

Summary of the winning paper of the I Edition of the "Jaime Fernández de Araoz Corporate Finance" Award

The Value Of Investor Protection: Firm Evidence From Cross-Border Mergers

In the classical law and finance literature, better legal protection of investors is associated with better financial markets. La Porta et al. (1998) (LLSV) provided pioneering results documenting a strong association between the quality of the legal protections and measures of financial development, and many other articles have extended these results. Spurred by the academic findings, politicians and regulators around the world have started a process of corporate governance reform aimed to improve the quality of the investor protection provided by the legal system. That is, cross-sectional differences among countries have translated into legal reforms within countries.

However, because of its cross-sectional approach, the academic literature is at best unhelpful when one is arguing either in favor of or against corporate governance reform. Most of the academic literature relies on the indicators constructed by LLSV, which are static by construction. Therefore, unless one has either episodic evidence (as in Glaeser et al., 2001, on the Poland-Czech Republic difference) or new indicators (as in Pistor, 2000, for transition economies; Black et al., 2006, for South Korea, and Hyytinen et al., 2001, for Finland), it is not possible to conclude that improvements in investor protection at the country level have positive effects in the financial markets. Also, a straight interpretation of the traditional law and finance view suggests that countries that opt into less protective regimes will end up with less valuable firms, yet no empirical evidence exists on that extreme.

The first contribution of our paper is that it provides evidence on the value of investor protection. We note that cross-border mergers are a mechanism how firms change corporate governance. Specifically, our study is based on the observation that in a cross-border merger the target firm usually adopts the accounting standards, disclosure practices and governance structures of the country of the acquiring firm. By international law the nationality of a firm changes when 100 percent of it is acquired by a foreign firm. Among other implications, a change in nationality implies that the law that applies to the target company--and, therefore, the protection provided by such law to the target firm's investors---changes as well. Our advantage is that the new law can even be less protective than before, a type of legal reform that is unheard of in the literature. Consequently, cross-border mergers are an ideal setting to analyze valuation effects of changes in legal protection. We measure the valuation effects of the merger with the merger premium.

The second contribution of our paper is that it distinguishes the value of changes in

firm-specific, corporate governance provisions, and the value of legal rules. In a cross-border merger the participating companies may contract upon the corporate governance system of the new firm, especially when the systems of protection of the target and the acquiror collide. For instance, the accounting standards of the target and the acquiror need to be unified, and the resulting standards will be the ones by default (the acquiror's in the case of a 100 percent merger) or the ones which the parties agree upon. We have data on the accounting standards (U.S. GAAP, IAS, EU standards, or local standards), of the merging firms, the merged firm, as well as on the consolidation rules of the acquiring company. In some mergers consolidation happens when the acquiror buys 20 percent of the target, and then the accounting system changes. In some other mergers the change happens when the acquiror buys 50 percent. In some mergers there is no consolidation at all. Consequently we can test the effect of firm-specific provisions on the valuation of the merger, relative to the legal minimum. Our analysis of accounting standards is then powerful enough to separate out the impact of legal rules from the impact of private contracts.

Our sample consists of 506 cross-border mergers in the period 1989 to 2002 worldwide. We measure the potential transfer of investor protection from the acquiror to the target with the difference in the indices of shareholder protection (at the country level) and accounting standards (at the firm level) computed by LLSV. We then analyze the effect of differences in investor protection in the two countries on the merger premium.

The results of the paper are consistent with the law and finance view, but our findings offer some additional insights:

- We find that the adjusted merger premium is significantly larger in 100 percent acquisitions for which the shareholder protection of the acquiror is better than the target's. This effect is not significant for acquisitions of less than 100 percent. The economic significance is substantial: in 100 percent acquisitions, a one standard deviation increase in the difference in the shareholder protection index between the acquiror and the target results in a premium that is 0.37 standard deviations higher. This result suggests a positive valuation effect of improving the legal protection of the target shareholders. Specifically, we show that premia are higher when the target firm is closely held, and where private benefits of control are most valuable because expropriation of minority shareholders is less penalized in the target country. Because premia are also positively related to the percentage difference in closely held shares between the acquiror and the target, our evidence is consistent with the theoretical model of investor protection in La Porta et al. (2002). They show that the benefits from improving shareholder protection are larger the smaller the percentage of cash flow rights owned by the entrepreneur.

- Individual firms' corporate governance provisions affect the premium. In particular, the accounting standards of the merging firms are significantly valuable, irrespective of the quality of the accounting standards in the two countries. When accounting standards change because of the firm-specific consolidation rules, a one-standard deviation increase in the difference in the accounting standards quality index between the acquiror and the target results in a merger premium which is about 0.3 standard deviations higher. When accounting standards change automatically because it is a 100 percent merger, the economic significance is 0.15 standard deviations. That is, firm-

specific provisions are economically more significant than legal rules. Indeed, in a horse race between legal differences and differences in firm characteristics, we confirm that it is the effect of adopting the acquiror's better accounting standards via consolidation which matters the most, even relative to the pure change in the legal protections induced by the merger.

- We do not find evidence on the symmetric effect. When the protections of the target firm shareholders deteriorate, either because it is 100 percent bought by an acquiror in a country with weaker legal protections, or because the merged firm chooses accounting standards that are worse than before the merger, the premium is not significantly lower. This result is consistent with three hypotheses, which we cannot distinguish: (i) Firms may overcome the reduction in investor protection induced by these deals by means of private contracts--for which we do not have sufficient data. (ii) The insignificant effect of legal rules is consistent with Doidge, Karolyi and Stulz (2006), who find that firm characteristics explain governance in more financially developed countries, while country characteristics explain governance in less developed countries. Consequently, in a merger where the target is from a more protective country, firm-specific provisions are more important; (iii) The market does not value reductions in investment protection.

The last two results challenge the established view of corporate governance that stresses the importance of the law and its effects on corporate value. First because we find that firm-specific provisions are more valuable than legal rules. Second, because we find that sometimes changes in legal rules do not translate into any market impact. We conclude that legal reform is desirable for a country both because it has a direct effect on firm performance---and we are not the first ones to show this---and because, by raising the legal minimum, it induces corporate governance changes at the firm level which are positively valued by the market.