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Where do firms issue debt? An empirical analysis of issuer location and regulatory competition in Europe

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ABSTRACT

In this article, we study the choice of issuer location and regulatory competition in the European corporate debt market. We find that, in absolute terms, Germany has by far the highest outflow of debt issues, while the Netherlands, the UK, Ireland, and Luxembourg see the most inflows (in that order). We use a panel gravity model to investigate country specific factors attracting foreign subsidiaries as issuers. The data clearly support the prediction that the locational choice is positively influenced by a low withholding tax rate. We find only mixed evidence that corporate tax rates play a role. In contrast to previous results of the 'law and finance' literature, we do not find support for creditor protection rules in bankruptcy as a driver of cross-border debt securities issues.

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1. Introduction

If offered a choice, firms will opt for the legal framework that best suits their business needs and the transaction at hand. It has been documented for various settings that firms choose a law of their liking and thus engage in 'legal arbitrage' (see Fleischer, 2010 for a definition). The most famous example is corporate law. In the U.S., firms have always been able to incorporate in any state, thereby effectively choosing the corporate law under which they are organized. Because supplying corporate law to firms may be attractive for states, jurisdictions in the U.S. have engaged in what has come to be known as 'charter competition.' More recently, a number of rulings by the European Court of Justice have set off a similar contest among European jurisdictions (Becht et al., 2008).

Firms' choice of law and regulatory competition between jurisdictions is not confined to corporate law. Other examples include forum shopping with respect to insolvency proceedings or the cross listings of public companies. We consider a somewhat less prominent but highly relevant area of business law: the legal rules governing corporate bonds. Recent legislation indicates that European jurisdictions actively compete in this area. Germany, for example, has modernized its Bond Debenture Act (SchVG) in 2009 to make it more competitive.[1] Our work examines the motives behind firms' choices. Knowing why firms prefer certain jurisdictions

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[1] See the somewhat confused statement of the former German justice minister, Brigitte Zypries: 'It is not the case that German issuers are not choosing German law at all. But we have found that many of them prefer foreign law.' ('Es ist nicht so, dass deutsche Emittenten deutsches Recht überhaupt nicht mehr wählen. Aber wir haben festgestellt, dass viele von ihnen ausländisches Recht bevorzugen.') Interview with Börsen-Zeitung, May 13, 2008, p. 7.

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and avoid others can provide valuable guidance to lawmakers seeking to improve their own legal framework. Such insights are also important if one wishes to evaluate the effects of regulatory competition.

Investigating legal arbitrage and regulatory competition in the European corporate bond market can also contribute to the 'law and finance' literature. The main proposition of this school of thought is that 'law matters', i.e., that legal rules advance financial and economic development. Numerous studies have documented a link between economic outcomes (such as the relative size of securities markets, ownership concentration or the amount of credit in the economy) and legal rules and institutions. A difficulty, however, lies in determining the direction of causality[2]: The coincidence of legal rules and indicators of financial development can mean that 'good' law causes superior economic performance. But it could also be the other way round, with the law responding to an increased demand for legal protection due to a growth in specific activities. Identifying causality, therefore, is a major challenge facing the law and finance movement. In this regard, legal arbitrage can be an indirect piece of evidence: If market players shop for particular legal rules, it follows that differences in law matter for economic activity. For instance, stronger creditor rights may coincide with a greater volume of credit in the economy. If firms facing a choice between different jurisdictions actively seek those with more robust creditor protection, then there is a case that creditor rights are the cause, and financial development the effect.

In the realm of public debt, legal arbitrage can occur at two different levels. First, debt securities are themselves governed by the terms of the indenture and hence by contract law. Second, there are various legal rules that attach to the issuer of the securities and that are equally important to investors and the firm. In this contribution, we examine legal arbitrage with respect to the second set of rules. Firms can effectively choose the applicable law by deciding where to locate the issuer of the debt securities – either by using an existing subsidiary or by establishing a new one in the jurisdiction of choice. To examine this decision, we employ a gravity model, nowadays a workhorse in international economics. Although it has been applied mostly to international trade, there is a more recent literature adapting this model to financial flows (De Ménil, 1999; Eaton and Tamura, 1994; Portes et al., 2001; Portes and Rey, 2005) and M&A activities (Ashcroft et al., 1994; Delannay and Méon, 2006; Di Giovanni, 2005; Hyun and Kim, 2010). To the best of our knowledge, this is the first analysis implementing a gravity model in a law and finance context.

The basic idea of gravity models is to focus not on individual countries but on the flows in country-pair relations. Our dependent variable, accordingly, is the number of cross-border debt security issues between a 'country of origin' and a 'host country' in a given year. We find that, in absolute terms, Germany has by far the highest outflow of debt issues, while the Netherlands, the UK, Ireland and Luxembourg see the most inflows (in that order). The data clearly support the prediction that inflows are influenced positively by a low withholding tax rate. By contrast, the evidence concerning corporate taxes and creditor protection rules under bankruptcy law remains inconclusive.

In Section 2, we describe the legal environment for corporate debt security issues and formulate hypotheses on the influence of creditor protection rules and tax law on issuer choice and location. Section 3 presents the methodology and data, Section 4 the gravity model results. Section 5 concludes.

[2] See La Porta et al. (2008) for extant evidence on the direction of causality.

2. The legal environment for corporate debt security issues

One can think of a variety of reasons why a firm would have a foreign subsidiary issue debt securities. We are interested whether 'law matters' for this decision. Based on theoretical considerations, there are two main aspects of the legal environment that can influence a firm's decision to locate its debt security issue in a particular jurisdiction. First, tax considerations can play a role in choosing where to issue debt securities (Section 2.2). Second, jurisdictions can differ in the degree of protection afforded to the holders of debt securities. If there is significant variation in this regard, one would expect firms to take it into account (Section 2.3). Before identifying relevant differences in these two areas of the law, we should clarify what we mean by a 'foreign' subsidiary or, correspondingly, by the 'location' of an issuer (Section 2.1).

2.1. 'Location' of issuer and parent

There are a great variety of legal criteria – depending on legal context – to determine an entity's 'location.' The place of incorporation and the statutory seat are strictly formal criteria. Many others consider the actual business activities, such as the 'headquarters,' 'center of main interests,' the 'real seat,' or the 'center of management.' In our data and hence in our analysis, 'issuer location' is defined as the country of incorporation. Accordingly, a 'foreign issuer' is an entity incorporated in a jurisdiction different from the corporate parent. From an empirical point of view, the country of incorporation should correlate strongly with the more substantive 'location' concepts. Before 1999, many European Economic Area (EEA) member states followed the 'real seat' doctrine and required a legal entity to incorporate in the jurisdiction in which it had taken its 'real seat,' i.e., its central management or principal place of business. While the European Court of Justice in its ground-breaking Centros (1999), Inspire Art (2002) and Überseering (2003) judgments have effectively dismissed the real seat doctrine and some firms have subsequently incorporated out-of-state (Becht et al., 2008), there are still significant barriers (Becht et al., 2009), and 'reincorporations' of existing entities have become workable only recently.[3] Accordingly, it seems safe to assume that most European firms, especially the large ones, are still incorporated in the country of their main business activities.

2.2. Tax law

The location of the issuer has important tax implications.[4] One potential type of tax law arbitrage involved in issuer location choice relates to the taxation of interest paid to bondholders. Interest is part of the taxable income in the investor's home country. From the point of view of the issuer, interest payments are expenses that reduce corporate income and hence the corporate tax burden. Many states, however, levy an additional tax on interest payments from the issuer. The tax is meant to be a tax on income received by investors, but it is collected as a 'withholding tax' 'at the source.' Issuer location thus determines whether and at what rate the debt security is subject to withholding tax. Typically, the investor's home country will grant a tax credit to equalize the effect of the withholding tax. Yet claiming the credit creates an additional burden and can entail costly delays. More importantly, a tax credit does

[3] A reincorporation is typically effected by means of a cross-border merger. Member states of the EU had to transpose the Directive 2005/56/EC on cross-border mergers of limited liability companies by December 2007.

[4] Tax laws and conventions use different location ('residence') criteria, cf. Art. 4(1) of the OECD Model Convention with Respect to Taxes on Income and on Capital. For the reasons just stated, we assume that the issuer's tax residence is in the incorporation state.

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