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Market standards in financial contracting: The Euro's effect on debt securities ☆

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ABSTRACT

The introduction of the Euro ushered in a rise to dominance of English contract law in European debt securities. Corporate issuers in the Euro zone chose English law significantly more often than a control group from other European countries. The Euro effect on choice of law is particularly strong for debt securities in local markets that, arguably, were most affected by the Euro. The Euro effect is not explained by differences in the suitability of English law compared to other laws, a change in issuer composition or debt securities types, and the greater market share of British and American underwriters. We argue that increased standardization benefits (network effects) from a boost in cross-border investment provide the best account of why English law conquered the European debt securities market.

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1. Introduction

Conventional theory predicts that financial contracting aims at minimizing agency costs. An example is the analysis of covenants in loan contracts and indentures (e.g., [Smith and Warner, 1979](#); [Gârleanu and Zwiebel, 2009](#); [Nikolaev, 2010](#); [Müller and Reisel, 2012](#)). We consider standardization as another, more mundane force shaping financial contracts. Our study focuses on corporate debt securities and a prominent contract feature, the choice of applicable contract law. We find that by

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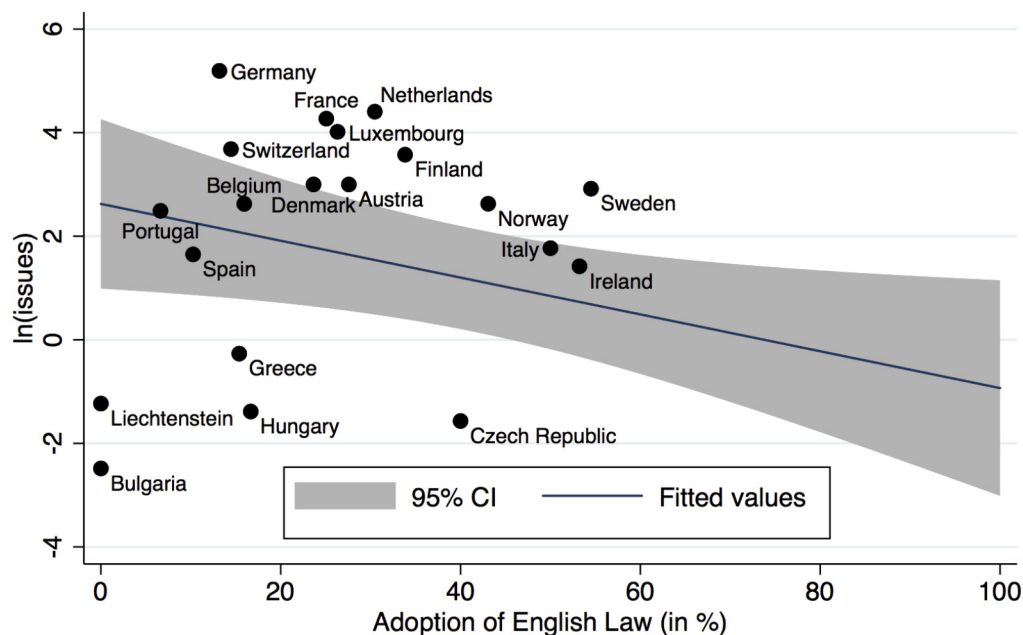


Fig. 1. The horizontal axis is the share of debt securities issues governed by English law, the vertical axis is market size, defined as the average number of debt securities issues per year in a given country. For EMU states, market size is based on the period between 1985 and the year the country introduced the Euro; for non-EMU states, the respective period runs from 1985 to 2008. The location of the issuer determines the country of the issue.

the late 2000s, 79 percent of European debt securities were governed by English law.¹ Such high concentration already suggests a demand for standardization. Historically, the rise of English law to market dominance coincided with the advent of the Euro in 1999. Adopting a similar approach as others before us (Bris et al., 2006, 2009, 2014; Kalemli-Ozcan et al., 2010), we use this event—the final stage of the Economic and Monetary Union (EMU)—as a natural experiment to investigate standardization as a determinant of contract design. It turns out that, with the arrival of the Euro, the share of English law increased significantly more for debt securities from EMU states than for a control group of European countries outside the EMU. Since neither English law nor other contract laws changed around this event, optimal contract design alone cannot explain the breakthrough of English law. The rise of British and American banks in the European underwriting market appears to be one driver. However, controlling for the shift in underwriting activity accounts only for a lesser part of the Euro effect. Another plausible explanation, in our view, is the desire for standardization in an increasingly international market.

Standardization reflects “network effects”—when users of a good derive a benefit from others using the same or a compatible good (see the excellent survey by Farrell and Klemperer, 2007). Network effects occur in many areas, from traditional products such as typewriter keyboards (David, 1985; Liebowitz and Margolis, 1990) to societal goods like languages, social norms or culture (see, e.g., Grewal, 2008; Church and King, 1993). Legal rules can also exhibit network effects (Klausner, 1995). Negotiating a contract is less costly when all parties to a contract are familiar with the same legal framework. Shared use of the same contract law, in this regard, resembles a common language that reduces the cost of transacting (Druzin, 2009).

This should be particularly relevant for the issuing process with its many participants—the issuer, underwriters, law firms, rating agencies, and investors. Fig. 1 gives a first hint at English law as the international standard for debt securities in Europe. It relates the fraction of debt securities governed by English law to the size of national debt securities markets. Smaller markets use English law more frequently.² They likely rely more on foreign investors and underwriters who are less familiar with local law; at the same time, domestic investors are more used to investing abroad. This should make small markets more inclined to adopt a contract law that international investors are familiar with, as suggested by Fig. 1.

Fig. 2 underscores the role of English law as a shared legal language. Eurobonds are marketed to a broad, international investor audience (Benzie, 1992, pp. 15–17; Coyle, 2002, pp. 23–25). Fig. 2 contrasts the English-law share in Eurobonds with that of domestic debt securities. We classify a security as “domestic” if the issuer, its ultimate parent and the currency denomination all belong to the same country. The surge of English law after the introduction of the Euro gives a first glimpse at our main result. But the key point here is that before the Euro international Eurobonds adopted English law far more frequently than debt securities aimed at the local market.

¹ For a sample of US corporate debentures in 2002, Eisenberg and Miller (2009, p. 1491) report a market share of 89 percent for New York law.

² The relationship is robust to excluding outliers such as Estonia, Iceland, Latvia, Lithuania, Poland, and Slovakia, as well as the UK.

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