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The Role of Cross-Border Mergers as a Mechanism for Corporate Governance Reform

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Related literature

Established link in the literature

Legal rules → Degree of Investor protection →

- Size of capital markets
- Firm value
- Firm dividend policy
- Firm ownership structure

Three Main Research Questions

- Do Cross-Border Mergers Have a Corporate Governance Effect?
  - Bris and Cabolis (Review of Financial Studies, 2007)
  - Bris and Cabolis (in “International Mergers and Acquisitions”, 2008)

- Do Corporate Governance changes affect firm value?
  - Bris and Cabolis (Review of Financial Studies, 2007)

- Is there any relationship between Corporate Governance and Industry Structure?
  - Bris, Brisley, and Cabolis (Journal of Corporate Governance, 2008)
  - Bris, Brisley, and Cabolis (2008)

Introduction

- Main Question: Do Changes in Corporate Governance affect firm value?
- Abundant evidence on cross-sectional effects of differences on corporate governance.
- However, it is difficult to analyze the time-series effect of changes in investor protection at the firm level: data availability
- Cross-border mergers provide a natural experiment to analyze changes in corporate governance.

- Examples:
  - Vivendi (France) – Seagram (Canada), 1999
  - Merita Nordbanken (Sweden) – Unidanmark (Denmark), 1996
  - Tabacalera (Spain) – Seita (France), 1999
  - Daimler (Germany) – Chrysler (USA), 1998

Motivation: Example 1

- *El Gauchito de Oro SA* (Uruguay) acquired by *McDonald's* (U.S.) in February 2002.
- *El Gauchito* was a franchise that owned 32 *McDonald's* Restaurants in Uruguay. It was publicly traded.
- The shareholders are now U.S. investors, and the firm is subject to US corporate law, and reports under US GAAP.

Motivation: Example 2

- *Bank Austria* (AUT) acquisition by *HypoVereinsbank* (Germany), in July 2000, worth $7.3bn
- *HypoVereinsbank* acquired 100% of *Bank Austria* in a 1:1 share exchange.
- Bank Austria's shareholders ended up with shares of a German company.

The Legal Framework I

Shareholder Protection

- The law applicable to companies is the law of the country of nationality of a firm.
- A cross-border merger results in a change of nationality of the target firm, and therefore in the applicable law.
- The *Principle of extraterritoriality* does not work in 100 percent acquisitions

Findings I

- The merger premium is significantly larger in 100% acquisitions for which the shareholder protection of the acquirer is better than the target's.

- Individual firms' corporate governance provisions affect the merger premium. (accounting standards)

  - When target firm's shareholder protection 'decreases' premium is not statistically lower.

Findings II

- There are two explanations for our findings:

  1. Acquirors from more protective countries have to pay higher premiums to compensate insiders for the lost private benefits of control.

  2. Minority shareholders in less protective countries value positively the improvement in shareholder protection brought about by the more protective acquiror.

Possible Explanations:
1. Higher Premiums reflect more efficient acquirors

- We study the Tobin's Q of the acquiror one year before the acquisition as an (ex ante) proxy of the managerial ability.
- We find that differences in investor protection are not correlated with differences in managerial ability of the acquiror.
- Therefore managerial ability cannot explain higher premiums

Possible Explanations:
2. An agency costs explanation

- In countries with better shareholder protection, ownership is more dispersed.
- Jensen and Meckling (1976) argue than in these firms there will be agency conflicts between managers and shareholders: managers tend to waste free cash flow, by making unprofitable acquisitions.
- This hypothesis predicts that merger premiums are correlated with ownership concentration in the acquiring firm.

Possible Explanations:
3. More competitive auctions in countries with better protection

- Maybe in more protective countries, there are more bidders, or else more competition, in cross-border mergers, so acquirors end up overpaying.
- We analyze merger premiums in cross-border mergers relative to premiums in domestic mergers, with similar acquirors.
- Premiums in domestic merger are indeed higher, not lower.

Possible Explanations:
4. Private benefits of control

- In less protective countries, private benefits of control are more valuable, hence acquirors need to pay enough to convince insiders to sell.
- Dyck and Zingales (2004) actually find that, when the acquiror is from more protective countries, control premiums are lower.
- They interpret this evidence as a lower willingness to pay for control in countries with stronger protection, and hence where expropriation is more difficult.
- We find the opposite.

Possible Explanations:
5. The Value of Investor Protection

- The previous results are consistent with the theoretical model in LLSV (2002).

- That is, the benefits of reducing ownership concentration are positively related to the difference in investor protection between the acquiror and the target.

- This implies that target shareholders positively value the better protection coming from the acquiror, and require a higher premium to compensate them.

Conclusion

- This paper identifies a way for firms to change their corporate governance structure and estimates the value of investor protection.
- It distinguishes the value of changes due to legal rules and due to firm specific corporate governance provisions.
- In general, improving the average investor protection results in a higher merger premium—the reverse is not true.
- Two explanations: compensation for lost private benefits of control, and positive value of improved shareholder protection.
- Our evidence provides a mechanism for how mergers create value.

Case Study of Aventis

- Describe and analyze the 1999 merger between the French firm Rhône-Poulenc and the German firm Hoechst that resulted in the creation of Aventis, a new entity domiciled in France.
- This case can be thought of as representative of the recent trend in cross-border mergers and acquisitions.

Why Aventis?

- The two merging parties:

1. Come from countries with similar institutional characteristics, economic development, and financial markets. [EU and EMS]
2. Come from countries with different legal origins.
3. Were multinational companies in the same industry (pharmaceuticals), and were listed in the New York Stock Exchange
4. Formed a merger of “equals”
5. A case where the design of governance rules facilitated the integration of the two different managerial cultures

Areas of Analysis

- We focus on 'shareholder protection' and we specifically study two main characteristics of the Aventis code of corporate governance:

1. the organization of the Board of Directors, and

2. the structure and functioning of the shareholder meetings.

Our Findings

- With respect to the Board of Directors, Aventis adopted a two-tiered German-style corporate governance structure comprised of a Supervisory Board of independent directors elected by shareholders and a Management Board of top executives selected by the Supervisory Board.
- With respect to the shareholder meetings, Aventis rather than combining the two merging structures, introduced new provisions that improved the governance structure of both merging companies.

Supervisory Board / Board of Directors I

	Rhône-Poulenc	Hoechst
Unitary System / Two-tier System	Unitary	Two-Tier
Members	12-18 members	20 members
Employees on the Board	3 (16-25 percent)	10 (50 percent)
Who can be a Member of the Board	Individuals and Corporations	Only Individuals
Ownership limits to become a Member of the Board	At least 10 shares	No Limit
Term	6 Years	5 Years
Age limit	At most 65 years old	No restriction
Frequency of Meetings	As often as necessary	At least once every 6 weeks
Majority Rule	Majority Rule	Simple Majority
Fees	Attendance Fee	Fixed Part + Variable Component
Control over Management Board	No Management Board	Supervisory Board appoints the members of the Management Board as well as the Chairman of the management Board for a fixed term. The Supervisory Board fixes the remuneration of the Management Board and can call general meetings. The Supervisory Board shall review the financial statements and the report of the Management Board

Supervisory Board / Board of Directors II

	Most Protective	Aventis	Is Aventis the Most Protective System?
Unitary System / Two-tier System	Two-Tier	Two-Tier	✓
Members	12-18 members	16 members	✓
Employees on the Board	3 (16-25 percent)	4 (25 percent)	✓
Who can be a Member of the Board	Only Individuals	Only Individuals	✓
Ownership limits to become a Member of the Board	At least 10 Shares	At least 1 share	
Term	5 Years	5 Years	✓
Age limit	At most 65 years old	At most 1/3 of members 75 years or older	
Frequency of Meetings	As often as necessary	Once Every Quarter	
Majority Rule	Simple Majority	Simple Majority	
Fees	Fixed Part + Variable Component	Fixed Part + Variable Component	
Control over Management Board	As Hoechst	As Hoechst	✓

Shareholder Meetings I

	Rhône-Poulenc	Hoechst
Deposit of Shares	Within 5 Days Before Meeting	Within 7 Days Before Meeting
Notice of Meetings	Published in ***BALO*** (*Bulletin des Annonces Légales Obligatories*)	Published in Official Bulletin
Proxy Voting	YES	YES
One-Share, One-Vote Rule	YES	YES. Multiple Voting Rights Depending on the Year of Acquisition of Shares
Majority Rule	Simple Majority	Simple Majority

Shareholder Meetings

	Most Protective	Aventis	Is Aventis the Most Protective System?
Deposit of Shares		Within 3 Days Before Meeting	
Notice of Meetings	Published in Official Bulletin	Published in **BALO** (*Bulletin des Annonces Légales Obligatoires*)	✓
Proxy Voting	YES	YES. Videoconference and Telecommunication Tools are Allowed	✓
One-Share, One-Vote R	YES	YES	✓
Majority Rule	Simple Majority	Simple Majority	✓

Conclusion I

- Our paper describes a case of corporate governance convergence through a cross-border merger where the resulting entity is

1. more protective of shareholders than the two original firms,
2. improving the default legal system prescribed in the national Corporate Code

A Theory of Optimal Expropriation, Mergers and Industry Competition

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Corporate Governance ‘Slack’

- “Law and Finance,” Shareholder view (U.S.)
  - Common (Anglo-Saxon) Law vs. Civil (Roman) Law
  - Developed vs. Emerging Economies

- Stakeholder view (Japan, Germany, France,…CSR)

- Why the variation in CG standards around the world?
  - Why don’t all countries adopt the strictest standards?
  - **We show why permitting corporate governance ‘slack’ (opportunities for expropriation) can be optimal in an economy.**

What *is* Corporate Governance?

- Traditional Shareholder view
- ‘Alternative’ view   e.g. Allen (2005)
  - *“…Corporate governance is concerned with ensuring that firms are run in such a way that society’s resources are used efficiently…”*
  - *“… alternative firm objective functions, such as pursuing the interests of all stakeholders, may help overcome market failures…”*

Traditional Cournot Model

- *n* firms in the industry
- competing in quantities, *q*
- and *choosing* unit costs, $\alpha \in [0,1]$
- Equilibrium Price, $P=1-nq$
- Firm profits, $\pi = q\left(P - \alpha\right)$

- Profit-maximizing solution (Cournot):

$\alpha=0$ $\qquad\qquad$ $q=1/(n+1)$

Cournot Competition with industry-wide Corporate Governance 'Slack', *g*.

Firm's objective:

$$\text{Max} \quad \Omega(\alpha, q) = (1-g)\cdot\pi + g\cdot E$$

where

$$\pi = q(P-\alpha) \qquad \text{profits}$$

$$E = q\left(\alpha - \frac{1}{2}\alpha^2\right) \qquad \text{'excess costs'}$$

$$g \approx \text{corporate governance 'slack', in the industry}$$

Excess costs, *E(α,q)*

- Agency view: direct selfish extraction of private benefits, perks, empire building...
  - "*…There are substantial social benefits as well as costs associated with private benefits…"* Mayer (1999)
- Stakeholder view: firms voluntarily (or obliged to) act also in the interests of employees, suppliers, customers, "the community," "the environment."
  - Expropriation: "*Depriving an owner of property by taking it for public use."*

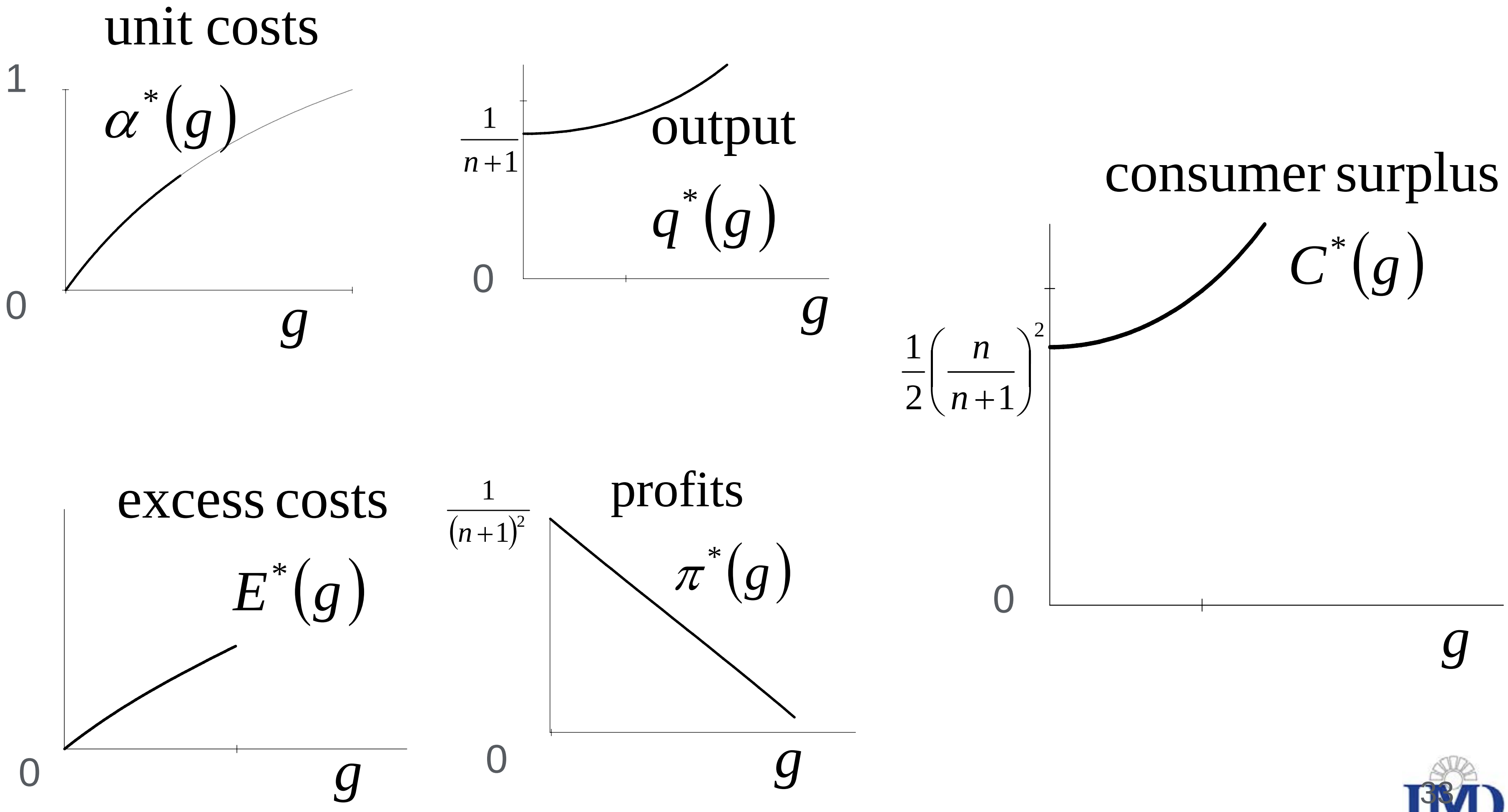
May lead to firms increasing their cost base, to the detriment of shareholder profits

Corporate Governance Slack, *g*.

$$\Omega(\alpha, q) = (1 - g) \cdot \pi + g \cdot E$$

- Determines the relative importance that firms will ascribe to Excess Costs vs. Profits
  - ‘Low *g*’ ≈ Strong CG, profit-maximization.
- Result of the regulatory framework and social context in the economy
- *Exog. constant across firms*, [in our basic model]
- Potentially a variable of choice for the government?
- Potentially a variable of choice for individual firms? (extension)

Firm strategies with industry-wide Corporate Governance slack, *g*.



Part 1:
Effect of CG slack in the economy

- *Counterweight* to tendency of profit-maximizing oligopoly to restrict output and inflate prices. May *substitute* for regulating industry prices or stimulating competition (increasing *n*)
  - Decreases shareholder profits
  - Increases Consumer surplus
  - May benefit other Stakeholders in the economy (employees, suppliers, the environment).

- *Some level* of CG slack may be optimal.
  - Function of industry structure and the relative importance Gov't attaches to the welfare of Investors vs. Consumers & other Stakeholders.
  - May explain some variation in CG standards, across economies

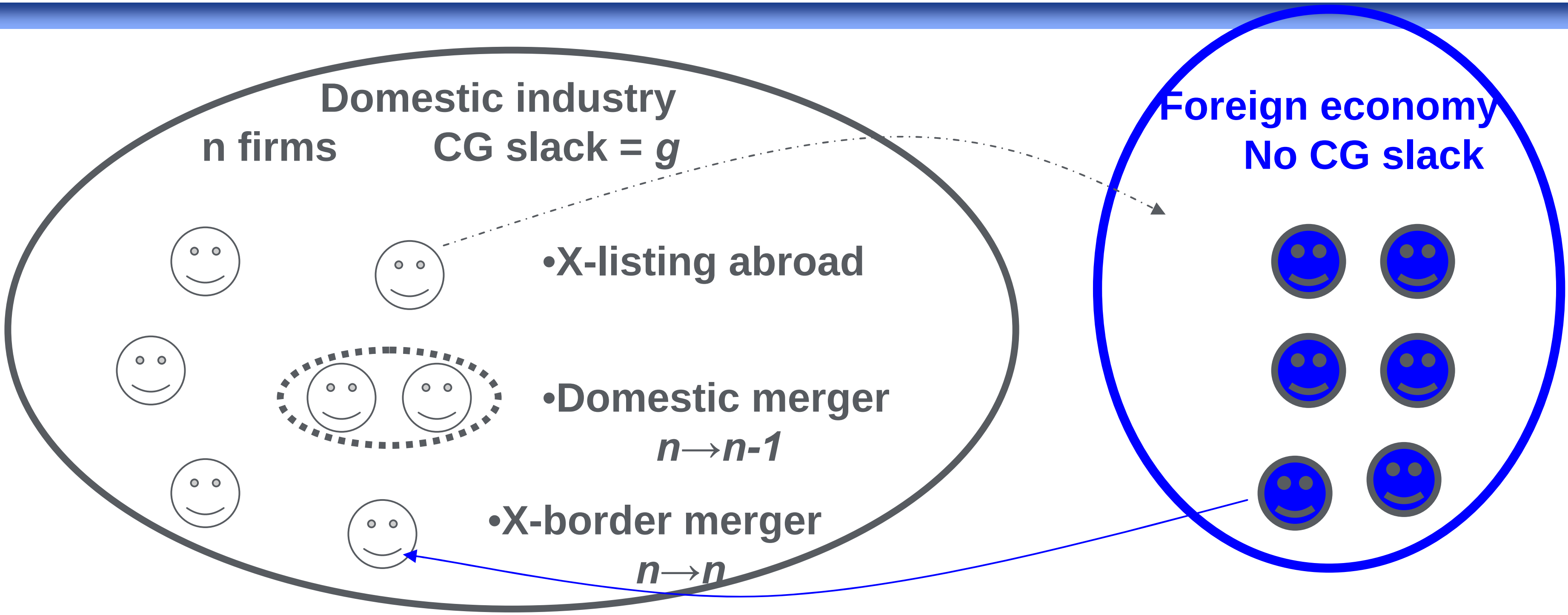
- Even if the observed level of CG slack is 'too high,' positive externalities can *mitigate* negative effects.

Part 2: Corporate Governance Reform

- Gov't may want to reduce *g*.
  - It can *impose* lower *g*, regulation via legislation and institutions. *Formal* reform (Gilson 2000)
  - It can *facilitate* convergence to lower *g*, removing barriers and allowing reform to be initiated by investors, firms, market participants. *Functional and Contractual* reform

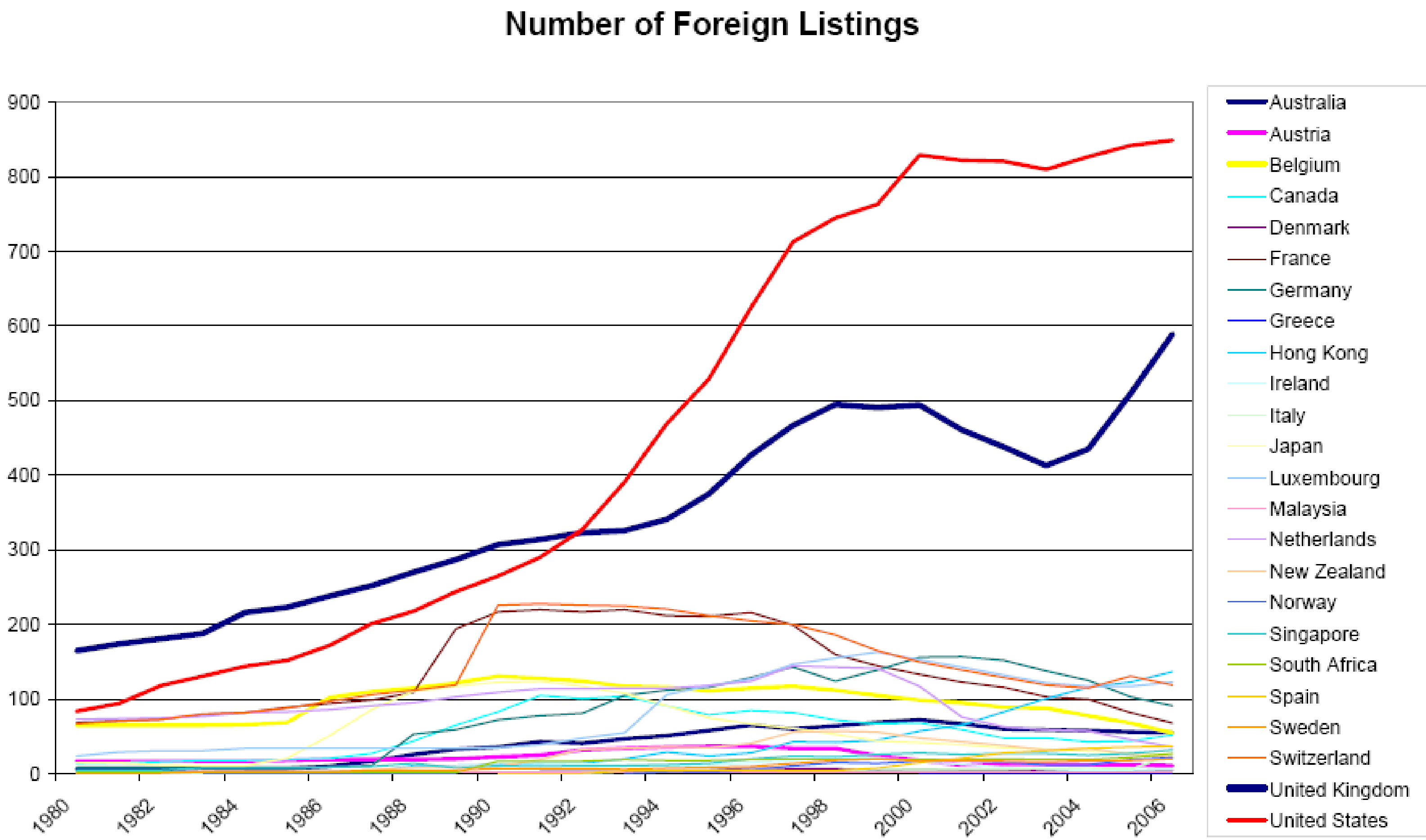
- Even if Gov't is reluctant to change *g*, firms may seek to change *g* unilaterally.

Functional/Contractual Convergence



- Voluntary/Forced reform by a *subset* of firms.
- Results driven by
  - strategic interaction between competing firms
  - incentives and decision rights of Shareholders vs. Managers

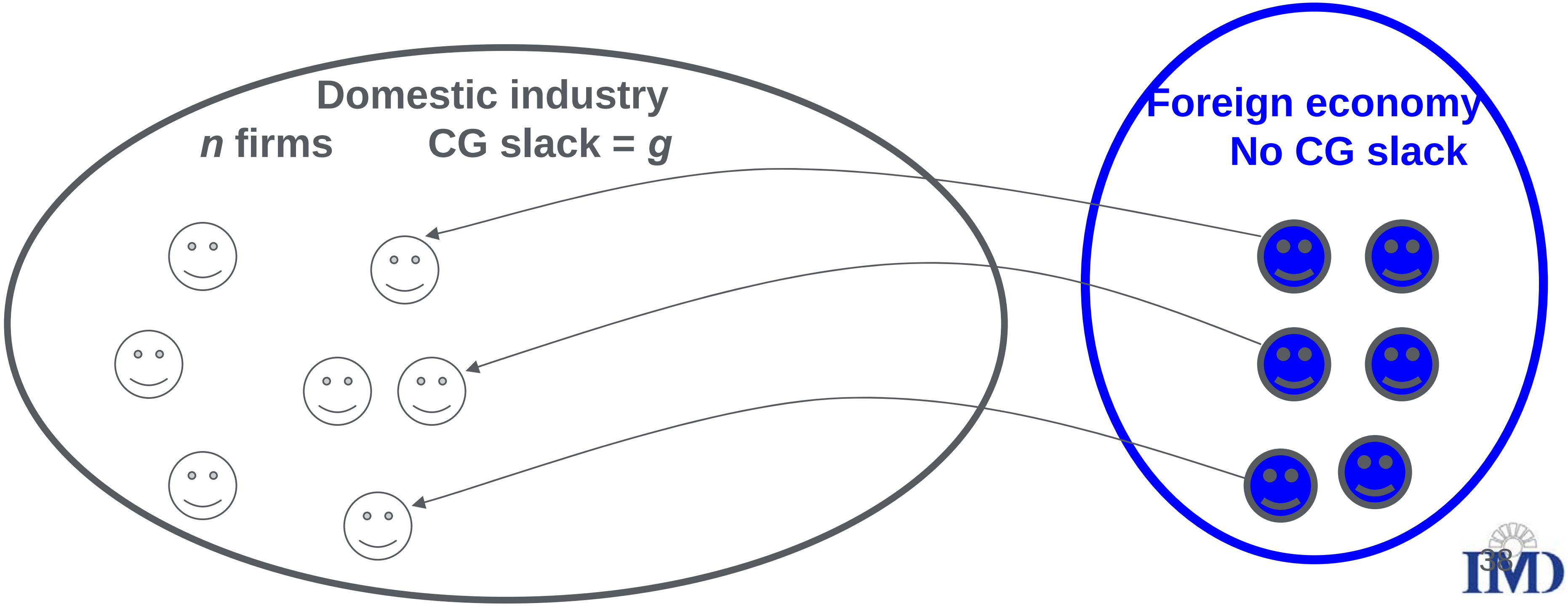
Cross-Listings



Source: Fernandes and Giannetti: "On the Fortunes of Global Stock Exchanges", European Corporate Governance Institute Working Paper 2008

Cross-border mergers

- *n*→*n*, **no** competitive effect
- Adoption of strong (foreign) CG standard by *subset* of domestic firms (cf X-listing)



Conclusion

- Investors Value Good Corporate Governance
- Cross-Border Mergers are a mechanisms through which target firms may opt into a more investor-protective system
- Corporate Governance considerations should be taken into account (are priced by investors) when engaging in cross-border M&A
- Even if governments are unwilling to reform corporate governance, the corporate sector will do it through the market for corporate control.
- Protecting shareholders is a political choice!