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Securities laws in the host countries and the capital structure of US multinationals

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ABSTRACT

We examine whether securities laws in the host countries influence the capital structure choice of United States (US) multinational corporations. We develop firm-level global indices to classify each corporation in terms of its exposure to the security laws that govern the rights of security holders in the countries where it has subsidiaries. The results show that the use of long-term debt is positively related to the firm's global standing in terms of common law legal origin, burden of proof, investor protection, disclosure requirements, and public enforcement. The securities laws in a country affect the capital structure of multinational corporations that has subsidiaries in that country.

1. Introduction

Capital structure theory suggests that the optimal level of debt a firm may use is determined by balancing the lower costs and tax benefits of debt against the disadvantages of debt such as higher agency costs to debtors and higher risk. Thus, if risk or exposure to agency costs decrease while all else remain constant a corporation may increase the amount of debt in its capital structure. Portfolio theory suggests that international diversification should reduce revenue risk. Thus, if the risk tolerance of shareholders, tax benefits, and agency costs remain constant, international diversification should increase a corporation's debt capacity. Yet, the empirical evidence seems to suggest the opposite and previous studies propose several explanations of the unanticipated result. Lee and Kwok (1988) report that US-based multinational corporations (MNCs) tend to have lesser debt ratios than domestic corporations. Burgman (1996) argues that debtors of MNCs are subject to increased agency problems, information asymmetry, and monitoring costs. In addition, Doukas and Pantzalis (2003) propose that restricted access to information and exposure to several country specific legal and political complications are other factors that increase agency costs of debt. These authors suggest that MNCs keep lower proportion of long-term debt to mitigate the increase in agency costs arising from having international operations.[2]

The purpose of this study is to examine the relation between the long-term debt ratio of US MNCs and the degree by which securities laws in the host countries protect investors. We propose that the quality of securities laws in a country affects the capital structure choice of the domestic corporations as well as the subsidiaries of the multinationals operating in that country. Thus, the securities laws of countries where a MNC's subsidiaries are located affect its capital structure choice. We hypothesize that having

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[2] Previous studies, for example Brounen et al. (2006), also suggest that the tax laws in the host countries may affect either positively or negatively the use of debt in the capital structure of MNCs. However, this study focuses on the relation between the long-term debt ratio and the securities laws in the host countries.

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subsidiaries in a country with securities laws similar to those of the US may have insignificant impact on the US MNC's long-term debt ratio. In contrast, if the host country's securities laws are less protective to investors than those of the US counterparts, the firm will tend to use a lower long-term debt ratio to mitigate the agency problems arising from having operations in a less protective legal environment. Thus, corporations with the same level of international diversification may have variations in the level of long-term debt in their capital structure. We expect that the impact of internationalization on agency costs and capital structure choice depends on the set of foreign countries (and the quality of their legal institutions) in which a MNC has subsidiaries.

This study builds on the work of La Porta, Lopez-De-Silanes, and Shleifer (2006) who develop several indices to rank countries based on securities legislation that govern equity issues. They find strong evidence that laws which mandate disclosure requirements and promote liability standards that facilitate investor recovery support the development of stock markets.[3] We expect that the same indices are good proxies for the status of a country in terms of its protection of debtors. For example, according to La Porta et al. (2006, page 5) "Securities laws, in so far as they reduce the costs of contracting and resolving disputes, can encourage equity financing of firms and stock market development. … solving the promoter's problem is important not only for equity markets but for debt markets as well." In addition, we argue that the foreign countries' securities laws that mandate disclosure requirements and promote liability standards that facilitate investor recovery decrease the agency costs of debtors by improving access to information and reducing information asymmetry. With this premise, we use the country-level indices and the US MNC's subsidiaries in foreign countries to develop firm-level indices to characterize the global securities laws environments of the sample corporations; and then we examine the impact of these indices on the long-term debt ratio. We find that the long-term debt ratio is positively affected by the firm-level indices that represent common law legal origin, burden of proof, investor protection, disclosure requirements, and public enforcement. Overall, our unique contributions include the creation of firm-level indices that measure the overall securities laws environment a corporation faces and showing that these indices affect a MNC's capital structure decision.

Our results are consistent with the findings of Demirguc-Kunt and Maksimovic (1999), Giannetti (2003), and Bancel and Mittoo (2004). They report a negative relation between the degree of investor protection in a country and the cost of debt to domestic firms. Their analysis suggests that the higher the level of investor protection the higher is the optimal level of debt in a firm's capital structure. In addition, our conclusions may explain the seemingly contradictory findings of previous studies. In particular, Doukas and Pantzalis (2003) report that in order to mitigate the increase in agency costs, firms operating internationally use less debt in their capital structure. In contrast Akhtar (2005) reports that the level of leverage of Australian MNCs does not differ significantly from that of domestic corporations. We show that the effect of international diversification on the long-term debt ratio varies depending on the securities laws in the countries where diversification occurs.

The results of this study have important practical and theoretical implications. They show that expanding internationally can lead to a decrease in the use of long-term debt in the capital structure and that the decrease is more pronounced when the expansion occurs in a country whose legal institutions provide weak protection to investors. As the cost of debt is usually lower than the cost of equity, a decrease in the utilization of long-term debt may increase the cost of capital and reduce the net present value of the firm's growth opportunities, hence its value. Overall, this study contributes towards our understanding of the costs of international expansion and suggests that it is important for managers to appropriately account for the impact of a target country's legal institutions on the cost of capital and firm value.

The remainder of this paper is organized as follows. Section 2 provides a brief literature review of the factors that influence the capital structure decision of multinational and domestic corporations, Section 3 presents the theoretical issues and the hypotheses, Section 4 describes the sample and outlines the research design, Sections 5 and 6 present the findings, and Section 7 concludes the study.

2. Literature review

The finance literature is rich with contributions that explain the relation between the capital structure choice and many firm-specific and environmental factors. These factors include corporate and personal taxes, bankruptcy costs, growth opportunities of the firm, uniqueness of a firm's assets and line of business, firm size, agency costs, profitability, and level of external stakeholders' interests. These contributions are made by many studies including Modigliani and Miller (1958), Ang, Chua, and McConnell (1982), Castanias (1983), Myers and Majluf (1984), Bradley, Jarrell, and Kim (1984), Myers (1984), Jensen (1986), Cornell and Shapiro (1987), Davis (1987), Titman and Wessels (1988), Barton, Hill, and Sundaram (1989), Baskin (1989), Burgman (1996), Krishnan and Moyer (1996), Harvey, Lins, and Roper (2004), Miao (2005), and Brounen, de Jong, and Koedijk (2006). However, the basic premises of this paper are that the firm's agency costs of debtors will increase when a firm diversifies internationally. Consequently, the MNC's use of long-term debt will drop. In addition, these effects will be particularly significant when diversification occurs in countries where laws which mandate disclosure requirements and promote liability standards that facilitate investor recovery are weaker than their counterparts in the United States. Thus, the following sections are devoted to explain the previous contributions that relate to agency costs of debt, the capital structure choice across countries, and the impact of securities laws on capital structure.

2.1. Agency costs of debt and capital structure

Previous studies argue that the agency costs of debt tend to negatively affect the levels of debt in the capital structure of firms. Titman and Wessels (1988) and Prowse (1990) find respectively for US and Japanese firms that debt ratios are inversely related to

[3] Consistent with this conclusion, Chiou, Lee, and Lee (2010) find that equities in countries of English common law origin are less risky and have lower risk premiums than the ones of civil law countries.