

# Integrating corporate governance systems

To execute a cross-border M&A, companies need to consider issues of corporate nationality. **Arturo Bris** and **Christos Cabolis** explain the legal implications of working across borders

In a merger, two companies come together and integrate their distribution lines, brands, work forces, management teams, strategies and cultures. In a cross-border merger, however, the merging companies must also integrate the legal system of their countries of origin. Specifically, they must unify accounting rules, standards of protection for investors, legal status of assets in case of default and, more generally, the corporate governance provisions of the merged company. Given that corporate governance rules differ between countries, the questions that arise are related to the process of the integration of the legal systems and the value implications to the various stakeholders.

This article will look at the corporate governance implications of cross-border M&As.

## Does corporate nationality matter?

In *Mastering Financial Management* (June 2006), Professor Bris argued that the concept of corporate nationality had blurred in recent years. But in legal terms, corporate nationality remains important. In a cross-border M&A, when one company buys 100 per cent of another business's assets, the nationality of the target entity changes to that of the acquirer.

Usually, domestic laws determine which companies are "national". In some countries, this is defined by the location of corporate headquarters. In others, it is the country of incorporation. And in some, such as the US, there is an additional "control" provision to determine the nationality of the corporation.

Ultimately, the co-ordination of several jurisdictions determines the principle applied. For instance, in the 1990 merger between the UK's Wilkinson Sword and the US's Gillette, 14 different agencies, including some outside the US and the EU, were involved in the proceedings.

The change of a business's nationality affects the corporate governance system of the new entity. There are three options for the new regime: to assume the nationality of the acquiring company, the target business or a mix of the two. For example, in 1999, when Spanish tobacco company Tabacalera acquired its French rival Seita, the new company, called Altadis, started to report under the Spanish GAAP. In contrast, the company resulting from the 1996 acquisition of

Sweden's Merita Nordbanken by Denmark's Unidanmark started to report under Swedish GAAP.

Consider another example. The 2002 merger between Germany's Hoechst and France's Rhône-Poulenc resulted in the creation of the French corporation Aventis (which is now part of the Sanofi-Aventis group). The corporate governance of Aventis is an improvement with respect to both merging companies. For instance, Rhône-Poulenc and Hoechst required a deposit of shares within five and seven days prior to the shareholders meeting, respectively. When shareholders are required to deposit their shares, they cannot sell if there is a disagreement with the management. Therefore, a deposit of shares limits shareholder rights. After the merger, however, Aventis required such a deposit for only three days.

## Buying in a protective system

In recent years, situations where the acquirer comes from a less protective environment have become more frequent. Our research shows that, between 1995 and 2001, the majority of cross-border M&As occurred between companies from similar legal systems (for example, the US and UK, Spain and Italy.). However, about one in five cross-border mergers involved an acquirer with a weaker legal system than the target. (By weaker, we mean a country for which the World Bank assigns indices of investor protection and accounting standards that are lower than in the target's market.)

Such deals represent a loss for the shareholders of the target company. For example, at Altadis, the French GAAP was arguably of higher quality than the Spanish standard at the time of the merger. If it is accepted that better reporting is valued by shareholders, one direct effect of the merger for Seita's former shareholders was that their new company became more opaque. Indeed, when Altadis switched to International Financial Reporting Standards in 2004, its reported dividend payout ratio fell from 61.4 per cent under Spanish accounting standards to 47.3 per cent. Different accounting standards give a completely different view of the same company.

Similarly, consider the case of a company from an emerging market trying to acquire a business in a developed economy. The challenge for the former is that the securities it offers to the target business's shareholders may have weaker protection than they currently enjoy. The acquirer pays taxes in its domestic market, and most of its

assets and human capital remain there, so the cross-border merger leads to a situation where the new company is governed under the rules of the acquirer. Even if the acquirer is required to register its securities with the SEC, as it happens in the US.

Should this be of concern to shareholders of the target company? In truth, it is difficult to quantify the impact on value of such a deterioration in investor protection because it is difficult to measure the quality of a governance system. In some countries, good governance means protecting employees and having them on the board. In others, however, good governance is about protecting minority investors.

The most widely used measuring system was compiled in 1998 by economists Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, and is known as the LLSV index. In our 2004 study, *The Value of Investor Protection: Firm Evidence from Cross-Border Mergers*, we found that the quality of the investor protection introduced by the acquirer had a significant effect on the merger premium. For instance, a US target

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company bought by a business in Chile, which has an LLSV index rating of 35, instead of an identical business in Argentina, which has a lower index measure of 21, receives a merger premium that is 5 per cent higher. The reason is that the assets of the US company are worth more when managed in a country that protects the interests of its shareholders better.

There is ample evidence that shareholders care about governance changes that result from cross-border mergers. In a detailed study of the DaimlerChrysler merger, Professor Andrew Karolyi of Ohio State University revealed that 95 per cent of the order flow on DaimlerChrysler ordinary shares that US investors in Chrysler received as merger consideration migrated back to Germany within the first six months of trading.

Of course, this is not due only to differences in investor protection between Germany and the US. It suggests, however, that local investors may be reluctant to hold foreign stock when foreign ownership implies weaker rights.

Another supporting piece of evidence is the price of earnings opacity. In a paper for the *Journal of Accounting Research*, economists Utpal Bhattacharya, Hazem Daouk and Michael Welker showed that an increase in overall earnings opacity in a country is linked to an increase in the cost of equity and a decrease in trading in the stock market of that country.

## Bringing good governance to emerging markets

The flip side of the argument outlined above is that a company based in a country with a strong corporate governance regime is paying less to acquire a target business in a weaker corporate governance country. Our research shows that a Spanish company pays 7 per cent more to acquire a French company than to acquire an identical Italian company because the Italian index of shareholder protection is three times lower than the French one. Unfortunately, this does not translate into a prescription for what a good acquisition should be, as the lower premium represents the lower value of the shares in countries with weaker investor protection. Nevertheless, the implication is that acquirers pay less for companies where shareholders have less protection.

How does this square with the fact that the acquirer brings its own legal system to the target company? Interestingly, cross-border M&As provide a mechanism for a company to modify its corporate governance system without the need for legal reform. This is known as corporate governance convergence by contract. It implies that companies operating in weak legal environments can opt into better ones by being acquired by a foreign company and, thus, improve on the limitations of the local legal system.

This type of corporate governance convergence is achieved not only through cross-border M&As. Dual-listings, for example, also represent a strong commitment to comply with more stringent requirements. Thus, dual-listed businesses in the US must comply with SEC disclosure requirements. Similarly, cross-border mergers provide a credible commitment for the shareholders of the target company

because they have access to courts in the acquiring company's country. Thus, a shareholder of a Mexican business that has been acquired by a US company has access to US courts. Obviously, if the Mexican company was to be acquired either by a US or an identical Brazilian business, the shareholders would prefer the former acquirer because of the higher security.

Accordingly, the United Nations Conference on Trade and Development (Unctad) reports that, in 2004, Mexican companies spent \$1.9bn on foreign M&As, while \$6.4bn worth of Mexican businesses ended up in foreign hands. By contrast, the US corporate sector bought \$110bn worth of assets, and sold \$81bn. In other words, Mexico is a net seller while the US is a net buyer of companies globally.

## Hybrid systems

In most cross-border M&As, the final result is a mix of the two scenarios described above. In essence, the level of shareholder protection and other aspects of corporate governance become an issue of negotiation, and depend on the bargaining power of the participants in the merger. For example, the corporate governance of AstraZeneca (the result of a merger between Swedish and UK companies) is neither Swedish nor British. It is a combination – and an improvement – of both governance systems.

The same can be said about Aventis. In the absence of any contract between the merging parties, Aventis should have, by default, followed the French system. However, even though the format and sections of the bylaws of Aventis are more like those of Rhône-Poulenc, the corporate governance structure is more similar to that of Hoechst. Specifically, before the merger, Hoechst had a dual-board structure typical of German corporations, with a management board and a supervisory board, unlike Rhône-Poulenc that did not have a management board. Aventis was French, yet it still had one.

## Do acquirers take corporate governance issues into account?

Is this as important as it seems? Do acquiring companies take into account the legal system of the companies they intend to purchase? Are corporate governance issues brought to the table during M&A negotiations?

It is clear that investors factor in corporate governance variables, so there is no reason why acquiring companies should not consider them important as well. The California Public Employees' Retirement System (Calpers), for example, follows its corporate governance principles when making investments abroad. For most institutional investors, the protection provided by the legal system is important as well.

Peter Clapman, senior vice-president and chief counsel for corporate governance at TIAA-CREF sum-

marises the situation well: "When global investors look at deals, particularly cross-border deals, they will often factor corporate governance issues into the equation, and these may have a practical effect on price and value."

## Conclusion

Countries differ in their legal systems and, in particular, in the protection they provide to shareholders under their jurisdiction. Cross-border M&As are complex deals because they require integration of management cultures, corporate resources and the governance systems under which the merging companies operate.

We have argued that differences in protection can be beneficial for both the acquirer and the target if the merger is negotiated efficiently. For the target, its shareholders can enjoy a system of better protection if their company is acquired by one operating in a more protective regime. For the acquirer, it is less expensive to buy in

emerging markets because corporate governance factors are priced in the merger premium.

We believe that cross-border M&As complement legal reform as a way to improve investor protection. But how can legal reforms and cross-border M&As live together? Specifically, what is the impact of reforms such as the Sarbanes-Oxley Act on cross-border M&As?

The effects of legal reform within a country can be easily overcome via cross-border M&As. As a result, initiatives like Sarbanes-Oxley will have a dual effect. First, they will make foreign acquisitions more expensive because acquirers in the US will be

further away from their targets in terms of investor protection. Thus, they will pay higher premiums for the value of the protection they bring about. In a sense, Sarbanes Oxley is great for foreign companies that are to be taken over by US businesses, but foreign acquirers of US companies will find it much more costly to buy businesses there.

Second, as US companies buy abroad, they will have to adapt the financial reports of their targets to the new standards. Thus, the cost of the acquisition in terms of management time and effort will be greater depending on whether the protection is weaker and the rules less transparent in the target market.

Overall, buying in emerging markets will be too expensive for acquirers in developed economies, and we foresee the number of these acquisitions to decrease. This is another example of how regulation becomes a barrier to globalisation.



**Arturo Bris** is professor of finance at IMD and a research associate at the European Corporate Governance Institute. [arturo.bris@imd.ch](mailto:arturo.bris@imd.ch)



**Christos Cabolis** is assistant professor of economics and finance at the Alba Graduate Business School and a fellow of the International Center for Finance at the Yale School of Management. [ccabolis@alba.edu.gr](mailto:ccabolis@alba.edu.gr)

This article is based on their working paper, *The Value of Investor Protection: Firm Evidence from Cross-Border Mergers*, which won the Jaime Fernández de Araoz award in corporate finance.

