Corporate Governance Reforms and Firm-Level Allocation of International Capital Flows

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This paper investigates how changes in investor protection (IP) of capital exporting and importing countries affect the firm-level allocation of international capital flows. A simple model illustrates that when a capital exporting country has stronger IP than the importing country, in cross-border acquisitions foreign bidders tend to target better-performing firms. This cherry picking tendency becomes stronger (weaker) when the gap in IP increases (decreases). Data on acquisition bids from 17 strong-IP countries for firms located in 18 weak-IP countries reveal that the cherry picking tendency declines after target countries undertake corporate governance reforms (CGRs), which narrow the gap in IP between the acquirer and target countries. In contrast, foreign acquirers respond to CGRs enacted by their own countries by increasing their cherry picking tendencies. These results imply that the gap in the strength of IP between acquirer and target countries prevent underperforming firms in weak-IP countries from gaining access to foreign capital.

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I. INTRODUCTION

"Cherry picking," foreign acquirers' tendency to target better-performing firms in emerging markets, is a well-documented but little understood phenomenon. Aitken and Harrison (1999) use panel data on Venezuelan plants and find that foreign equity acquisition is positively correlated with plants' pre-acquisition productivity. Sabirianova, Svejnar, and Terrell (2005) demonstrate a similar phenomenon with data on Eastern European firms. This phenomenon seems to be unique in emerging markets. For example, Bloom, Sadun, and Van Reenen (2007) find no evidence that foreign acquirers cherry pick U.K. firms. Data on U.S. acquisitions show that underperforming firms are more likely to become targets of domestic acquirers (e.g., Maksimovic and Phillips, 2001; Yang, 2008).

How efficiently international capital inflows are utilized depends on where capital is invested. The cherry picking phenomenon implies that the market for cross-border acquisitions is not fully functioning for emerging countries. Underperforming firms there may be in greater need of foreign capital and management improvement, presenting opportunities for greater synergies to foreign acquirers. Why, then, do foreign acquirers shy away from underperforming firms?

In this paper, I present a simple model to demonstrate how legal environments of acquirer and target countries affect international capital flows at the firm level. It predicts: (1) when the acquirer country has stronger investor protection (IP) than the target country, better-performing firms are more attractive to foreign acquirers; and (2) this pattern becomes stronger (weaker) when the gap in IP becomes greater (smaller).

Since target selection in cross-border acquisitions is affected by many other country-level factors, to test these predictions, I employ corporate governance reforms (CGRs) to isolate the effects of changes in the IP gap. I examine how acquirers from strong-IP countries change their target selections in weak-IP countries in response to CGRs undertaken by either acquirer or target countries. The results show that foreign acquirers tend to select even better-performing firms after their own countries undertake CGRs, which enlarge the gap in IP with the target countries. Conversely, the tendency to cherry pick declines after target countries undertake CGRs, which narrow the gap in IP between acquirer and target countries.

The theoretical discussion employs a law and finance framework in which a controlling shareholder derives two types of benefits: (1) cash flows from share holdings and (2) private benefits through control rights (La Porta, et al., 2002).[2] When a firm is acquired, both cash flow rights and control rights are transferred and the transaction price reflects the values of both rights. The value of cash flow rights is reflected in the value of traded assets. Control rights are priced as control premiums at the value of private benefits of control (Dyck and Zingales, 2004).

Weak IP allows controlling shareholders to consume more private benefits than those in strong-IP countries. However, even within a weak-IP country, there are variations in the quality of governance across firms. Durnev and Kim (2005) show that within a given legal regime the incentive to consume private benefits is smaller when firms have more profitable investment opportunities because diversion of corporate resources may lead to forgoing profitable investments. Thus, when a potential target firm has more profitable investment opportunities, the controlling shareholder will consume fewer private benefits and demand a lower control premium. Such a firm is more attractive to controlling shareholders in strong-IP countries, who are required to consume fewer private benefits because of more stringent legal restrictions and therefore value control premiums less.[3] That is, when acquirers from strong-IP countries target firms in weak-IP countries, they are likely to choose firms with more profitable investment opportunities, which tend to perform better. Thus, the cherry picking tendency is caused by the gap in IP between acquirer and target countries. I predict that greater (smaller) gaps in IP between acquirer and target countries result in greater (smaller) disagreement in valuation of control premiums in cross-border acquisitions, leading to a stronger (weaker) tendency to cherry pick.

The main conclusion from this theoretical analysis is that an important barrier against international capital flows is the difference in the strength of legal IP between acquirer and target countries, rather than the strength of IP in target countries alone. The analysis also shows that where international capital eventually flows is jointly determined

[2] Private benefits of control are derived in various ways: tunneling companies' resources, paying abnormally high compensation, enjoying excessive perks, for example.

[3] Dyck and Zingales (2004) document that acquirers from stronger-IP countries tend to pay lower control premiums in corporate acquisitions.

by both firm-level and country-level factors. Foreign acquirers may overcome the country-level barrier by selecting better performing targets. However, this may result in less efficient utilization of international capital flows by preventing underperforming firms from gaining access to foreign capital and advanced technological and managerial know-how.

Over the past decade many countries have undertaken CGRs, generating within-country variation in legal environments. Of 35 acquirer and target sample countries, I identify 26 countries that have enacted CGRs since 1998. The identification is done through careful, painstaking procedures. Although CGRs are not identical across countries, they share the common objective of enhancing legal IP. When the acquirer country has stronger IP than the target country, the IP gap will be narrowed by a CGR undertaken by the target country and it will be enlarged by a CGR enacted by the acquirer country. The changes in the IP gap allow for the comparison of the type of firms targeted before and after a CGR, controlling for unobservable acquirer and target country characteristics.

I investigate how foreign acquirers from strong-IP countries change their target selections in weak-IP countries in response to CGRs undertaken by either target or acquirer countries. The focus is on pre-acquisition bid performance of targets. Performance is not measured by raw values because a CGR may affect the reported performance of all firms in the country. Instead, the performance is measured by a cumulative density function (CDF) based on each target firm's country-industry-year matched sample. The CDF indicates how well a target firm has performed relative to other firms in the same industry and same country during the same year.

Estimation results indicate a significant decline in the cherry picking tendency following a CGR undertaken by a target country: Relative to pre-CGR years, firms targeted by foreign bidders from strong-IP countries are about 14 percentile lower in asset utilization growth rates and 16 percentile lower in valuation as measured by the market to book value ratio. A CGR enacted by a strong-IP acquirer country, by contrast, exacerbates the cherry picking tendency: Bidders from the affected countries pursue firms located in weak IP countries that are about 16 percentile higher in asset utilization growth rates and 15 percentile higher in valuation.

Confounding effects around regulation regime years are of major concern for studies of this type. Following Bertrand and Mullainathan (2003) and Branstetter, Fisman, and Foley (2006), I include a set of dummies corresponding to the periods before and after CGRs. The alternative specification indicates that the results are not driven by confounding effects around CGR years.

A battery of robustness tests is conducted. They include controlling for effects of privatizations, additional deal-specific characteristics, changes in the openness of target countries, cross-border acquisition bids in regulated industries, the heterogeneity in CGRs, and clustering standard errors at different levels. The results are robust.

Previous studies examine how legal environments affect international capital flows across countries. Gelos and Wei (2005) and Alfaro, Ozcan, and Volosovych (2008) demonstrate that weak legal environments can be a reason for insufficient capital flow from rich to poor countries; namely, the "Lucas Paradox." The results of this paper demonstrate that the real barrier to international capital flows is disparity in the quality of legal environments between countries, rather than weak legal environments of capital importing countries alone.

This paper also contributes to the international capital flow literature by focusing on the firm-level allocation. The results show that international capital flows are jointly determined by both firm-level factors and country-level factors. The joint consideration yields insights into the reasons why the imbalance in legal environments between acquirer and target countries leads to disagreements in valuation of control rights, inducing foreign acquirers from strong-IP countries to target better performing firms in weak-IP countries.

Two recent studies examine the cherry picking phenomenon. Leuz, Lins, and Warnock (forthcoming) conduct an empirical investigation of U.S. investors' positions in non-US equities and document that they invest less in firms with ownership structures conducive to governance problems when they enter countries with weak IP. Kim, Sung, and Wei (2008) study foreign investment in Korea and document that investors from low-wedge countries disfavor high-wedge stocks in South Korea, where the wedge stands for the average wedge between cash flow and control rights and is used to proxy the strength of corporate governance. This paper extends these single country studies on several fronts.

First, it provides a theoretical framework to explain the cherry picking phenomenon. Second, the empirical design employs within-country variation caused by CGRs enacted in a staggered fashion. CGRs are relatively exogenous events to individual firms, allowing identification of impacts of IP regulations on firm-level allocation of international capital flows. Third, the sample covers 17 strong-IP countries and 18 weak-IP countries, rendering more general results.

In the law and finance literature, it is well documented that IP plays important roles in the development of the economy and financial markets, firm valuation, corporate restructuring decisions, and M&A activities; e.g., La Porta et al. (1997, 2002), Nenova (2003), Dyck and Zingales (2004), Atanassov and Kim (2009), and Rossi and Volpin (2004). This paper adds to this literature by documenting how the disparities in IP between acquirer and target countries distort the market for cross-border acquisitions.

The paper proceeds as follows. A simple model is presented in Section II. Section III provides an empirical investigation of how changes in IP gap generated by CGRs affect the type of firms targeted by foreign acquirers. Section IV concludes.

II. THEORETICAL CONSIDERATIONS

To relate investor protection (IP) and the value of control rights to acquisition decisions and to focus on the firm-level allocation of international capital flows, I allow firm-level heterogeneity within a target country but treat foreign bidders from a given country identically.

Following La Porta et al. (2002), a target firm's controlling shareholder derives two types of benefits from the firm: cash flow from share holdings and private benefits via control rights. When an acquisition takes place, both cash flow and control rights are transferred from the controlling shareholder of the target to the acquirer (Dyck and Zingales, 2004). The value of cash flow rights reflects the underlying value of the traded assets. Control rights are priced as control premiums equal to the value of the private benefits that the incumbent controlling shareholder consumes. I first analyze how legal environments and firm-level characteristics jointly determine the amount of private benefits consumed by the controlling shareholder.

The controlling shareholder has $\alpha < 1$ fraction of a firm's outstanding shares (IP becomes irrelevant when $\alpha = 1$). Firm profitability is denoted by π, representing the gross return per unit of investment. The controlling shareholder diverts *d* percent of π for private benefits and leaves the rest in the firm. The cost of diversion is $(1/2)c(\pi d)^2$, where $c > 0$ reflects the strength of IP. A higher *c* indicates stronger IP. The cost of diversion is convex in the amount diverted, which is a standard assumption made by previous studies (e.g., Johnson et al., 2000; La Porta et al., 2002; Shleifer and Wolfenzon, 2002; Doidge, Karolyi, and Stulz, 2004; and Durnev and Kim, 2005).

The total benefits the controlling shareholder derives from her ownership of the firm consist of the value of cash flow rights after the diversion and the value of diversion net of diversion costs: $\alpha(1-d)\pi + d\pi - (1/2)c(\pi d)^2$. The controlling shareholder chooses *d* to maximize:

$$\alpha\pi + (1-\alpha)d\pi - (1/2)c(\pi d)^2 \qquad (1)$$

Differentiating (1) with respect to *d* and setting it equal to zero, the controlling shareholder's optimal level of diversion is:

$$d^* = (1-\alpha)/(\pi c) \qquad (2)$$

Differentiating (2) with respect to *c* and π, we obtain:

$$\partial d^*/\partial c = -(1-\alpha)/(\pi c^2) < 0 \qquad (3a)$$

$$\partial d^*/\partial \pi = -(1-\alpha)/(\pi^2 c) < 0 \qquad (3b)$$

Inequality (3a) is a restatement of the widely accepted notion that a controlling shareholder diverts less when the firm is located in a stronger-IP country, because stricter, more effective IP regulations make tunneling, stealing, and excessive compensation more costly for the controlling shareholder (e.g., La Porta et al., 2002; Doidge et al., 2009). In the context of an acquisition, this implies that, other things being equal, a controlling shareholder values control premiums higher when the firm is located in a country with weaker IP.

Inequality (3b) indicates that controlling shareholders of firms with more profitable investment opportunities divert less percentage from the cash flows generated from operation, as previously shown and documented by Durnev and Kim (2005). Diversion for private benefits reduces corporate resources available for investments in profitable projects and may lead to rejection of some positive NPV projects. The

possibility of such suboptimal investments reduces the value of cash flow rights. The damage to the value of cash flow rights will be greater, the more profitable are investment opportunities; hence, diversion will be smaller when firms possess more profitable investment opportunities. As Durnev and Kim state, "One is less likely to commit a crime if one has something valuable to lose." (p. 1462)

The controlling shareholder's net private benefits at the optimal level of diversion is $PB^* = (1 - \alpha)d^*\pi - (1/2)c(\pi d^*)^2 = (1 - \alpha)^2/2c$. The reservation price of the target's controlling shareholder is equal to the total benefits he derives from the firm (Barclay and Holderness, 1989; Dyck and Zingales, 2004): $\alpha\pi + PB_T^*$.

To focus on factors unique to cross-border acquisitions, I assume that the acquisition is motivated by synergistic gains, *G*, arising from the acquiring firm's specialized recourses that are unrelated to target's pre-acquisition π. Such is the case when a foreign acquirer launches a new project with a technology unavailable to local firms or manufactures goods using processes inaccessible to local firms. Combining the new technology or process with resources unique to the target country, but not to the target firm, such as natural resources or cheap labor, may generate operating synergies unique to the acquirer. [4]

When the source of synergistic gains is the acquirer's specialized resources, the bidder has stronger bargaining power, enabling it to acquire the control right at a price closer to the reservation price of the target's controlling shareholder. I assume that when the acquirer purchases α percent of target shares, it pays the target's controlling shareholder $\alpha\pi + PB^*_T$. Then the return to the acquirer's controlling shareholder is:[5]

$$R = (PB^*_A - PB^*_T) / (\alpha\pi + PB^*_T)) + G \qquad (4)$$

PB^*_A and PB^*_T represents the optimal level of private benefits consumed by the controlling shareholder of the acquirer after the acquisition and the controlling shareholder of the target before the acquisition, respectively. *G*, the operating synergistic gains, must to be big enough to compensate for the smaller private benefits that the

[4] Synergistic gains may also arise from a target's specialized resources. An example would be utilization of the target's resources that can be redeployed to higher-valued uses under stronger management. Such synergistic gains can also be obtained by domestic acquisitions and are not unique to cross-border acquisitions.

[5] The difference between post-acquisition π and pre-acquisition π is included in *G*.

foreign acquirer is allowed to consume. Otherwise, the return will be negative and no acquisition will take place.

Now let c_A and c_T represent the strength of IP in the acquirer and target countries. In the empirical section, I consider cases in which $c_A > c_T$, which, in turn, implies $PB^*_A < PB^*_T$. The foreign acquirer is subject to its acquirer country's strong regulations, forcing its controlling shareholder to consume fewer private benefits after the acquisition than the previous controlling shareholder. However, it is possible to have $c_A \leq c_T$ (a Chinese firm acquiring an American firm, for example). In such a case the acquired firm will be subject to the stronger regulations of the target country after the acquisition, keeping PB^*_T unchanged. That is, $PB^*_A = PB^*_T$ and $R = 0 + G$.

Substituting d^* into PB_A^* and PB_T^* and differentiating R with respect to π yields:[6]

$$\partial R/\partial \pi > 0, \text{ if } c_A > c_T \qquad (5a)$$

$$\partial R/\partial \pi = 0, \text{ if } c_A \leq c_T \qquad (5b)$$

Inequality (5a) implies that when the acquirer country has stronger IP than the target country, acquiring a target firm with more profitable investment opportunities generates a higher rate of return to the controlling shareholder of a foreign acquirer. Inequality (5b) shows the return is unrelated to investment opportunities when IP in the acquirer country is no stronger than in the target country. Therefore, a foreign acquirer will target well-performing firms only when it enters a country with weaker IP than that of its own country; otherwise, it will exhibit no such cherry picking tendency.

To see how the cherry picking tendency changes with changes in the IP gap between acquirer and target countries, (5a) is differentiated with respect to c_A and c_T to obtain[7]:

If $c_A > c_T$,

$$\partial^2 R/\partial \pi \partial c_T < 0 \qquad (6a)$$

$$\partial^2 R/\partial \pi \partial c_A > 0 \qquad (6b)$$

[6] $\partial R/\partial \pi = -\left(\left((1-\alpha)^2/(2c_A) - (1-\alpha)^2/(2c_T)\right)\right)\alpha)/(\alpha\pi + (1-\alpha)^2/(2c_T))^2 = ((1-\alpha)^2(1/(2c_T) - 1/(2c_A))\alpha)/(\alpha\pi + (1-\alpha)^2/(2c_T))^2$.

[7] $\partial^2 R/\partial \pi \partial c_A = \left(\left(1/(2c_A^2)\right)\alpha(1-\alpha)^2\right)/(\alpha\pi + (1-\alpha)^2/(2c_T))^2$; $\partial^2 R/\partial \pi \partial c_T = \left(-\alpha(1-\alpha)^2(1/(2c_T^2))\right)/(\alpha\pi + (1-\alpha)^2/(2c_T))^2 + (1/(2c_T) - 1/(2c_A))\left(\alpha(1-\alpha)^4(1/(2c_T^2))\right)/(\alpha\pi + (1-\alpha)^2/(2c_T))^3)$

Inequality (6a) shows that the cherry picking tendency decreases when the target country strengthens its IP. In contrast, (6b) indicates that the cherry picking tendency increases when the acquirer's own country strengthens its IP.

The intuition is that strong IP forces a controlling shareholder to consume fewer private benefits, making her value control premiums lower than does a controlling shareholder in a weak-IP country. Within a given legal regime, controlling shareholders of better-performing firms divert less percentage of cash flows generated from operation (i.e., condition (3b)) making PB^* relative to the corresponding cash flow rights ($\alpha\pi$) smaller compared to those by controlling shareholders of underperforming firms. As a result, better-performing firms are more palatable to a foreign acquirer from a stronger-IP country. The disagreement in the value of control premiums between the foreign acquirer and target becomes greater (smaller) when the gap in IP between the acquirer and target country increases (decreases); consequently, foreign acquirers' tendency to cherry pick becomes stronger (weaker).

In contrast, when the IP of the target country is no weaker than the acquirer country (i.e., $c_A \leq c_T$) private benefits consumed by the controlling shareholder of the target will not change after the acquisition. This is because the foreign acquirer must abide by the IP of target country. Thus, control premiums required by the target do not matter for target selection decisions.

These predictions assume that an acquirer cannot perfectly price-discriminate between the controlling shareholder and minority shareholders of a target when it acquires 100% of the outstanding shares. In practice, perfect price discrimination is not possible because at the announcement of an acquisition bid by a foreign firm from a strong-IP country, rational investors increase the value of traded assets anticipating fewer private benefits under the new management. Thus, the minority shareholders will not sell shares at the pre-announcement price.

III. CORPORATE GOVERNANCE REFORMS AND TARGET SELECTION

The predictions developed in the preceding section are tested by employing corporate governance reforms (CGRs) undertaken by either acquirer or target countries. The details of the CGRs are summarized in the Appendix. Although the extent of

improvement in IP varies across CGRs, the signs of improvements are in the same positive direction. This allows the use of CGRs to identify changes in the IP gap between acquirer and target countries and examine how the changes affect the type of firms being targeted by foreign acquirers.

III.A. EMPIRICAL METHODOLOGY

Acquirer and target countries are selected so that an acquirer country has stronger IP than the target country. This allows the assumption that the IP gap between the acquirer and target countries is narrowed by a CGR enacted by the target country, and enlarged by a CGR enacted by the acquirer country. The specification is:

$$Y_{ijmnkt} = \alpha + \gamma X_{ijmnkt} + \delta ACGR_{mt} + \lambda TCGR_{nt} + \sum_{j=1}^{J-1} d_j + \sum_{m=1}^{M-1} d_m + \sum_{n=1}^{N-1} d_n + \sum_{t=1}^{T-1} d_t + \varepsilon_{ijmnkt} \quad (7)$$

Subscript i indexes target firms; j indexes industries of target firms; m indexes acquirer countries; n indexes target countries; k indexes acquirers; and t indexes years. The dependent variable, Y_{ijmnkt}, is target i's performance prior to the announcement of the acquisition bid; d_j is target industry dummy; d_t is year dummy; d_m (d_n) is acquirer (target) country dummy; X_{ijmnkt} is a vector of control variables; $ACGR_{mt}$ is an indicator equal to one if acquirer country m undertakes a CGR by the time the acquisition bid of target i is announced; $TCGR_{nt}$ is an indicator equal to one if target country n undertakes a CGR by the time the acquisition bid of target i is announced; and ε_{ijmnkt} is the error term. Table I provides a description of all variables used in this study. To account for the presence of serial correlation among target firms within a country, the model is estimated by clustering at the level of target countries (Bertrand, Duflo, and Mullainathan, 2004). For a robustness check, the model is also estimated by clustering at the level of acquirer countries.

The variables of main interest are *ACGR* and *TCGR*. The coefficient on *ACGR* is expected to be positive; foreign acquirers' tendency to pursue better-performing firms increases after their own country undertakes a CGR. In contrast, the coefficient on *TCGR*

is expected to be negative; the tendency to pursue better-performing firms decreases after the target country undertakes a CGR. The CGR year for each country is provided in the Appendix.

The main advantage of this specification is that it employs within-country IP variation caused by an external shock, and controls for country time-invariant unobservable characteristics of both acquirer and target countries. This empirical design provides cleaner results than the traditional approach relying on legal indices that usually lack time-series variation and are highly correlated with many other country-level factors.

III.B. DATA

III.B.1. Corporate governance reforms and identification of CGR years

Since the late 1990s a number of countries have undertaken CGRs, defined here as deliberate interventions in a country's corporate governance tradition by the state, security and exchange commission, or stock exchanges. Usually, CGRs are undertaken through publication of a set of codified corporate governance norms or amendments to countries' corporate and/or securities laws pertaining to such issues as the role and composition of the board of directors; the installment of board subcommittees (e.g., audit, compensation, and nomination committees); the appointment and rules of operation applying to external auditors; the distribution of rights and powers over professional managers, shareholders, and other stakeholders; the role of media in information dispersion; and the protection of whistle blowers and penalty enhancement of corporate fraud (Aguilera and Cuervo-Cazurra, 2004). Typical CGRs include Indian Clause 49, Australian Corporate Law Economic Reform Program (CLERP 9), and U.S. Sarbanes-Oxley Act.

To identify a relevant CGR for each of the sample countries, I search websites of the European Corporate Governance Institute, the Asian Corporate Governance Association, the International Finance Corporation (IFC) at the World Bank, the Financial Standards Foundation, and countries' stock exchanges, book chapters, journal articles, law review articles, and media news over the period of 1991 to 2007. The point of collecting information from so many different sources is to understand, as much as possible, the circumstances, contents, outcomes, and comments of each legislative

activity designed to enhance corporate governance system. The basic identification criteria are as follows:

1. The central objectives of the reform is to improve financial transparency, provide better monitoring by changing board structure and/or internal control systems, empower shareholders, and establish effective legal systems. The content of the reform should cover some or all of the following issues: enhancing disclosure requirements; strengthening the mechanisms of internal governance by specific requirements concerning the role and composition of the board of directors; empowering shareholders; and strengthening public enforcement.

2. The reform may have some exemptions[8] but should be applied to most publicly listed firms in the country.[9]

3. The level of enforcement of new rules must be either legal rules or comply-or-explain regulations, not purely voluntary. Voluntary compliance recommendations (e.g., Danish Shareholders' Association Guidelines of 2000 and Berlin Institutive Code of 2000) are not enforceable and, hence, are not considered CGRs. The new rules covered by a reform may be associated with different levels of enforcement. In such cases, the legislative action is defined as a CGR, if the majority of the issues covered by the reform are legal rules or comply-or-explain regulations,.

4. The reform has received generally positive comments on its influence and effectiveness. Phrases, such as "milestone" or "the most important development of financial markets," are used to infer that the new rules are relatively sound and effective.[10]

5. Improving corporate governance is normally a long-term process. It may involve multiple regulatory regimes. When a country enacts multiple reforms, the most influential one is considered the CGR of the country. If the multiple reforms are more or

[8]For example, Indian Clause 49 is identified as India's CGR, although it does not apply to firms with paid up share capital below Rs. 3 *crores.*

[9]Some regulations or new rules apply only to a subgroup of firms rather than all publicly listed firms in the country. For example, in Finland, Handling of Corporate Governance Issues (2000) applies only to state-owned companies and their associated companies. My definition of CGRs does not include these regulation changes.

[10]Some reforms may not significantly affect a country's corporate governance system. For example, Japan enacted new regulations in 2002 to introduce more "U.S.-style" governance practices. However, the new rules were too weak to have sufficient impact on Japanese corporate governance practices to be considered as a CGR.

less equivalent, the earliest one is considered the CGR of the country. In as much as each legal regime is part of a broader set of legal reforms geared toward an enhanced corporate governance system, the earlier one contains implicit information about the future schedule of corporate governance improvement.

The basic principle of determining the CGR year of each country is the earliest year when the new rules take effect. The Appendix describes how each CGR year is chosen for each country. For Austria and India, the timing information of implementation of the new rules is ambiguous. For these two countries, a primary CGR year is chosen for the main tests and an alternative CGR year is used for robustness tests.

Because of potential concerns about subjectivity in identifying these CGRs, I implement a meticulous identifying procedure. The initial coding of the CGR of each sample country was independently performed by the author and a research assistant (a law (JD) student). For a few countries we initially had inconsistent opinions on whether the country undertakes a CGR; which one should be identified as the CGR when there is more than one legislative activity on improving the corporate governance system; or which year should be considered as the CGR year for an identified reform. For each inconsistency, the author and research assistant analyze the case until consensus is reached. After the initial coding, the author and a different research assistant (another law (JD) student) re-code CGRs without referencing the prior coding. Again, when the coding is not clear, both the author and the research assistant read the relevant documents and discuss to ensure consistency in the definition of CGRs across countries. Additionally, I verify the validity of the CGRs by conducting a broad survey of academic articles to see whether the CGRs we identify have been employed as important regulatory changes by existing corporate governance studies.

These efforts yield a rather lengthy Appendix with a detailed description of each CGR and how its CGR year is defined. The Appendix begins with a table summarizing each CGR year, the level of enforcement, whether a CGR is weak relative to others. It contains a detailed description of each CGR, comprised of six sections: background information; key dates; scope; level of enforcement; outcome and criticism; and CGR regulations.

The background information section briefly describes motivations, objectives, and contents of the CGR. It also summarizes important, but unsuccessful legislative activity on the corporate governance system before or during the identified CGR year. This information helps justify our choice of the CGR for a particular country. The key dates section states the announcement date, effective date, and other relevant timing issues. The scope section describes the targets of the reform. The level of enforcement section conveys the strength of enforcement of the new rules. The outcome and criticism section summarizes comments from media, journal articles, or surveys by local, foreign, or international organizations about the reform. The CGR regulation section describes new regulations under five separate categories: (1) reforms on board structure, director independence and internal controls; (2) disclosure; (3) performance evaluation and incentive scheme; (4) shareholder meeting, minority shareholder rights, and market for corporate control; and (5) crime and penalty enhancement. Complete information is not available for all countries for all sections, and the details covered for each CGR vary from country to country.

This documentation allows us to identify 26 CGRs enacted by 11 weak-IP target countries and 15 strong-IP acquirer countries over the sample period. Although the regulations contained by these CGRs are not identical, our screening criteria and procedures generate strong commonalities in terms of their central objectives, scope, contents, and effectiveness--all geared toward improving governance. The estimated coefficients of *ACGR* and *TCGR* should be interpreted as the average effects of these CGRs on target selection.

The 26 countries with CGRs include Brazil and Switzerland. These countries' CGRs are very limited in the scope of covered subjects and contain regulations that are less restrictive than the other 24 countries. Initially, regressions are estimated employing only the 24 CGRs, which are more comparable in terms of the scope of issues covered and the enforceability of the contents. In the robustness section, I re-estimate regressions with all 26 CGRs.

III.B.2. Sample construction

Because the objective is to study target selection, I do not distinguish between successful or unsuccessful acquisition bids. Unsuccessful bids are included because some bids are acceptable to targets' controlling shareholders yet fail due to government interventions, opposition by labor unions, and so on. Nor do I distinguish between friendly or hostile bids.[11] The sample is constructed at the level of acquisition bids, identified using the following criteria:

1. In each bid, the bidder has to be from a strong-IP country and the target has to be located in a weak-IP country. To remove noise arising from "round-tripping capital,"[12] company nationalities are defined by the nationalities of their ultimate parents. Strong-IP and weak-IP countries are defined by the value of an IP index incorporating both de jure and de facto aspects of regulation. The de jure regulation is proxied by the *Anti-self-dealing* index compiled by Djankov et al. (2008), which measures minority shareholder protection against controlling shareholders' actions hurting shareholder value. This index is country-specific and time invariant. The de facto regulation is measured by the *Law-and-Order* index provided by International Country Risk Guide, which measures the effectiveness of the enforcement of formal rules. This index is updated monthly. I take yearly averages to construct the IP index.

The IP index is a weighted average of the normalized *Anti-self-dealing* index and *Law-and-Order* index. Weighting these two indices requires a subjective judgment. A common, but naïve, approach would give each an equal weight. However, the equal weight approach would rank countries such as China and Thailand ahead of France in terms of IP strength. Although France has Civil law origination, such a low relative ranking for France seems unreasonable. Thus, I experiment with different combinations of weights to come up with a reasonable ranking of countries in IP. The final choice is to give 20 – 80 percent weights to the *Anti-self-dealing* and *Law-and-Order* indices, at which point Italy is the only G-7 country that ranks as a weak-IP country. Strong-IP and

[11] Schwert (2000) finds that economic differences between friendly and hostile takeovers are indistinguishable. Under a strong view of managerial entrenchment, managers may wish to avoid any change in control, including those appearing friendly in the press.

[12] "Round-tripping capital" means that capital is originally from a country (usually a developing country), and is routed to another country before re-entering the original country as foreign direct investments (FDI) inflows. In some developing countries (e.g., China), round-tripping capital is a popular phenomenon. For example, Prasad and Wei (2005) estimate that round-tripping capital represents as much as one-third of Chinese FDI. Round-tripping capital is also often associated with tax evasion (Fisman and Wei, 2004).

weak-IP countries are separated by the median value of the index, yielding 17 strong-IP countries and 18 weak-IP countries. Table II lists these strong-IP and weak-IP countries under the title of acquirer and target countries.

2. Acquisition bids are announced during January 1, 1991 to December 31, 2007. Many emerging economies opened domestic stock markets to foreign investors in the late 1980s (e.g., Bekaert and Harvey, 2000; Henry, 2000; Kim and Singal, 2000). Prohibitions against foreign investors gaining control of local firms continued until the mid-1990s in a number of East Asian countries. Consequently, there were few cross-border acquisitions in emerging markets prior to the 1990s.

3. Bidder and target firms must be publicly listed. This criterion ensures no target firm is 100% owned by a single shareholder. Most CGRs apply only to publicly listed companies and do not cover private firms.

4. The bidder does not own any shares of the target prior to the announcement of the acquisition bid. This eliminates the influence pre-existing foreign ownership may have on target selection, performance, and governance.

5. Following Dyck and Zingales (2004), I require that bids are made for at least 10% of outstanding target shares. This is also consistent with the definition of FDI by the Bureau of Economic Analysis. The mean and median percentage shares sought by the bidders are 72.4% and 90.73%, respectively, indicating that most bids are made for majority control rights.

These screens yield 572 cross-border acquisition bids: 237 bids are announced after bidders' own countries undertook CGRs; 233 bids are announced after the target countries enacted CGRs. Table II presents the sample distributions by acquirer and target countries. Among acquirer countries, the U.S. is associated with the most acquisition bids (212), accounting for 37.06% of the sample. Among target countries, South Korea receives the most foreign acquisition bids (66), accounting for 11.54% of the sample.

Data on acquisition bids are taken from SDC Thompson's International M&A database. The primary firm-level data on acquirers and targets are taken from a dataset combining Compustat North America and Compustat Global. Compustat North America covers U.S. and Canadian companies and some international firms cross-listed on U.S. or Canadian stock exchanges. The Compustat Global database provides financial market

data on non-U.S. and non-Canadian marketplaces. It covers over 28,500 companies, representing over 90% of the world's market capitalization.[13] Compustat Global states that the data are normalized to provide comparability across different accounting standards and practices.[14]

III.B.3. Firm performance variables

The empirical analysis focuses on how changes in IP impact the tendency to target better performing firms. Two proxies are used to measure targets' performance prior to the announcement of acquisition bids. The first proxy is the growth rate of the ratio of sales to total assets, *SALES/TA_Gr*, one year prior to the announcement of acquisition bids. This measures the growth rate in asset utilization. When assets are utilized at a higher rate to generate sales, firms tend to perform better and invest more. In a cross-country study, the comparability of accounting data is an important concern. The ratio of sales to total assets is less affected by different local accounting rules and possible earnings management than earnings based performance measures. It also is unaffected by inflation and exchange rate. The growth rate, rather than the level, of this ratio is employed for two reasons. First, with U.S. acquisition data, Yang (2008) shows that changes in performance, rather than performance levels, are related to the likelihood of being targeted. Second, Durnev and Kim (2005) provide evidence that sales growth rate is positively related to the strength of firm-level corporate governance.

The second proxy is the market to book value (*MB*) ratio one year prior to the announcement of acquisition bids. The *MB* ratio is used to measure the value of growth opportunities implicit in the stock market's valuation of the firm.

Any observed changes in targets' pre-acquisition performance may reflect country and/or industry wide changes in the reported performance of all firms that may coincide and/or are caused by the target country's CGR. For example, CGRs may deflate accounting-based performance through stricter accounting standards. For this reason, I use the cumulative density function (CDF) of *SALES/TA_Gr* or of *MB*, one year prior to the announcement of an acquisition bid. The CDF variable measures each target firm's

[13]For example, Global Compustat data include 90% of the Asian market cap, 90% of the Indian market cap, 95% of the Taiwanese market cap, and 95% of the European market cap.
[14]See http://wrds-web.wharton.upenn.edu/wrds/ds/comp/index.cfm.

relative performance ranking among all firms in the same country and same industry during the same year.[15]

Compared to raw performance measures, the CDF has several advantages. First, it has better economic interpretation. Using a CDF as the dependent variable, the estimation results of Regression (7) can be interpreted as the impact of the CGRs on the change in the location of target firms in the distribution of performance of all firms in the same country, year, and industry. Second, using CDF reduces the importance of outliers by normalizing the variable into a unit interval. Third, it helps control for the heterogeneity in accounting rules and the quality of performance information across countries.

To reduce potential noise in the CDF measures, I require that for each target firm in the sample, there are at least 10 firms available in its country-year-industry matched sample from Compustat. With this restriction, the mean (median) number of matched non-target firms for each target firm is 171 (115), suggesting that this CDF measure provides reasonable information on the relative location of each target firm's pre-acquisition performance.

Table III reports the summary statistics of the two firm performance variables. The mean (median) value of the CDF of target firms' *SALES/TA_Gr* is 0.56 (0.57) and the mean (median) value of the CDF of target firms' *MB* is 0.63 (0.67). These statistics suggest that foreign acquirers from strong-IP countries tend to target better performing firms.

II I.C. RESULTS

III.C.1. Basic results

Table IV presents the baseline results concerning how CGRs undertaken by either the acquirer or target country affect the type of firms being targeted in weak-IP countries by acquirers from strong-IP countries. The variables of main interest are *ACGR* and *TCGR*. Columns (1) and (3) show estimation results without control variables, other than year, target industry, target country, and acquirer country dummies. The dependent variables are CDFs of *SALES/TA_Gr* and *MB*. Both columns show positive and significant coefficients for *ACGR* and negative but insignificant coefficients for *TCGR*.

[15] Industries are classified into 13 groups as in Campbell (1996).

The results imply that CGRs undertaken by acquirer countries increase the cherry picking tendency in cross-border acquisition target selections.

Columns (2) and (4) include deal-, target-, bidder-, and country-level control variables. *Cross List* is an indicator for target shares cross-listed on a foreign stock exchange at the time of an acquisition bid announcement. Cross-listed firms are subject to regulations of both countries. Doidge et al. (2004) show that firms in weak-IP countries cross-listed on stock exchanges of strong-IP countries practice higher quality governance. Such firms would be more attractive targets to foreign acquirers.

When target countries undertake CGRs, the improvement in local legal environments may attract more foreign direct investment, resulting in more foreign acquisitions and greater variation in the types of firms being targeted. Thus, I control for foreign merger waves in a particular country during a particular year by including *Num of Deals* in the regression. *Num of Deals* is the total number of acquisition bids (meeting our selection criteria) made by acquirers from the 17 strong-IP countries.

Acquirer firm characteristics, such as size and profitability, may influence the cherry picking tendency. Firm size of acquirer, *Acquirer Total Assets*, is measured by the logged value of total assets of the acquirer one year prior to the announcement of an acquisition bid. Firm profitability, *Acquirer EBITDA/TA*, is measured by the acquirer's earnings before interest, taxes, depreciation, and amortization (EBITDA) divided by its total assets one year prior to the announcement of an acquisition bid.

Diversified is an indicator equal to one, if the acquirer and target do not operate in the same industry, as defined by the Campbell (1996) industry grouping. Diversification related acquisitions may have different strategic purposes from horizontal or vertical acquisitions, which may lead to different target choices.

Foreign acquirers may alter their acquisition strategies in response to a financial crisis in the target country (Aguiar and Gopinath, 2005).[16] Hence, an indicator of financial crisis is included in the regression. It is equal to one, if the observation is in the following target country-year combinations: Thailand, 1997-99; South Korea, 1997-99;

[16]Aguiar and Gopinath (2005) find that the nature of M&As during a crisis contradicts productivity-based explanations of acquisitions. They also find that the number of foreign M&As in East Asia increased by 88% between 1996 and 1998.

Indonesia, 1997-99; Argentina, 2001-02; Brazil, 1998-99; Mexico, 1994-95; Turkey, 1994, and 2000-01; and Russia, 1998.

GDPPA Distance is the gap in GDP per capita between the acquirer and target countries one year prior to the announcement of an acquisition bid. The difference in economic conditions between the acquirer and target countries may affect acquirers' target selection decisions.

Adding these control variables reduces the sample size due to data unavailability. However, the results are stronger. While the coefficients of *ACGR* continue to be positive and significant, the negative coefficients of *TCGR* are now significant at the 5% level in both columns. The *TCGR* coefficient in Column (2) implies that after the target country undertakes a CGR, firms targeted by foreign acquirers are about 14 percentile lower in asset utilization growth rates. After a acquirer country undertakes a CGR, by contrast, acquirers form the country pursue firms with about 16 percentile higher in asset utilization growth rates.

Similar evidence is found when the pre-acquisition performance is measured by the market to book value ratio, *MB*, the proxy for the stock market's assessment of growth opportunities. Acquirers from strong-IP countries target firms with 16 percentile lower in valuation after a target country undertakes a CGR. In contrast, they respond to their countries' CGRs by targeting firms with 15 percentile higher in valuation.

Of the control variables, *Acquirer EBITDA/TA* and *Cross List* show significant coefficients in both regressions. The positive coefficient on *Acquirer EBITDA/TA* indicates that more profitable firms tend to pursue better-performing targets. According to Durnev and Kim (2005), controlling shareholders of better performing firms consume less private benefits. Such controlling shareholders value control premiums less and, hence, are more attracted to better performing targets, which demand lower control premiums.

The negative coefficient on *Cross List* implies that foreign acquirers are less reluctant to target underperforming firms if they are cross-listed. Because cross-listed firms tend to be subject to stronger-IP regulations of their cross-listing countries, this result is also consistent with the hypothesis that IP regulations governing potential target firms affect acquirers' target selection.

III.C.2. Timing of reforms and confounding effects

CGRs may not occur randomly. Once a country reaches a certain level of development, internal and external pressure may build up for a stronger corporate governance system. Also, a country may adopt a CGR when local companies are in greater need of foreign capital. India's enactment of Clause 49 is an example of internal and external pressures leading to a CGR.[17]

To examine the potential confounding effects, I borrow the method used in Bertrand and Mullainathan (2003) and Branstetter et al. (2006). Explanations based on coincident changes in economic and business environments may predict changes in the type of firms being targeted in the years surrounding the CGR year. The effects of the coincident changes are examined by introducing a set of dummies corresponding to the periods before and after a CGR. To reduce multi-collinearity problems, the confounding effects of *ACGR* and *TCGR* are tested in separate regressions.

Table V reports estimation results. When the confounding effects of *ACGR* (Columns (1) and (3)) are tested with the timing dummies, target countries' CGRs are controlled. Similarly, Columns (2) and (4) report the results testing the confounding effects of *TCGR* with the timing dummies, while controlling for acquirers' CGRs. In constructing the timing dummies, three or more years prior to the CGR year are used as the base years. Hence, the reform dummies start with two years prior to the CGR year. *ACGR_t-2* (*ACGR_t-1*) is equal to one if the acquisition announcement is made two (one) years before the acquirer country's CGR year. *ACGR_t* is equal to one if the acquisition bid is announced in the year of the acquirer country's CGR year. *ACGR_t+1* is equal to one if the announcement is made within one year after the acquirer country's CGR year. Finally, *ACGR_t+2* is equal to one if the announcement is made two or more years after the acquirer country's CGR year. Timing dummies for target countries' CGR (*TCGR*) are constructed in the same way.

Table V shows insignificant coefficients on dummies for years prior to both target and acquirer countries' CGRs, revealing no evidence of changes in the type of firms

[17] The desire to access global capital markets has been cited as a leading driver of the support for corporate governance reforms among Indian regulators and corporate leaders. (Afsharipour, 2009).

targeted prior to the reforms. However, the coefficients on acquirer countries' post-CGR year dummies in Columns (1) and (3) are all positive and significant. These results imply that CGRs enacted by acquirer countries have immediate and lasting effects of exacerbating the cherry picking tendency. The coefficients on target countries' post-CGR year dummies in Columns (2) and (4) are all negative and mostly significant, implying that CGRs enacted by target counties decrease foreign acquirers' cherry picking tendencies.

In sum, the main results concerning the effects of target and acquirer countries' CGRs on foreign bidders' cherry picking tendency are not driven by confounding effects surrounding the CGR years.

Another concern on the timing of CGRs is that during a given CGR year, non-CGR countries also may introduce regulations improving corporate governance but their impacts are not substantive enough to be classified as a CGR. Such regulatory actions are likely to strengthen rather than weaken IP. Thus, to the extent that such reforms are present in our non-CGR countries, our estimates of CGR impacts will be smaller, weakening the power of the test.

Finally, changing the corporate governance system of a country is typically a long-term process. Many countries continue to issue new IP regulations after enacting the CGRs. These additional regulatory changes often have the same direction as the CGRs. Thus, they will narrow the estimated difference in the type of firms being targeted between CGR and non-CGR countries in a particular year, biasing the results against finding significant impacts.

III.C.4. Robustness tests

This section contains a battery of robustness checks. I re-estimate the regression to address various concerns and report the results in Table VI. For the sake of brevity, the estimated coefficients of control variables are not reported.

a. The impact of privatization

There are 48 foreign acquisitions of state owned enterprises (SOEs) in the sample. These acquisitions could be a part of an on-going privatization process in the target country, and privatization waves sometimes coincide with other regulatory changes such

as a CGR. In addition, governance structures of SOEs are different from those of privately owned firms. Thus, I control for an indicator of a SOE target. The results, reported in Panel A, are robust, regardless of which measure of target firms' performance is used. The coefficients of *SOE* are insignificant.

b. Additional acquisition characteristics

Legal environments may also have an influence on acquisition strategies. For example, Rossi and Volpin (2004) find that more hostile takeovers take place in countries with common law, higher accounting standards, and greater shareholder protection. There are 220 acquisitions defined as unfriendly acquisitions in the sample. Whether the acquisition is hostile or not could be a missing factor. To address this concern, I include an indicator of a friendly acquisition, *Friend*. Along a similar vein, tender offer vs. non-tender offer acquisition bids are treated separately by including an indicator for a tender offer bid, *Tender*. There are 46 acquisition bids made in the form of tender offers. The results, reported in Panel B, are robust to controlling for these two additional deal-specific variables. The coefficients of both *Friend* and *Tender* are mostly insignificant.

c. Accounting for the changes in openness of target countries

In some developing countries, financial liberalization policies may coincide with new regulations improving corporate governance standards. This raises the possibility that the main results are driven by the changes in the openness of target countries. Although including the control variable *Num of Deals* partially addresses this concern, I explicitly address the issue by including target countries' foreign direct investment (FDI) net inflows as percent of GDP, *FDI Inflow/GDP,* as a control variable. Because this variable is time-variant, it will reflect changes in the openness toward foreign capital. Panel C shows that the coefficients of *FDI Inflow/GDP* are insignificant and that the estimates of *ACGR* and *TCGR* are virtually unchanged regardless of whether the performance is measured by *SALES/TA_Gr* or *MB*. The baseline results do not appear to be driven by omitted variables correlated with changes in the openness of target countries.

d. Excluding acquisitions in regulated industries

Acquisitions of firms in regulated industries may require approval by local governments and, hence, may have different motives and attributes. Thus, I re-estimate the baseline results excluding the foreign acquisition bids for firms in financial services

(the first two SIC code: 60-69) and utility industries (the first two SIC code: 40-49) in Panel D. Although this sample construction greatly reduces the sample size, the results are robust.

e. Including weak CGRs

As discussed earlier, CGRs are not identical. The heterogeneity in CGRs will introduce variation in their impacts. Although I require the level of enforcement of each CGR to be either legal rules or comply-or-explain, the new rules could be very lax in content and cover fewer subjects than most other CGRs. The CGRs undertaken by Brazil and Switzerland are cases in point (see the Appendix). These CGRs contain very lax regulations and are very limited in the scope of covered subjects. As such, I identify them as weak CGRs and treat the two counties as having no CGRs in all regression estimates. In Panel E, I re-estimate the regressions while including the two weak CGRs. Again, the qualitative results do not change.

f. Other robustness checks

A number of additional tests are conducted. The results are summarized below without reporting them. The sample distribution across acquirer countries is more unbalanced than target countries. Five countries (Austria, Belgium, Denmark, Finland, and Norway) have fewer than 10 observations. Regressions are re-estimated by excluding the cross-border acquisitions made by firms from these five countries. The results are similar in both magnitude and the level of significance. For target countries, there is less concern with this issue, since among all target countries, only Turkey has fewer than 10 observations (it has 9 observations).

Because of possible correlations among acquisitions made by firms from the same acquirer country, I re-estimate the regressions by clustering at the acquirer countries. The results are robust in both magnitude and the level of significance.

As discussed earlier and in the Appendix, the precise CGR year for Austria and India is somewhat ambiguous. The facts described in the Appendix suggest that 2004 was the primary CGR year for Austria, but 2002 may have had as important an impact on Austrian IP. Because the sample contains no acquisition bids by Austrian firms between 2002 and 2004, no further test is conducted. The primary CGR year for India is 2002, but a case can be made for 2001. For India, I re-estimate the baseline regressions with 2001

as India's CGR year. The estimated impacts of *ACGR* are robust. The results of the estimated impact of *TCGR* are also robust when the dependent variable is CDF of *SALES/TA_Gr* and slightly weaker with the CDF of *MB* as the dependent variable.

Finally, one may argue that if foreign acquirers always favor better-performing firms in weak-IP countries, the number of better-performing firms available for acquisitions may decrease over time, thereby giving the appearance of reduced cherry picking following target countries' CGRs. However, this cannot be the driving force, because it also predicts a continual reduction in cherry picking over time, which is contradicted by the increased tendency to cherry pick following acquirer countries' CGRs.

IV. CONCLUSIONS

This paper investigates how investor protection (IP) of acquirer and target countries affects international capital flow allocation at the firm level. A simple model provides an explanation for a well documented but little understood phenomenon on international capital flows--namely, foreign acquirers' tendency to target better-performing firms in emerging markets. When the acquirer country has stronger IP than the target country, the foreign bidder's controlling shareholder values control premiums less than the controlling shareholder of the local target firm. Within a given legal environment, controlling shareholders of better-performing firms consume fewer private benefits because of the greater opportunity costs of foregoing profitable projects and, hence, they may demand lower control premiums. Lower control premiums, in turn, make these firms more attractive to foreign acquirers, who are subject to stronger-IP regulations and consume fewer private benefits. This tendency to select better-performing targets becomes weaker (stronger) as the IP gap between the acquirer and target countries decreases (increases), because smaller (larger) IP gaps cause less (greater) disagreement on the value of control premiums at the country level.

These predictions are tested with data on cross-border acquisition bids. Among 35 acquirer and target sample countries, I identify corporate governance reforms (CGRs) undertaken by 26 countries, which are used to estimate the impacts of changes in the IP gap between acquirer and target countries on the cherry picking tendency. I find a significant decrease in the cherry picking tendency after weak-IP target countries reduce

the IP gap by undertaking CGRs. In contrast, CGRs undertaken by acquirer countries increase the IP gap, exacerbating the cherry picking tendency among foreign bidders after their own countries enact CGRs.

These findings imply that weak IP in target countries impedes cross-border M&A markets from functioning fully. In particular, weak IP in target countries prevents poorly performing local firms from gaining access to foreign investors. These firms tend to have greater room for improvement, which can be facilitated by foreign capital and managerial know-how. Thus, the negative impact of weak IP is particularly damaging to the spread of the potential benefits of globalization. More generally, the results in this paper highlight the importance of investor protection in guiding international capital flows not only across countries, but also across firms within a country.

Finally, recent studies (e.g., Rossi and Volpin, 2004; Bris and Cabolis, (forthcoming); Chari, Ouimet, and Tesar, (forthcoming)) demonstrate that cross-border acquisitions are an important channel to transfer corporate governance systems from strong to weak legal regimes. However, this paper identifies an important distortion in that channel. The transmission of governance systems through cross-border acquisitions may occur only for firms that already have relatively sound governance systems, leaving firms with weak governance untouched. When weak-IP capital importing countries improve their legal environments, they help alleviate the distortion by inducing foreign acquirers to reach out to underperforming firms, which in turn enhances the allocation efficiency of foreign capital. However, when strong-IP capital exporting countries enact reforms to enhance legal IP, the reforms have the unintended consequence of exacerbating the distortion by inducing foreign acquirers to further shy away from poorly performing firms.

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Table I: Variable Description

Panel A: Corporate Governance Reform Variables	
ACGR	An indicator equal to one if the acquirer country has undertaken a CGR (defined in the Appendix) by the announcement of the acquisition bid.
TCGR	An indicator equal to one if the target country has undertaken a CGR (defined in the Appendix) by the announcement of the acquisition bid.
Panel B: Firm and Deal-specific Variables	
SALES/TA_Gr	Target firms' growth rate of sales divided by the book value of total assets one year prior to the announcement of an acquisition bid. (Source: SDC and Compustat Global and Compustat North America)
MB	The ratio of the market value of the common equity to the book value of equity one year prior to the announcement of an acquisition bid. Observations with negative *MBs* are replaced by zeros. (Source: SDC and Compustat Global and Compustat North America)
Cross List	An indicator equal to one, if the target firm's listing location is different from its nationality, when the acquisition bid is announced. (Source: SDC and Compustat Global and Compustat North America)
Diversified	An indicator equal to one if the acquirer and target are not in the same industry defined as Campbell (1996) industry groupings. (Source: SDC and Compustat Global and Compustat North America)
Acquirer Total Assets	The acquirer's natural logarithm value of the book value of total assets one year prior to the announcement of the acquisition bid. The book value of assets is denominated in 2000 $US. (Source: SDC and Compustat Global and Compustat North America)
Acquirer EBITDA/TA	The acquirer's earnings before interest, taxes, depreciation and amortization (EBITDA) divided by total assets one year prior to the announcement of the acquisition bid. (Source: SDC and Compustat Global and Compustat North America)
SOE	An indicator equal to one if the ultimate parent of the target firm is the government of the target country. (Source: SDC)
Friend	An indicator equal to one if the acquisition bid is defined as a friend acquisition. (Source: SDC)
Tender	An indicator equal to one if the acquisition bid employs a tender offer. (Source: SDC)
Panel C: Country-level Variables	
IP	Measured as (*0.2*Anti-self-dealing + 0.8*Law-and-Order*); a higher score indicates stronger investor protection. *Anti-self-dealing* measures the amount of disclosure before and after the transaction has occurred, the need for approval by disinterested shareholders, and litigation governing a specific self-dealing transaction. It is a time invariant country level measure. (Source: Djankov, et al., 2008) *Law-and-Order* measures the strength and impartiality of a legal system and of the popular observance of the law. It is a country level and changes every year. (Source: International Country Risk Guide)
GDPPA Distance	The gap in GDP per capita between the acquirer and target countries one year prior to the announcement of acquisition bid; all values in GDPPA are converted into thousand dollars in 2000. (Source: World Development Indicators for all countries except Taiwan; MarketLine-Research Database for Taiwan)
FDI Inflows/GDP	Net inflows of foreign direct investments as the percent of GDP. (Source: World Development Indicators for all countries except Taiwan; Economist Intelligence Unit (EIU) for Taiwan)
Num of Deals	The total number of cross-border acquisition bids by foreign acquirers from the 17 sample acquirer countries taken place in each target country during a given year. (Source: SDC)
Crisis	An indicator equal to one if the acquisition bid is announced in the following country-year specific combinations: Thailand, 1997-99; South Korea, 1997-99; Indonesia, 1997-99; Argentina, 2001-02; Brazil, 1998-99; Mexico, 1994-95; Turkey, 1994, and 2000-01; Russia, 1998. (Source: SDC)

Table II: Sample Description by Acquirer and Target Countries

This table reports the sample description by acquirer (home) and target (host) countries. In Panel A, Column (1) lists the acquirer countries covered by the sample. Column (2) presents the number of acquisition bids by firms from each acquirer country. Column (3) presents the sample distribution across acquirer countries. Column (4) presents the number of acquisition bids announced before the acquirer country undertakes a CGR by firms in that country. Column (5) presents the distribution of pre-CGR sample across acquirer countries. Column (6) presents the number of acquisition bids after the acquirer country undertakes a CGR by firms in that country. Column (7) presents the distribution of the post-CGR sample across acquirer countries. In Panel B Column (1) lists the target countries covered by the sample. Column (2) presents the number of acquisition bids of firms located in each target country. Column (3) presents the sample distribution across target countries. Column (4) presents the number of acquisition bids of target firms located in each target country announced before the target country undertakes a CGR. Column (5) presents the distribution of the pre-CGR sample across target countries. Column (6) presents the number of acquisition bids of target firms located in each target country after the target country undertakes a CGR. Column (7) presents the distribution of post-CGR sample across target countries. The CGRs include both strong and weak CGRs and are identified in Appendix.

Panel A: Sample Distribution by Acquirer Countries						
ACQUIRER COUNTRY	**N**	**%**	**N**	**%**	**N**	**%**
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**
AUSTRALIA	20	3.5	17	5.07	3	1.27
AUSTRIA	4	0.7	2	0.6	2	0.84
BELGIUM	6	1.05	5	1.49	1	0.42
CANADA	13	2.27	10	2.99	3	1.27
SWITZERLAND	18	3.15	9	2.69	9	3.8
GERMANY	52	9.09	31	9.25	21	8.86
DENMARK	7	1.22	7	2.09	0	0.00
FINLAND	6	1.05	2	0.6	4	1.69
FRANCE	13	2.27	6	1.79	7	2.95
UNITED KINGDOM	64	11.19	7	2.09	57	24.05
HONG KONG	41	7.17	31	9.25	10	4.22
JAPAN	53	9.27	53	15.82	0	0.00
NETHERLANDS	16	2.8	13	3.88	3	1.27
NORWAY	3	0.52	1	0.3	2	0.84
SINGAPORE	34	5.94	19	5.67	15	6.33
SWEDEN	10	1.75	8	2.39	2	0.84
UNITED STATES	212	37.06	114	34.03	98	41.35
TOTAL	**572**		**335**		**237**	

Panel B: Sample Distribution by Target Countries						
TARGET COUNTRY	**N**	**%**	**N**	**%**	**N**	**%**
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**
BRAZIL	25	4.37	17	5.01	8	3.43
CHILE	11	1.92	8	2.36	3	1.29
CHINA	65	11.36	13	3.83	52	22.32
CZECH REPUBLIC	13	2.27	13	3.83	0	0.00
SPAIN	50	8.74	34	10.03	16	6.87
INDONESIA	23	4.02	23	6.78	0	0.00
INDIA	61	10.66	14	4.13	47	20.17
ITALY	34	5.94	26	7.67	8	3.43
SOUTH KOREA	66	11.54	7	2.06	59	25.32
MEXICO	16	2.8	12	3.54	4	1.72
MALAYSIA	57	9.97	26	7.67	31	13.3
PHILIPPINES	19	3.32	19	5.6	0	0.00
POLAND	11	1.92	6	1.77	5	2.15
RUSSIA	13	2.27	13	3.83	0	0.00
THAILAND	27	4.72	27	7.96	0	0.01
TURKEY	9	1.57	9	2.65	0	0.02
TAIWAN	37	6.47	37	10.91	0	0.03
SOUTH AFRICA	35	6.12	35	10.32	0	0.04
TOTAL	**572**		**339**		**233**	

Table III: Summary of Statistics

This table reports the summary of statistics of the variables used in the paper. All variables are described in Table I.

Variables	N	Mean	Median	Std. Dev.	Min	Max
(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**	**(7)**
CDF(SALES/TA_Gr)	533	0.564	0.571	0.299	0.009	1
CDF(MB)	354	0.630	0.667	0.290	0.012	1
Cross List	572	0.073	0	0.261	0	1
Diversified	572	0.294	0	0.456	0	1
SOE	572	0.084	0	0.278	0	1
Tender	572	0.079	0	0.269	0	1
Friend	572	0.631	1	0.483	0	1
Num of Deals	572	6.713	6	4.035	1	16
GDPPA Distance	572	22.215	22.409	8.675	2.421	40.059
Acquirer Total Assets	529	9.174	9.384	2.700	-7.006	14.554
Acquirer EBITDA/TA	531	0.044	0.094	0.978	-22	0.804

Table IV: Impacts of CGRs on the Type of Firms being Targeted

This table reports the baseline results of the impact of CGRs undertaken by either acquirer or target country on the type of firms being targeted. In Columns (1)-(2), the dependent variable is the numerical cumulative density functions (CDFs) of the growth rate of sales divided by total assets of the target firm (SALES/TA_Gr). In Columns (3)-(4), the dependent variable is the market to book value (MB) ratio. All variables are defined in Table I. All regressions are estimated with year, target industry (defined as in Campbell (1996) industry groupings), target country, and acquirer country dummies. Robust standard errors (in parentheses) are corrected by clustering the observations by target countries. *, **, and *** indicate significance at the 10%, 5% and 1%, respectively.

	CDF(SALES/TA_Gr)		**CDF(MB)**	
	(1)	**(2)**	**(3)**	**(4)**
ACGR	0.133**	0.163**	0.184***	0.151**
	(0.059)	(0.061)	(0.047)	(0.053)
TCGR	-0.047	-0.140**	-0.131	-0.161**
	(0.058)	(0.052)	(0.082)	(0.073)
Cross List		-0.103*		-0.142*
		(0.057)		(0.073)
Diversified		0.009		0.048
		(0.030)		(0.031)
Num of Deals		0.011**		0.003
		(0.005)		(0.005)
GDPPA Distance		-0.005		0.018***
		(0.006)		(0.003)
Crisis		0.124		0.094
		(0.143)		(0.100)
Acquirer Total Assets		-0.001		-0.004
		(0.005)		(0.006)
Acquirer EBITDA/TA		0.022***		0.041***
		(0.007)		(0.007)
Constant	0.275*	0.895***	0.478**	0.627**
	(0.156)	(0.224)	(0.200)	(0.240)
Year Dummies	Y	Y	Y	Y
Target Industry Dummies	Y	Y	Y	Y
Target Country Dummies	Y	Y	Y	Y
Acquirer Country Dummies	Y	Y	Y	Y
Observations	533	492	354	333
R-squared	0.18	0.24	0.33	0.41
Adj-Rsquare	0.07	0.11	0.18	0.25

Table V: Timing of Reforms and Confounding Effects

This table reports the test results on the impact of confounding effects on the type of firms being targeted. The dependent variable is the numerical cumulative density function (CDF) of SALES/TA_Gr in Columns (1)-(2) and CDF of MB in Columns (3)-(4). ACGR_t-2 (ACGR_t-1) is equal to one if the announcement is made two (one) years before the acquirer country's CGR year. ACGR_t is equal to one if the acquisition bid is announced in the year of the acquirer country's CGR year. ACGR_t+1 is equal to one if the announcement is made in one year after the acquirer country's CGR year. ACGR_t+2 is equal to one if the announcement is made two or more years after the acquirer country's CGR year. Timing dummies for target countries' CGRs (*TCGR*) are constructed in the same way. All variables are defined in Table I. All regressions are estimated with year, target industry (defined as in Campbell (1996) industry groupings), target country, and acquirer country dummies. Robust standard errors (in parentheses) are corrected by clustering the observations by target countries. *, **, and *** indicate significance at the 10%, 5% and 1%, respectively.

	CDF(SALES/TA_Gr)		**CDF(MB)**	
	(1)	**(2)**	**(3)**	**(4)**
TCGR	-0.137**		-0.137*	
	(0.056)		(0.072)	
ACGR_t-2	0.040		-0.104	
	(0.057)		(0.060)	
ACGR_t-1	0.091		0.106	
	(0.087)		(0.084)	
ACGR_t	0.169*		0.071	
	(0.083)		(0.087)	
ACGR_t+1	0.120**		0.154*	
	(0.046)		(0.077)	
ACGR_t+2	0.254***		0.189**	
	(0.064)		(0.077)	
ACGR		0.163**		0.159***
		(0.063)		(0.052)
TCGR_t-2		0.028		-0.133
		(0.110)		(0.110)
TCGR_t-1		0.052		-0.064
		(0.105)		(0.177)
TCGR_t		-0.124		-0.262**
		(0.086)		(0.104)
TCGR_t+1		-0.054		-0.137*
		(0.074)		(0.074)
TCGR_t+2		-0.152*		-0.226**
		(0.087)		(0.104)
Cross List	-0.104*	-0.096	-0.127	-0.136*
	(0.057)	(0.055)	(0.074)	(0.076)
Diversified	0.006	0.005	0.040	0.049
	(0.029)	(0.033)	(0.033)	(0.032)
Num of Deals	0.010*	0.010**	0.004	0.000
	(0.005)	(0.005)	(0.005)	(0.005)
GDPPA Distance	-0.005	-0.004	0.018***	0.018***
	(0.005)	(0.006)	(0.003)	(0.003)
Crisis	0.118	0.119	0.053	0.112
	(0.146)	(0.129)	(0.115)	(0.078)
Acquirer Total Assets	-0.002	-0.002	-0.003	-0.004
	(0.006)	(0.005)	(0.005)	(0.006)
Acquirer EBITDA/TA	0.024***	0.023***	0.041***	0.040***
	(0.007)	(0.007)	(0.007)	(0.007)
Constant	0.921***	0.910***	0.722**	0.137
	(0.219)	(0.237)	(0.270)	(0.284)
Year Dummies	Y	Y	Y	Y
Target Industry Dummies	Y	Y	Y	Y
Target Country Dummies	Y	Y	Y	Y
Acquirer Country Dummies	Y	Y	Y	Y
Observations	492	492	333	333
R-squared	0.25	0.24	0.42	0.41
Adj-Rsquare	0.11	0.10	0.25	0.24

Table VI: Robustness Checks

This table reports the robustness of the results in Table IV to alternative model specification and sample constructions. All regressions include the same control variables used in Columns (3) and (6) of Table IV but not reported. The definitions of all variables are given in Table I. Robust standard errors (in parentheses) are corrected by clustering of the observations by target countries. *, **, and *** indicate significance at the 10%, 5% and 1%, respectively.

		CDF(SALES/TA_Gr)	**CDF(MB)**
		(1)	**(2)**
Panel A: Controlling for state owned enterprises	*ACGR*	0.166**	0.151**
		(0.061)	(0.053)
	TCGR	-0.143**	-0.160**
		(0.052)	(0.074)
	SOE	0.058	-0.057
		(0.047)	(0.091)
	Year, Target Industry, Target Country and Acquirer Country Dummies	Y	Y
	Observations	492	333
	R-squared	0.24	0.41
	Adj-Rsquare	0.11	0.25
Panel B: Controlling for friendly takeover bids and tender offer bids	*ACGR*	0.160**	0.152**
		(0.062)	(0.054)
	TCGR	-0.151**	-0.172**
		(0.053)	(0.073)
	Friend	-0.003	-0.041*
		(0.027)	(0.020)
	Tender	-0.090	-0.012
		(0.052)	(0.098)
	Year, Target Industry, Target Country and Acquirer Country Dummies	Y	Y
	Observations	492	333
	R-squared	0.24	0.41
	Adj-Rsquare	0.11	0.25
Panel C: Controlling for changes in the openness of target countries by target countries' FDI net inflows as a percentage of GDP	*ACGR*	0.163**	0.152**
		(0.059)	(0.052)
	TCGR	-0.146**	-0.160**
		(0.055)	(0.075)
	FDI Inflows/GDP	-1.404	0.276
		(0.896)	(1.576)
	Year, Target Industry, Target Country and Acquirer Country Dummies	Y	Y
	Observations	492	333
	R-squared	0.24	0.41
	Adj-Rsquare	0.11	0.24

Table VII: Robustness Checks (Continue)

		CDF(SALES/TA_Gr)	CDF(MB)
		(1)	**(2)**
Panel D: Excluding acquisitions of financial and utility firms	*ACGR*	0.182*	0.151*
		(0.090)	(0.077)
	TCGR	-0.126**	-0.171*
		(0.054)	(0.093)
	Year, Target Industry, Target Country and Acquirer Country Dummies	Y	Y
	Observations	335	222
	R-squared	0.27	0.40
	Adj-Rsquare	0.08	0.15
Panel E: Including weak CGRs in Brazil and Switzerland	*ACGR*	0.142**	0.140**
		(0.063)	(0.048)
	TCGR	-0.115*	-0.164**
		(0.055)	(0.073)
	Year, Target Industry, Target Country and Acquirer Country Dummies	Y	Y
	Observations	492	333
	R-squared	0.23	0.40
	Adj-Rsquare	0.10	0.24