

# Cross-Border Alliances and Risk Management

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## Abstract

We study U.S. firms' foreign expansion choices, and investigate alliances as risk management devices used to mitigate partner risk. Firms venturing abroad are constrained by the availability of potential partners. One set of partners are foreign companies the firm shares the venture with (direct partners). The second set of partners is the institutions/government of the host country (indirect partners). Firms are more likely to choose alliances (over M&As) when indirect (direct) partner risk is high (low). The sensitivity to direct partner risk varies in the cross-section, and is weakened by firm's financial constraints and/or greater ease of monitoring foreign partners.

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“Without local guides, your enemy employs the land against you.”

Sun Tzu, “The Art of War”

## Introduction

Recent decades have witnessed a spectacular expansion of international investment by U.S. corporations. Between 1990 and 2009 only, U.S. firms were involved in over 52 thousands cross-border investment transactions. The finance literature has largely focused on cross-border M&A activity (e.g., Bris and Cabolis, 2008, Erel, Liao, and Weisbach, 2012, Rossi and Volpin, 2004 etc). However, M&As are not the only channel for cross-border expansion, nor are they even the most common one. In fact, nearly two thirds of these deals were strategic alliances, and in 17 out 20 years, alliances outnumbered M&As.<sup>1</sup>

What drives the choice between alliances and acquisitions, and in particular, what makes a strategic alliance the preferred form of cross-border expansion? This question goes to the core of the very definition of the boundaries of the firm and the decision to internalize vs. outsource (e.g., Williamson, 1975, Hart and Moore, 1990).

In our paper, we study these issues through the lens of corporate finance, focusing on risk-management as a primary driver of the choice between alliances and M&As. This approach provides a new perspective on alliances, complementary to the existing literature. Traditionally, the finance literature has viewed strategic alliances as a “commitment technology” used to overcome agency problems *within* the firm. Intuitively, the manager of a partner firm has better ex ante incentives to exert effort, since he can retain a larger share of the surplus generated by the alliance, compared to an internal divisional manager, who could be expropriated by the corporate headquarters (e.g., Stein, 1997, Mathews and Robinson, 2008, Robinson, 2008). In the context of cross-border investment, however, the risk of ex post expropriation by an *external* alliance partner can be economically more relevant than the provision of ex ante optimal incentives, due to the greater monitoring difficulty, lack of knowledge of local economic conditions, or potentially limited legal protection (e.g., Grossman and Hart, 1986, Acemoglu and Johnson, 2005). Such risk can take different

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<sup>1</sup> Includes alliances and acquisitions of controlling stake; based on SDC data.

forms, such as unjustified and unplanned increase in prices by local supplier, distribution fees charged by the local distribution network, or even cross-subsidization that the local partner enacts between its own business and the business managed with or on behalf of the international partner.

A cross-border acquisition could, in principle, address this problem, allowing full control of the foreign partner. However, it would also expose the firm to the risk of hold-up and expropriation by the host country government and institutions, once the firm has committed resources by undertaking the investment (Kindleberger, 1969, Vernon, 1971). Typical example of this behavior are either direct expropriation of assets in place (e.g., Conoco in Venezuela, Repsol in Argentina, Royal Dutch and Shell in Russia) or opportunistic behavior meant to change the contractual conditions at which the product was expected to be sold in the country (e.g., Enron in India, Nedbank in Gabon). On the other hand, since an alliance involves neither a large fixed investment nor a high integration cost (e.g., Kogut and Singh, 1988, Doz, 1996, Hennart and Reddy, 1997) it could limit the scope for losses caused by opportunistic behavior of the host country government.

These arguments suggest that the choice of the mode of cross-border expansion – via an acquisition or an alliance – emerges as an optimal response to the risk of expropriation by the partners that the firm faces when venturing abroad: its foreign partner companies, or *direct partners*, and the host country government and institutions, or *indirect partners*. The solution to the trade-off between *direct* and *indirect* partner risk will favor a cross-border alliance when the risk of expropriation by the direct partners (direct partner risk) is low and indirect partner risk is high, and a cross-border acquisition when direct partner risk is high and indirect partner risk is low.

We take these ideas to the data, studying worldwide cross-border alliances and acquisitions made by U.S. firms over the past two decades. The focus on international transactions allows us to confront the unexplored issue of the impact of host country contracting institutions and direct partner risk on cross-border corporate growth, as well as to provide an account for the empirical relevance of cross-border alliances.

In our empirical approach, we rely on the rationale of Acemoglu and Johnson (2005). They distinguish between the types of institutional arrangements that better protect against the opportunistic behavior of the two types of partner: “property rights institutions” – i.e., protection against expropriation by the government and powerful elites – and “contracting institutions” – i.e., the ability to enforce contracts between private counterparties. The quality of property rights institutions influences indirect partner risk, while the quality of contracting institutions affects direct partner risk. Therefore, following Acemoglu and Johnson (2005), we resort to proxies for direct and indirect partner risk rooted in the law and finance and financial development literatures. To proxy for direct partner risk, we utilize Legal Formalism (Djankov et al., 2003) and Procedural Complexity (World Bank, 2004), which measure the quality of regulation of arm’s length relationships among business partners. Our main proxies for indirect partner risk, on the other hand, are Constraints on Executive Power (Gurr, 1997) and Protection Against Expropriation (Knack and Keefer, 1995).

The reliance on country-based variables of partner risk has several advantages. First, it allows us to define *ex-ante* the set of characteristics available to firms when considering their expansion choices. Second, it is less subject to potential endogeneity than any type of firm-specific variable. Third, it allows to directly link our analysis to the literature on international M&As (e.g., Rossi and Volpin, 2004, Bris and Cabolis, 2008, Ellis, Moeller, Schlingemann, and Stulz, 2012).

We start by focusing on the choice of the form of cross-border expansion – i.e., alliance vs. M&A – as a function of the trade-off between direct and indirect partner risk. One potential issue could be that neither the set of U.S. firms venturing abroad nor their choices of host countries are randomly determined. We thus first examine the decision to venture abroad and the host country choice. We document that the overall quality of institutions – both property rights and contracting ones – attracts investment to a given host country. Conditional on the decision to invest abroad, the choice to expand into a given country via either an alliance or an acquisition is negatively related to both direct and indirect partner risk. To gauge the impact of these risks on cross-border expansion decisions, consider the effect of one standard-deviation increase in one of the direct partner risk proxies, Legal Formalism. This index ranges in our sample from

1.58 to 6.01, with a standard deviation of about 1.00, roughly corresponding to the difference between Canada (2.09) and Brazil (3.06).<sup>2</sup> Our estimates imply that one standard-deviation higher level of direct partner risk as measured by Legal Formalism is associated with a 16.45% lower probability of any cross-border deal (alliance or M&A) into a given host country.<sup>3</sup> Similarly, one standard-deviation higher level of indirect partner risk as measured by Constraints on the Executive Power, roughly corresponding to the difference between South Korea and Malaysia, is associated with a 4.93% lower probability of cross-border expansion into the host country. Host country direct and indirect partner risk, therefore, have a tangible impact on attracting investment.

These results allow us to control for sample selection, and focus on the impact of partner risk on the *form* of cross-border investment. As anticipated, we find that direct and indirect partner risks have opposite effects: while a greater direct partner risk makes an acquisition the preferred form of expansion, a greater indirect partner risk creates an incentive to opt for an alliance. The economic impact of direct and indirect partner risk is also substantial. One standard-deviation higher level of direct partner risk as measured by Legal Formalism (Procedural Complexity) is associated with a 5.79% (3.67%) lower probability of the U.S. firm choosing an alliance over an acquisition. Similarly, one standard-deviation higher level of indirect partner risk as measured by the Constraints on the Executive Power (Protection Against Expropriation) index is associated with a 19.51% (11.18%) higher probability of choosing an alliance.

A possible concern with these findings is that country institutions could be endogenous. For instance, property rights and contracting institutions could be a tool of economic policy designed to attract and shape the flow of foreign investment. We address this concern with two sets of checks. First, we follow Acemoglu and Johnson (2005) and resort to legal origin and European settler mortality as instruments for, respectively, direct and indirect partner risk. The results based on instrumental variables estimation confirm our baseline

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<sup>2</sup> To facilitate the interpretation of the results throughout the paper we change the signs of measures of direct and indirect partner risk so higher values of these measures represent higher partner risk.

<sup>3</sup> Throughout the paper all economic differences are reported relative to the corresponding sample means.

findings, and suggest that direct and indirect partner risks are major determinants of the form of foreign expansion.

Next, we perform a set of tests based on a diff-in-diff specification around two sets of events. First, we consider Eurozone accession. Eurozone membership represents an external shock to indirect partner risk, as it reduces the possibility of “stealth” government expropriation through high inflation, since Euro member countries surrender their monetary policy to the European Central Bank. We find that indirect partner risk loses at least 38% of its impact on the alliance/M&A choice after the introduction of the Euro.

Additionally, we focus on changes in governments following political elections as a shock to indirect partner risk. Again, as anticipated, we find that when the political regime becomes more “pro-business”, indirect partner risk loses about half of its economic effect on the choice of the form of expansion. Similar results hold if we use alternative proxies of political regimes. All these tests confirm our results providing evidence in favor of a causality interpretation.

The main contributions of the first part of our analysis are the joint treatment of cross-border M&As and alliances as outcomes of risk-management policy, and the recognition of direct partner risk as a determinant of cross-border investment flows. The literature has acknowledged that international portfolio/minority investors face the “twin agency problem” of potential expropriation by companies’ majority owners or by the host country government (Stulz, 2005). The risk of expropriation by a direct partner company that arises from weak contracting institutions provides an additional element of the problem. Unlike in a majority-minority shareholder type of conflict, where the agency issues revolve around the allocation of cash flows *within* the company, this risk stems from the limited ability to enforce legal contracts with *external* counterparties.

This observation motivates the second part of our study, in which we build on the previous findings to further explore direct partner risk management. While direct partner risk is an “environmental” factor, depending on host country characteristics, the sensitivity to it will vary in the cross-section of U.S. firms expanding cross-border. We focus on two main drivers of direct partner risk sensitivity: (i) implementation cost, and (ii) the firm’s ability to resort to risk management tools alternative to the form of investment.

Implementation costs depend on financial constraints, as well as on the ease of monitoring the foreign partners. Financial constraints limit the ability to choose the optimal cross-border expansion policy: a financially constrained firm might lack the resources necessary to undertake an acquisition, suggesting that financial constraints should lower the sensitivity to direct partner risk. This argument reflects a more general trade-off between financing and risk management. On the other hand, “environmental” factors that limit the ease of monitoring partner companies, such as characteristics of the market segment, nature of the business, or host country infrastructure, can increase sensitivity to direct partner risk. For example, a higher communication hurdle vis-à-vis potential alliance partners can, *ceteris paribus*, render a cross-border acquisition more convenient (e.g., Fama and Jensen, 1983).

We provide evidence consistent with these arguments. First, we document that firms facing less stringent financial constraints, proxied by the Whited and Wu (2006) and Hadlock and Pierce (2010) indexes, are indeed more sensitive to direct partner risk in their choice of expansion channel (alliance vs. M&A).

We supplement this evidence with the analysis of a natural experiment based on the American Jobs Creation Act (AJCA) of 2004. The AJCA provided a windfall gain to companies with large retained foreign earnings (also known as Permanently Reinvested Earnings, or PRE), allowing them to repatriate foreign earnings at a reduced cost, and thus relaxing financial constraints for the firms with the largest pre-AJCA PRE levels. We perform difference-in-differences estimation, comparing the change in sensitivity to direct partner risk around the AJCA experiment for firms with high and low pre-AJCA PRE levels. Consistent with our hypothesis, we find that, during AJCA “tax holiday” window, the sensitivity to direct partner risk increases three-fold for high-PRE firms. In contrast, the impact of direct partner risk on the cross-border investment choices of low-PRE firms is virtually unchanged.

Second, we examine the impact of the firm’s ability to turn to alternative risk management tools. Strategic alliances are, in general, flexible contractual arrangements that take a variety of forms, depending, among other things, on direct partner risk. We focus on a contractual feature of first-order visibility to investors and economic relevance: alliance location. Our sample alliances are located in the partner firms’

country (43.36% of our sample deals), in the U.S. (26.48%), or in a third country (“supranational” alliances, 30.15%). These location choices reflect corporate risk management policy. Indeed, the alliance’s location can limit firm’s exposure to the direct partner risk, for instance by having the alliance fall under a jurisdiction where private contracts are more stringently enforced.

The evidence is consistent with this claim. Our estimates indicate that alliances with partners from countries characterized by greater direct partner risk are less likely to be located in the partner firm’s country: one standard-deviation higher level of Legal Formalism (Procedural Complexity) is associated with a 6.80% (3.49%) lower probability that the alliance’s principal activities are located in the partner firm’s country.

Finally, we directly look at the market reaction to the expansion decision, and test whether the market react more positively if the choice of expansion form aligns with partner risk management. We document that M&A announcement returns are more positive if indirect partner risk is low (i.e., state expropriation is limited) and direct partner risk is high (i.e., risk of being taken advantage by private counterparty is high). Similarly, alliance announcements face a more positive abnormal stock price reaction if indirect partner risk is high and direct partner risk is low.

Our results are robust to alternative proxies of partner risk, the language fractionalization index of Alesina et al. (2003) and the anti self-dealing index (Djankov et al., 2008) for direct partner risk and the ICRG corruption index and ICRG repudiation index for indirect partner risk.

Overall, these findings provide evidence of the importance of contracting institutions in shaping the cross-border expansion strategy of U.S. firms. In addition, they provide a plausible account of the growing relevance of cross-border alliances, taking a novel look at alliances as a partner risk management tool.

More specifically, our results make the following contributions. First, the literature has acknowledged that international portfolio/minority investors face the “twin agency problem” of potential direct expropriation from companies’ majority owners and indirect (via expropriation of the company) expropriation from the state (Stulz, 2005). Stulz argues that these “implicit” barriers represented by governance problems are major obstacles to cross-border portfolio investment. Our paper explores the



complementary issue of controlling/majority investment in a venture involving foreign partners. In this case, the firm faces the risk of being expropriated by its partners. As we argued, unlike in a majority-minority shareholder type of conflict, where the agency issues revolve around the allocation of cash flows *within* the company, this risk stems from the limited ability to enforce legal contracts with *external* counterparties. Our findings provide evidence on the economic relevance of its impact on cross-border investment decisions.

Second, we contribute to the understanding of alliances. Our approach provides a new perspective on alliances, complementary to that of the existing literature. Traditionally, the finance literature has viewed alliances as a “commitment technology” used to overcome agency problems within the firm. They provide an optimal mix between coordination and the need to incentivize managers within the firm (e.g., Teece, 1996, Rey and Tirole, 2001, Fulghieri and Sevilir, 2003, Mathews and Robinson, 2008, Robinson, 2008). The rationale is that alliances allow a ring-fencing of the resources for a specific project, allowing the CEO to commit resources in a more efficient way (e.g., Lerner and Merges, 1998, Elfenbein and Lerner, 2003, Lerner, et al., 2003, Robinson and Stuart, 2007, Mathews and Robinson, 2008, Robinson, 2008, Bodnaruk et al., 2012). We contribute to this literature by taking a novel perspective on alliances, focusing on their role in the solution to trade-off between direct and indirect partner risk.

Third, we contribute to the literature on the impact of country governance on corporate choices. The corporate finance literature has extensively investigated how country-level governance quality affects corporate decisions (Claessens et al. 2000, La Porta et al., 2002, Claessens and Laeven, 2003, Lemmon and Lins, 2003, Laeven and Levine, 2008). Poor institutional governance has been shown to be related to less efficient investments (Wurgler, 2000), a more levered capital structure, a different debt maturity (Booth et. al. 2001; Demirguc-Kunt and Maksimovic, 1999), as well as slower economic growth (Acemoglu, et al., 2003, Acemoglu, Johnson, and Robinson, 2005, Acemoglu and Johnson, 2005). However, the link between the method of cross-border expansion (direct investment in the form of an acquisition, or instead as a strategic alliance) and the quality of country contractual institutions has not yet been drawn – our paper fills this gap.

Finally, we contribute to the literature on financial constraints, by showing their role in choice of the form of international expansion. To the best of our knowledge, ours is the first study relating the governance role of financial constraints to cross-border alliances and their characteristics.

## II. Hypotheses

The literature has thus far treated cross-border M&As and alliances in isolation. Cross-border M&A activity has been related to the quality of corporate governance (Bris and Cabolis, 2008, Ellis et al., 2012) and the risk of direct expropriation by the host country government (Stulz, 2005). Strategic alliances have been considered as “commitment devices” to ensure optimal ex ante incentives compared to running an investment within a corporate division (Stein, 1997, Mathews and Robinson, 2008, Robinson, 2008).

We take a novel perspective, and consider cross-border alliances and M&As jointly as outcomes of corporate risk-management policy. We concentrate on a specific form of risk: “partner risk” – i.e., the potential for misconduct on part of the firm’s partners in the foreign investment. We argue that, when venturing abroad, the firm faces two sets of partners: the *direct* partners – i.e., the host country partner companies – and the *indirect* partners – i.e., the host country government and institutions. The potential for expropriation by either set of partners confronts the firm with a trade-off between direct and indirect partner risk. The first part of our analysis focuses on the impact of this trade-off on the choice of the form of cross-border expansion, between alliances and acquisitions.

By expanding into a foreign country, the firm faces hold up (“obsolescing bargain”) and expropriation risk vis-à-vis the host country government and institutions. Prior to the investment, the firm enjoys a considerable bargaining power, since the host country government may want to attract it on account of its capital, technology, or marketing expertise. However, once the investment is sunk, the firm’s vulnerability increases, as the original bargain becomes “obsolete” (Vernon, 1971). The host country government may want to revise the original contractual terms, either by outright expropriation, or by squeezing revenue

streams.<sup>4</sup> Forming an alliance with a foreign firm, as opposed to making an acquisition, reduces the scope for opportunistic behavior by the host government, as the alliance does not involve a large fixed investment or commitment (Kogut and Singh, 1988; Doz, 1996, Hennart and Reddy, 1997). The flexibility of the alliance thus limits the scope for indirect partner risk.

However, the alliance can expose the firm to the risk of opportunistic behavior by the *direct* partners since, in contrast to an acquisition, the partner firm remains an independent legal entity – i.e., there is no acquisition of control. Thus, the direct partner risk is the risk of an opportunistic behavior by the local partner firm. This can take the form of higher prices charged by a local supplier or higher distribution fees charged by a local distribution network or even cross-subsidization that the local partner enacts between its own business and the business managed with or on behalf of the international partner.

The direct partner risk can be eliminated or greatly reduced if the firm internalizes the production process by directly buying the local partner. In this case, if it is able to impose its line of control, it will be able to avoid such opportunistic behavior. The direct partner risk is especially relevant when the quality of private contract enforcement in the country is poor.

These considerations suggest a trade-off between direct and indirect partner risks, allowing us to formulate our first hypothesis:

*H1: A lower direct partner risk and a higher indirect partner risk in the host country are associated with a greater propensity to prefer alliances to acquisitions as the form of cross-border expansion.*

In the second part of our analysis, we focus on direct partner risk, and on the cross-sectional determinants of the firm's sensitivity to it. In particular, we study the factors related to the cost of implementation of direct partner risk management policies, as well as to the availability of risk management tools complementary to the choice of cross-border expansion form.

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<sup>4</sup> An example of such state expropriation is a forced sale of a half of a Shell's stake in Sakhalin-II oil and gas project to Russian state-backed Gazprom at a well-below market price (see Abraham Lustgarten, "Shell Shakedown" in the February 2007 issue of *Fortune* magazine).

Implementation costs depend on financial slack. A financially constrained firm has more limited capacity for acquisitions, and will more generally lack flexibility in its investment choices. In other words, the more binding the financial constraints, the less the firm is capable to pursue an optimal risk management policy. These considerations allow us to formulate our second hypothesis:

*H2: The sensitivity to direct partner risk is weaker for financially constrained firms.*

The ability to resort to alternative or complementary risk management devices will also reduce the impact of direct partner risk on the choice of cross-border expansion channel. The contractual features of an alliance agreement, for instance, can act as tools of the risk management policy. We restrict the attention to a specific contractual feature of first-order visibility and economic relevance: alliance location. Indeed, locating the alliance in a country with more efficient contracting institutions reduces direct partner risk, as a superior system of contract enforcement and regulatory environment applies. Hence, our third hypothesis:

*H3: In the presence of greater direct partner risk, the alliance is more likely to be located outside of the partner firm's country.*

Before moving to the tests, we describe the data and the main variables employed in the analysis.

### **III. Data and Main Variables**

In this section, we report on our data sources, and discuss the main variables of interest and their construction.

#### **A. Data Sources**

The data on cross-border expansion choices come from the Securities Data Corporation (SDC) Database, from which we extract all alliances and M&As involving U.S. firms over the period 1990-2011. We then relate these data to the accounting information from COMPUSTAT, as well as to stock returns from CRSP.

We consider all cross-border alliances involving U.S. firms – i.e., deals in which one or more alliance partner is a U.S. firm and at least one other alliance partner is a non-U.S. firm. Following Bodnaruk et al.

(2013), we define alliances as all partnership agreements in which two or more entities combine resources to form a new, mutually advantageous business arrangement to achieve predetermined objectives. This includes joint ventures, strategic alliances, research and development agreements, sales and marketing agreements, manufacturing agreements, supply agreements, and licensing and distribution agreements.<sup>5</sup>

Additionally, we consider international mergers and acquisitions by U.S. companies. Following Rossi and Volpin (2004) and Bris and Cabolis (2008) we identify a transaction as a cross-border M&A if the following criteria are met: (1) the transaction is for the majority of the shares of the target firm – i.e., the ownership percentage sought after the deal is above 50%; (2) the deal is completed by the end of our sample period; (3) SDC identifies the bidder company as a U.S.-based firm and the target as a non-U.S. firm. We exclude from the sample leveraged buyouts, spin-offs, recapitalizations, self-tender offers, exchange offers, repurchases, minority stake purchases, and privatizations.

We include in our analysis host countries with at least 100 deals (alliances and M&As) involving U.S. firms (about 8 transactions per year on average) over the entire sample period.<sup>6</sup> Additionally, we require the availability of measures of direct and indirect partner risk, as well as firm level characteristics for the U.S. firms involved (see below). These filters lead to a final sample including deals between U.S. firms and companies from the following 39 non-U.S. countries: Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Czech Republic, Denmark, Finland, France, Germany, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Malaysia, Mexico, Netherlands, New Zealand, Norway, Philippines, Poland, Portugal, Russia, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, and United Kingdom.

## **B. Main Variables**

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<sup>5</sup> Our results are robust if we add to the sample of alliances minority stake purchases of equity and/or remove joint ventures.

<sup>6</sup> Expanding our sample by including countries with between 50 and 99 deals over our sample period does not affect the results.

Our choice of proxies for direct and indirect partner risk is guided by Acemoglu and Johnson's (2005) analysis of contracting and property rights institutions, and rooted in the law and finance and financial development literatures.

Our proxies for *direct partner risk* are related to the quality of private contract enforcement in the host country. In principle, an ideal measure of direct partner risk should consider the likelihood of opportunistic behavior by every potential partner firm in a given host country, not just the partners with which the firm actually engages. To the best of our knowledge, firm-level partner risk data with this kind of coverage is generally not available for the countries in our sample. We thus follow the literature and resort to country-level measures as sufficient statistics for direct partner risk. In particular, we use the Procedural Complexity (World Bank, 2004) and the (Revised) Legal Formalism (Djankov et al., 1997) indexes. These measures proxy for the way arm's length relationships are regulated among contractual partners. Procedural Complexity, retrieved from the "Doing Business" World Bank database, is an index of the difficulty of resolving an unpaid commercial debt case. Among our sample countries, Australia and Canada have the lowest complexity score (2.92), while Spain has the highest (8.26) (the U.S. score is 4.60). Legal Formalism, on the other hand, indexes the complexity of resolving an unpaid check case. New Zealand has the minimum score in our sample (1.58), while Argentina has the highest one (5.40) (the U.S. score is 2.62). Therefore, the higher the value of the index, the higher the direct partner risk.

Our proxies for *indirect partner risk* are related to the quality of protection against government expropriation. Also in this case, we consider two alternative proxies: Constraints on Executive Power from the Polity IV dataset (Gurr, 1997) and Protection Against Expropriation from the International Country Risk Guide (Knack and Keefer, 1995). The Constraints on Executive Power index has a scale ranging from 1 = unlimited authority of the executive to 7 = executive parity or subordination. Among our sample countries, Indonesia has the lowest score (2.82) (the U.S. has a score of 7). The Protection Against Expropriation index is retrieved from the Political Risk Services database, and ranges from 1 = lowest protection to 10 = highest protection. Among our sample countries, the Philippines have the lowest score (5.22), while Switzerland and the Netherlands have the highest (9.98), equal to that of the U.S. To facilitate

the interpretation of the results and to make measures of indirect partner risk homogenous vis-à-vis measures of direct partner risk we change the sign of Constraints on Executive and Protection Against Expropriation measures so a higher value is related to a higher indirect partner risk.

We tabulate measures of direct and indirect partner risk by country in Appendix 1 and present correlations between these variables in Appendix 2. The correlation between the measures of indirect partner risk is 53.4% and between the measures of direct partner risk is 85.5%. The average pairwise correlation between measures of direct and indirect partner risk is 19.6%, suggesting that they describe different dimensions of partner risk.

The total sample includes 8,551 alliances and 5,679 M&As. The distribution of alliances and M&As by host country is presented in Table 1, Panel A.

As for the measures of financial constraints, we use two standard proxies most recently used in the literature: the accounting-based measure proposed by Whited and Wu (2006) (henceforth WW index) and the size- and age-based measure developed by Hadlock and Pierce (2010) (henceforth SA index). In order to attenuate concerns about the potential simultaneity of financial constraints to the cross-border expansion decision, we rely on industry averages of these variables. We report descriptive statistics for the main variables in Panels B and C of Table 1. Panel B illustrates the characteristics of U.S. firms expanding abroad in a given year, compared to those which do not undertake any international ventures. Firms expanding abroad tend to be larger, value firms, with higher sales growth, larger cash reserves, and higher profitability. They also tend to operate in more competitive industries, characterized by a lower industry concentration (based on market shares). Firms expanding internationally are also more likely to have done cross-border investment via alliances or acquisitions in the past, and have industry peers which frequently engage in international ventures.

In Panel C, we report the characteristics of the partner countries. By going abroad, the U.S. firms on average are subject to a higher risk of expropriation from the host state than at home. The average (median) Constraints on Executive Power and Protection Against Expropriation for our sample countries are -6.34 (-7.00) and -8.51 (-9.20) respectively, whereas for the U.S. the values of these measures are -7.00 and -9.98.

Likewise, the comparative analysis of the quality of private contract enforcement suggests that venturing abroad raises the risk of dealing with partner companies. The average (median) Legal Formalism index for our sample countries is 3.39 (3.24), well above the corresponding value for the U.S. (2.62); similarly, the Procedural Complexity index displays a mean (median) value of 6.63 (5.14), clearly larger than in the U.S (4.60). Also, it is worth noting that there is a significant cross-sectional variation in these measures of direct and indirect partner risk, as well as other country attributes across countries.

#### **IV. Choice to Expand Abroad and Host Country Selection**

Our analysis proceeds in several steps. First, we characterize the set of U.S. firms that engage in *any* cross-border deal, regardless of the host country. These firms likely represent a non-random sample of the overall population of U.S. firms, so this analysis allows us to control for potential selection issues in subsequent stages. Second, we study the matching between the U.S. firm and a given foreign country, regardless of the method of cross-border expansion. This matching is also non-random, and, moreover, it is driven by direct and indirect partner risks. We present these two preliminary steps in this section. The subsequent sections will study the choice between cross-border M&As and alliances, and the cross-sectional determinants of the sensitivity to direct partner risk, conditional on the first two steps. The results presented in this section thus allow us to control econometrically for the sample selection issues in the rest of the analysis.

Note that, following the literature (e.g., Kogut and Singh, 1988, Akerberg and Botticini, 2002, Giannetti and Yafeh, 2012), we have implicitly assumed a sequential choice approach: first, conditionally on having decided to invest abroad, the firm selects the host country; second, it chooses the mode of cross-border expansion – i.e., alliance or M&A. As a robustness check, we also re-ran the analysis using nested logit and multinomial logit models, obtaining qualitatively similar results (omitted for brevity).

##### **A. Choice to Expand Internationally**

In this section we focus on the decision of the U.S. firms to invest abroad. We report on this test in Table 2, where we employ several alternative estimation methods: specification (1) is a Logit, specification (2) is



a Tobit, and specification (3) is a multinomial Logit. These alternative specifications allow us to examine the choice of going abroad from different angles: whether the firm engages in a cross-border deal at all, how many deals it conducts, and their types. The dependent variable in specification (1) is a dummy variable which takes the value of one if the firm has done at least one cross-border M&A or alliance in the following year, and zero otherwise. The dependent variable in specification (2) is the logarithm of one plus the number of international alliances and M&As that the firm has done over the subsequent year. The dependent variable in specification (3) takes the value of one if the firm has done an international alliance, two if it did an M&A, three if it did both an alliance and M&A, and zero if none of the above.

The key identifying variables are Foreign Tax – i.e., the ratio of foreign taxes paid by the company to its total assets – and Industry Unionization – i.e., the fraction of unionized workers in the industry (SIC3).<sup>7</sup> The amount of foreign taxes is used as a proxy for the firm’s international exposure. A firm with larger international presence should be more likely to engage in a new venture abroad. The extent of unionization in the firm’s industry captures the degree to which the firm lacks flexibility, particularly with respect to its international expansion, as unions in the U.S. are vocal critics of what they see as “shipping jobs abroad” (e.g., Feldstein, 1995). Both variables are unlikely to affect any of the outcomes examined in the remainder of the analysis through any channel other than the U.S. firm’s decision to go abroad.

We also account for the firm’s and industry international expansion by including the number of international alliances and the number of international M&As that the firm and its industry peers have done during the year. We also control for a host of company characteristics including size, B/M, growth of sales, cash holdings, capital expenditures, profitability (ROE), leverage (debt-to-equity ratio), past stock price performance and volatility, and industry concentration as well as time and industry fixed effects. The standard errors are clustered at the industry-year level. All variables are described in detail in Appendix 2. The sample includes all the U.S. firms present in COMPUSTAT over the sample period.

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<sup>7</sup> Industry unionization data by year obtained from [www.unionstats.com](http://www.unionstats.com). For details about data construction see Hirsch and Macpherson (2003).

The results reported in Table 2 show a positive (negative) relation between the amount of taxes paid on foreign income (industry unionization) and the decision to go abroad. Firms that have one standard-deviation higher foreign taxable income (unionization rate) are 6.3% more likely (3.2% less likely) to start a new venture abroad (Specification 1, Logit), and do 77.7% more (34.8% less) ventures (Specification 2, Tobit). These values are relative to the corresponding sample means.

Among the control variables, we see that the firm's *current* international expansion strategy strongly affects its decision to undertake cross-border investments in the future. One standard deviation increase in (the logarithm of) the number of alliances (M&As) increases the likelihood of expanding abroad next year by 21.0% (16.2%) and the number of foreign ventures by 216.9% (170.9%). At the same time, industry level international alliance and M&A activity has statistically and economically little impact on the firm's choice to expand abroad in the future.

Less financially constrained companies – larger companies – are more likely to venture abroad.<sup>8</sup> This suggests that these firms have higher flexibility of their investment choices and are capable of following more optimal expansion policy. The implication of this will be further studied in Section VI.

## **B. Host Country Choice**

Next, we focus on the choice of the country of expansion. The sample includes U.S. firms which have ventured abroad (regardless of the host country) in a given year, and the unit of observation is thus a given firm-country pair.

We report these tests in Table 3, Panel A. Again, we consider several alternative specifications: specifications (1) and (2) are Logit models, while specifications (3) and (4) are Tobit models. The dependent variable in specifications (1) and (2) is an indicator which takes the value of one if the U.S. firm has done either an alliance or M&A in a given country, and zero otherwise. The dependent variable in specifications (3) and (4) is the logarithm of one plus the number of alliances and M&As that the U.S. firm has done in a

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<sup>8</sup> In unreported analysis we also explicitly included WW and SA indexes of financial constraints among control variables. The results confirm that financially constrained firms are less likely to expand internationally.

country. From the estimates of Table 2 we obtain an inverse Mills ratio (Heckman's Lambda), which allows us to control for the potential selection of the U.S. firms that engage in any cross-border deal. The inverse Mills ratio is identified by the exclusion of the variables Foreign Tax and Industry Unionization. While these two variables affect the U.S. firm's likelihood to expand abroad, they should not influence the choice of a specific country; in other words, they affect the matching between the U.S. firm and the country not directly, but only through their impact on the decision to expand internationally.

The main variables of interest are the proxies for the potential for opportunistic behavior of the direct partners – i.e., Legal Formalism and Procedural Complexity – and that of the indirect partners – i.e., Constraints on the Executive Power and Protection Against Expropriation. Recall that to facilitate the interpretation of the results for all our measures of partner risk higher values indicate higher level of risk. The key identifying variable at this stage is the Change in Currency Exchange Rate between the host country and the U.S. over the previous year. Exchange rate appreciation and depreciation can affect the cost of investing in the local market, profitability of the venture, and thus the marginal benefit to the U.S. firm of expanding in a given foreign country (Erel, Liao, and Weisbach, 2010). It should have no direct impact, however, on the choice of the form of expansion, or any of the other outcome variables we consider in the remainder of the analysis.

We control for the same U.S. firm characteristics as in Table 2, as well as for the average market and firm characteristics in the host country. The latter include the ratio of stock market capitalization to GDP, stock market turnover, number of listed firms per capita, and average B/M, leverage, cash, and ROA for listed firms in the country of expansion.

The decision to invest in a given country may also be affected by its business and labor environment. To account for this, we include the amount of taxes and mandatory contributions borne by the business in the second year of operation, expressed as a share of commercial profit (Profit Taxes) and a measure of labor market rigidity (Rigidity of Employment), both obtained from World Bank, among our controls. We also include U.S. firm's SIC2 industry and year fixed effects; the standard errors are clustered at the country-U.S. firm's industry-year level.

The results show that the decision to invest in a given country is negatively related to the potential for opportunistic behavior of both direct and indirect partners. This result is robust and holds across the different specifications. If we focus on specification 1 (2), we see that one standard-deviation higher Legal Formalism (Procedural Complexity) reduces the probability of a deal in the country by 16.45% (19.29%), while one standard-deviation higher Constraints on the Executive Power (Protection Against Expropriation) reduces the probability of a deal in the country by 4.93% (17.42%).

Among the other variables, we see that countries with more developed and liquid stock markets, and with less levered and less capital-intensive firms, attract more U.S. investment; the same applies to countries whose currency recently depreciated against U.S. dollar. At the same time, countries with more rigid labor laws are less attractive for U.S. investment.

As a robustness check, in Panel B, we estimate linear regressions with U.S. firm fixed effects. This allows us to better control for the differences in characteristics across firms venturing abroad. The dependent variables are defined as in Panel A. While the economic effects are more difficult to interpret in this case as predicted values need not lie within the unit interval, it is comforting to observe that the negative relation between both types of partner risk and the likelihood and the number of investments in the country is preserved and statistically significant.

## **V. The Choice of Alliances vs. M&As**

We now move on to the core of our analysis, and assess how the choice between international alliances and M&As is affected by the potential for opportunistic behavior by direct and indirect partners. The sample includes all firms which made at least one alliance or M&A in a given country in a given year.

In Table 4, Panel A, we sort the number of alliances and M&As by U.S. firms by host country direct and indirect partner risk. When indirect partner risk is high, U.S. firms tend to do a relatively larger fraction of their ventures in the form of alliances rather than M&As. More specifically, when the Constraints on Executive Power (Protection Against Expropriation) index is above the sample median, 68.02% (70.59%) of the foreign deals take the form of alliances, as opposed to 57.50% (56.52%) when the value of the

measure is below the sample median. On the other hand, when direct partners are known to have a high propensity to misconduct, U.S. firms have a stronger incentive to expand in the country through M&As. In this case, when the Legal Formalism (Procedural Complexity) index is above the median alliances represent 57.90% (57.88%) of all the foreign deals, whereas when it is below the median this number goes up to 67.62% (66.54%). These univariate results are consistent with the hypothesis that direct and indirect partner risks affect the choice of the mode of cross-border expansion, favoring alliances over M&As when direct partner risk is low and indirect partner risk is high.

Our sample countries provide a few illustrative examples. India, for instance, has a considerably lower indirect partner risk – i.e. lower Constraints on Executive Power index – than China (-7, compared to China's -3). Consistent with Hypothesis 1, mergers and acquisitions make up a larger fraction of all ventures by U.S. firms in India (22%, or 96 out of 439 deals in our sample) than in China (14%, or 115 out of 818 deals). Similarly, Japan has a lower direct partner risk than China (Legal Formalism index equal to 2.98, compared to China's 3.41), and alliances make up a larger fraction of all cross-border ventures by U.S. firms in Japan (96%, or 1,764 out of 1,843 deals in our sample) than in China (86%, or 703 out of 818 deals in our sample).

While instructive, these examples should be taken with a grain of salt: we are not suggesting that direct and indirect partner risks are the only drivers of the mode of cross-border expansion. Indeed, other factors than partner risk can potentially influence the cross-border investment choices of U.S. firms, such as the characteristics of the firm venturing abroad, the degree of economic and financial development of the host country, corporate taxation, exchange rates, etc.

To properly control for these potentially confounding effects, we perform a multivariate analysis in which we control for a number of U.S. firm and host country characteristics. The results are reported in Panel B of Table 4. We study both the choice of individual modes of cross-border expansion as well as the combination of alliances and acquisitions into a given country. Specifications (1) and (2) are multinomial Logits, while specifications (3) and (4) are Tobits. The dependent variable in specifications (1) and (2) takes the value of one if a firm has done an M&A, two if it did both an alliance and M&A, and zero if it did an

alliance. The dependent variable in specifications (3) and (4) is the ratio of the number of M&As to the total number of alliances and M&As that a firm has done in a country.

Heckman's Lambda, estimated from specification (1) in Table 2, controls for the decision to expand internationally (regardless of the country or the mode of expansion). Heckman's Lambda 2, estimated from specifications (1) and (2) in Table 3, accounts for the decision to expand into a particular country (regardless of the mode of expansion). As in the previous section, Heckman's Lambda is identified by the exclusion of Foreign Tax and Industry Unionization, which only affect the decision to expand abroad, but neither the choice of the country nor that between alliance and acquisition. Heckman's Lambda 2 is identified by the exclusion of the Change in Currency Exchange rate, which only affects the expected profitability of expanding into a given country, but not directly the choice between alliance and acquisition.

The results confirm our univariate findings and show that the choice between alliances and M&As is influenced by the potential for opportunistic behavior of direct and indirect partners in the country. If we focus on specification 1 (2), we see that one standard-deviation higher Constraints on the Executive Power (Protection Against Expropriation) index increases the probability of choosing an alliance over M&A by 19.51% (11.18%), while one standard deviation higher Legal Formalism (Procedural Complexity) index decreases the probability of the firm choosing an alliance by 5.79% (3.67%).

Turning our attention to the U.S. firm-specific control variables, we observe that larger companies and value companies tend to prefer alliances. More profitable and faster-growing companies, as well as companies with better recent stock market performance, however, are more likely to engage in M&As. With respect to the characteristics of the partner country, we find that higher average leverage and profitability by host country firms is associated with more acquisitions, whereas larger profit taxes shift the choice toward alliances.

As a robustness check, as in the previous section, in Panel C, we also estimate linear regressions with U.S. firm fixed effects. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As that a firm has done in a country. As before, we find that the inclusion of firms fixed

effects does not affect the direction and the statistical significance of the relation between measures of partner risk and the choice of expansion method.

## **VI. Handling Potential Endogeneity of Direct and Indirect Partner Risk**

One potential concern with the above analysis is that our measures of direct and indirect partner risk could be endogenous or spuriously related to some unobservable country-specific characteristic. We now consider three different facets of this endogeneity/spurious correlation issue.

### **A. Spurious Correlation with Country Growth Opportunities**

One potential concern with the above analysis is that our measures of direct and indirect partner risk could be spuriously related to some unobservable country-specific characteristic. One possibility is that the institutions affecting partner risk and foreign investment are both a function of growth opportunities of the country.

To address this issue, we follow Acemoglu and Johnson (2005) and use measures of “European settler mortality” as an exogenous determinant of the quality of property rights institutions – i.e., of indirect partner risk. The rationale is that Western migrants settled in countries with superior health conditions (and thus lower mortality rates), leading to the establishment of a legal system with stronger property rights. In contrast, they ruled countries with poorer health conditions via the local establishment, as opposed to direct settlement, preventing or limiting the development of property rights. Thus, settler mortality will affect the quality of property rights institutions. At the same time, settler mortality is driven by factors such as climate, availability of water, etc. which unlikely have a first-order direct impact on foreign investment decisions.

In addition, we instrument direct partner risk with the host country legal origin. La Porta et al. (1997, 1998) and Djankov et al. (2002, 2003) among others show that legal origin has an important effect on the extent of legal formalism, i.e., the complexity of enforcement of private contracts. In particular, French (civil-law) legal origin countries have considerably higher degree of legal formalism than UK (common-law) legal origin countries.

We therefore re-estimate our previous findings instrumenting indirect partner risk with the logarithm of (one plus) European settler mortality (set to zero for non-colonies), and direct partner risk using an indicator for British common law legal origin. In Panel A of Table 5, we report the results of the first stage regressions. They display a strong positive correlation between indirect partner risk and settler mortality. In specification (1), one standard-deviation higher settler mortality is related to 6.71% higher values of Constraints on Executive Power and 7.31% higher Protection against Expropriation (all relative to the sample average). Also, we document a strong negative correlation between common law legal origin and direct partner risk. Countries with common law legal origin have 49.31% lower values of Legal Formalism and 51.85% lower values of Procedural Complexity (all relative to the sample means). The F-test of the joint significance of the instruments rejects the null of weak instruments (Staiger and Stock, 1997). To assess whether the second criterion is met – i.e., the instruments do not affect the dependent variables in the second stage through other channels than the instrumented variables – in all subsequent specifications, we report the Hansen’s test of overidentification. They always fail to reject the null, providing supporting evidence in favor of the quality of our instruments.

Next, we re-estimate all the main specifications of the previous analysis using the same full set of control variables and clustering as in the prior analysis. In the interest of brevity, we only report the main focus variables. In Panel B, we report the results for the choice of the going abroad and, in Panel C we report the results for the choice of form of expansion.

The results are in line with the previous findings. In particular, the decision to invest in a given country is negatively related to the potential for opportunistic behavior of direct and indirect partners in the country. One standard-deviation higher indirect partner risk reduces the probability of a deal in the country by 25.06%. One standard-deviation larger direct partner risk reduces the probability of a deal in the country by 5.22%. The economic effects of direct and indirect partner risk on the choice between cross-border alliance and M&A implied by the instrumental variables estimation are thus large, but not implausible, and reasonably close to the ones discussed in the previous sections.



Even more importantly, the choice between alliances and M&As is influenced by the potential for opportunistic behavior of direct and indirect partners in the country. One standard-deviation higher value of instrumented Indirect Partner Risk increases the probability of choosing an alliance over M&A by 23.37%, while one standard-deviation higher value of instrumented measures Direct Partner Risk decreases the probability of the firm choosing an alliance by 6.40%. Overall, these results confirm the previous ones and suggest that direct and indirect partner risks are major determinants of the form of expansion of the company.

### **B. Spurious Correlation with Country Financial Development**

A second potential concern is that our results are spuriously induced by financial development in the host country. To address this issue, we re-estimate the main specifications explicitly controlling for financial sector development. Namely, we control for a broad range of variables measuring the development of a country's stock market and banking sectors: the stock market-to-GDP ratio, the stock market turnover, the number of listed firms per capita, as well as the average characteristics of the listed firms such as book-to-market ratio, cash holdings, capex, and ROA, the bank debt-to-GDP ratio, the bank credit-to-deposit ratio, the bank cost-to-income ratio, and a measure of concentration of banking sector. The results (for brevity reported in the Internet Appendix, in Table A1) show that our results remain unaffected by these additional controls.

### **C. Reverse Causality and Institutional Changes**

In this section, we perform two difference-in-differences tests around shocks to the institutional environment: Eurozone accession and political regime change. These tests allow us to directly inspect the direction of causality: they provide an exogenous change to partner risk, and allow studying its impact on cross-border expansion decisions.

First, we consider the creation of the Eurozone as an external shock to indirect partner risk. One important dimension of indirect partner risk is the possibility of “stealth” government expropriation through

high inflation. Since revenues of U.S. companies abroad are primarily denominated in local currency, irresponsible local government policies can undermine project profitability and, ultimately, viability. Upon joining the Euro area, eleven countries in Europe surrendered their monetary policy to the ECB (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain), and additional countries through the successive enlargement of the Eurozone. We expect that this, by limiting the ability of local governments to pursue independent policies, would mitigate the impact of indirect partner risk on the choice of investment. Moreover, Eurozone membership has significantly reduced any residual risk related to inability to repatriate capital or related to “unfair” country specific financial rules. While the EU membership has already generated a “level playing field” among its members, membership of the Eurozone has further increased it.

We therefore set a Eurozone-member indicator equal to one for the Eurozone member countries after they join the EMU, and interact it with measures of indirect partner risk. We report the results in Table 6. Consistent with the above argument and your intuition, we find that measures of indirect partner risk lose at least 38% of their power after the introduction of the Euro.

Second, we explore the effect of political regime switches following political elections as shocks to indirect partner risk.<sup>9</sup> We hand collected data on the outcomes of all political elections for our sample countries. We then assign each country to a “political regime” depending on the election outcome, focusing on the attitude of the ruling party / regime to the protection of private property, intervention of the state in the economy, and taxation for social spending. We set a ProBusiness indicator to be equal to one if the political regime describes itself as center to right, but is not a dictatorship, and zero otherwise.

The results, presented in Table 7, show that when a political regime is more ProBusiness, indirect partner risk loses about half of its economic effect on the choice of the form of expansion. The ProBusiness indicator itself is positively related to the choice of M&A rather than alliance as the form of expansion; this is consistent with the idea that pro-business policies may facilitate direct investment.

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<sup>9</sup> We thank a referee for suggesting this additional test.

As a robustness check, we further exploit cross-country differences in political environment. Indeed, the classification of regimes into pro-business and not-pro-business might appear arbitrary. As an auxiliary test, we therefore, also perform a test using the “Institutionalized Democracy” variable from the Polity IV dataset (e.g., Glaeser, La Porta, Lopez-De-Silanes, and Shleifer, 2004). This variable combines three independent elements: the “presence of institutions and procedures through which citizens can express effective preferences about alternative policies and leaders”; the “existence of institutionalized constraints on the exercise of power by the executive”; and the “guarantee of civil liberties to all citizens”.

The Democracy indicator is an additive eleven-point scale (0-10). This variable is very stable over time. Additionally, most countries in our sample have consistently very high level of democracy (in the 8 to 10 points range). Still, several of our sample countries— have transitioned from low democracy to high democracy regime (e.g., Mexico’s democracy score went from 2 in 1990 to 8 in 2000 and remained at 8 until the end of our sample period). We introduce a HighDemocracy dummy (=1 if Democracy score is 8 and above and 0 otherwise) and interact it with our measures of indirect partner risk.

We report the results in Table 8. We find that HighDemocracy is positively related to the choice of M&A (as opposed to alliance). Additionally, it reduces the effect of measures of indirect partner risk on the choice of expansion method – i.e. the interaction coefficient between measures of vertical governance and HighDemocracy points toward the reduction of the effect of indirect partner risk.

All these tests confirm our results providing evidence in favor of a causality interpretation.

## **VII. Cross-Sectional Sensitivity to Direct Partner Risk**

The first part of our analysis provides evidence that the form of cross-border expansion of U.S. firms (via alliances or M&As) is affected by direct and indirect partner risks. In the second part of the analysis, we focus on the role of, so far neglected in the literature, direct partner risk. In particular, we study the cross-sectional determinants of U.S. firms’ sensitivity to direct partner risk, considering financial constraints and the ease of monitoring the direct partners, as well as alliance contractual features, restricting the attention to alliance location.

## **A. Financial Constraints and Sensitivity to Partner Risk**

We start by focusing on the role played by financial constraints. As we argued, a firm facing laxer financial constraints has greater ability to respond to partner risk by optimally choosing its cross-border expansion strategy. In contrast, financially constrained firms have less flexibility in their investment choices, and should thus be less sensitive to partner risk. We should thus expect a stronger impact of partner risk in the presence of less stringent financial constraints.

We therefore re-examine the choice between alliance and M&A, conditioning on the tightness of financial constraints faced by the U.S. firms. We use two standard financial constraints proxies: the Whited-Wu (WW) and Size-Age (SA, Hadlock and Pierce, 2010) Indexes; to lessen concerns about the potential endogeneity of these measures, we focus on industry (2-digit SIC code) indexes, constructed as averages of the WW and SA variables.

We report the results in Table 9. They strongly support our predictions. Financially constrained firms are both economically and statistically less sensitive to the potential for opportunistic behavior of the direct partners. These results support Hypothesis 2a, suggesting that the link between the potential for opportunistic behavior of the partners and the choice of the form of growth is directly impacted by the firm's financial flexibility.

One potential difficulty with the interpretation of the results just discussed is that financial constraints and investment policy could be jointly determined in equilibrium. Alternatively, they could both be driven by some unobservable economic factor, and thus be spuriously correlated. This issue is less likely to have a material effect on the SA Index, which is a function of firm size and age, since age is, strictly speaking, not a firm policy, and is in general driven by *past* investment and financing choices rather than future expansion decisions. However, to mitigate any residual concerns about the potential endogeneity of financial constraints, we turn our attention to a natural experiment, related to the American Jobs Creation Act (AJCA) of 2004.

Since the United States taxes corporations on a worldwide basis, U.S. multinational companies pay corporate income taxes both on their domestic and foreign revenues. However, they are allowed to defer

taxes on the earnings of foreign subsidiaries until these earnings are repatriated back to the U.S. parent company. These deferred taxes could be substantial, as the U.S. corporate income tax – 35% – is one of the highest in the world (Foley et al., 2007). Naturally, multinationals have been reluctant to repatriate earnings of their subsidiaries, leading to a steady growth in the aggregate amount of permanently reinvested (foreign) earnings (PRE) over the years.

The American Jobs Creation Act (AJCA), passed on the 22<sup>nd</sup> of October, 2004, provided U.S. corporations with a one-time opportunity to repatriate earnings previously reinvested in foreign subsidiaries obtaining an 85% deduction for eligible dividends distributed to the parent company. The dividend eligible for the deduction was limited to the *greater* of 1) \$500 million; 2) the earnings shown as permanently invested outside the U.S. on the most recently audited financial statements certified before July 1, 2003. For the dividends to qualify for the repatriation dividends-received deduction, the repatriated earnings should have been invested in the United States under an IRS (tax authority) approved domestic reinvestment plan. This tax break was temporary, and the companies willing to repatriate PREs exploiting this opportunity should have done so within a two-year window.

Although the primary intended purpose of AJCA was to boost U.S. domestic investment, the mere fact that it provided a 29.75% ( $= 35\% \times 85\%$ ) windfall gain on repatriated assets increased the value of the firms (and their collateral), effectively loosening up the financial constraints for the firms taking advantage of such a provision. The ensuing windfall gain should allow firms with large pre-AJCA permanently reinvested foreign earnings to undertake more investment projects, both domestically and abroad.<sup>10</sup>

Thus, the Act creates a natural experiment: it allows us to test the impact of a relaxation of financial constraints on the sensitivity to partner risk. Given that the expected dollar gain from repatriation is a direct function of the outstanding stock of PREs, the AJCA effectively loosens up the financial constraints in direct proportion to the amount of accumulated PREs. Since the outstanding stock of PREs is largely a

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<sup>10</sup> Indeed, a domestic project, previously supposed to be financed with a loan, could be now undertaken with repatriated foreign earnings (to satisfy repatriation requirements), while the loan could be used to finance projects abroad; and a company would still record a windfall-gain from dividend tax deduction.

function of past firm choices, the impact of the AJCA varies in the cross-section of U.S. firms in a way that is largely exogenous. We exploit this variation to test how changes in financial constraints affect the sensitivity of the form of expansion of the firm to partner risk. We expect that during AJCA window of opportunity for repatriation, the sensitivity to partner risk increases for firms with higher amounts of accumulated PREs.

To implement this test, we hand-collect data on permanently reinvested earnings of U.S. multinational companies between 2001 and 2004 from the 10-K filings.<sup>11</sup> This results in a sample of 513 companies, which reported a total of \$484.5 billion in PRE for the year 2003. The average (median) outstanding PREs were \$946.2 (\$122.0) million with a standard deviation of \$2.9 billion. The descriptive statistics of our data closely matches those reported by Faulkender and Petersen (2012).

We re-estimate our analysis of the choice between alliance and acquisition, conditioning on the AJCA. Rather than studying the amount of PRE actually repatriated, which could be endogenously related to investment decisions in 2004, we focus on the *potential* gains from repatriation, proxied by the PRE stock as of December 2003. In this part of the analysis, we require that each sample firm has reported its outstanding PREs amount in 2003, or one or two years before (or explicitly stated in the 10-K filing that it does not have any PREs). Following the provisions of the AJCA, we estimate the potential benefits from repatriation as the larger between \$500 million and the maximum PRE level over 2001-3 (scaled by 2003 total assets). We then test how the potential repatriation benefits affect the firm's sensitivity to partner risk over the period 2004-2006.

As before, the sample includes only the firms which have made at least one alliance or M&A in the country in a given year. We further require that the firm should have reported the amount of permanently reinvested earnings in 2003. The AJCA dummy takes the value of one if the year is 2004, 2005, or 2006.

We report the results in Table 10. Since our objective is to investigate the effect of the Act on the firm's sensitivity to partner risk as a function of the amount of outstanding PREs, in the specifications we include

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<sup>11</sup> Companies are not required to disclose the exact amount of PRE in the 10-K filing, but only to mention if they have any PRE. We only rely on the information about the amount of PRE, whenever it is available.

as variables AJCA, PRE, and the measure of direct partner risk, their interactions, as well as the triple interaction term, the latter being the terms of interest. As before, we account for the self-selection in the decision to invest abroad and to choose a particular country.

The estimates of Table 10 indicate that the exogenous relaxation of financial constraints for firms with large PRE stocks generated by the AJCA is associated with a greater sensitivity to partner risk. From specification 1, prior to AJCA, companies with high and low levels of PREs had similar sensitivity to Legal Formalism. Following 2004, on the other hand, the sensitivity to Legal Formalism associated with high-PRE firms (PRE above the 75<sup>th</sup> percentile) increases three-fold. In contrast, the sensitivity to Legal Formalism of low-PRE firms (PRE below the 25<sup>th</sup> percentile) is virtually unchanged.<sup>12,13</sup>

Taken together, these results are consistent with a cross-sectional dispersion in the sensitivity to partner risk related to financial flexibility: the ability to manage partner risk via the choice between cross-border alliances and M&As depends on financial constraints.

## **B. The Choice of the Location of the Alliance**

How does partner risk affect the contractual features of cross-border alliances? In this section, we study whether, conditional on engaging in a cross-border alliance, the firm chooses the characteristics of the alliance as a function of the potential opportunistic behavior of its partners. We focus on a key feature of the alliance: its location. This is an important choice, as it defines the legal jurisdiction.

We report the results in Table 11. We consider all the firms that announce at least one alliance in a country in a given year. In Panel A, we estimate Logit regressions where the dependent variable takes the value of one if an alliance location is the country of a partner and zero otherwise (i.e., it is the U.S., a third country, or a supranational location). The results show that the higher the potential for opportunistic behavior of direct partners, the less the U.S. firms choose to locate the alliance in the partners' country. One

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<sup>12</sup> We do not account for the effect of Legal Formalism  $\times$  PRE term since it is not statistically significant.

<sup>13</sup> These numbers are calculated as the coefficient on Legal Formalism plus the coefficient on Legal Formalism  $\times$  AJCA  $\times$  PRE multiplied by the 0.153 (PRE value for firms in 75<sup>th</sup> percentile) or 0.024 (PRE value for firms in 25<sup>th</sup> percentile). We ignore other terms since their coefficients are not statistically significant.

standard-deviation higher Legal Formalism (Procedural Complexity) index is related to a 6.80% (3.49%) lower probability of the firm choosing the location of the alliance in the country of its partners.

Interestingly, there is a positive correlation between *indirect* partner risk and the likelihood that alliance activities are conducted in the country of the partner. In particular, for the same specification, one standard-deviation higher Constraints on Executive Power (Protection Against Expropriation) index is related to a 14.0% (11.02%) higher probability of choosing the location of the alliance in the country of the partners. A likely explanation of this result is that in many countries with weak government institutions there are significant restrictions on foreign ownership – e.g., foreign companies are not allowed to have a majority ownership in projects. Forming an alliance with a domestic partner becomes the only available form of venturing in the country. An example of this “alliance out of necessity” would be the joint development of Sakhalin-I oil and gas fields in Russia by Exxon Mobil of USA, ONGC of India, and SODECO of Japan together with host country partner Rosneft.

In Panel B, we present the estimates of linear probability regressions with U.S. firm fixed effects. While the economic effects are difficult to interpret in this case, we observe that the relation between measures of partner risk and location of alliance activities is preserved and is also strongly statistically significant.

In Panel C, similar to the analysis reported in Table 5, we present the results of a regression with instrumented measures of partner risks. Instrumental variables estimation results confirm that the higher the potential for opportunistic behavior of direct partners, the less the U.S. firms choose to locate the alliance in the partners’ country. One standard-deviation higher Direct Partner Risk decreases the probability of the firm choosing the location of the alliance in the country of its partners by 5.27%.

## **VIII. Further Robustness Checks**

We now consider some additional robustness checks. First, we consider alternative proxies of partner risk. The choice of the proxies of partner risk we focused on so far is motivated by the work of Acemoglu and Johnson (2005). As a robustness check, we also consider two additional proxies for direct partner risk and two additional proxies for indirect partner risk. The first additional proxy for direct partner risk is the



language fractionalization index of Alesina et al. (2003), which measures language heterogeneity in the country of prospective investment. As, for example, Alesina and Ferrara (2002) show, higher population heterogeneity is related to lower trust. We therefore anticipate that higher language fractionalization should be related to a lower level of trust among contracting partners, and thus greater direct partner risk. The second additional proxy for direct partner risk is the anti self-dealing index (Djankov et al., 2008)). This index measures the constraints on the ability of one of stakeholders to benefit at the expense of other stakeholders. A poorer protection against self-dealing suggests that the direct partners will be less reliable contracting partners, i.e. a greater exposure to direct partner risk.

Further, we consider two additional proxies for indirect partner risk: the ICRG corruption index and ICRG repudiation index. The corruption index assesses government corruption. Lower scores indicate that “high government officials are likely to demand special payments” and “illegal payments are generally expected throughout lower levels of government” (ICRG data manual). The repudiation index measures the risk of modification in a contract taking the form of repudiation, postponement, or scaling down due to a change in government or a change in government economic and social priorities. In both cases, a higher value of the index is associated with a greater likelihood of expropriation by the local government, i.e. greater indirect partner risk. As in the case with our core measures of direct and indirect partner risk, we change the sign on ICRG Corruption, ICRG Repudiation, and Anti-Self-Dealing indexes so larger values of these variables indicate higher partner risk.

We replicate our tests for the choice of the country of expansion and the choice of expansion method (i.e., M&A vs alliance) using the aforesaid alternative proxies. We report the results in the Internet Appendix, Tables A2 and A3. The results show that our findings hold and our conclusions are unaffected, confirming that our argument is not sensitive to the choice of a particular proxy or set of proxies.

In a second robustness check, we look at the market’s reaction to cross-border announcement decisions, as an ex-ante market evaluation of the quality of partner risk management. Namely, the market should react more positively to the announcement of expansion into a given country, if the choice of expansion form aligns with partner risk management. Thus, M&A announcement returns should be more positive if indirect

partner risk is low (i.e., state expropriation is limited) and direct partner risk is high (i.e., risk of being taken advantage by private counterparty is high). Similarly, alliance announcements should be met with a more positive abnormal stock price reaction if indirect partner risk is high and direct partner risk is low.

For each M&A and alliance announcement in our sample we calculate 4-factor (market, size, value, and momentum risk factors) adjusted abnormal stock returns over a (-5; +5) days window around the announcement. The factor loadings are estimated over a (-316; -64) days window (Schwert, 1996). We then relate abnormal returns to the measures of partner risk. Panel A of Table 12 presents the results for M&A announcement returns. Panel B reports findings for alliance announcement returns. Control variables are as indicated in the corresponding specifications. U.S. firm controls and country of expansion controls are as utilized in Table 4.

The results indicate that the market takes into account whether the firm has made an optimal expansion choice from the partner risk management perspective. The stock price of the U.S. company goes up more if the M&A is done in the country with lower indirect partner risk (a one standard deviation higher value of Constraint on Executive (Protection Against Expropriation) is related to 0.81% (0.60%) lower M&A announcement premium) and with higher direct partner risk (a one standard deviation higher value of Legal Formalism (Procedural Complexity is related to 0.34% (1.10%) lower M&A announcement premium). Likewise, the stock price reaction to alliance announcement is more positive when the alliance is forged with a partner from a country with high indirect partner risk (a one standard deviation higher value of Constraint on Executive (Protection Against Expropriation) is related to 0.40% (0.36%) lower M&A announcement premium) and low direct partner risk (a one standard deviation higher value of Legal Formalism (Procedural Complexity is related to 0.43% (0.39%) lower M&A announcement premium). These economic affects appear to be quite sizeable, given that average announcement returns to international acquirers are in the order of 1%.

## **Conclusion**

We take a new perspective on U.S. firms' cross-border investment policies, and investigate their role as "risk management" devices. When venturing abroad, the firm faces two sets of partners: direct partners – the firms that share the venture – and indirect partners – the host country government and institutions. Both can potentially engage in opportunistic behavior, giving rise to direct and indirect partner risk. Alliances help to reduce/manage the opportunistic behavior of the government, but expose the firm to the risk of opportunistic behavior by the direct partners in the venture. This generates a trade-off between direct and indirect partner risk.

Consistent with this argument, we find that the choice of the method of cross-border expansion (alliance vs. M&A) depends on partner risk. *Ceteris paribus*, a U.S. firm venturing abroad will prefer a cross-border alliance when indirect partner risk (risk of host country government misconduct) is high and direct partner risk (risk of host country partner firm misconduct) is low. In addition, the choice of the location of the alliance is sensitive to direct partner risk: the alliance's legal domicile is more likely outside of the host country when direct partner risk is high.

Overall, this evidence suggests a strategic behavior by the U.S. firms, which appear to follow the advice of Sun Tzu's from the opening quote, and condition their choice of expansion channel on the potential for opportunistic behavior of both the direct and the indirect partners. Our results provide the first direct evidence of how host country institutional characteristics represent a set of constraints that, by inducing or facilitating opportunistic behavior by the direct and indirect foreign partners, affect U.S. firms' international expansion strategy.

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## Appendix 1. Measures of Indirect and Direct Partner risk by Country

We tabulate measures of indirect and direct partner risk by the country of expansion. Measures of indirect partner risk are Constraints on Executive Power from the Polity IV dataset (Gurr, 1997) and Protection Against Expropriation by Political Risk Services. Measures of direct partner risk are Legal Formalism (Djankov, et al., 2003) and Procedural Complexity (World Bank). To facilitate the interpretation of the results and to make measures of indirect partner risk homogenous vis-à-vis measures of direct partner risk we change the sign of Constraints on Executive and Protection Against Expropriation so a higher value is related to a higher indirect partner risk. Panel B reports correlations between measures of partner risk.

country	Measures of Indirect Partner risk		Measures of Direct Partner risk	
	Constraints on Executive	Protection Against Expropriation	Legal Formalism	Procedural Complexity
Argentina	-5.18	-5.91	5.40	7.99
Australia	-7.00	-9.27	1.80	2.92
Austria	-7.00	-9.69	3.52	5.39
Belgium	-7.00	-9.63	2.73	5.35
Brazil	-6.00	-7.62	3.06	4.79
Canada	-7.00	-9.67	2.09	2.92
Chile	-7.00	-7.50	4.57	7.29
China	-3.00	N/A	3.41	5.21
Czech Republic	-7.00	N/A	4.06	6.46
Denmark	-7.00	-9.67	2.55	4.03
Finland	-7.00	-9.67	3.14	4.79
France	-6.00	-9.65	3.23	7.92
Germany	-7.00	-9.90	N/A	6.40
Hungary	-7.00	N/A	3.42	5.69
India	-7.00	-7.75	3.34	4.97
Indonesia	-2.82	-7.16	3.90	6.74
Ireland	-7.00	-9.67	2.63	4.24
Israel	-7.00	-8.25	3.30	5.07
Italy	-7.00	-9.35	4.04	6.43
Japan	-7.00	-9.67	2.98	3.92
Malaysia	-4.46	-7.95	2.34	4.10
Mexico	-4.55	-7.29	4.71	6.18
Netherlands	-7.00	-9.98	3.07	4.58
New Zealand	-7.00	-9.69	1.58	3.13
Norway	-7.00	-9.88	2.95	4.79
Philippines	-6.18	-5.22	5.00	7.50
Poland	-6.36	N/A	4.15	6.53
Portugal	-7.00	-8.90	3.93	5.42
Russia	-3.44	N/A	3.39	4.79
Singapore	-3.00	-9.30	2.50	4.86
South Africa	-7.00	-6.88	1.68	5.56
South Korea	-6.00	-8.31	3.37	5.00
Spain	-7.00	-9.52	5.25	8.26
Sweden	-7.00	-9.40	2.98	4.44
Switzerland	-7.00	-9.98	3.13	4.44
Taiwan	-5.00	-9.12	2.37	3.68
Thailand	-6.27	-7.42	3.14	5.30
Turkey	-7.00	-7.00	2.53	3.82
United Kingdom	-7.00	-9.71	6.00	8.06
United States	-7.00	-9.98	2.62	4.60

## Appendix 2. Correlations between Measures of Partner Risk

We report correlations between measures of indirect and direct partner risk by the country of expansion. Measures of indirect partner risk are Constraints on Executive Power from the Polity IV dataset (Gurr, 1997) and Protection Against Expropriation by Political Risk Services. Measures of direct partner risk are Legal Formalism (Djankov, et al., 2003) and Procedural Complexity (World Bank). To facilitate the interpretation of the results and to make measures of indirect partner risk homogenous vis-à-vis measures of direct partner risk we change the sign of Constraints on Executive and Protection Against Expropriation so a higher value is related to a higher indirect partner risk.

	Constraint on Executive	Protection Against Expropriation	Legal Formalism
Protection Against Expropriation	0.534		
Legal Formalism	0.064	0.311	
Procedural Complexity	0.078	0.331	0.857

### Appendix 3. Variable Definitions

Variable	Description of Variable and Source of Data
<i>U.S. firm specific variables</i>	
Alliance	A dummy which takes the value of one if a U.S. firm has been involved in international alliances in a given year, and zero otherwise. Alliance is considered to be international if one or more alliance partners is a U.S. firm and at least one another alliance partner is a non-U.S. firm. These include joint ventures, strategic alliances, research and development agreements, sales and marketing agreements, manufacturing agreements, supply agreements, and licensing and distribution agreements. Estimated from SDC
M&A	A dummy which takes the value of one if a U.S. firm has acquired a foreign target or was involved in international merger in a given year, and zero otherwise. mergers and acquisitions by the U.S. companies. Following Rossi and Volpin (2004) and Bris and Cabolis (2008) we identify a transaction as a cross-border M&A by the U.S. firm if the following criteria are met: (1) the transaction is for the majority of the shares of the target firm (the ownership percentage sought after the deal is above 50%); (2) the deal is completed by the end of our sample period; (3) SDC identifies a bidder company as a U.S.-based firm and the target is a non-U.S.-based firm. We exclude leveraged buyouts, spin-offs, recapitalizations, self-tender offers, exchange offers, repurchases, minority stake purchases, and privatizations from the sample.
Past Alliances	Number of alliances a U.S. firm conducted abroad in the previous year: estimated from SDC
Past M&As	Number of M&As a U.S. firm conducted abroad in the previous year: estimated from SDC
Past Industry Alliances	Number of alliances conducted by other firms in the firm's primary SIC2 industry (excluding the firm itself) abroad in the previous year: estimated from SDC
Past Industry M&As	Number of M&As conducted by other firms in the firm's primary SIC2 industry (excluding the firm itself) abroad in the previous year: estimated from SDC
MktCap	Year-end equity market capitalization: (price x shares outstanding), CCM data 24 x data 25.
Book-to-Market, B/M	Ratio of book value of equity to its market value: CCM data 60/ data (24x25).
Growth of Sales	Percentage growth in sales (Compustat item 12) from the past year.
Cash	Ratio of cash holdings to total assets: CCM data 1/ data 6
Capex	Ratio of capital expenditures to total assets of the firm: CCM data 128/ data 6.
ROE	Ratio of earnings to average equity for prior fiscal year: $CCM \text{ data } 20 / (\text{data } 60 + \text{data } 60(t - 1))/2$ .
Debt-to-Equity, D/E	Ratio of long-term debt to the total equity of the firm: CCM data 9/ data 60.
Momentum	Prior year 12 months return on a company stock: estimated from CRSP
Volatility	Annualized standard deviation of daily returns on a company stock over the previous 12 months: estimated from CRSP
Industry Concentration	Sum of squared market share of each firm in the same industry during a year. Market share is defined as the total sales of the firm in a given year divided by the total sales of the industry in the year. The industry is defined at the three-digit SIC code level, where the SIC codes have been obtained from CRSP Monthly Stocks (SICCD). The sales data come from CCM: data 12.



Foreign Tax	Ratio of taxes a company paid in foreign jurisdictions to total assets: CCM data 64/ data 6
Industry Unionization	Percentage of workers in the company primary SIC3 industry which are members of the labor union in a given year: obtained from <a href="http://www.unionstats.com">www.unionstats.com</a> .
Premium	Four-factor adjusted abnormal return on a company stock over (-63; +42) day window around alliance announcement

*Country of Investment Specific Variables*

Constraints on Executive Power	Seven-category scale, from 1 to 7, where a higher score indicates more constraint: 1 indicates unlimited authority; 3, slight to moderate limitations; 5, substantial limitations; 7, executive parity or subordination; 2, 4, and 6, intermediate values; obtained from Polity IV dataset. Variable described in Gurr (1997); reported with the negative sign to facilitate the interpretation of the results.
Protection Against Expropriation	Index of protection against government expropriation (1-lowest, 10- highest) by Political Risk Services); reported with the negative sign to facilitate the interpretation of the results.
Legal Formalism	Number of different legal procedures necessary to resolve a case of an unpaid check (Djankov et al., 2003)
Procedural Complexity	Index of difficulty in resolving the case of an unpaid commercial debt (World Bank, Doing Business 2004). Original date range from 0 to 100; here divided by 10.
Stock Market / GDP	Ratio of country stock market capitalization to GDP: obtained from World Bank
Stock Market Turnover	Turnover ratio is the total value of shares traded during the year divided by the average market capitalization for the year: obtained from World Bank
Average BM	Market capitalization weighted average BM ratio of listed firms in the country: aggregated from Worldscope
Average Cash	Market capitalization weighted average ratio of cash to total assets for the listed firms in the country: aggregated from Worldscope
Average Capex	Market capitalization weighted average ratio of capital expenditures to total assets for listed firms in the country: aggregated from Worldscope
Average ROA	Market capitalization weighted average Return on assets for listed firms in the country: aggregated from Worldscope
Change in Exchange Rate	A percentage depreciation of domestic currency to U.S. dollar over the previous year: obtained from World Bank
Profit Taxes	Total amount of taxes payable by businesses (except for labor taxes) after accounting for deductions and exemptions as a percentage of profit: obtained from World Bank
Rigidity of Employment	The rigidity of employment index measures the regulation of employment, specifically the hiring and firing of workers and the rigidity of working hours. This index is the average of three subindexes: a difficulty of hiring index, a rigidity of hours index, and a difficulty of firing index: obtained from World Bank

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**Table 1: Descriptive Statistics**

We report descriptive statistics of our data. Panel A presents the descriptive statistics on the number of alliances and M&A involving U.S. firms by country of investment as well as the ratio of alliances to total number of deals (alliances and M&As). Panel B reports characteristics of U.S. companies expanding abroad in a given year vs. companies which do not undertake any international ventures. There are 8694 and 70764 firm year observations for firms venturing abroad and staying at home respectively. Panel C presents characteristics of countries that the U.S. firms venture into, i.e. do alliances or M&As. Measures of indirect partner risk are reported with the negative sign to facilitate the interpretation of the results.

**Panel A: Number of Alliances and M&As done by U.S. Firms by Host Country**

country	M&As	Alliances	Alliances/Total	country	M&As	Alliances	Alliances/Total
Argentina	93	49	0.345	Malaysia	11	57	0.838
Australia	255	306	0.545	Mexico	125	147	0.540
Austria	31	10	0.244	Netherlands	172	262	0.604
Belgium	65	70	0.519	New Zealand	51	39	0.433
Brazil	172	115	0.401	Norway	66	59	0.472
Canada	872	764	0.467	Philippines	7	32	0.821
Chile	36	27	0.429	Poland	35	33	0.485
China	115	703	0.859	Portugal	21	13	0.382
Czech Republic	34	22	0.393	Russia	26	169	0.867
Denmark	73	66	0.475	Singapore	52	131	0.716
Finland	47	70	0.598	South Africa	51	48	0.485
France	392	407	0.509	South Korea	44	252	0.851
Germany	610	558	0.478	Spain	90	85	0.486
Hungary	14	22	0.611	Sweden	120	146	0.549
India	96	343	0.781	Switzerland	107	155	0.592
Indonesia	6	41	0.872	Taiwan	43	209	0.829
Ireland	72	49	0.405	Thailand	14	67	0.827
Israel	89	137	0.606	Turkey	15	47	0.758
Italy	191	157	0.451	United Kingdom	1287	920	0.417
Japan	79	1764	0.957				

total                      5679      8551

**Panel B: Descriptive Statistics of U.S. Firms Venturing Abroad**

	<u>Expanding Abroad</u>		<u>Staying Home</u>		t-test	p-value	Wilcoxon	p-value
	mean	median	mean	median				
log(MktCap)	3.094	3.061	2.441	2.398	64.40	(0.01)	61.17	(0.01)
log(BM)	-0.403	-0.395	-0.256	-0.244	-47.44	(-0.01)	-44.29	(-0.01)
Growth of Sales	0.215	0.109	0.195	0.092	3.75	(0.01)	10.24	(0.01)
Cash	0.109	0.067	0.096	0.043	9.84	(0.01)	19.30	(0.01)
Capex	0.056	0.042	0.056	0.036	0.28	(0.78)	14.84	(0.01)
ROE	0.087	0.121	0.054	0.090	13.26	(0.01)	21.31	(0.01)
D/E	0.497	0.278	0.604	0.294	12.09	(0.01)	5.52	(0.01)
Momentum	0.200	0.189	0.182	0.166	3.54	(0.01)	5.92	(0.01)
Volatility	0.057	0.051	0.061	0.055	-16.40	(-0.01)	-13.35	(-0.01)
Industry Concentration	0.067	0.044	0.074	0.046	-8.80	(-0.01)	-3.75	(-0.01)
Foreign Tax x 100	0.633	0.280	0.193	0.000	43.25	(0.01)	65.15	(0.01)
Industry Unionization	0.108	0.071	0.107	0.063	0.11	(0.92)	4.73	(0.01)
Past Alliances	0.754	0.000	0.051	0.000	26.57	(0.01)	83.95	(0.01)
Past M&As	0.355	0.000	0.045	0.000	33.30	(0.01)	72.07	(0.01)
Past Industry Alliances	112.243	66.000	70.515	25.000	26.39	(0.01)	36.86	(0.01)
Past Industry M&As	46.701	30.000	33.031	13.000	20.59	(0.01)	32.21	(0.01)

**Panel C: Descriptive Statistics of Host Countries**

	mean	median	std
Constraints on Executive	-6.341	-7.000	1.241
Protection Against Expropriation	-8.507	-9.195	1.372
Legal Formalism	3.386	3.242	1.063
Procedural Complexity	6.625	5.135	8.761
Stock Market/ GDP	0.643	0.478	0.537
Stock Market Turnover	0.730	0.534	0.657
# of listed per capita	0.236	0.140	0.271
log of average BM	-0.219	-0.239	0.190
Average Leverage	0.166	0.168	0.078
Average Cash	0.063	0.054	0.046
Average Capex	0.076	0.070	0.036
Average ROA	0.107	0.058	0.492
Change in Exchange Rate	0.024	0.008	0.140
Profit Taxes	48.069	45.450	17.180
Rigidity of Investment	26.889	29.50	15.550

**Table 2: Expanding Internationally**

We report results on U.S firms' decision to expand internationally. The sample includes all COMPUSTAT firms in a given year. Specification (1) is logit, specification (2) is Tobit, and specification (3) is multinomial logit. The dependent variable in specification (1) is a dummy variable which takes the value of one if a firm has done at least one international M&A or alliance in the following year, zero otherwise. The dependent variable in specification (2) is the logarithm of one plus the number of international alliances and M&As that a firm has done over the subsequent year. The dependent variable in specification (3) takes the value of one if a firm has done an international alliance, two if it did M&A, three if it did both an alliance and M&A, and zero if neither of the above. The key explanatory variables are Foreign Tax (the ratio of foreign taxes paid by the company to its total assets) and Industry Unionization (a fraction of unionized workers in the SIC3 industry). All variables are described in Appendix.

	<u>(1) Expand Abroad</u>			<u>(2) N Foreign</u>			<u>(3) Type of Expansion</u>							
	<u>Logit</u>			<u>Tobit</u>			<u>Multinomial Logit</u>							
	<u>Alliance or M&amp;A</u>			<u>Alliances and M&amp;As</u>			<u>Alliance</u>		<u>M&amp;A</u>			<u>Alliance and M&amp;A</u>		
	estimate	t-stat	ME	estimate	t-stat	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	ME
log(1+Alliances)	3.347	(33.06)	0.209	0.891	(41.78)	4.114	(34.99)	0.110	1.177	(7.08)	0.025	4.179	(24.21)	0.004
log(1+MAs)	3.322	(28.17)	0.207	0.902	(31.76)	1.801	(9.94)	0.046	3.977	(28.98)	0.091	4.101	(19.92)	0.004
log(Industry Alliances)	0.131	(1.75)	0.008	0.036	(1.78)	0.273	(2.57)	0.007	0.036	(0.35)	0.001	0.080	(0.42)	0.000
log(Industry MAs)	-0.077	(-0.99)	-0.005	-0.026	(-1.25)	-0.100	(-0.92)	-0.003	-0.067	(-0.65)	-0.001	-0.054	(-0.26)	0.000
log(MktCap)	0.905	(37.89)	0.056	0.261	(37.46)	0.991	(28.82)	0.026	0.689	(21.79)	0.015	1.668	(24.98)	0.002
log(BM)	0.035	(0.57)	0.002	0.010	(0.61)	0.053	(0.61)	0.001	0.096	(1.11)	0.002	0.171	(0.94)	0.000
Growth of Sales	0.029	(1.33)	0.002	0.011	(1.87)	-0.013	(-0.43)	0.000	0.085	(3.05)	0.002	0.001	(0.01)	0.000
Cash	0.216	(1.59)	0.013	0.072	(1.95)	0.786	(4.99)	0.021	-0.510	(-2.44)	-0.012	0.137	(0.38)	0.000
Capex	-0.782	(-2.56)	-0.049	-0.174	(-2.17)	0.357	(0.97)	0.011	-2.630	(-5.41)	-0.061	-0.575	(-0.70)	0.000
ROE	-0.433	(-5.42)	-0.027	-0.126	(-5.75)	-0.885	(-8.49)	-0.024	0.268	(2.47)	0.007	-0.240	(-1.25)	0.000
D/E	0.010	(0.50)	0.001	0.005	(0.92)	0.017	(0.64)	0.000	-0.007	(-0.24)	0.000	0.037	(0.79)	0.000
Momentum	0.059	(1.27)	0.004	0.017	(1.36)	-0.114	(-1.81)	-0.003	0.275	(4.08)	0.006	0.059	(0.49)	0.000
Volatility	1.328	(1.94)	0.083	0.458	(2.48)	6.511	(7.73)	0.178	-5.196	(-5.05)	-0.125	3.361	(1.67)	0.003
Ind. Concentration	-0.960	(-2.21)	-0.060	-0.255	(-2.22)	-1.144	(-1.87)	-0.031	0.192	(0.35)	0.005	-2.266	(-1.95)	-0.002
Foreign Tax	16.695	(9.09)	1.042	5.277	(10.28)	8.932	(3.25)	0.224	23.304	(11.21)	0.535	17.719	(4.82)	0.016
Industry Unionization	-0.509	(-1.96)	-0.032	-0.142	(-2.02)	-0.599	(-1.77)	-0.016	-0.456	(-1.19)	-0.010	0.083	(0.13)	0.000
Industry FE		Sic2			Sic2					Sic2				
Time FE		Yes			Yes					Yes				
Clustering		Sic2 + Year			Sic2 + Year					Sic2 + Year				
Pseudo R <sup>2</sup>		0.230			0.252					0.220				
N		70286			70286					70286				

### **Table 3: Host Country Selection**

We report results on the decision of the U.S firm to venture in a specific country. The sample includes U.S. firms which have ventured abroad in a given year. Heckman's Lambda estimated from specification (1) in Table 2 accounts for the decision to expand internationally. The dependent variable in specifications (1) and (2) is a dummy which takes a value of one if U.S. firm has made either an alliance or M&A in a given country, zero otherwise. The dependent variable in specifications (3) and (4) is the logarithm of one plus the number of alliances and M&As that a firm has done in a country. The key independent variables are measures of partner risk. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3. Clustering is done at U.S. firm, country of investment, and time level. In Panel A, we use SIC2 (U.S firm) industry and time fixed effects. Specifications (1) and (2) are logits; Specification (3) and (4) are Tobits. Marginal effects are multiplied by 100. In Panel B, we employ U.S. firm and time fixed effects. All specifications are OLS. All coefficients are multiplied by 100.

**Panel A: Multivariate Analysis with Industry Fixed Effects**

	<u>Venturing in a country: Alliance / M&amp;A or nothing</u>						<u>N of Alliances and M&amp;As in a Country</u>			
	<u>Logit</u>			<u>Logit</u>			<u>Tobit</u>		<u>Tobit</u>	
	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	estimate	t-stat
Constraints on Executive	-0.116	(-8.97)	-0.273				-0.032	(-8.08)		
Protection against Expropriation				-0.407	(-18.45)	-1.007			-0.104	(-17.89)
Legal Formalism	-0.509	(-24.60)	-1.195				-0.155	(-24.74)		
Procedural Complexity				-0.852	(-23.67)	-0.829			-0.095	(-25.07)
log(MktCap)	0.352	(12.34)	0.826	0.327	(11.43)	0.809	0.106	(12.20)	0.099	(11.52)
log(BM)	0.263	(4.75)	0.618	0.219	(3.96)	0.541	0.079	(4.70)	0.067	(4.08)
Growth of Sales	0.009	(0.45)	0.020	0.008	(0.44)	0.020	0.003	(0.48)	0.001	(0.26)
Cash	0.045	(0.39)	0.106	0.037	(0.33)	0.092	0.011	(0.33)	0.014	(0.42)
Capex	0.575	(2.16)	1.350	0.446	(1.73)	1.104	0.206	(2.53)	0.184	(2.39)
ROE	-0.020	(-0.30)	-0.048	-0.084	(-1.25)	-0.207	-0.008	(-0.38)	-0.025	(-1.28)
D/E	0.006	(0.35)	0.014	-0.012	(-0.67)	-0.029	0.003	(0.47)	-0.002	(-0.41)
Momentum	0.028	(0.69)	0.066	0.061	(1.53)	0.151	0.012	(0.95)	0.022	(1.86)
Volatility	0.284	(0.41)	0.668	-0.198	(-0.29)	-0.490	0.081	(0.39)	-0.013	(-0.06)
Industry Concentration	0.117	(0.23)	0.274	0.431	(0.88)	1.066	0.024	(0.16)	0.129	(0.91)
<u>Host Country characteristics</u>										
Stock Market/ GDP	0.663	(19.93)	1.557	0.727	(19.41)	1.799	0.214	(20.17)	0.218	(19.82)
Stock Market Turnover	0.184	(7.59)	0.433	-0.019	(-0.65)	-0.047	0.056	(7.46)	0.002	(0.23)
# of listed firms per capita	0.619	(8.64)	1.453	-0.173	(-1.67)	-0.427	0.191	(8.91)	-0.018	(-0.68)
log(Average BM)	0.040	(0.41)	0.095	-0.023	(-0.22)	-0.058	0.011	(0.39)	-0.018	(-0.59)
Average Leverage	-0.114	(-0.56)	-0.269	-0.952	(-3.98)	-2.354	0.017	(0.28)	-0.206	(-2.98)
Average Cash	2.762	(9.29)	6.487	-0.729	(-2.28)	-1.803	0.806	(8.55)	-0.202	(-2.07)
Average Capex	-3.196	(-6.94)	-7.505	1.701	(2.90)	4.207	-0.928	(-6.84)	0.485	(2.87)
Average ROA	-0.256	(-5.60)	-0.601	-0.091	(-1.24)	-0.225	-0.070	(-6.11)	-0.014	(-0.95)
Profit Taxes	0.037	(33.04)	0.088	0.029	(24.35)	0.072	0.011	(34.20)	0.009	(25.41)
Rigidity of Employment	-0.010	(-6.88)	-0.023	-0.009	(-7.00)	-0.021	-0.003	(-6.99)	-0.002	(-7.01)
Change in Exchange Rate	-0.551	(-5.53)	-1.293	-0.179	(-2.03)	-0.443	-0.150	(-5.61)	-0.068	(-2.70)
Lambda	-0.161	(-8.21)	-0.378	-0.153	(-7.69)	-0.377	-0.052	(-8.60)	-0.048	(-8.02)
Industry FE		US Sic2			US Sic2			US Sic2		US Sic2
Time FE		Yes			Yes			Yes		Yes
Clustering (Country, US Sic2, and Year)		Yes			Yes			Yes		Yes
Adj R <sup>2</sup>		0.074			0.090			0.079		0.099
N		275279			245379			275349		245379

**Panel B: Multivariate Analysis with Firm Fixed Effects**

	<u>Venturing in a country: Alliance / M&amp;A or 0</u>				<u>N of Alliances and M&amp;As in a Country</u>			
	<u>OLS</u>		<u>OLS</u>		<u>OLS</u>		<u>OLS</u>	
	(1)	(2)	(3)	(4)	(1)	(2)	(3)	(4)
	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat
Constraints on Executive	-0.163	(-4.27)			-0.039	(-3.10)		
Protection against Expropriation			-0.527	(-9.80)			-0.163	(-9.12)
Legal Formalism	-1.306	(-21.96)			-0.430	(-21.87)		
Procedural Complexity			-1.763	(-10.70)			-0.932	(-11.49)
log(MktCap)	1.455	(5.68)	1.627	(5.81)	0.584	(6.60)	0.657	(6.90)
log(BM)	0.894	(2.41)	1.015	(2.49)	0.338	(2.64)	0.397	(2.85)
Growth of Sales	0.138	(1.56)	0.143	(1.47)	0.053	(1.78)	0.056	(1.72)
Cash	-0.546	(-0.90)	-0.499	(-0.72)	-0.160	(-0.81)	-0.133	(-0.59)
Capex	-1.116	(-0.69)	-1.527	(-0.86)	-0.204	(-0.37)	-0.294	(-0.50)
ROE	-0.016	(-0.05)	-0.135	(-0.35)	-0.082	(-0.72)	-0.145	(-1.12)
D/E	0.036	(0.33)	0.034	(0.28)	0.017	(0.45)	0.016	(0.40)
Momentum	0.051	(0.30)	0.269	(1.44)	0.070	(1.22)	0.144	(2.29)
Volatility	-1.263	(-0.37)	-3.166	(-0.84)	-0.817	(-0.73)	-1.559	(-1.28)
Industry Concentration	-1.118	(-0.56)	-0.062	(-0.03)	-0.218	(-0.31)	0.225	(0.28)
<u>Host Country characteristics</u>								
Stock Market/ GDP	2.189	(15.04)	2.873	(16.79)	0.715	(14.58)	0.953	(16.38)
Stock Market Turnover	0.385	(4.77)	-0.241	(-2.65)	0.137	(4.94)	-0.078	(-2.50)
# of listed firms per capita	1.910	(7.13)	-0.782	(-2.23)	0.586	(6.69)	-0.292	(-2.55)
log(Average BM)	-0.050	(-0.19)	-0.543	(-1.78)	-0.017	(-0.19)	-0.182	(-1.78)
Average Leverage	1.221	(2.54)	-0.843	(-1.41)	0.375	(2.31)	-0.293	(-1.47)
Average Cash	6.336	(6.01)	-4.511	(-3.70)	2.132	(5.99)	-1.621	(-3.99)
Average Capex	-6.098	(-5.16)	8.437	(4.76)	-2.066	(-5.20)	2.890	(4.87)
Average ROA	-0.586	(-9.66)	-0.171	(-2.99)	-0.194	(-9.98)	-0.061	(-3.32)
Profit Taxes	0.096	(28.11)	0.080	(23.93)	0.032	(27.34)	0.026	(23.29)
Rigidity of Employment	-0.036	(-8.10)	-0.032	(-7.12)	-0.013	(-8.27)	-0.011	(-7.08)
Change in Exchange Rate	-1.158	(-6.35)	-1.061	(-5.17)	-0.392	(-6.35)	-0.364	(-5.37)
Lambda	-0.068	(-0.80)	-0.057	(-0.59)	-0.013	(-0.43)	-0.009	(-0.29)
US. Firm FE	Yes		Yes		Yes		Yes	
Time FE	Yes		Yes		Yes		Yes	
Clustering (Country, US Sic2, Year)	Yes		Yes		Yes		Yes	
Adj R <sup>2</sup>	0.022		0.029		0.026		0.034	
N	275349		245441		275349		245441	

**Table 4: Choice of the Form of Expansion into a Given Country**

We report results on the choice of the form of expansion in a country by U.S. firms. The sample includes firms which has made at least one alliance or M&A in a country in a given year. Heckman's Lambda estimated from specification (1) in Table 2 accounts for the decision to expand internationally. Heckman's Lambda 2 estimated from specifications (1) and (2) in Table 3 accounts for the decision to expand into a particular country. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. In Panel A we present the descriptive statistics on the number of alliances and M&As done by U.S. firms by measures of direct and indirect partner risk. In Panel B we report the results of multivariate analysis with SIC2 (U.S. firm) industry and time fixed effects. Specifications (1) and (2) are multinomial logits. Specifications (3) and (4) are Tobits. The dependent variable in specifications (1) and (2) takes the value of one if a firm has done an M&A, two if it did both an alliance and M&A, and zero if it did an alliance. The dependent variable in specifications (3) and (4) is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country. In Panel C, we report the results of OLS regressions with U.S. firm fixed effects. The dependent is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 2.

**Panel A: Univariate Sorts**

Indirect Partner risk			Direct Partner risk		
Constraints on Executive	Below median	Above Median	Legal Formalism	Below median	Above Median
alliances	6139	2553	alliances	2311	6381
M&As	4544	1202	M&As	1109	4637
alliances/total	0.575	0.680	alliances/total	0.676	0.579
Protection against Expropriation	Below median	Above Median	Procedural Complexity	Below median	Above Median
alliances	6018	2674	alliances	2560	6132
M&As	4632	1114	M&As	1286	4460
alliances/total	0.565	0.706	alliances/total	0.665	0.579



**Panel B: Multivariate Analysis with Industry Fixed Effects**

	<u>Choice of Expansion Method</u>												<u>Relative Shares of Expansion Choices</u>			
	<u>Multinomial Logit</u>						<u>Multinomial Logit</u>						<u>Tobit</u>		<u>Tobit</u>	
	(1)						(2)						(3)		(4)	
		<u>M&amp;A</u>		<u>Alliance &amp; M&amp;A</u>			<u>M&amp;A</u>		<u>Alliance &amp; M&amp;A</u>				<u>Fraction of M&amp;As</u>		<u>Fraction of M&amp;As</u>	
	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	estimate	t-stat
Constraints on Executive Protection vs Expropriation	-0.324	(-11.39)	-0.080	-0.084	(-1.11)	-0.000							-2.764	(-8.91)		
Legal Formalism	0.159	(3.12)	0.039	0.299	(1.99)	0.000	-0.255	(-5.12)	-0.064	0.141	(1.01)	0.000	1.333	(3.02)	-0.044	(-4.79)
Procedural Complexity							0.008	(4.33)	0.002	0.014	(2.71)	0.000			0.001	(4.23)
log(MktCap)	-0.849	(-13.43)	-0.211	0.149	(0.74)	0.001	-0.858	(-13.82)	-0.215	0.180	(0.89)	0.001	-7.153	(-9.35)	-0.170	(-14.92)
log(BM)	-0.186	(-1.42)	-0.046	0.296	(0.65)	0.000	-0.155	(-1.19)	-0.039	0.399	(0.89)	0.001	-1.589	(-1.41)	-0.028	(-1.13)
Growth of Sales	0.146	(3.05)	0.036	0.140	(1.16)	0.000	0.155	(3.28)	0.039	0.148	(1.31)	0.000	1.263	(3.10)	0.028	(3.48)
Cash	-1.644	(-6.20)	-0.408	-0.511	(-0.56)	0.000	-1.700	(-6.54)	-0.424	-0.577	(-0.64)	0.000	-14.313	(-5.79)	-0.335	(-6.83)
Capex	-3.321	(-4.89)	-0.828	4.018	(2.13)	0.007	-3.631	(-5.35)	-0.910	2.880	(1.66)	0.007	-27.844	(-4.70)	-0.679	(-5.59)
ROE	1.716	(9.11)	0.426	0.949	(1.80)	0.000	1.696	(9.04)	0.423	0.937	(1.67)	0.000	13.740	(7.16)	0.315	(9.71)
D/E	-0.034	(-0.84)	-0.008	-0.285	(-1.44)	0.000	-0.014	(-0.34)	-0.003	-0.171	(-0.95)	0.000	-0.318	(-0.90)	-0.002	(-0.22)
Momentum	0.432	(4.76)	0.107	0.394	(1.40)	0.000	0.410	(4.62)	0.102	0.293	(1.08)	0.000	3.813	(4.66)	0.082	(4.88)
Volatility	-13.150	(-8.04)	-3.267	-0.389	(-0.07)	0.007	-13.586	(-8.62)	-3.398	2.260	(0.40)	0.014	-115.048	(-6.95)	-2.778	(-9.58)
Industry Concentration	1.670	(1.81)	0.416	-2.136	(-0.73)	-0.003	1.355	(1.53)	0.341	-2.769	(-0.99)	-0.005	12.836	(1.67)	0.234	(1.49)
<u>Host Country characteristics</u>																
Stock Market/ GDP	0.070	(0.83)	0.017	-0.103	(-0.47)	0.000	0.087	(0.98)	0.022	-0.002	(-0.01)	0.000	0.581	(0.81)	0.013	(0.78)
Stock Market Turnover	-0.552	(-7.46)	-0.137	-0.827	(-4.20)	-0.001	-0.460	(-6.18)	-0.115	-0.517	(-3.22)	0.000	-4.570	(-6.97)	-0.070	(-7.19)
# of listed per capita	0.075	(0.61)	0.018	0.068	(0.21)	0.000	-0.214	(-1.70)	-0.054	0.094	(0.26)	0.000	0.636	(0.61)	-0.040	(-1.66)
log(Average BM)	0.801	(4.25)	0.199	0.762	(1.47)	0.000	0.869	(4.26)	0.216	1.369	(2.50)	0.001	6.894	(4.15)	0.149	(4.14)
Average Leverage	1.873	(3.55)	0.465	0.699	(0.47)	0.000	2.254	(4.05)	0.562	1.647	(1.09)	0.001	15.435	(3.33)	0.413	(4.14)
Average Cash	-2.590	(-3.62)	-0.642	-1.868	(-1.00)	-0.001	-1.717	(-2.30)	-0.427	-3.025	(-1.41)	-0.003	-21.888	(-3.46)	-0.335	(-2.38)
Average Capex	-3.493	(-3.58)	-0.867	-1.530	(-0.62)	0.000	-4.304	(-3.86)	-1.071	-5.565	(-2.00)	-0.005	-27.949	(-3.33)	-0.803	(-4.11)
Average ROA	0.181	(2.54)	0.045	0.164	(0.75)	0.000	0.311	(3.49)	0.078	0.159	(0.80)	0.000	1.615	(2.63)	0.059	(3.75)
Profit Taxes	-0.003	(-1.00)	-0.001	-0.010	(-1.32)	0.000	0.008	(2.82)	0.002	-0.007	(-0.84)	0.000	-0.025	(-1.03)	0.001	(2.61)
Rigidity of Employment	0.003	(1.30)	0.001	-0.001	(-0.17)	0.000	-0.004	(-1.31)	-0.001	0.000	(0.04)	0.000	0.028	(1.28)	-0.001	(-1.43)
Lambda	-0.041	(-0.92)	-0.010	-0.164	(-1.07)	0.000	-0.066	(-1.47)	-0.016	-0.141	(-1.00)	0.000	-0.343	(-0.89)	-0.013	(-1.56)
Lambda2	-0.254	(-5.58)	-0.063	-0.587	(-4.22)	-0.001	-0.182	(-3.32)	-0.045	-0.613	(-3.43)	-0.001	-2.225	(-5.38)	-0.035	(-3.37)
Industry FE				US Sic2						US Sic2					US Sic2	
Time FE				Yes						Yes					Yes	
Clustering (Country, US Sic2, and Year)				Yes						Yes					Yes	
Adj R <sup>2</sup>				0.185						0.184					0.180	
N				9271						9402					9271	

**Panel C: Multivariate Analysis with Firm Fixed Effects**

	<u>OLS</u>		<u>OLS</u>	
	estimate	t-stat	estimate	t-stat
Constraints on Executive Protection vs Expropriation	-0.050	(-9.93)	-0.039	(-3.73)
Legal Formalism	0.027	(3.04)		
Procedural Complexity			0.001	(2.24)
log(MktCap)	-0.001	(-0.03)	-0.008	(-0.25)
log(BM)	0.005	(0.11)	-0.023	(-0.51)
Growth of Sales	0.029	(2.59)	0.033	(2.91)
Cash	0.053	(0.65)	-0.014	(-0.16)
Capex	-0.372	(-1.88)	-0.341	(-1.65)
ROE	0.221	(5.31)	0.177	(4.03)
D/E	-0.039	(-2.67)	-0.039	(-2.61)
Momentum	0.026	(1.27)	0.024	(1.15)
Volatility	-0.585	(-1.33)	-0.904	(-2.07)
Industry Concentration	0.173	(0.78)	0.136	(0.62)
<u>Host Country characteristics</u>				
Stock Market/ GDP	0.008	(0.48)	0.005	(0.30)
Stock Market Turnover	-0.052	(-5.57)	-0.042	(-4.31)
# of listed per capita	0.025	(0.96)	-0.027	(-0.97)
log(Average BM)	0.051	(1.56)	0.064	(1.70)
Average Leverage	0.212	(2.17)	0.296	(2.87)
Average Cash	-0.351	(-2.53)	-0.271	(-1.81)
Average Capex	-0.583	(-3.38)	-0.731	(-3.57)
Average ROA	0.016	(1.00)	0.036	(1.95)
Profit Taxes	-0.001	(-1.12)	0.001	(1.85)
Rigidity of Employment	0.000	(0.07)	-0.001	(-1.82)
Lambda	0.015	(1.40)	0.017	(1.53)
Lambda2	-0.024	(-2.82)	-0.015	(-1.32)
US firm FE	Yes		Yes	
Time FE	Yes		Yes	
Clustering (Country, US Sic2, and Year)	Yes		Yes	
Adj R <sup>2</sup>	0.432		0.427	
N	9271		9402	

**Table 5: Accounting for Endogeneity of Measures of Partner Risk**

We re-estimate our previous findings accounting for the (potential) endogeneity of measures of partner risk. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. We instrument indirect partner risk with the logarithm of European settler mortality (set zero for non-colonies). Direct partner risk measures are instrumented with UK legal origin dummy. The choice of instrumental variables is motivated by Acemoglu and Johnson (2005). First stage regressions of instrumental variables on measures of direct and indirect partners risk are reported in Panel A. Panels B, and C report the results of second stage regressions with instrumented measures of partner risk. All our regressions include full set of control variables and clustering as in the prior analysis.

**Panel A: First Stage Regressions of Instrumental Variables on Measures of Direct and Indirect Partners Risk**

	Constraints on Executive		Protection Against Expropriation		Legal Formalism		Procedural Complexity	
	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat
Log(Settler Mortality)	0.350	(4.11)	0.446	(4.74)	0.198	(1.61)	0.110	(1.47)
UK Legal origin	-0.260	(-0.71)	-0.588	(-1.45)	-1.481	(-4.72)	-1.769	(-3.72)
Adj R <sup>2</sup>	0.305		0.383		0.422		0.308	
N	39		39		39		39	
F-test	10.81		11.24		12.47		10.25	
	(0.01)		(0.01)		(0.01)		(0.01)	

**Panel B: Venturing into a country**

	<u>logit</u>		ME	<u>Tobit</u>	
	estimate	t-stat		estimate	t-stat
Indirect Partner Risk	-0.510	(-9.35)	-1.139	-0.110	(-7.98)
Direct Partner Risk	-0.988	(-27.92)	-2.205	-0.279	(-29.99)
Controls		Yes			Yes
Clustering		Yes			Yes
Adj R <sup>2</sup> / Pseudo R <sup>2</sup>		0.084			0.088
N		267328			267396
Hansen		1.64			1.70
		(0.20)			(0.20)

**Panel C: Choice of Expansion**

			<u>multinomial logit</u>			<u>Tobit</u>		
	<u>M&amp;A</u>		ME	<u>Alliance and M&amp;A</u>		<u>Fraction of M&amp;As</u>		
	estimate	t-stat		estimate	t-stat	estimate	t-stat	
Indirect Partner Risk	-0.634	(-9.06)	-0.156	-0.263	(-1.14)	0.000	-5.346	(-7.48)
Direct Partner Risk	0.130	(1.96)	0.033	-0.397	(-1.88)	-0.002	1.084	(1.93)
Controls			Yes				Yes	
Clustering			Yes				Yes	
Adj R <sup>2</sup> / Pseudo R <sup>2</sup>			0.191				0.1738	
N			9064				9064	
Hansen			0.07				0.03	
			(0.80)				(0.86)	

**Table 6: Partner Risk and the Choice of the Form of Expansion: Creation of Eurozone**

We report results on the choice of the method of expansion in a country by U.S. firms around creation of Eurozone. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. Euro is a dummy value which takes the variable of 1 for the year when a country of expansion was a part of European single currency area, zero otherwise. We account for self-selection to go abroad (Table 2) and invest in a country (Table 3). In Specifications (1) and (3) Heckman's Lambda is estimated from specification (1) in Table 2 and accounts for the decision to expand internationally; Heckman's Lambda 2 are estimated from specifications (1) and (2) in Table 3 and accounts for the decision to expand into a particular country. In Specifications (2) and (4) Heckman's lambdas are estimated with event, PRE, and interaction between them included in the 1<sup>st</sup> (going abroad) and 2<sup>nd</sup> (invest in a country) stages of investment decisions. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country; all regressions are Tobits. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3.

	<u>Choice of Expansion Method</u>												<u>Relative Shares of Expansion Choices</u>			
	<u>Multinomial Logit</u>						<u>Multinomial Logit</u>						<u>Tobit</u>		<u>Tobit</u>	
	(1)			(2)			(3)			(4)			Fraction of M&As		Fraction of M&As	
	<u>M&amp;A</u>		<u>Alliance &amp; M&amp;A</u>		<u>M&amp;A</u>		<u>Alliance &amp; M&amp;A</u>		<u>M&amp;A</u>		<u>Alliance &amp; M&amp;A</u>		estimate	t-stat	estimate	t-stat
	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	ME	estimate	t-stat	estimate	t-stat
Constraints on Executive	-0.331	(-11.91)	-0.082	-0.138	(-1.77)	0.000							-2.830	(-9.27)		
Const on Executive × Euro	0.126	(2.32)	0.031	0.044	(0.07)	0.000							1.144	(2.04)		
Protection vs Expropriation							-0.415	(-9.72)	-0.104	-0.135	(-1.06)	0.000			-0.554	(-7.58)
Prot vs Exprop × Euro							0.201	(3.31)	0.099	0.081	(0.55)	0.000			0.425	(3.34)
Legal Formalism	0.147	(3.40)	0.036	0.224	(1.65)	0.000							1.222	(3.03)		
Procedural Complexity							0.010	(5.28)	0.002	0.015	(2.43)	0.000			0.003	(5.18)
Euro	10.211	(3.11)	2.543	2.470	(0.15)	0.001	11.687	(3.29)	2.912	7.310	(0.51)	0.001	9.143	(2.91)	10.412	(3.32)
Controls and Lambdas		Yes			Yes			Yes			Yes		Yes		Yes	
Industry FE			US Sic2						US Sic2				US Sic2		US Sic2	
Time FE			Yes						Yes				Yes		Yes	
Clustering (Country, US Sic2, and Year)			Yes						Yes				Yes		Yes	
Adj R <sup>2</sup>			0.198						0.191				0.180		0.174	
N			9271						9402				9271		9402	

**Table 7: Partner Risk and the Choice of the Form of Expansion: Political Regime Change**

We report results on the choice of the method of expansion in a country by U.S. firms following changes in political regimes. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. ProBusiness is a dummy variable which takes the value of 1 for the year if a political regime could be described as center or right-center, but not a dictatorship. We account for self-selection to go abroad (Table 2) and invest in a country (Table 3). In Specifications (1) and (3) Heckman's Lambda is estimated from specification (1) in Table 2 and accounts for the decision to expand internationally; Heckman's Lambda 2 are estimated from specifications (1) and (2) in Table 3 and accounts for the decision to expand into a particular country. In Specifications (2) and (4) Heckman's lambdas are estimated with event, PRE, and interaction between them included in the 1<sup>st</sup> (going abroad) and 2<sup>nd</sup> (invest in a country) stages of investment decisions. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country; all regressions are Tobits. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3.

	<u>Choice of Expansion Method</u>												<u>Relative Shares of Expansion Choices</u>			
	<u>Multinomial Logit</u>						<u>Multinomial Logit</u>						<u>Tobit</u>		<u>Tobit</u>	
	(1)			(2)			(3)			(4)		(3)		(4)		
	estimate	<u>M&amp;A</u> t-stat	ME	<u>Alliance &amp; M&amp;A</u> estimate	t-stat	ME	<u>M&amp;A</u> estimate	t-stat	ME	<u>Alliance &amp; M&amp;A</u> estimate	t-stat	ME	estimate	t-stat	estimate	t-stat
Constraints on Executive	-0.411	(-11.76)	-0.102	-0.097	(-1.02)	0.000							-3.489	(-9.21)		
Const on Exec × ProBus	0.222	(3.70)	0.055	-0.096	(-0.52)	0.000							1.877	(3.59)		
Protection vs Expropriation							-0.687	(-8.70)	-0.165	-0.093	(-0.71)	0.000			-0.328	(-3.18)
Prot Expropr × ProBuso							0.236	(3.45)	0.059	-0.000	(-0.22)	0.000			0.144	(2.14)
Legal Formalism	0.160	(3.75)	0.040	0.188	(1.39)	0.000							1.222	(3.03)		
Procedural Complexity							0.006	(3.35)	0.001	0.010	(1.81)	0.000			0.050	(3.33)
ProBus	1.397	(3.49)	0.348	-0.828	(-0.66)	-0.001	2.334	(3.62)	0.582	-0.144	(-0.07)	-0.001	9.143	(2.91)	19.277	(3.50)
Controls and Lambdas		Yes			Yes			Yes			Yes		Yes		Yes	
Industry FE			US Sic2						US Sic2				US Sic2		US Sic2	
Time FE			Yes						Yes				Yes		Yes	
Clustering (Country, US Sic2, and Year)			Yes						Yes				Yes		Yes	
Adj R <sup>2</sup>			0.197						0.191				0.180		0.175	
N			9271						9402				9271		9402	

**Table 8: Partner Risk and the Choice of the Form of Expansion: Level of Democracy**

We report results on the choice of the method of expansion in a country by U.S. firms following changes in political regimes. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. HighDem takes the value of 1 for the year if country is classified as having the Democracy score between 8 and 10, zero otherwise. Democracy variable is obtained from Polity IV database and described in Appendix 3. We account for self-selection to go abroad (Table 2) and invest in a country (Table 3). In Specifications (1) and (3) Heckman’s Lambda is estimated from specification (1) in Table 2 and accounts for the decision to expand internationally; Heckman’s Lambda 2 are estimated from specifications (1) and (2) in Table 3 and accounts for the decision to expand into a particular country. In Specifications (2) and (4) Heckman’s lambdas are estimated with event, PRE, and interaction between them included in the 1<sup>st</sup> (going abroad) and 2<sup>nd</sup> (invest in a country) stages of investment decisions. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country; all regressions are Tobits. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3.

	<u>Choice of Expansion Method</u>												<u>Relative Shares of Expansion Choices</u>			
	<u>Multinomial Logit</u>						<u>Multinomial Logit</u>						<u>Tobit</u>		<u>Tobit</u>	
	(1)			(2)			(3)			(4)		(3)		(4)		
	estimate	<u>M&amp;A</u> t-stat	ME	<u>Alliance &amp; M&amp;A</u> estimate	t-stat	ME	<u>M&amp;A</u> estimate	t-stat	ME	<u>Alliance &amp; M&amp;A</u> estimate	t-stat	ME	estimate	t-stat	estimate	t-stat
Constraints on Executive	-0.604	(-5.40)	-0.150	-0.079	(-0.22)	0.000							-5.068	(-5.08)		
Const on Exec × HighDem	0.501	(4.00)	0.124	0.038	(0.09)	0.000							4.222	(3.88)		
Protection vs Expropriation							-0.537	(-3.93)	-0.125	-0.189	(-0.60)	0.000			-0.463	(-3.87)
Prot Exprop × HighDem							0.211	(1.90)	0.057	-0.020	(-0.22)	0.000			0.204	(1.95)
Legal Formalism	0.174	(4.00)	0.043	0.222	(1.61)	0.000							1.465	(3.79)		
Procedural Complexity							0.007	(4.46)	0.002	0.011	(2.05)	0.000			0.064	(4.32)
HighDem	2.666	(4.88)	0.662	0.445	(0.25)	0.001	3.567	(3.21)	0.787	0.458	(0.46)	0.001	22.570	(4.66)	27.998	(3.07)
Controls and Lambdas		Yes			Yes			Yes			Yes		Yes		Yes	
Industry FE			US Sic2						US Sic2				US Sic2		US Sic2	
Time FE			Yes						Yes				Yes		Yes	
Clustering (Country, US Sic2, and Year)			Yes						Yes				Yes		Yes	
Adj R <sup>2</sup>			0.199						0.194				0.182		0.179	
N			9271						9402				9271		9402	

**Table 9: Partner Risk and the Choice of the Form of Expansion: Role of Financial Constraints**

We report results on the choice of the method of expansion in a country by U.S. firms conditional on their degree of financial constraints. The sample includes firms which has made at least one alliance or M&A in a country in a given year. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. We also consider two indexes of financial constraints WW index of Whited and Wu (2006) and SA-index of Hadlock and Pierce (2010). A firm is considered to be constrained (unconstrained) according to a WW (SA) index if the average value of the index for the firms in the same SIC2 industry is above (below) the median of all SIC2 industry averages for a given year. In each specification we account for self-selection to go abroad (Table 2) and invest in a country (Table 3) including industry level financial constraints among control variables. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country; all regressions are Tobits. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3.

	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat
Constraints on Executive Protection against Expropriation	-2.860	(-9.51)	-2.860	(-9.51)			-3.478	(-8.50)
Legal Formalism								
× WW constrained	0.790	(2.02)						
× WW not constrained	1.948	(3.63)						
× SA constrained			0.820	(2.17)				
× SA not constrained			1.794	(3.34)				
Procedural Complexity								
× WW constrained					0.038	(2.14)		
× WW not constrained					0.088	(3.66)		
× SA constrained							0.034	(2.15)
× SA not constrained							0.095	(3.99)
Constraint Indicator (WW or SA)	1.041	(0.53)	-0.605	(-0.32)	-1.110	(-1.12)	-1.209	(-1.47)
Constraint Indicator in 1 <sup>st</sup> and 2 <sup>nd</sup> stages	Yes		Yes		Yes		Yes	
Controls	Yes		Yes		Yes		Yes	
Industry FE	US Sic2		US Sic2		US Sic2		US Sic2	
Time FE	Yes		Yes		Yes		Yes	
Clustering (Country, US Sic2, Year) Yes			Yes		Yes		Yes	
Adj R <sup>2</sup>	0.1801		0.180		0.1738		0.174	
N	9271		9271		9402		9402	
F-test	3.97		2.90		4.12		6.56	
	0.05		0.09		0.05		0.02	

**Table 10: Partner Risk and the Choice of the Form of Expansion: American Jobs Creation Act**

We report results on the choice of the method of expansion in a country by U.S. firms around American Jobs Creation Act (AJCA) of 2004. The sample includes firms which has made at least one alliance or M&A in a country in a given year and reported the amount of their permanently reinvested earnings in 2003 or at least one year prior to 2003. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. AJCA takes the value of 1 if the year is 2004, 2005, or 2006. PRE is the larger of 500 million dollars and maximum value of permanently reinvested earnings reported between 2001 and 2003, divided by total assets. We account for self-selection to go abroad (Table 2) and invest in a country (Table 3). In Specifications (1) and (3) Heckman's Lambda is estimated from specification (1) in Table 2 and accounts for the decision to expand internationally; Heckman's Lambda 2 are estimated from specifications (1) and (2) in Table 3 and accounts for the decision to expand into a particular country. In Specifications (2) and (4) Heckman's lambdas are estimated with event, PRE, and interaction between them included in the 1<sup>st</sup> (going abroad) and 2<sup>nd</sup> (invest in a country) stages of investment decisions. The dependent variable is the ratio of the number of M&As to the total number of alliances and M&As a firm has done in a country; all regressions are Tobits. We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3.

	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat
Constraints on Executive	-1.953	(-6.21)	-1.848	(-5.46)				
Protection vs. Expropriation					-2.010	(-4.70)	-2.138	(-4.88)
AJCA	1.901	(0.43)	1.786	(0.32)	2.220	(0.65)	2.500	(0.72)
PRE	0.962	(0.46)	0.944	(0.40)	0.258	(0.15)	0.526	(0.30)
Legal Formalism	1.008	(2.02)	1.779	(3.79)				
AJCA × PRE	-40.45	(-1.75)	-33.879	(-1.45)				
Leg. Form. × AJCA	-1.439	(-0.99)	-0.777	(-0.54)				
Leg. Form. × PRE	-0.561	(-0.75)	-1.027	(-1.16)				
Leg. Form. × AJCA × PRE	16.688	(2.16)	16.509	(2.12)				
Procedural Complexity					0.021	(1.97)	0.017	(1.74)
Proc. Comp. × AJCA					-0.745	(-1.11)	-0.760	(-1.12)
Proc. Comp. × PRE					-0.276	(-0.74)	-0.401	(-1.08)
Proc. Comp. × AJCA × PRE					6.435	(1.85)	7.067	(2.00)
AJCA, PRE in 1 <sup>st</sup> and 2 <sup>nd</sup> stage	No		Yes		No		Yes	
Controls	Yes		Yes		Yes		Yes	
Industry FE	US Sic2		US Sic2		US Sic2		US Sic2	
Time FE	Yes		Yes		Yes		Yes	
Clustering (Country, US Sic2, Year)	Yes		Yes		Yes		Yes	
Adj R <sup>2</sup>	0.223		0.225		0.212		0.217	
N	3091		3091		3091		3091	



**Table 11: Alliance Location**

We report results on the choice of alliance location. The sample includes firms which has made at least one alliance in a country in a given year; each alliance is a separate observation. Heckman's Lambda estimated from specification (1) in Table 2 accounts for the decision to expand internationally. Heckman's Lambda 2 estimated from specifications (1) and (2) in Table 3 accounts for the decision to expand into a particular country. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. Specifications are logits. The dependent variable takes the value of one if an alliance location is the country of a partner, zero otherwise (the U.S., third country, or supranational). We control for the U.S. firm specific characteristics and average market and firm characteristics in the country of expansion. All variables are described in Appendix 3. In Panel A, we report the results of logit regressions with SIC (U.S. firm) industry fixed effects. In Panel B, we report the results of OLS regressions with U.S. firm fixed effects. Panel C reports the results of regressions with instrumented measures of partner risks (see Table 5 for details).

**Panel A: Logistic Regressions with Industry Fixed Effects**

	estimate	<u>Logit</u> t-stat	ME	estimate	<u>Logit</u> t-stat	ME
Constraints on Executive Protection vs Expropriation	0.391	(13.09)	0.095	0.669	(13.31)	0.155
Legal Formalism	-0.180	(-2.70)	-0.044			
Procedural Complexity				-0.005	(-2.05)	-0.001
log(MktCap)	0.083	(0.89)	0.020	-0.029	(-0.43)	-0.007
log(BM)	0.063	(0.69)	0.015	-0.092	(-0.69)	-0.021
Growth of Sales	0.129	(3.00)	0.031	0.088	(2.11)	0.020
Cash	-0.663	(-1.88)	-0.161	-0.077	(-0.27)	-0.018
Capex	-1.214	(-1.18)	-0.294	-0.021	(-0.03)	-0.005
ROE	-0.160	(-0.99)	-0.039	-0.064	(-0.44)	-0.015
D/E	0.052	(0.93)	0.013	0.017	(0.42)	0.004
Momentum	0.172	(2.70)	0.042	0.064	(0.86)	0.015
Volatility	-3.176	(-1.65)	-0.770	0.199	(0.14)	0.046
Industry Concentration	-0.573	(-0.87)	-0.139	-0.289	(-0.28)	-0.067
<u>Host Country characteristics</u>						
Stock Market/ GDP	-0.471	(-3.67)	-0.114	-0.043	(-0.41)	-0.010
Stock Market Turnover	-0.033	(-0.68)	-0.008	-0.046	(-0.97)	-0.011
# of listed per capita	-0.459	(-2.32)	-0.111	-0.168	(-1.05)	-0.039
log(Average BM)	0.104	(0.96)	0.025	0.135	(1.34)	0.031
Average Leverage	0.396	(0.61)	0.096	0.267	(0.38)	0.062
Average Cash	-1.059	(-1.16)	-0.257	1.960	(2.39)	0.454
Average Capex	6.399	(5.79)	1.551	2.132	(1.78)	0.494
Average ROA	0.123	(0.94)	0.030	-0.052	(-0.50)	-0.012
Profit Taxes	0.011	(3.57)	0.003	0.009	(2.66)	0.002
Rigidity of Employment	-0.021	(-7.44)	-0.005	-0.043	(-5.06)	-0.004
Lambda	-0.054	(-0.81)	-0.013	0.022	(0.41)	0.005
Lambda2	0.222	(1.26)	0.054	-0.189	(-1.81)	-0.044
Industry FE		US Sic2			US Sic2	
Time FE		Yes			Yes	
Clustering (Country, US Sic2, and Year)		Yes			Yes	
Adj R <sup>2</sup>		0.158			0.127	
N		9266			9266	

**Panel B: OLS Regressions with Firm Fixed Effects**

	<u>OLS</u>		<u>OLS</u>	
	estimate	t-stat	estimate	t-stat
Constraints on Executive Protection vs Expropriation	0.076	(12.05)	0.125	(10.60)
Legal Formalism	-0.031	(-2.01)		
Procedural Complexity			-0.002	(-2.79)
log(MktCap)	0.030	(0.70)	0.023	(0.51)
log(BM)	0.008	(0.14)	0.008	(0.14)
Growth of Sales	0.016	(1.11)	0.021	(1.44)
Cash	-0.043	(-0.44)	-0.050	(-0.51)
Capex	-0.137	(-0.55)	-0.004	(-0.02)
ROE	-0.038	(-0.81)	-0.040	(-0.80)
D/E	-0.005	(-0.26)	0.004	(0.22)
Momentum	0.041	(2.08)	0.041	(1.88)
Volatility	-0.002	(0.00)	0.340	(0.67)
Industry Concentration	0.066	(0.22)	-0.138	(-0.44)
<u>Host Country characteristics</u>				
Stock Market/ GDP	-0.063	(-2.67)	-0.006	(-0.23)
Stock Market Turnover	-0.024	(-2.09)	-0.006	(-0.43)
# of listed per capita	-0.103	(-2.33)	0.004	(0.10)
log(Average BM)	0.051	(2.40)	0.022	(0.80)
Average Leverage	0.195	(1.26)	0.001	(0.00)
Average Cash	0.166	(0.90)	0.335	(1.59)
Average Capex	1.302	(5.00)	0.548	(1.76)
Average ROA	0.020	(0.67)	-0.028	(-0.94)
Profit Taxes	0.002	(3.29)	0.001	(1.53)
Rigidity of Employment	-0.004	(-7.01)	-0.003	(-4.18)
Lambda	0.008	(0.52)	0.007	(0.44)
Lambda2	0.001	(0.03)	0.003	(0.09)
US firm FE		Yes		Yes
Time FE		Yes		Yes
Clustering (Country, US Sic2, and Year)		Yes		Yes
Adj R <sup>2</sup>		0.213		0.171
N		9266		9266

**Panel C: Instrumented Measures of Partner Risk**

	estimate	t-stat	ME
Indirect Partner Risk	1.090	(14.28)	0.263
Direct Partner Risk	-0.268	(-2.86)	-0.065
Controls		Yes	
Clustering		Yes	
Adj R <sup>2</sup>		0.1705	
N		9266	

**Table 12: Abnormal Returns around M&A and Alliance Announcements**

We present the results of regressions of abnormal returns around M&A and alliance announcements on measures of direct and indirect partner risk. We consider two measures of indirect partner risk: Constraints on Executive Power and Protection Against Expropriation, and two measures of direct partner risk: Legal Formalism and Procedural Complexity. To facilitate the interpretation of the results we change the sign of Constraints on Executive and Protection Against Expropriation measures. So for all measures of both indirect and direct partner risk a higher value indicates higher risk. The abnormal returns are calculated as the difference between the returns on a company stock and four-factor model predicted return over a (-5; +5) trading day window around the event announcement; factor loadings are estimated over (-316;-63) days window prior to the announcement. We control for U.S. firm and country of investment characteristics as in Table 5. Panel A presents results for M&A announcement returns; Panel B reports findings for alliance announcement returns.

**Panel A: Abnormal Returns around M&A Announcements**

	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat		
Constraints on Executive Protection vs Expropriation	-0.556	(-2.06)	-0.540	(-2.05)	-0.546	(-2.11)			-0.640	(-2.30)	-0.616	(-2.12)	-0.625	(-1.87)
Legal Formalism	0.465	(2.04)	0.458	(1.95)	0.470	(2.04)								
Procedural Complexity									0.808	(2.11)	0.830	(2.05)	0.802	(2.07)
Firm controls			Y		Y						Y		Y	
Country controls					Y								Y	
Time and Industry FE	Y		Y		Y		Y		Y		Y		Y	
Adj R <sup>2</sup>	0.031		0.036		0.037		0.031		0.037		0.037		0.037	
N	4939		4939		4939		4939		4939		4939		4939	

**Panel B: Abnormal Returns around Alliance Announcements**

	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat	estimate	t-stat		
Constraints on Executive Protection vs Expropriation	0.269	(2.18)	0.274	(1.98)	0.272	(1.87)			0.249	(1.80)	0.333	(2.21)	0.349	(2.17)
Legal Formalism	-0.467	(-1.88)	-0.436	(-2.12)	-0.590	(-2.48)								
Procedural Complexity									-0.261	(-1.90)	-0.268	(-1.95)	-0.285	(-2.10)
Firm controls			Y		Y						Y		Y	
Country controls					Y								Y	
Time and Industry FE	Y		Y		Y		Y		Y		Y		Y	
Adj R <sup>2</sup>	0.031		0.032		0.032		0.035		0.045		0.045		0.046	
N	7498		7498		7498		7498		7498		7498		7498	

