The Bonding Hypothesis

BY STEEF M. BARTMAN
PROFESSOR OF COMPANY LAW, LEIDEN UNIVERSITY, THE NETHERLANDS

23

Two years ago an interesting book was published by Columbia University Press (Ed. Curtis J. Milhaupt), titled Global Markets, Domestic Institutions, with subtitle: Corporate Law and Governance in a New Era of Cross-Border Deals. In his contribution, the Impact of Cross-Listings and Stock Market Competition on International Corporate Governance, Professor John C. Coffee sets out the meaning of the so-called Bonding Hypothesis as an explanation of the phenomenon of cross-listing, in particular the popularity of the NYSE and the NASDAQ with foreign companies. The Bonding Hypothesis entails that firms incorporated in a jurisdiction with weak protection instruments for minority shareholders, or poor enforcement mechanisms, may *voluntarily* subject themselves, by obtaining a listing in another jurisdiction, to higher disclosure standards and stricter enforcement provisions to attract investors who would otherwise be reluctant to invest. Studies show that merely the announcement of the decision to cross-list may already have a significant positive impact on the company's stock value. Professor Coffee's main message is that law matters, albeit in different ways given different circumstances.

Of course the Bonding Hypothesis does not always and by definition lead to a cross-listing in the life cycle of a foreign company. The legal requirements of the contemplated host country may be considered too much of an administrative burden to the current management, with the effect that the firm is deterred from cross-listing. The (perception of the) higher litigation risk involved with the new legal and oversight system, may enhance this deterrence. For similar reasons a cross-listing, once established, may even be undone by a subsequent management decision. The effect of the strict Sarbanes Oxley rules on European companies is rather significant in this respect. Also, a major controlling shareholder may consider the loss of his private benefits, against the gain of a higher market valuation of his shares, a bad deal.

Nevertheless, the fact remains that the Bonding Hypothesis in many cases gives a plausible explanation of a company's decision to seek a cross-listing. To a certain extent cross-listing serves as an alternative to a weak corporate governance system in the firm's home country. The strong legal and non-legal devices protecting minority investors in the US are quite self-explanatory. Reference is made to (i) the enforcement powers of the SEC; (ii) the availability of procedural instruments such as the class action and the derivative action; (iii) the severe disclosure requirements and the application of the US GAAP to the company's annual accounts; (iv) the close monitoring by securities analysts and (v) the negotiating powers of institutional investors.

Professor Coffee's analysis does not include the EU attempts to at least come level with the US, in terms of corporate governance and minority protection, and their impact on the attractiveness of European stock exchanges to foreign companies. However, focusing on the EU initiatives on the legal front, it is clear that they, in time, will increase such attractiveness. Realisation of the European Commission's Financial Services Action Plan, in particular by implementation of the Prospectus and Market Abuse Directives, and the growing coordinating role of the Committee of European Securities Regulators (CESR), have already led to an improved oversight on and transparency of the European capital market (*see* ECL 05/1). Starting the fiscal year of 2005 the consolidated accounts of all EU listed companies must comply with the International Accounting Standards, as a result of respectively the EC IAS Regulation and the EC IAS 39 Directive. The 13th EC Directive on Public Takeover Bids, which must be implemented in national law on 20 May 2006, requires a shareholder with a controlling stake to make a mandatory offer to the other shareholders. It also grants every minority shareholder a sell out right if a public bid has led to a (minimum) 95 per cent stake of the bidder. Such protective devices do not exist under US federal law or under Delaware corporate law. Therefore one could say that Europe is on the right track, although the instrument of a derivative suit is still lacking in many EU countries.

However, offering adequate minority protection is one thing, making investors aware of this is quite a different thing. The Bonding Hypothesis presupposes thorough investors' knowledge of the corporate governance systems applicable in the various jurisdictions in which they may seek cross-listing. Hence it is extremely important to not only put effort into creating legal minority protection, but also to advise potential investors adequately of the protection which is already available. This issue of ECL is richly filled with such information. Ms Tuijtel's comparative overview of the current Dutch inquiry proceedings gives detailed insight into this unique form of minority shareholder protection and sheds light on how this successful instrument may trigger the European legislator to introduce this instrument in the EU in the near future. Professor Werlauff explains how the implementation of the EC Takeover Directive affects the position of investors in companies listed in Denmark, while Mr. Blommendaal illustrates that any theoretical framework to "measure" the quality of a national corporate governance and/or securities regulation system should be applied carefully, without neglecting other relevant factors outside the scope of the used model.