a firm with concentrated control, it is possible that the dominant shareholder extracts private benefits of control by influencing managerial decisions for his own benefit. This may lead to the expropriation of minority shareholders' rights. We quantify the regulatory provisions related to minority shareholder protection (e.g. board representation, minority claims, extraordinary general meetings, blocking minorities), the one-share-one-vote principle (dual class shares, voting caps, break-through rule, equal treatment principle), ownership transparency, and the relative decision power in case of a takeover threat. A higher index score signifies that minority shareholders' interests are better protected.
- (iii) The *creditors rights* index hinges on the regulatory provisions that allow creditors to force repayment more easily, to take possession of the collateral, or even to gain control over the firm in case of financial distress. In creating this creditor rights index, we closely follow the approach of LLSV and investigate the regulation related to the violation of debt covenants (deviations from the debtor priority ranking in case of bankruptcy), the possibility for debtors to impose restrictions on borrowers (e.g. limitations on filing for reorganization/liquidation), and the creditors' rights in financially distressed firms (e.g., automatic stay on assets).