Litigations with the Home State and Internationalization

Laura Fernández-Méndez (Universidad Pontificia Comillas-ICADE, Spain)
Esteban García-Canal (Universidad de Oviedo, Spain)
Raquel García García (Universidad de Oviedo, Spain)

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Abstract

Purpose: This paper aims to investigate whether FDI can be driven by the creative compliance knowledge that firms gather in their home country through litigations with the government.

Design/methodology/approach: We draw on the knowledge-based view and organizational learning theory to argue that there is an inverted U-shaped relationship between experience in litigating with the home State and a firm's level of FDI. We test this hypothesis using negative binomial regressions on a sample of Spanish listed firms for the period between 1986 and 2008.

Findings: Our findings confirm the hypothesized inverted U-shaped relationship between a firm's experience in litigating with the home State and its FDI levels. Firms seem to face an exploration-exploitation dilemma regarding their compliance with domestic regulation. Once they have accumulated a certain amount of creative compliance knowledge, it would be better for them to exploit it both domestically and internationally in the form of creative compliance routines, instead of continuing to push the limits of regulation.

Originality/value: Firms willing to explore the grey areas of the law are usually forced to litigate with the State. As a result, they develop creative compliance knowledge that they can incorporate into their legal routines and capabilities so that they can later exploit it in foreign countries. To the

best of our knowledge, this is the first paper that attempts to understand the influence of creative compliance knowledge on a firm's international investments.

Keywords: creative compliance knowledge; organizational learning; exploration-exploitation; institutions; FDI.

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Introduction

A recent stream of IB research notes that firm international expansion is conditioned by the government and institutions of the home country (Aguilera and Grøgaard, 2019; Cuervo-Cazurra *et al.*, 2018a; Cuervo-Cazurra *et al.*, 2019; Li *et al.*, 2018; Nieto *et al.*, 2021). These papers have used different contexts to test their hypotheses. Some have focused on the expansion of emerging market multinationals (Cuervo-Cazurra *et al.*, 2018b; Li and Ding, 2017; Nuruzzaman *et al.*, 2020; Voss *et al.*, 2010). Meanwhile, others have tried to understand the investment decisions of multinationals from developed and developing countries in emerging and politically unstable economies (Chen *et al.*, 2019; Lupton *et al.*, 2021; Valdés-Llaneza *et al.*, 2021). Another set of studies has adopted a comparative perspective to examine how the responses of firms to their home institutions vary across emerging and developed countries (Holburn and Zelner, 2010).

The most obvious response to a firm's home institutional environment that impacts internationalization is the so-called escape FDI; that is, expanding to foreign countries to avoid

operating in an unfavorable institutional domestic environment (Pinkham and Peng, 2017). This is a common response for firms from emerging countries, where institutions are weak and poorly developed (He and Cui, 2012). However, international expansion can also be driven by the aim of leveraging the nonmarket knowledge and capabilities gained from interacting with home country institutions (Cuervo-Cazurra and Genc, 2008). Scholars have analyzed two extreme cases of nonmarket resource transfer. On the one hand, firms may venture into countries with similar institutions to capitalize on the knowledge gained while adapting to domestic conditions (Cuervo-Cazurra and Genc, 2008; Cuervo-Cazurra *et al.*, 2018b). On the other hand, they may expand to countries with discretionary governments to exploit their homegrown political capabilities developed while influencing domestic regulators (Fernández-Méndez *et al.*, 2018; García-Canal and Guillén, 2008; Holburn and Zelner, 2010). A fourth response to domestic regulation consists in the exploration of new ways of stretching it, which may result in litigations with the home State (Casarin, 2015).

Law is one of the most hidden components of a firm's strategy (Pyman, 2005; Snell, 2004). Some researchers have tried to understand how firms can create a competitive advantage by operating in the legal environment (Bird, 2011; Snell, 2004). This link with competitive advantage is why litigating can be included in what Baron (1995) calls nonmarket strategy, which tries to profit from engaging with regulators and governments, among other stakeholders. Casarin stated that "the purpose of suing is to shift the game away from the market or the legislative or bureaucratic arena and towards the courts, where the interest group expects to get via litigation what it was unable to obtain with other strategies" (2015, p. 155). Only a few notable exceptions have started to pursue this avenue of research in recent times, looking at how in-house legal

expertise (White *et al.*, 2020) and collective actions (Oh *et al.*, 2020) can affect the position of firms in a certain host country.

Litigating with the State as a response to domestic regulation remains unexplored, and the degree to which the nonmarket capabilities accumulated by doing so influence international expansion through FDI has yet to be documented. Answering this research question is critical to have a more complete picture of how domestic regulation affects internationalization. For this reason, we address this gap in the literature by drawing on the knowledge-based view and the organizational learning theory. We argue that firms that explore new ways of stretching domestic regulation learn how to better identify the limits of the law and find opportunities for value creation. This, in turn, enables them to build up what can be labeled as *creative compliance knowledge*, which can be incorporated into *creative compliance routines*. In this paper, we define the role of homegrown creative compliance knowledge in internationalization. We claim that the mechanisms used to transfer this knowledge abroad resemble those of political routines and capabilities (e.g., Fernández-Méndez *et al.*, 2018).

Most legal scholars see avoiding the intended impact of law as the essence of creative compliance (Batory, 2016; McBarnet and Whelan, 1991; Pyman, 2005), and "one of several strategies in dealing with law" (McBarnet and Whelan, 1991, p. 871). Although the notion of creative compliance has been widely analyzed in the legal literature (for a review, see Pyman, 2005), to the extent of our knowledge this paper is the first one to examine it within the IB field. We apply this concept to those situations in which firms have the option to take advantage of the law or regulations, even at the expense of entering into litigations with the State.

We argue that firms need to find an adequate balance between the exploitation and exploration of their creative compliance routines. On the one hand, those that solely rely on

straightforward compliance have restricted freedom to develop their products and strategies (Bird, 2011). On the other, those that constantly explore the limits of the law and litigate with the government are wasting resources to marginally improve their situation, while risking fines and penalties. We suggest that firms that effectively litigate with the home government will increase the number of entries into foreign countries until the costs of litigation exceed the benefits. We test this hypothesis on a panel dataset of Spanish listed firms (1986-2008). We use the Spanish context because most firms from this country started venturing abroad within the studied timeframe. This is an advantage for a paper that tries to identify the critical factors explaining internationalization decisions.

We provide robust evidence of an inverted U-shaped relationship between experience in litigating with the home State and FDI. This finding contributes to previous IB research on the impact of home country institutions on internationalization. The identification of creative compliance as part of the nonmarket strategy also adds to the broader nonmarket literature and, more specifically, to the research on strategic legal decision-making (Bagley, 2008; Bird and Orozco, 2014; Casarin, 2015; Orozco, 2021). We also extend the knowledge-based view and organizational learning theory. We show that firms that build and integrate homegrown creative compliance knowledge into routines are more internationalized than those that blindly comply with the law or constantly litigate. This relates to our main managerial contribution. We hope that practitioners reading this study realize the benefits of following a balanced approach when stretching the law, especially if they are willing to expand abroad.

Learning by stretching the law

Previous nonmarket research in the IB domain has analyzed the influence of home institutions —and the capabilities that firms accumulate when dealing with them— on

internationalization (Aguilera and Grøgaard, 2019; Cuervo-Cazurra *et al.*, 2018a; Cuervo-Cazurra and Genc, 2008; Fernández-Méndez *et al.*, 2018; García-Canal and Guillén, 2008; Holburn and Zelner, 2010; Pinkham and Peng, 2017). Three different strategies to deal with domestic regulations can be identified in this research: *avoid, influence*, and *adapt*. In this paper, we add a fourth one: *stretch*. Figure 1 summarizes the main features of each strategy as well as the degree to which the firm can generate knowledge and capabilities susceptible to be leveraged in foreign markets. Adaptation and avoidance are reactive responses where firms do not try to change the impact that regulations have on their domestic activities. Meanwhile, stretching the law and influencing domestic regulations can be defined as proactive. Firms that stretch the law play by the rules while trying to make the most of them. By contrast, firms attempting to influence regulation wish to alter the rules for their own benefit.[1]

Please insert Figure 1 here

Our research revolves around the creative compliance knowledge that firms can accumulate from stretching the law. Firms try to abide by the regulations that specify the rules of the game in each market (North, 1990). Theoretically, these laws specify the legality of actions. However, every

[1] This two-by-two matrix can be considered an extension of the typology of reactions to performance decline introduced by Albert Hirschman (1970)—i.e., exit, voice, and loyalty. *Stretch* and *influence* could be considered two opposing ways of using the voice option, *avoid* would correspond to the exit option, and *adapt* would be the most passive manifestation of loyalty. This matrix simplifies the bidirectional relationship that exists between regulation and firm strategies (see, for instance, Cuervo-Cazurra *et al.*, 2019). Nonetheless, it allows us to identify different types of domestic knowledge and capabilities that can influence the internationalization of firms. It is interesting to notice that despite not generating knowledge susceptible to be exploited abroad, the avoidance option, by definition, leads firms to internationalization (escape FDI).

legal system contains grey areas conformed of actions that are neither clearly legal nor clearly illegal, because a perfectly detailed set of laws and regulations is costly to establish and introduces excessive rigidity in the system (Endicott, 2000; Evans and Gabel, 2013; Pyman, 2005). Said grey areas can appear for a variety of reasons having to do with legal indeterminacy (Pyman, 2005). This indeterminacy can be reinforced by vagueness, ambiguity, and arbitrariness of the law and regulations (Endicott, 2000; Pyman, 2005), which can result in divergent or overlapping legislations, or even a lack of legislation altogether.

Firms face a dilemma when deciding whether to explore the limits of the law. On the one hand, they can choose to ignore any grey areas to eliminate the risk of undertaking actions whose legality is unclear, albeit at the cost of losing opportunities that would create value for their customers and/or for them (Bagley, 2008, 2010; Bird, 2010, 2011). On the other hand, they can approach the limits of the law by identifying and undertaking actions in the grey areas and litigating with the State to defend the legality of such actions, when necessary. For the purposes of this paper, we understand that compliance-related litigation happens around three main areas: 1) taxes; 2) labor legislation/regulation; and 3) antitrust.

Since we use Spanish listed firms as our research setting, we have searched for several recent examples within this context to illustrate this point. The first one falls under the "taxes" categorization. In 2014, the Spanish Supreme Court sided with the Spanish bank Kutxabank in a legal fight against the regional tax agency where the company is located. The final ruling excused the firm from paying over €20 million for the taxation of the stock that the bank had in the Spanish petrochemical multinational Repsol over the years 2001 to 2004. The tax agency accused Kutxabank of creating a secondary company called RepInves to manage the stock (instead of managing it by itself) to evade paying the required taxes. Since the same tax agency had

greenlighted the creation of RepInves in 1997 during its routine inspections, the Supreme Court concluded that it had no basis for overturning its previous decision.[2]

More recently, in 2019, the Supreme Court also agreed with the mining company Hullera Vasco-Leonesa when ruling that a "surprise" audit carried out by tax officials at the firm's premises had gone against the inviolability of the home rights included in the Spanish Constitution. This warned tax and labor inspectors to follow proper protocol in subsequent "surprise" audits.[3]

The third and final example has to do with antitrust. In 2019, the Spanish Supreme Court revoked a sentence from the Spanish Competition Authority that fined telecom multinationals Telefónica, Vodafone and Orange €46.4 million, €43.5 million and €29.9 million, respectively, for excessive pricing practices in the wholesale termination market for SMS and MMS. According to the Supreme Court, the Spanish Competition Authority had failed to carry out a proper economic assessment of the definition of the relevant markets and the individual dominant position of the companies involved in the ruling.[4]

The above examples illustrate some straightforward advantages of adopting a proactive attitude towards regulation. But firms that litigate with the State also benefit from others that are less tangible. Firms that act in the grey areas of the law and expose themselves to litigations can also accumulate creative compliance knowledge, which will allow them to better identify the viability of their actions. Firms can learn regardless of the outcome of the litigation since past failures can also generate positive future outcomes (Deichmann and van den Ende, 2014).

[2] *El Supremo respalda a la Kutxa en su conflicto con la Hacienda vasca*, El País, 24 March 2014.
[3] *El Tribunal Supremo blinda a las empresas ante registros sorpresa de la Inspección*, Vozpópuli, 12 November 2019.
[4] *Nuevo varapalo judicial a la CNMC: el Tribunal Supremo anula la multa de 120 millones que impusieron a Telefónica, Vodafone y Orange*, El Economista, 14 January 2019.

Nonetheless, favorable rulings will obviously indicate that firms are succeeding in the process of stretching the regulation.

The creative compliance knowledge obtained while exploring the limits of the law is tacit and can be hardly acquired in the market (Evans and Gabel, 2013). Even if firms can hire the best lawyers available when they need to go to court, sometimes external lawyers come in when it is too late to win the case. Each firm faces a unique set of legal claims (Bird, 2008, 2011), which makes the process of acquiring creative compliance knowledge path dependent on the previous trajectory and choices made.

According to organizational learning theory, experience per se is not as effective in improving organizational outcomes as when it is codified and incorporated into organizational routines (Zollo and Winter, 2002). These authors state that knowledge is transformed into routines after completing a cycle of accumulation, articulation, and codification. Empirical evidence suggests that articulation and, above all, codification play a key role in the success of knowledge transfer (Graebner *et al.*, 2017; Zollo and Singh, 2004). Therefore, firms need to find an adequate balance between exploitation and exploration, as these activities are hardly compatible given that they compete for scarce resources (Gupta *et al.*, 2006; March, 1991). For this reason, once firms have accumulated a certain amount of creative compliance knowledge, they will be better off codifying and exploiting it as routines, instead of dedicating more resources and attention to push the limits of the law.

Building on prior research on the diminishing returns of high levels of experience (Argote and Miron-Spektor 2011; Katila and Ahuja 2002), the net contribution of new litigations may turn negative beyond a certain threshold. Organizational learning theory predicts that iterative processes of learning will stop once a satisficing outcome is reached (Winter, 2000). Otherwise, firms are

expected to suffer from the "costs of experimentation without gaining many of its benefits" (March, 1991, p. 71). Consequently, firms that place excessive attention on the exploration of new experience and knowledge through litigations fail to take full advantage of their accumulated experience. Conversely, firms willing to exploit this creative compliance knowledge can use it to thrive both at home and abroad.

Figure 2 illustrates the conceptual framework elaborated in this section. Firms can take two stances regarding grey areas. They can either avoid them by blindly complying with the established regulation or they can explore them by stretching the law. Firms that opt for the latter option run the risk of having to litigate with the home State to prove the legality of their actions. This leads to the accumulation of creative compliance knowledge, which is then transformed into creative compliance routines through a learning process that articulates and codifies it. The successful integration of knowledge into routines improves the firms' effectiveness in assessing the limits of the law. This, in turn, reduces their need to enter future litigations with the home government (hence the discontinuous line that represents the decrease). In addition, firms that have learned from exploring the grey areas of the law are in a better position to exploit their creative compliance routines not only at home but also abroad. This contrasts with the path followed by firms choosing to blindly comply with the established regulation. We expect this set of firms to focus more on the domestic market because they are less prepared to navigate foreign regulatory environments. In the following section, we lay the grounds for our hypothesis on the relationship between experience in litigating with the home country government and FDI.

Please insert Figure 2 here

Creative compliance and FDI

Previous studies have found that firms can exploit the experience gathered when dealing with home institutions in their foreign expansion (Cuervo-Cazurra and Genc, 2008; Fernández-Méndez *et al.*, 2015, 2018; Holburn and Zelner, 2010). We build upon this research to propose that the experience accumulated in litigating with the home State shapes the internationalization of firms. This experience can be useful when operating in foreign countries, as regulatory differences are factors that increase the firms' liability of foreignness, thus conditioning the firms' location choice (Fernández-Méndez *et al.*, 2015) and profitability (García-García *et al.*, 2019).

Firms that possess creative compliance knowledge are better prepared to deal with the liabilities of internationalization and the ambiguities in foreign regulation. And those that excel in incorporating this knowledge into their routines are better equipped to understand the spirit of the law and the evolution of the regulation. This allows them to identify profitable opportunities while avoiding legal issues (Bagley, 2008, 2010; Evans and Gabel, 2013), regardless of the location. In this sense, experience in dealing with regulation may help managers think creatively about the legal environment that surrounds their business (Bird, 2011).

However, the effective exploitation of the accumulated knowledge requires articulation and codification efforts that integrate it into routines (Zollo and Winter, 2002). Firms that fail to do so will continue to litigate with the home government to validate the legality of their actions. Said differently, we suggest that firms with the longest track record of litigations with the home State do not have the most refined creative compliance routines. For this reason, they will be less willing and able to expand to foreign countries to leverage them.

In addition, firms that keep litigating by pushing the limits of the law will likely lack the required time and financial resources to invest in foreign countries, regardless of whether they

employ in-house or outside lawyers. According to Bird (2011), firms that outsource their legal counseling need to devote a significant amount of time to forge strong lawyer-client relationships that help both parties exchange knowledge that improves their decision-making. Therefore, both in-house and outside counseling require significant managerial attention. Besides, litigations are often long-lasting processes that consume a substantial amount of resources that could be allocated to other business activities (Barnett *et al.*, 2018; Cohen *et al.*, 2019; Koh *et al.*, 2014; Smeets, 2015), especially when firms need to pay the fines and penalties associated with unfavorable rulings. The same rationale applies to foreign investments, which are also pursued by diverting resources from other activities (Matos Torres *et al.*, 2016). As a result, firms that keep fighting their home government are more likely to focus on their domestic environment, leaving aside the international sphere (Sapienza *et al.*, 2005).

Based on the above arguments, we expect that the relationship between experience accumulated in litigating with the home State and foreign country entries will display an inverted U-shaped pattern. Initially, litigations with the home State provide firms with valuable creative compliance knowledge. Firms can incorporate this knowledge into routines to effectively address the regulatory challenges of internationalization and find opportunities in the grey areas of the regulations in host countries. However, constantly pushing the limits of the law at home can be too much of a good thing. It drains the resources required for a successful foreign expansion while preventing firms to transform their experience into creative compliance routines. Thus, beyond a saturation point, increased litigation lowers the probability of FDI aimed at exploiting creative compliance capabilities. In sum, we propose that:

Hypothesis 1: Experience in litigating with the home country government displays an inverted U-shaped relationship with the number of firm entries into a foreign country.

Data and method

Sample

Our sample comprises all firms listed on the Madrid Stock Exchange in 1990 for the 1986-2010 period. It covers a range of industries that vary in their level of exposure to regulations. For instance, manufacturing firms tend to be less exposed to them than telecommunication operators. The use of this sample and period of analysis has two main advantages. First, we avoid left-censored data because we can include the bulk of the foreign investments made by the firms in the sample. It was only after 1986 that Spanish FDI experienced a significant boost, after the entrance of the country into the European Economic Community (currently known as the European Union). The second advantage is that establishing 2008 as the final year of the analysis reduces potential biases in our results stemming from the global financial crisis.

Dependent variable

Our dependent variable is the count of a firm's entries into a particular country in year *t*. We only consider FDI because it entails higher risks and costs than alternative entry modes, such as exporting. Following the definition of FDI provided by the U.S. Bureau of Economic Analysis (2004), we include operations where the firm holds at least 10% of the ownership of the foreign operation. We obtained the FDI data from the *Systematic Database on International Operations of Spanish Companies* created under the sponsorship of the Spanish Institute for Foreign Trade, ICEX (see Guillén and García-Canal, 2007).

Independent variable

Our independent variable measures the firms' level of success in litigating with the home government. We calculate this variable as the cumulative number of Supreme Court rulings

favorable to the firm divided by the maximum number of cumulative favorable Supreme Court rulings in the sample (i.e., 136). The index takes values between 0 and 1. Even though firms can learn regardless of the outcome, we expect that they accumulate higher-quality knowledge from positive rulings. We introduce this variable in its linear and quadratic forms to test the hypothesized inverted U-shape relationship.

Civil-law-based countries separate the administrative and civil jurisdictions (Amaral-García, 2019a). For this reason, we only incorporate rulings from the Administrative Section of the Supreme Court (the so-called *recursos contencioso-administrativos* in Spain) in which the Spanish government is either the defendant or the plaintiff, being the firm the other party. We filtered the positive outcomes whose nature has to do with regulatory/legal compliance (i.e., taxes, labor legislation/regulation, and antitrust) to better proxy creative compliance knowledge.

Focusing on Supreme Court legal disputes also allows us to refine the operationalization of this variable. In civil-law-based countries like Spain, the Supreme Court is the only jurisdiction that can create Case Law through its decisions, which to some extent can change the regulatory environment and benefit firms in the future (Amaral-García, 2019b; Shavell, 2010). In this regard, Article 1.6. of the Spanish Civil Code explains that "Case Law shall complement the legal system by means of the opinion repeatedly handed down by the Supreme Court in its construction and application of written laws, customs and the general legal principles."[5] (for additional information, see Parra Lucán, 2016). As a result, litigating in the Supreme Court may not only allow firms to take advantage of grey areas but also to change regulations in their favor when this court's opinion and interpretation of the law goes agrees with them. Another advantage of using Supreme Court

[5] The English version of the Spanish Civil Code can be accessed at the following website: https://www.mjusticia.gob.es/es/AreaTematica/DocumentacionPublicaciones/Documents/Spanish%20Civil%20Code.pdf (Last accessed 22 September 2021).

rulings is better data access compared to those in lower courts since all rulings are available in a single and open database (Amaral-García, 2019a).[6]

Control variables

We include several variables to control for alternative explanations of why firms decide to enter a foreign country. *Homegrown political capabilities* positively impact international expansion (Fernández-Méndez *et al.*, 2018; García-Canal and Guillén, 2008; Holburn and Zelner, 2010). This control variable is important because political capabilities and creative compliance knowledge can act as complements or substitutes (Casarin, 2015). We operationalize political capabilities as the percentage of former politicians on the firm's board. We instrumented this variable to deal with endogeneity concerns. Based on Fernández-Méndez *et al.* (2018), we chose the population of the city where the firm is headquartered as our instrumental variable.[7]

We also include variables to control for additional firm-level factors: *size* (logged total assets); level of intangible assets, proxied by the firm's *Tobin's q*[8] (Berry, 2006; Villalonga, 2004); *age* (number of years since inception); *prior international experience* (dummy taking the value of 1 if the firm is already a multinational, and 0 otherwise); *family ownership* (percentage of stock held by the founder and/or their family); and *state ownership* (dummy taking the value of 1 if the Spanish government is a shareholder, and 0 otherwise). The information required to build these variables comes from a variety of sources. We retrieved the financial data from COMPUSTAT, DATASTREAM, the Spanish Securities Market Commission, and the firms' websites. We

[6] We compiled the information used to develop our independent variable from this database (CENDOJ), which can be accessed online at http://www.poderjudicial.es/search/indexAN.jsp (Last accessed 22 September 2021).

[7] Please refer to Fernández-Méndez *et al.* (2018) for a detailed explanation of the procedure followed to develop this variable.

[8] We calculated this variable using Chung and Pruitt's formula (1994).

consulted press releases, directories (DICODI, DUNS, The Maxwell Espinosa Shareholders Directory), and the research of Vergés (1999, 2010) to create the State and family ownership variables.

At industry level, we include *industry dummies* to control for the focal industry of operation of the firm and a dummy indicating whether the firm operates in an *infrastructure* industry. We consider as infrastructure firms those operating in electricity, water, oil, gas, transportation, telecommunications, and construction (Fernández-Méndez *et al.*, 2015; García-García *et al.*, 2019).

There are also host country-level factors that can condition a firm's investment decisions. For this reason, we control for the effect of the political, regulatory, and legal environments. We measure the host country's level of governmental discretion to unilaterally change "the rules of the game" by using the reverse of Henisz's (2000) Political Constraints Index (1-POLCONV). This continuous variable ranging between 0 and 1 has been prominently featured in the literature (e.g., García-Canal and Guillén, 2008; Holburn and Zelner, 2010; Yasuda and Kotabe, 2020).

We also acknowledge the similarity between the home and host country conditions because firms may prefer to invest in foreign locations that resemble their origins (Ghemawat, 2001). We introduce a measure of cultural dispersion using a count of Ronen and Shekar's global clusters (2013). We also calculated the administrative, geographic, and economic distances between Spain and the host countries from the cross-national distance database available at the Penn Lauder CIBER website (Berry *et al.*, 2010). We include a variable named *civil code legal system* that is valued at 1 if the host country belongs to the same legal system as Spain (i.e., civil code), and 0

otherwise.[9] We obtained the information from La Porta *et al.*'s database (1998). We consulted the CIA World Fact Book to complete the information required to generate this variable.

Because major regulatory reforms in the host country may also affect the internationalization decision, we built a dummy indicating whether the host country had launched any *pro-market reforms* (Henisz *et al.*, 2005; Wallsten, 2002). We also consulted the ICRG database to add variables accounting for the host country's *lack of corruption* and the strength of its legal system (i.e., *law and order*).

The last set of host-country control variables regard economic conditions: *size of the economy* (logged GDP at constant 2000 prices); *economic growth* (GDP growth rate); *macroeconomic uncertainty;*[10] level of *host country's attractiveness* to foreign investors (total inward FDI as a percentage of GDP); and *trade openness* (ratio of trade to GDP).

Finally, we add year dummies to control for the year of the observation. We introduce a one-year lag between our dependent and remaining variables to deal with potential reverse causality problems.

Statistical method

We employ negative binomial regressions to examine whether experience in litigating with the home government affects a firm's number of entries into a particular country. The negative binomial is a generalization of the Poisson model in which the assumption of equal mean and

[9] We codified countries with a mixed legal system as civil law-based countries whenever civil law was the predominant legal system (La Porta *et al.*, 1998).
[10] To calculate this variable, we followed the procedure developed by Servén (1998) that accounts for unexpected changes in economic growth.

variance is relaxed (Cameron and Trivedi, 1998; Hausman *et al.*, 1984). We favored this method over Poisson due to overdispersion issues.

We use the Generalized Estimating Equation (GEE) with an exchangeable correlation structure and heteroscedasticity consistent standard errors to deal with the longitudinal character of the data. This method is more advantageous than random and fixed-effects specifications (Krishnan and Kozhikode, 2015). Table 1 reports the descriptive statics and the correlation matrix. There seem to be no high correlations except for the linear and quadratic specifications of the litigation success index. In addition, the mean VIFs of the models are below 6. Taken together, the values suggest that there are no multicollinearity issues.

Please insert Table 1 here

Results

Table 2 shows the main results of our study. Following Ahlstrom *et al.* (2013), we provide three specifications of the model: the first one contains the control variables; the second one adds the linear effect of our independent variable; and the last one displays the full model with both the linear and quadratic terms. In line with our hypothesis, successful litigations with the home State display an inverted U-shaped relationship with a firm's number of entries into a foreign country ($\beta = 2.42$; p-value = 0.02; $\beta = -1.88$; p-value = 0.04).

Please insert Table 2 here

Figure 3 illustrates the main findings of the study. Firms achieve the greatest propensity to invest abroad at around 0.65. After this point, the multiplicative effect decreases, although never below 1. This seems to indicate that firms that obtain favorable Supreme Court rulings at home are more prone to invest in foreign countries even if their internationalization efforts decrease after a certain threshold. This means that intermediate values of the index have the greatest impact on FDI, which supports our view that firms need to find an adequate balance between exploitation and exploration when approaching the limits of the law.

Please insert Figure 3 here

The results of our control variables also offer interesting insights. According to them, FDI increases with firm size, age, and international experience. By contrast, political capabilities deter internationalization (Fernández-Méndez *et al.*, 2018). Host country characteristics also impact internationalization. Our findings suggest that firms prefer to invest in countries with a favorable institutional environment, and in those with a shared legal system. The negative and significant coefficients of cultural dispersion, as well as the administrative and economic distances, further imply that commonalities between home and host country matter when deciding where to invest. Geographic distance is the only dimension of Ghemawat's CAGE framework (2001) that does not seem to affect the location of foreign investments.

We ran several additional regressions to test the robustness of our results and offer supplementary evidence.[11] First, we used an alternative measure of our independent variable. We

[11] We do not provide the tables due to space limitations. However, they are available from the authors on request.

changed our litigation success index to the cumulative number of Supreme Court rulings favorable to the firm. Our results hold to this modification. Second, we considered the possible moderating effect of the independence of the judiciary in the host country. It could be argued that creative compliance knowledge is more useful in countries where the judiciary is not independent of the executive and legislative branches of power. We rule out this alternative explanation of our findings. The interaction effect between the litigation success index and the host-country level of governmental discretion, which accounts for the independence of the judiciary, is not significant. We also find nonsignificant results when introducing the interaction between our independent variable and the host-country level of High Court independence, which considers whether "decisions merely reflect government wishes regardless of its sincere view of the legal record". [12]

DISCUSSION AND CONCLUSIONS

This study applies the concept of creative compliance knowledge to the IB domain to determine how successfully litigating with the home government influences internationalization. We uncover an inverted U-shaped relationship between these two variables. This suggests that firms that excel in incorporating creative compliance knowledge into their organizational routines are better prepared to deal with foreign regulations and find value-adding opportunities. Conversely, those that keep exploring the limits of the law and fighting their home government to validate their actions will forgo internationalizing.

Our research contributes to the nonmarket strategy literature, which has not paid much attention to the legal domain even though firms can interact in the legal arena to gain a competitive advantage (Bagley, 2008; Bird, 2008; Bird and Orozco, 2014; Siedel and Haapio, 2010). For this

[12] This variable is included in the V-Dem dataset: https://www.idea.int/gsod-indices/about (Last accessed 22 September 2021).

reason, litigation could be understood as the third dimension of a firm's nonmarket strategy, together with corporate political activity and corporate social responsibility (Casarin, 2015). Researchers have so far concentrated on the latter two dimensions when analyzing how multinationals navigate institutional complexity (Sun *et al.*, 2021). Meanwhile, litigation has often been relegated to the study of the consequences of corporate social irresponsibility (Barnett *et al.*, 2018; Dharwadkar *et al.*, 2021; Hadani, 2020; Koh *et al.*, 2014). One remarkable exception is the study by White *et al.* (2015), where the authors analyze how managerial perceptions of host countries' legal systems influence the political tie intensity of wholly owned foreign subsidiaries.

Furthermore, we advance the current knowledge of how the domestic institutional environment of the firm shapes its internationalization (e.g., He and Cui, 2012; Li and Ding, 2017; Nuruzzaman *et al.*, 2020). The existing literature acknowledges that firms can avoid, influence, or adapt domestic regulations. We argue that they can also try to stretch them, even if it means going to court to justify their actions. In doing so, we also add to the existing literature in strategic legal decision-making. We approach litigation from a regulatory angle, which has been largely overlooked in the strategic management literature. Scholarly attention in this area has mainly focused on patent litigation (e.g., Awate and Makhija, 2021; Cohen *et al.*, 2019; Somaya, 2003) and contracting issues (Azevedo *et al.*, 2018; Drahozal and Hylton, 2003; Orozco, 2021).

Our theoretical framework extends the knowledge-based view and organizational learning theory into the legal domain by examining the exploration-exploitation dilemma, and how firms balance the two dimensions. We consider exploration and exploitation as a continuum rather than an ambidextrous strategy (Gupta et al., 2006). The curvilinear relationship that we find between experience in litigating with the home government and FDI shows that the firms with a higher propensity to invest abroad are those that effectively balance exploration and exploitation. This

goes in line with Wang and Li (2008), who analyzed the inefficiencies of overexploration and overexploitation.

We want to highlight that the observed inverted-U shape cannot be explained on the grounds of risk-taking since firms with higher levels of successful litigations are not the ones undertaking more FDI. We claim that it reflects an attitude to find profitable opportunities in the grey areas of the law, as well as to defend the legality of such actions in court. The most important managerial implication of our paper is that firms that follow regulation blindly could be losing opportunities to innovate for their clients, both at home and abroad. Our evidence also warns managers against stretching domestic regulation indefinitely, as there seems to be a point of diminishing returns beyond which the firm's resources and attention are diverted to the detriment of other growth opportunities such as internationalization.

Despite the contributions and implications described in this section, our study also has limitations that offer interesting avenues for future research. One of said limitations is that we only analyze listed firms, which could constrain the generalization of our results. Future research could use alternative samples to determine whether our findings hold in other contexts, such as small- and medium-sized enterprises (SMEs). SMEs offer an interesting research setting because they are often unlisted and have more restricted political influence and financial resources to engage in litigations than larger firms.

Due to data limitations, we were unable to better measure creative compliance knowledge. However, we believe that our paper paves the way for further research using more microanalytic data that sheds more light on the process of accumulation of this knowledge. Since studies such as De Villa *et al.* (2019) and Regnér and Edman (2014) have started to unearth nonmarket responses to host-country institutions, upcoming papers could also look at creative compliance knowledge

from the perspective of litigations with foreign states. Furthermore, we only considered favorable rulings of legal disputes between firms and the home government reaching the Supreme Court. However, some cases do not reach the Supreme Court, or do not go to court altogether. Legal disputes can be resolved through alternative mechanisms, such as arbitration, mediation, and conciliation (Escartín Escudé, 2012). Examining how creative compliance knowledge is created depending on how disputes are resolved offers another promising research opportunity.

It would also be important to extend the literature on law and business ethics (e.g., Bagley et al., 2010; Bird, 2018; Michael, 2006) to discuss the ethical implications of using creative compliance knowledge to advance the interests of firms. Corporate political initiatives are often labeled as the "dark side of nonmarket strategies" because they aim to influence the government. However, there is a lack of research that examines whether legal strategies can also be part of said dark side depending on their objectives.

Finally, and related to the above point, we analyze the legal dimension of the firms' nonmarket strategy in isolation. Prior studies have called for a more explicit connection between corporate political activity and corporate social responsibility (Mellahi *et al.*, 2016; Sun *et al.*, 2021). We broaden this call to study the interdependencies between the legal dimension of the nonmarket strategy and the remaining two. Although recent papers have linked corporate political activity and corporate social responsibility more clearly (e.g., den Hond *et al.*, 2014; Liedong *et al.*, 2017; van den Broeck, 2021), there is still a major disconnect in the study of these two dimensions and actions in the legal domain. Our findings suggest that firms' homegrown compliance knowledge shapes FDI efforts. Future research might build on them to examine the combined effect of the three legs of nonmarket strategy (i.e., political, social, and legal) on foreign

investments. The joint study of these three dimensions would aid academics and managers in further disentangling their impact on internationalization.

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Table 1.

Descriptive statistics and correlations

		Mean	Std. Dev.	Min	Max	1	2	3	4	5	6	7	8	9	10	11
1	Firm entries-country-year	0.02	0.18	0.00	7.00	1										
2	Litigation success index	0.04	0.11	0.00	1.00	0.13	1									
3	Litigation success index^2	0.01	0.08	0.00	1.00	0.10	0.91	1								
4	Political capabilities	0.05	0.04	-0.04	0.19	0.08	0.36	0.23	1							
5	Firm size	6.72	2.15	1.75	13.72	0.11	0.57	0.38	0.58	1						
6	Tobin's q	1.89	2.34	-4.20	26.87	-0.02	-0.07	-0.03	-0.06	-0.10	1					
7	Firm age	70.89	40.68	15.00	233.00	0.04	0.16	0.09	0.42	0.35	0.00	1				
8	International experience	0.67	0.47	0.00	1.00	0.07	0.22	0.13	0.14	0.40	-0.13	0.22	1			
9	Family ownership	7.24	17.11	0.00	92.60	0.00	-0.06	-0.06	-0.35	-0.12	-0.08	-0.21	0.09	1		
10	State ownership	0.05	0.22	0.00	1.00	0.01	0.02	-0.01	0.51	0.20	-0.07	-0.02	-0.05	-0.10	1	
11	Infrastructure industry	0.23	0.42	0.00	1.00	0.09	0.36	0.24	0.60	0.47	-0.13	0.11	0.13	0.06	0.21	1
12	Governmental discretion	0.45	0.29	0.10	1.00	-0.03	0.00	0.00	-0.02	0.01	0.00	0.00	-0.02	-0.01	0.00	0.01
13	Cultural dispersion	5.26	2.89	1.00	11.00	-0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
14	Administrative distance	13.41	19.04	0.04	121.42	-0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00
15	Geographic distance	5826.53	3917.78	346.84	19836.65	0.01	0.00	0.00	0.00	0.00	0.00	0.00	-0.01	0.00	0.00	0.00
16	Economic distance	4.56	6.25	0.01	81.81	-0.03	0.05	0.04	-0.01	0.04	-0.01	0.03	0.06	0.00	-0.04	0.00
17	Civil code legal system	0.66	0.48	0.00	1.00	0.03	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
18	Pro-market reforms	0.63	0.48	0.00	1.00	0.06	0.06	0.05	-0.01	0.03	-0.02	0.03	0.10	0.02	-0.07	-0.01
19	Lack of corruption	3.37	1.37	0.00	6.00	-0.01	-0.06	-0.05	0.01	-0.05	0.02	-0.04	-0.09	-0.01	0.07	0.00
20	Law and order	3.99	1.48	0.00	6.00	0.01	0.00	0.00	0.03	-0.02	0.01	-0.01	0.01	0.01	0.00	-0.01
21	Size of the economy	24.59	1.91	21.12	30.09	0.10	0.02	0.02	0.00	0.01	0.00	0.01	0.02	0.00	-0.01	0.00
22	Economic growth	3.84	4.03	-24.70	22.70	0.00	0.05	0.05	0.02	0.04	0.00	0.03	0.07	0.00	-0.04	-0.01
23	Macroeconomic uncertainty	-7.23	1.14	-12.25	-1.44	-0.01	-0.03	-0.03	0.00	-0.02	0.01	-0.02	-0.05	-0.01	0.03	0.00
24	Host country's attractiveness	6.53	34.02	-15.03	564.92	-0.01	0.02	0.01	-0.01	0.01	-0.01	0.01	0.03	0.01	-0.02	0.00
25	Trade openness	76.55	49.96	10.83	437.39	-0.05	0.04	0.04	-0.01	0.03	-0.01	0.02	0.06	0.01	-0.04	0.00

Table 1 (contd.).

		Mean	Std. Dev.	Min	Max	12	13	14	15	16	17	18	19	20	21	22	23	24	25
12	Governmental discretion	0.45	0.29	0.10	1.00	1													
13	Cultural dispersion	5.26	2.89	1.00	11.00	-0.05	1												
14	Administrative distance	13.41	19.04	0.04	121.42	-0.11	0.03	1											
15	Geographic distance	5826.53	3917.78	346.84	19836.65	0.05	0.20	-0.14	1										
16	Economic distance	4.56	6.25	0.01	81.81	-0.02	0.20	-0.05	0.03	1									
17	Civil code legal system	0.66	0.48	0.00	1.00	0.03	-0.49	-0.24	-0.19	-0.07	1								
18	Pro-market reforms	0.63	0.48	0.00	1.00	-0.04	-0.13	-0.16	0.36	-0.04	-0.03	1							
19	Lack of corruption	3.37	1.37	0.00	6.00	-0.54	0.20	0.29	-0.11	0.04	-0.22	-0.14	1						
20	Law and order	3.99	1.48	0.00	6.00	-0.59	0.17	0.21	-0.22	0.11	-0.21	-0.04	0.66	1					
21	Size of the economy	24.59	1.91	21.12	30.09	-0.35	0.24	-0.04	0.07	-0.03	-0.18	0.30	0.32	0.40	1				
22	Economic growth	3.84	4.03	-24.70	22.70	0.11	0.00	-0.06	0.03	0.14	-0.05	0.14	-0.18	0.00	-0.09	1			
23	Macroeconomic uncertainty	-7.23	1.14	-12.25	-1.44	0.20	-0.15	0.03	0.03	0.08	0.13	-0.12	-0.21	-0.19	-0.31	0.04	1		
24	Host country's attractiveness	6.53	34.02	-15.03	564.92	-0.09	0.05	-0.07	-0.11	0.44	0.06	-0.11	0.12	0.14	-0.05	0.06	0.00	1	
25	Trade openness	76.55	49.96	10.83	437.39	-0.10	0.03	-0.06	-0.14	0.78	-0.04	0.01	0.09	0.19	-0.21	0.16	0.06	0.4	1

Table 2.

GEE negative binomial regressions predicting a firm's number of entries in a foreign country

	Model I		Model II		Model III	
	Coeff.	p-val	Coeff.	p-val	Coeff.	p-val
Litigation success index			0.93†	0.07	2.42*	0.02
Litigation success index^2					-1.88*	0.04
Political capabilities	-6.83	0.12	-10.73*	0.04	-10.45*	0.04
Firm size	0.00	0.11	0.00†	0.06	0.00*	0.04
Tobin's q	-0.06	0.24	-0.07	0.18	-0.07	0.19
Firm age	0.49***	0.00	0.45***	0.00	0.42***	0.00
International experience	1.72***	0.00	1.80***	0.00	1.79***	0.00
Family ownership	-0.00	0.46	-0.01	0.28	-0.01	0.30
State ownership	0.28	0.46	0.64	0.17	0.59	0.20
Infrastructure industry	-0.17	0.64	0.09	0.84	0.15	0.72
Governmental discretion	-0.88***	0.00	-0.88***	0.00	-0.89***	0.00
Cultural dispersion	-0.16***	0.00	-0.16***	0.00	-0.15***	0.00
Administrative distance	-0.04*	0.01	-0.04*	0.01	-0.04*	0.01
Geographic distance	-0.00	0.52	-0.00	0.52	-0.00	0.53
Economic distance	-0.11***	0.00	-0.11***	0.00	-0.11***	0.00
Civil code legal system	0.45***	0.00	0.45***	0.00	0.45***	0.00
Pro-market reforms	0.80***	0.00	0.80***	0.00	0.79***	0.00
Lack of corruption	0.01	0.83	0.01	0.81	0.01	0.81
Law and order	-0.12†	0.06	-0.13†	0.05	-0.13†	0.05
Size of the economy	0.58***	0.00	0.58***	0.00	0.58***	0.00
Economic growth	0.05***	0.00	0.05***	0.00	0.05***	0.00
Macroeconomic uncertainty	0.21***	0.00	0.21***	0.00	0.21***	0.00
Host country's attractiveness	0.01***	0.00	0.01***	0.00	0.01***	0.00
Trade openness	-0.01*	0.01	-0.01*	0.01	-0.01*	0.01
Industry dummies	Included		Included		Included	
Year dummies	Included		Included		Included	
Constant	-20.35***	0.00	-19.98***	0.00	-20.11***	0.00
Observations	77,013		77,013		77,013	
Number of firms	99		99		99	

Significance levels: ***p<0.001, ** p<0.01, * p<0.05, † p <0.10.

Figure 1.

Responses to domestic regulation and their associated knowledge and capabilities.

ATTITUDE	COMPLIANCE	Playing by the rules	Changing the rules
	Proactive	**Stretch** *Creative compliance knowledge/capabilities*	**Influence** *Political knowledge/capabilities*
	Reactive	**Adapt** *Institutional-adaptation knowledge/capabilities*	**Avoid** *No further knowledge/capabilities*

Figure 2. Firms' stance on grey areas and internationalization decisions.

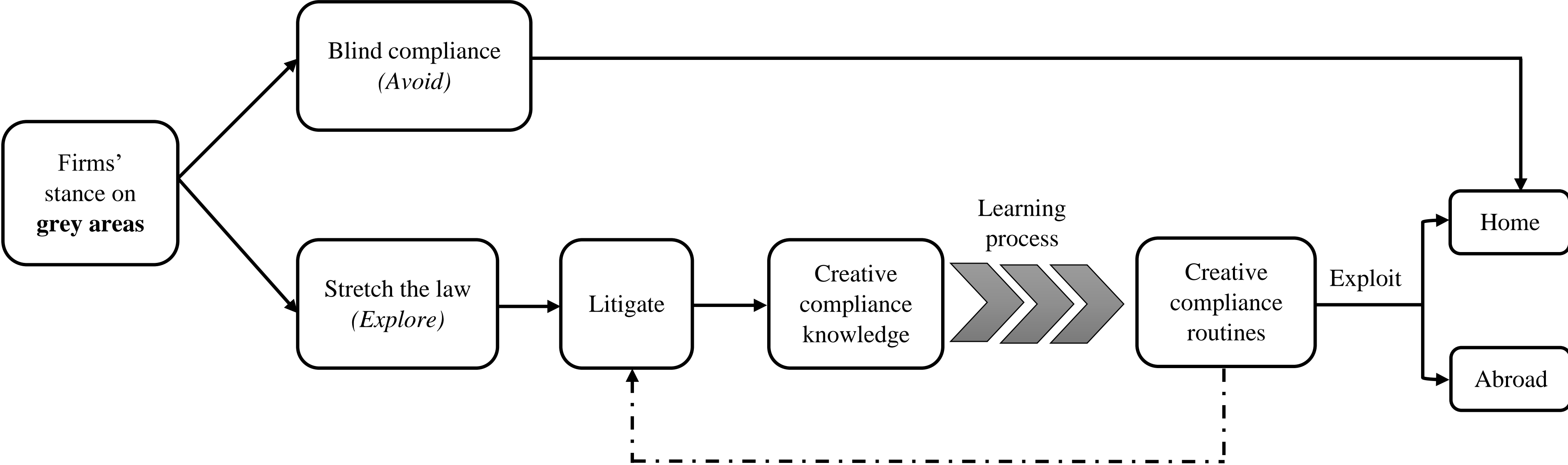

Figure 3.

Inverted U-shaped relationship between litigation success and propensity to invest in foreign countries.