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Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity

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The Quarterly Journal of Economics, Volume 120, Issue 1, February 2005, Pages 223–246, <https://doi.org/10.1162/0033553053327443>

Published: 01 February 2005

Abstract

Analyzing 210 developing country private equity investments, we find that transactions vary with nations' legal enforcement, whether measured directly or through legal origin. Investments in high enforcement and common law nations often use convertible preferred stock with covenants. In low enforcement and civil law nations, private equity groups tend to use common stock and debt, and rely on equity and board control. Transactions in high enforcement countries have higher valuations and returns. While relying on ownership rather than contractual provisions may help to alleviate legal enforcement problems, these results suggest that private solutions are only a partial remedy.

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