

Dividend Policy with Controlling Shareholders

Law Working Paper N° 250/2014

March 2014

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ECGI Working Paper Series in Law

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We thank participants in the Financial Regulation and Comparative Corporate Governance conference held by the Cegla Center at Tel Aviv University, January 2014.

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Abstract

This Article investigates the determinants of dividend policy in firms with concentrated ownership structure. A review of the empirical literature shows that dividend payout ratios are lower in firms with controlling shareholders. We explain this finding as a consequence of the legal rules governing cash distributions, which leave the dividend decision in the hands of the firm insiders, and the lack of monitoring mechanisms for checking the power of controlling shareholders. The analysis of the empirical evidence on dividend policy points out to the existence of an unresolved agency conflict between controlling shareholders and outside investors. We conclude that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

Keywords: Corporate Governance, Ownership Structure, Corporation Law, Controlling Shareholders, Minority Expropriation, Payout Policy, Dividends

JEL Classifications: G32, G34, G35, K22

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Abstract: *This Article investigates the determinants of dividend policy in firms with concentrated ownership structure. A review of the empirical literature shows that dividend payout ratios are lower in firms with controlling shareholders. We explain this finding as a consequence of the legal rules governing cash distributions, which leave the dividend decision in the hands of the firm insiders, and the lack of monitoring mechanisms for checking the power of controlling shareholders. The analysis of the empirical evidence on dividend policy points out to the existence of an unresolved agency conflict between controlling shareholders and outside investors. We conclude that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.*

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Introduction

In this Article we review the literature that studies the determination of dividend policy in firms with concentrated ownership structures. Most of the literature on dividend policy studies the design of an optimal payout policy when managers determine the reinvestment of the shareholders' money. However, in firms with concentrated ownership structures, the large shareholders will play a key role in the determination of dividend policy. And this role is not yet well understood.

We start by discussing the effectiveness of dividend policy to reduce agency conflicts inside the firm by forcing the distribution of free cash-flows. Company insiders have incentives to retain free cash-flows inside the firm, where they can make use of them to generate private benefits for themselves at the expense of outside investors. And this problem will appear both in companies with dispersed ownership structures, where the main agency problem is between the manager and the shareholders, and in companies with concentrated ownership structures, where the main agency problem is between the controlling shareholders and the minority shareholders. The financial literature makes a strong case of the usefulness of a generous dividend policy as a means to reduce this agency conflict. However it leaves unexplained the issue of why will the powerful insiders choose to give back the money and renounce their private benefits. In this paper we argue that dividend policy will only serve to distribute free cash-flows either if the outsiders have real power in its design or if there are complementary corporate governance arrangements that discipline and change the incentives of the insiders.

A careful analysis of the legal rules governing cash distributions leads us to conclude that the law grants the control of dividend policy to the powerful insiders with weak protection for the interests of outside shareholders in this regard. Moreover, when we turn to the relationship between dividend policy and other corporate governance mechanisms, we find that while external and internal monitoring give managers incentives to pay higher dividends, this is not the case for controlling shareholders. The empirical evidence is clearly

consistent with this argument. When we review the literature on dividend policy we find overwhelming evidence that firms with controlling shareholders have lower payout ratios, and that these ratios are positively correlated to the quality of corporate governance.

Our main conclusion is that in firms with dispersed ownership structures, although dividend policy is unlikely to reach the first best, managers are subject to the pressure of different control mechanisms that induce them to select payout policies that increase shareholders value. However, the lack of control mechanisms to discipline controlling shareholders allows them to select dividend policies that damage minority shareholders and hinder the growth opportunities of firms with concentrated ownership structures.

There is fundamental conflict of interest between the controlling insiders and the outside investors with respect to the preferred dividend policy, and the empirical evidence shows that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

This article proceeds as follows. Part I reviews the theory on dividend policy, and particularly its role as a tool to reduce the agency cost of free cash-flows. Part II examines the legal determinants of dividend policy and finds that control over dividend policy is mainly awarded to the corporate insiders. Then Part III discusses the role of alternative corporate governance mechanisms to force insiders to pay out free cash-flows, explaining the differences in the functioning of market and internal monitoring in firms with dispersed and concentrated ownership. Finally, Part IV shows that all the empirical evidence on dividend policy points out to the existence of an unresolved agency conflict between controlling shareholders and outside investors. We conclude that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

I. Why Are Dividends Important?

Dividends are a central piece in corporate finance because equity investors receive their payoffs as dividends. The market value of a share is the discounted value of the expected cash-flows in the form of future dividends that the owner is entitled to receive. However these dividends are uncertain. Every year there will have to be a decision on which percentage of net income is reinvested in the firm and which percentage is paid out as a dividend. Reinvesting income results in lower current cash-flows, but in the expectation of higher future cash-flows. Therefore dividend policy is a key determinant of equity value and firm value.

As a matter of fact, dividend policy has been an area of intense research in corporate finance ever since the publication of the original Merton Miller and Franco Modigliani ¹(1961) irrelevance propositions. They proved that dividend policy does not affect neither equity nor firm value (i.e. dividend policy is irrelevant) as long as (i) the firm operates in perfect capital markets and (ii) operating cash-flows are not affected by financial choices. If these two conditions hold, investors are indifferent as to whether profits are distributed or withheld within the corporation. This is a direct consequence of the two assumptions of the model. At the aggregate level, these assumptions guarantee that the investment opportunities of the firm and its overall value do not depend on the availability of retained earnings as a source of funding. Investments can be funded through the issuance of equity or debt at exactly the same cost. And, at the individual level, each shareholder can sell stock at no cost to create his preferred "homemade" dividend so as to fit his investment and consumption choices period by period. However, since neither of the two conditions holds in practice, dividend policy is an important determinant of firm value.

But, when we consider more realistic conditions, there are many factors that have to be taken into account in the design of the dividend policy. At the aggregate level, issuance costs, asymmetric information and agency conflicts make security issuance a costly process and imply that investment opportunities depend on the availability of retained earnings. At the individual level personal and corporate taxes and trading costs make homemade

¹ Franco Modigliani and Merton H. Miller, *Dividend Policy, Growth, and the Valuation of Shares* 34 (4) THE JOURNAL OF BUSINESS, 411 (1961).

dividends a poor substitute for actual dividends. The question that the finance literature has tried to answer since Modigliani and Miller is whether it is possible to establish an optimal dividend policy in this complex environment.

At the empirical level there exists an ample literature that studies which factors are better predictors of firms' observed dividend policy and how does dividend policy impact firm value. Early empirical evidence provided by John Litner (1956)² showed that dividend policy is considered very important by managers, that they alter the dividend payout ratio so as to smooth dividends and make them less volatile than earnings per share, and that managers are very reluctant to cut dividends. Moreover, Franklin Allen and Roni Michaely (2003)³ document that announcements of dividends initiations and increases are followed by increases in market value, while announcements of dividend reductions and omissions are negatively received by the market. Also, Eugene Fama and Kenneth French (2001)⁴, Suman Banerjee, Vladimir Gatchev, Paul Spindt (2007)⁵ study the determinants of dividend policy using very long time series for US firms and find that the firms that have higher dividend payout ratios are usually the larger, older and the more profitable ones but with fewer growing opportunities. Henry DeAngelo, Linda DeAngelo and Douglas J. Skinner (2004)⁶ and William W. Bratton (2005)⁷ document the relative use of dividends and share repurchases as alternative ways to distribute cash flows to the shareholders considering their different tax treatment and a reduction over time in the propensity of firms to pay dividends.

Interestingly, these empirical facts are to some extent consistent with the predictions of several alternative theoretical models that determine which is the

² John Litner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 (2) THE AMERICAN ECONOMIC REVIEW 97 (1956).

³ Franklin Allen and Roni Michaely, Chapter 7: *Payout Policy*, in G. Constantinides, M. G. Harris and R. Stutz (ed.), *Handbook of the Economics of Finance*. North Holland: Elsevier (2003).

⁴ Eugene Fama and Kenneth French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 JOURNAL OF FINANCIAL ECONOMICS 3 (2001).

⁵ Suman Banerjee, Vladimir Gatchev, Paul Spindt, 42(2), *Stock Market Liquidity and Firm Dividend*. JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS, 369-397, (2007).

⁶ Henry DeAngelo, Linda DeAngelo and Douglas J. Skinner, *Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings*, 72 JOURNAL OF FINANCIAL ECONOMICS, 425 (2004).

⁷ On agency costs explanation, see William W. Bratton, *The New Dividend Puzzle*, 93 Geo. L.J. 845 (2005)

optimal dividend policy when one introduces different market imperfections and conflicts of interest to modify the Modigliani and Miller Theorem⁸.

The first explanations had to do with taxes and trading costs that generate heterogeneous dividend clienteles, the so called “*dividend clientele*” or “*catering theory of dividend policy*”. Depending on the different tax rates and transaction costs they face when buying and selling securities, different groups of investors will have preferences for different dividend policies, and firms will position themselves to cater to one of these clienteles. According to this theory, at the aggregate level, we will observe higher payout ratios at times when the price of the shares of firms with high payout ratios are high relative to those of firms that pay no dividends or have low payout ratios. Malcom Baker and Jeffrey Wurgler (2004a, b)⁹ find that the number of dividend initiations and omissions for US firms are positively related to the so called “dividend premium”, the difference between the market-to-book ratios of dividend payers and non-payers in a given year. But their findings have not been confirmed by subsequent research. In particular Danid J. Denis and Igor Osobov (2008)¹⁰, using data from several countries, show that there are not enough switches to justify a significant impact of tax clienteles on the determination of dividend policies. Moreover Henry DeAngelo, Linda DeAngelo and Douglas J. Skinner (2004)¹¹ point out that this theory is inconsistent with the repurchase puzzle, because despite their tax advantages share repurchases have not made dividends disappear. Finally this theory cannot explain why dividends are concentrated among large, old, profitable firms.

⁸ DeAngelo, DeAngelo and Skinner (2009), DeAngelo and DeAngelo (2006), and Allen and Michaely (2003) provide excellent surveys of the literature on dividend policy. DeAngelo, H., DeAngelo, L., *The Irrelevance of the MM Dividend Irrelevance Theorem*, 79, JOURNAL OF FINANCIAL ECONOMICS 293-315, (2006). Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, Douglas J., *Corporate Payout Policy* (May 7, 2009). Vol. 3, Nos. 2-3, Foundations and Trends in Finance, pp. 95-287, (2008). Allen, Franklin, and Roni Michaely, 2003, *Payout Policy*, in North-Holland Handbook of Economics edited by George Constantinides, Milton Harris, and Rene Stulz; North-Holland.

⁹ Malcom Baker and Jeffrey Wurgler, *A Catering Theory of Dividends*, vol. LIX-3 JOURNAL OF FINANCE, p. 1125, (2004). Malcom Baker and Jeffrey Wurgler, *Appearing and Disappearing Dividends: The Link to Catering Incentives*, 73 JOURNAL OF FINANCIAL ECONOMICS, 271–288, (2004).

¹⁰ Danid J. Denis and Igor Osobov, *Why Do Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy*, 89 JOURNAL OF FINANCIAL ECONOMICS , 62, (2008).

¹¹ Supra note 6.

The introduction of asymmetric information into the picture gives rise to the “*dividend signaling theory*”. Suddipto Bhattacharia (1979)¹², Kose John and Joseph Williams¹³ (1985) and Merton Miller and Kevin Rock¹⁴ (1985) developed theory models where some firms are undervalued because managers have positive information that they cannot communicate to the market investors in a credible way. In these models dividends are costly and inefficient, but managers of firms that have good news to communicate to the market use them to prove that, unlike less worthy firms, they can afford to burn money. The main prediction of these theory is that the market will react to dividend announcements exactly as it does, with announcements of dividends increases and initiations (decreases and omissions) being perceived as good (bad) news and that managers will be reluctant to cut dividends.

However, there are important problems with this theory. The first problem is that the signaling theory is inconsistent with the fact that dividends are concentrated among the larger, older, more profitable firms, which are the ones that suffer less asymmetric information problems. The second problem is that if dividends are signals, they seem to be quite inefficient signals, because there is a post-announcement drift for 3 years after announcement (as reported by Roni Michaely, Richard H. Thaler, Kent L. Womack 1995)¹⁵. Therefore the market takes three years to update all the positive or negative information conveyed by the announcement of the dividend change. The third problem is that, after the announcement, firm performance does not change in the expected way. In particular Gustavo Grullon, Roni Michaely and Bhaskaran Swaminathan (2002)¹⁶ show that return on assets increases (decreases) years before dividend increases (decreases) but it does not increase (decrease) after dividend increases (decreases).

¹² Suddipto Bhattacharya, *Imperfect Information, Dividend Policy, and "The Bird in the Hand" Fallacy*, THE BELL JOURNAL OF ECONOMICS, Vol. 10-1 (Spring), pp. 259-270, (1979)

¹³ Kose John, and Joseph Williams, *Dividends, Dilution, and Taxes: A Signaling Equilibrium*, 40 (4) JOURNAL OF FINANCE, 1053 (1985)

¹⁴ Merton Miller and Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 (4) JOURNAL OF FINANCE, 1031 (1985).

¹⁵ Roni Michaely, Richard H. Thaler, Kent L. Womack, *Price Reactions to Dividend Initiations and Omissions*, 38 JOURNAL OF FINANCE, 1597-1606, (1995)

¹⁶ Gustavo Grullon, Roni Michaely and Bhaskaran Swaminathan, *Are Dividend Changes a Sign of Firm Maturity?*, THE JOURNAL OF BUSINESS p. 387-424 (2002).

Neither the catering nor the signaling theory of dividends allow for conflicts of interest and agency costs, since they both assume that the company insiders are following an investment and financial policy aimed at maximizing equity value. However, managers will follow their own agenda and their preferred investment policies need not coincide with the policies that would maximize equity value. Jeremy Stein (2003)¹⁷ reviews systematically the different costs generated by the agency problem between managers and shareholders, and shows that managers will generally bias investment policy to obtain private benefits, reduce risk and favor short-term over long-term projects. The recognition of the conflict of interest between the insiders that select the firms' investment and the outside investors, who finance those investments, gives rise to the "*agency cost over the lifecycle*" theory of dividend policy.

According to this theory dividends do not convey good news; they are good news by themselves. Frank H. Easterbrook (1984)¹⁸ and Michael C. Jensen (1986)¹⁹ argue that in this context dividends will be welcomed by the market because high dividend payout ratios imply that retained earnings will be low relative to investment opportunities. With high dividends managers will be unable to fund their suboptimal investment projects with free cash-flows and will be forced to issue either debt or equity if they want to raise money for investment. Therefore, although issuing securities is a costly process that could be avoided by retaining earnings, it has the advantage of allowing outside investors to monitor investment policy and reduce agency conflicts.

The main prediction from this theory is that the optimal dividend policy forces firms with agency problems to distribute their free cash-flows as dividends. Moreover, dividend policy is expected to evolve over the life cycle of the firm, driven by the investment opportunity set and the need to distribute the firm's

17 Jeremy Stein, *Agency, Information and Corporate Investment*, in Handbook of the Economics of Finance, George Constantinides, Harris, Milt, and Stulz, Rene. Amsterdam: North Holland.p.109-163, (2003).

¹⁸ Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AMERICAN ECONOMIC REVIEW, 650-59, (1984).

¹⁹ Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 (2) AMERICAN ECONOMIC REVIEW, 323, (1986)

free cash-flow. Young firms with low retained earnings and highly profitable investment opportunities do not have free cash-flows and do not need to pay dividends to reduce agency problems. Mature firms with high retained earnings and poor investment opportunities generate free cash-flows that can be wasted by the insiders and should pay high dividends.

This theory fits very well the accumulated empirical evidence. It explains why larger, older and more profitable firms have higher payout ratios, since they are the ones that will have free cash-flows. It explains the positive (negative) market reaction to dividend increases and initiations (decreases and omissions); since they reduce (increase) the discretion of managers. It also explains the post-announcement drift, since in the medium term market values will increase when better investment decisions are made. It is also consistent with the changes in ROA observed by Gustavo Grullon, Roni Michaely and Bhaskaran Swaminathan (2002)²⁰ implying that dividends should increase (decrease) when profitability has been high (low). Finally the results of Malcom Baker and Jeffrey Wurgler (2004b)²¹ in support of the catering hypothesis can also be interpreted as consistent with the agency theory of dividends. They find that non-payers are more likely to start paying dividends when the market-to-book ratios of dividend payers are high relative to those of non-payers. But market-to-book ratios are good proxies for growth opportunities. According to agency theory, non-payers should start paying when their growth opportunities deteriorate, i.e. when the market-to-book ratio of payers to non-payers is high.

Moreover, the most recent empirical evidence is also consistent with this view. Linda DeAngelo, Douglas J. DeAngelo, and Rene M. Stulz (2006)²² show that propensity to pay dividends is positively related to the ratio of retained earnings to total equity, which proxies for the firm's life-cycle stage. Danid J. Denis and Igor Osobov (2008)²³ find that that the likelihood of paying dividends is strongly associated with the ratio of retained earnings to total equity, and that the fraction of firms that pay dividends is high when firms' equity consists primarily

²⁰ *Supra* note 16.

²¹ *Supra* note 9.

²² Linda DeAngelo, Douglas J. DeAngelo and Rene M. Stulz, *Dividend Policy and the Earned/Contributed Capital Mix: A Test of the Lifecycle Theory*, 81 JOURNAL OF FINANCIAL ECONOMICS, 227-254, (2006).

²³ Danid J. Denis and Igor Osobov, *supra* note 10.

of retained earnings and is low when retained earnings are negative. Finally, Yakov Amihud and Stoyan Stoyanov (2013)²⁴ present a direct test of the usefulness of dividend policy as a toll to reduce agency problems between managers and shareholders. Using a sample of US firms for the period 1990 through 2006, they find that the stock market price reaction to announcements of dividend increases and initiations is stronger for firms with weaker governance, where agency problems are more likely.

Summing up all we find that the current view on dividend policy that arises from the study of the financial literature is that optimal dividend policy is mainly determined by the need to reduce the agency problems generated by free cash-flows that appear over the life cycle of the firm. But one of the issues that this theory leaves unresolved is why would the company insiders voluntarily select a dividend policy that reduces their discretion and prevents them from pursuing their preferred investment strategy. For this reason we need to investigate the rules governing the distribution of dividends and constraining the dividend policies of the insiders. In the next section we will study the legal restrictions placed on the insiders for the determination of the dividend policy and we will discuss whether these rules really protect outside investors and encourage the distribution of free cash-flows.

II. The Legal Determinants Of Corporate Distributions

In the traditional legal conception, there are two key elements in the ownership of a firm: the right to control the firm and the right to receive the firm's net earnings. The receipt of a dividend is the means way by which the shareholder gets the return of his investment in a company. For this reason, dividend payout was categorized in early times by legal scholars, as one of the "rights" of the shareholders, in the understanding that the status as shareholders determines an array of demands -from the corporation- and duties -to the corporation-. This general conception changes across organizations, being stronger in partnerships and closely held corporations. Nevertheless, in public companies,

²⁴ Yakov Amihud and Stoyan Stoyanov, *Corporate Governance and Dividend Policy: An Empirical Investigation of the Free Cash Flow Hypothesis*, Mimeo (2013)

shareholders have no right to force the distribution of a dividend. It is a discretionary decision of the insiders that control the firm whether to distribute the earnings as a dividend or to reinvest them so as to generate future earnings. In practice, the decision on whether the business surplus is being distributed or not, and the amount distributed, is taken by the directors on the board -in those corporations with dispersed ownership structure- or by the controlling shareholders through the general meeting -typically in the case of corporations with a concentrated ownership structure-²⁵. So we see that the determination of the dividend policy is in practice left to the firm insiders. But there are some rules that limit their discretion and are aimed at protecting the outside investors.

So why is control of such a critical decision awarded to the insiders? Asymmetric information and conflicts of interest between insiders and outsiders are at the bottom of the matter. Important business decisions are under the discretion of the party that holds control in a corporation. Similarly to other decisions - regarding the business strategy or investment choices-, the distribution policy is discretionary because it requires information and expertise that only insiders have, but the decision will be distorted when there are conflict of interest between the expert insider making the decision and the outside investors. *For dividend policy the conflict of interest appears when managers or controlling shareholders choose to retain profits instead of distributing them, in order to pursue their own interests (investments in self-dealing projects or empire building) and to avoid discipline (financial constraints reduces agency costs).*

What is the answer of the Law to this situation? In broad terms, the business judgment rule safeguards the controllers' discretion and precludes bringing a claim against the board or the general meeting²⁶. The idea is that courts should

²⁵ For instance, in jurisdictions with controlling shareholders like Italy, Japan or Germany, the general shareholders meeting is required to approve the distribution of the company earnings. Luca Enriques, Henry Hansmann and Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class*, in *ANATOMY OF CORPORATE LAW*, 55, 74 (Oxford University Press, 2nd ed. 2009).

²⁶ Nevertheless, there are some exceptions. In the close-corporation setting lacks a market for its shares, and the correction of control power should come from the ex post judiciary scrutiny of the dividend policy. Disputes on dividend suppression is one of the cases labeled under "minority oppression". Shareholders in close corporations are more than mere investors: they invest capital, but

not second-guess controller decision about dividend policy because they are not more likely to get it right than the board or the general meeting. That is, absent fraud or gross abuse of discretion, the controllers have discretion to declare dividends or to refrain from doing so. Moreover, as far as the minority shareholder get their pro-rata share of any dividend, the decision is labeled as "fair". Again, as happens in other corporate issues that deal with managerial decisions, *the legal system is not aimed at identifying some optimal dividend policy but rather at ensuring inhibition against indiscriminate and disproportionate cash-outs to shareholders*²⁷. In other words, the question of how a particular dividend policy affects firm's value is beyond the scope of the regulation. Under this perspective, efficiency must be achieved by other means. But given the conflict of interest between insiders and outsiders, we would expect that dividend policy will be more efficient if the interests of outside investors are well protected. So we now investigate which is the degree of protection that the law offers to the outside investors under this arrangement.

A. Rules Protecting Creditors

they also expect employment and some influence in the management of the corporation. Nevertheless, majority rule and centralized management put the minority in a weak position vis-a-vis the majority shareholder, in the case they face a falling-out between them sometime in the future. The block-holder can take actions to harm the interests of the minority -for instance, firing them-, and often, the purpose of the oppression is to freeze -out the minority shareholders at an unfairly low price in the absence of the possibility to escape the abuses selling their stock in a market (Edward. B. Rock and Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation*, in CONCENTRATED CORPORATE OWNERSHIP, (Randall Morck ed., NBER/Univ. of Chicago 2000), also published in 24 J. Corp. L. 913 (1999) and 42 CORP. PRACT. COMMENTATOR 1 (2000) . For these reasons, corporate law and courts have developed remedies at the court disposal to relief the minority shareholders: the traditional way out of this situation in most jurisdiction was the dissolution of the corporation to ensure an exit option for the oppressed shareholder, or its less drastic derivative, the buyout of the oppressed investor's shares.

²⁷ Regulation has its limitations. We cannot demand from regulation what is not in its power to ensure. Regulation cannot ensure investment efficiency and welfare in other matters as well, like self-dealing. Again, anti-self dealing regulations guarantees in the best case that there is no minority expropriation at all in every case. Then, contractual solutions are the response to implement an "efficient" rate in each case of private benefits. Maria Gutierrez and Maria I. Saez, *A Contractual Approach to Discipline Self-Dealing by Controlling Shareholders*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176072.

Most jurisdictions impose distribution restrictions in order to prevent asset dilution²⁸. The regulation prevents cash distributions to shareholders whenever the company's net assets are lower than the stated value of its capital. But in some countries (and in particular in Continental Europe) these regulations are based on accounting values, while in other countries they are based on a solvency test, so that cash cannot be distributed to the shareholders if the distribution will lead to the corporation's insolvency²⁹. In either case, it seems rational to admit that the shareholders, as the firm's residual claimants, have the right to receive the residual earnings or net profits. Nevertheless, legal rules limiting distributions are more restrictive in European countries, than in other legal environments, like the U.S.³⁰. The explanation can be found in path dependence, because traditionally European corporations have relied strongly on debt financing, so creditor protection was a top priority from a governance perspective³¹. As a matter of fact, the problem is especially pronounced in close corporations or non listed ones, because of the lack of separation between ownership and control: shareholders have incentives to divert firm's resources to their own pocket and engage in high risk projects that promise high returns but harm the debt-holders.

This approach has been standardized in Europe through the capital maintenance provisions, of mandatory nature, regulated by the Second

²⁸ For a description of these rules on distribution restrictions, Rudiger Veil, *Capital Maintenance*, in Lutter (ed), *Legal capital in Europe*, ECFR, special volume 1, Berlin, (De Gruyter, 2006).

²⁹ The restrictions vary from the accounting based profit distributions restrictions to the solvency-based model. Strong capital requirements is a German "product", that has been successfully exported to other European countries through the second Directive. About the rigidity of the system, see Andreas Cahn and David C. Donald, *COMPARATIVE COMPANY LAW*, (2010), 222-226.

³⁰ An analysis comparing both systems is done by Andreas Engert, *Life Without Legal Capital: Lessons from American Law*, in Lutter (ed), *Legal capital in Europe*, ECFR, special volume 1, Berlin, (De Gruyter, 2006), p. 646. Interestingly, Continental Europe prefers the ex ante rules-based strategy to the ex post standards strategy, and the US, in whose State corporate laws rules on creditor protection are noticeable largely by their absence and where creditors' interests are addressed through a standards-based strategy under the heading of Federal 'fraudulent transfer laws'. See also, Marcel Kahan, *Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences between European and US Approaches*, in K. Hopt and E. Wymeersch (eds.), *CAPITAL MARKETS AND COMPANY LAW* (Oxford, OUP, 2003) 145 – 149 .

³¹ The shareholder-creditor agency problem has determined and shaped company law in these jurisdictions. Shareholder-creditor conflicts have the potential to reduce the overall value of the firm's assets. Thus, legislators have introduced provisions in company law to prevent that shareholders may siphon assets out of the corporate pool in favor of themselves and at the expense of the creditors. But the mechanisms put in place to address these sort of inefficiencies vary across countries. See John Armour, *Legal Capital: An Outdated Concept?*, 7 EBOR, (2006).

Company Law Directive³². These capital maintenance provisions are creditor-oriented provisions which allow creditors to participate to some degree in control or/and net earnings. More specifically, these provisions limit cash distributions to shareholders when they may hurt creditors. They are intended to reinforce the shareholders' compromise of maintaining their investment in the firm until the debt is repaid. Interestingly these provisions do not only cover dividends but also other forms of "open" distributions, whereby assets are directly or indirectly transferred to shareholders for less than market value – including share repurchases, the giving of financial assistance by a company for the acquisition of its own shares, and extends to other "hidden" distributions such as undervalue transactions between a company and its members³³.

The most common prohibition is the prohibition to pay dividends if the dividend exceeds the difference between the book value of the company's assets and the amount of its legal capital as stated in the balance sheet (the sum of unsubscribed capital plus non-distributable reserves). Notice that legal capital is a rigid and mechanical (and even naive) approach to govern the distribution policy inside the corporation³⁴, and therefore rules which sustain this framework might not be appropriate to protect the creditors.

Rules on mandatory legal capital have been replaced in other countries by other instruments more effective at avoiding fraud against creditors, like claw-back rules in bankruptcy provisions, or wider disclosure rules to provide creditors with information on the company's financial condition, and self-help devices like

³² The critic comes from the mandatory requirement, not by choice of the firm, Wolfgang Schön, *The Future of Legal Capital*, 5 EBOR (2004) p. 438-439; John Armour, *Legal Capital: An Outdated Concept?*, 7 EBOR, (2006).

³³ In Germany and the UK, the restrictions cover not only dividends or share repurchase, but also to any transaction between the company and its shareholders that has not been dealt at arm's length, see Pierre-Henric Conac; Luca Enriques; Martin Gelter; *Constraining Dominant Shareholders' Self-dealing: The Legal Framework in France, Germany and Italy*, 4 European Company and Financial Law Review 491 (2007); Holguer Fleisher, *Disguised distributions and capital maintenance in European company Law*, in Lutter (ed), *Legal capital in Europe*, ECFR, special volume 1, 95 (De Gruyter, 2006); Ellis Ferran, *The Place for Creditors Protection on the Agenda for Modernization of Company Law in the European Union*, 3 European Company and Financial Law Review, 178, (2006).

³⁴ American commentators consider legal capital an outdated concept, STEPHEN M. BAINBRIDGE, *CORPORATE LAW AND ECONOMICS*, (2002), p. 78; 768-770; BAYLESS MANNING, *LEGAL CAPITAL*, 3rd edn. St. Paul, MN: West Publishing, 1990, p. 92.

financial covenants in debt contracts. The common view is that the creation and maintenance of share capital provisions are of little assistance for creditors³⁵. Moreover, they are ineffective to ensure better decisions regarding distribution, or to reduce conflicts of interests among shareholders.

B. Rules Protecting Outside Equity

Both the pro-rata distribution rule and the majority rule bear to reduce conflicts of interest among shareholders. The pro-rata distribution rule is premised on the idea that all shareholders are treated equal, which in this context states that they shall receive the payment on profits proportional to the amount of capital contributed to the firm, and that the majority shareholder shall not receive a disproportionate share of the company's profits. This principle works also in the event of dissolution, ensuring that the residual assets of the firm are divided pro-rata among the shareholders. The majority rule tries to limit control power by demanding that the decision to distribute profits shall be taken by all shareholders. Notice that the only limit to shareholders freedom is the rigorous regime on capital maintenance rules under the second directive in interest of firm creditors. The problem is that these two rules might be insufficient to reduce majority-minority agency costs.

1. The Equal Treatment Norm

The equal treatment norm is a fundamental norm in corporate law meant to constrain controlling shareholders' powers. Although there are differences in its implications and enforcement³⁶, most jurisdictions embrace the norm more

³⁵ Manning, *Legal Capital*, 1990. The discussion on legal capital is open in Europe, John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?*, 63 *MLR* (2000) p. 355; Luca Enriques and Jonathan Macey, *Creditors Versus Capital Formation: The Case against the European Legal Capital Rules*, 86 *Cornell LR* (2001) p. 1165; Peter O. Mülbart and Max Birke, *Legal Capital – Is There a Case against the European Legal Capital Rules?*, 3 *EBOR* (2002) p. 696; Jonathan Rickford, ed., *Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance*, 15 *EBLR* (2004) p. 919; Wolfgang Schön, *The Future of Legal Capital*, 5 *EBOR* (2004) p. 429.

³⁶ In some jurisdictions, like the civil law ones, the equal treatment norm is considered a wide ranging source of law that can trigger any shareholder action. In others, like the common law ones, it is more precise and regards particular issues, rather than a general provision. Luca Enriques, Henry Hansmann and Reinier Kraakman, *supra* note 23, at 96-97. For instance, the principle of equal treatment rules out defensive tactics commonly used in U.S takeover battles, like greenmail, poison pills, or selective self-tender.

strongly in the area of corporate distributions. The proportionality rule is a simple and useful rule to distribute the firm's earnings based on the capital investment of each shareholder in the firm, which is an objective measure.

Nevertheless, even though each shareholder's contribution to total capital is a homogeneous measure and dividends as such are subject to the pro-rata distribution rule, controlling shareholders can take advantage of their power and expropriate minority shareholders by other means, like self-dealing or excessive perks. The faculty of retaining profits inside the corporation, where they control the day-to-day business decisions, gives the majority shareholders control over those resources. In other words, the prohibition of discriminatory dividends does not prevent the controlling shareholders from distributing a lower amount of profits against the interest of the minority, and tunnel those non-distributed profits to themselves³⁷. Cash dividends go directly to the shareholders' pockets while retained profits are mere expectations of future profits and are controlled by the insiders. It is true that good anti-self dealing regulation would help to discipline the controlling shareholders to make better decisions on the distribution issue³⁸, but nevertheless they would still prefer to keep profits as cheap financing resources than submit the control power to the discipline of the markets.

2. The Majority Rule

The vote on the decision by the majority of shareholders does not discipline controlling shareholders either because of their voting power. This is an endemic limitation of the empowerment strategies in the presence of a controlling shareholder: dominant shareholders can use voice to control management at the expense of the interest of outside shareholders. In this

³⁷ For an explanation of the different ways in which insiders can extract (tunnel) wealth from firms see Vladimir A. Atanasov, Bernard S. Black and , *Self-Dealing by Corporate Insiders: Legal Constraints and Loopholes*, RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW, Chapter 22, Brett McDonnell and Claire Hill, eds., (2014).

³⁸ Some jurisdictions try to combat this problem applying the rules on dividends. Germany and UK can characterize conflicted transactions as unlawful distribution. In a sense, it pretends to work as an imperfect substitute of anti-self dealing norms under the aspects of fixed legal capital and creditor protection, the so called "disguised distributions", see note 7.

respect, the function of the shareholders meeting as a mechanism to discipline decision making powers in hands of the insiders is very much in doubt³⁹.

Nevertheless, the main advantage of holding a shareholder meeting to approve the company's accounts and the managers' dividend proposal is that it makes the decision's proceedings public. Publicity by itself can restrain the abuse of control of majority shareholders to some extent (at least in listed companies), but it is unlikely to ensure the efficiency of the decision adopted. As a matter of fact, shareholders usually receive "some" amount of profits to elude bad press and try to look good⁴⁰. This may be the reason why dividend omissions are much less likely in listed firms than in close corporations, where dividends are often omitted several years in a row. It is not surprising that publicity does the job of disciplining controlling shareholders better than other legal mechanisms, like litigation. The general meeting decision can be challenged in court to prevent the abuse of the majority, but nullity is rarely enforced. Apart from notorious cases, courts tend to estimate that, unless formal requirements are not fulfilled, the decision is valid as it serves the interest of the corporation (formally represented by the votes of the majority). As long as the corporation gives a meaningful explanation for the non-distribution decision, validity is not questionable.

The overall conclusion we reach from this analysis is that current regulation gives the insiders the power to determine the dividend policy and does not protect minority investors, because they do not have the means to force the distribution of free cash-flows. Especially in jurisdictions with concentrated ownership, the regulation of dividend policy is designed so as to deter opportunistic conduct by the shareholders that may harm creditors. But the majority-minority conflict stays untouched: in these corporations the distribution policy doesn't work as a device to check the managerial powers of the controlling shareholders.

³⁹ Maria I. Sáez and Dámaso Riano, *Corporate Governance and the Shareholders' Meeting: Voting and Litigation*, 14-3 EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 343 (2013).

⁴⁰ Interesting anecdotic evidence of this type of behavior is presented by Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, *supra* note 8.

This conclusion is discouraging. Dividend policy is an important determinant of firm value, but the optimal decision may be distorted by conflicts of interest between the informed insiders and the outside investors. We have seen that the law gives control over the dividend decision to the insiders and offers little protection to outside shareholders. Therefore we would expect dividend policy to be inefficient. Nevertheless, even if the insiders have the legal power to fix their preferred dividend policy, there may be other corporate governance factors that force them to distribute free cash-flows. Dividend policy should be understood as one of the mechanisms available to solve agency problems in the firm. But it has to be analyzed in the broader context of corporate governance⁴¹. There are several alternative control mechanisms that help outside investors control the insiders' powers. Therefore in the next section we discuss how other corporate governance arrangements interact with dividend policy.

III. Corporate Governance And Dividend Policy

According to Marco Becht, Patrick Bolton and Alisa Röell (2003)⁴² corporate governance refers to the set of policies that help shareholders control managers. This definition includes mechanisms such as leverage, takeovers, independent board members, managerial reputation, concentrated ownership stakes, contingent remuneration... and also dividend policy. An unresolved issue is which or when will these mechanisms act as substitutes or as complements with respect to dividend policy. For example Rafael La Porta,

⁴¹ If we consider the dividend policy problem in isolation, the only way to solve the conflict would be to change the regulation to put control over dividends in the hands of outsiders. Alternative ways for doing this are discussed by Zohar Goshen, *Shareholders Dividend Options*, 104 *Yale.L. J.*, 881, (1995), who proposes a extreme solution through a mandatory option mechanism.

⁴² Marco Becht, Patrick Bolton and Alisa Röell, *Corporate Governance and Control*, in: G.M. Constantinides & M. Harris & R. M. Stulz (ed.), *Handbook of the Economics of Finance*, vol. 1, chapter 1, pages 1-109 (2003).

Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (2000)⁴³ think of dividend policy as complementary to corporate governance. They study the dividend policies of listed firms in 33 countries and, in consistency with this idea they find that, in countries where shareholders rights are well protected shareholders have the power to force managers to pay dividends. However John Kose and Anzhela Knyazeva (2006)⁴⁴ and John Kose and Anzhela Knyazeva and Diana Knyazeva (2013)⁴⁵ think of dividends as a substitute for other internal corporate governance mechanism and find that in the US firms with better governance have lower payout ratios, which is consistent with the idea that they do not need to pay dividends because they can make sure that retained earnings will be used optimally because managers are afraid of low market prices. How can these seemingly contradictory results be reconciled?

We believe that the answer to this puzzle requires an understanding of the procedures for the determination of dividend policy in the firm. These procedures can be controlled by either the outside investors or by the insiders. If outsiders have control over the dividend policy, this policy will be used as a substitute when other corporate governance mechanisms fail. The reasoning is that outside investors will reduce free cash-flows by choosing a dividend policy with high payouts because, even though this is costly, they know that there are no other mechanisms that can reduce the agency conflict. But, if insiders have control over the dividend policy, this policy will be a complement that will work hand in hand with other corporate governance mechanisms. When insiders are in control of the dividend policy and overall corporate governance is weak, dividend policy will fail to reduce agency conflicts. But when insiders are in control of the dividend policy, but other corporate governance mechanisms are functioning well, and they give the insiders the right incentives, dividend policy will be designed so as to reduce free cash-flows. In particular we would expect that when insiders control dividend policy, they will use the dividend policy to

⁴³ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, *Investor Protection and Corporate Governance*, 58 JOURNAL OF FINANCIAL ECONOMICS 3–27, (2000).

⁴⁴ John Kose and Anzhela Knyazeva, *Payout Policy, Agency Conflicts, and Corporate Governance* (May 2006). Available at SSRN: <http://ssrn.com/abstract=841064> or <http://dx.doi.org/10.2139/ssrn.841064>

⁴⁵ John Kose and Anzhela Knyazeva, and Diana Knyazeva, *Governance and Payout Precommitment: Antitakeover Laws, Structure of Payouts, and the Dividend-Debt Tradeoff* (May 1, 2013). Available at SSRN: <http://ssrn.com/abstract=1101062> or <http://dx.doi.org/10.2139/ssrn.1101062>

reduce free cash-flows only if there is an incentive to do so, whether it comes from the fear of a takeover, from stock options in the remuneration packages of the executives, the pressure of independent board members, the activism of institutional investors, etc.

In the previous section we have seen that legally dividend policy is controlled by the insiders, therefore we expect that the dividend policy will reflect the overall quality of corporate governance and it will be complementary. So we now need to establish which are the alternative corporate governance mechanisms that will force managers to distribute cash-flows. We will now briefly analyze how both external and internal monitoring can align the incentives of the insiders with those of the outside investors and modify the dividend policy.

Regarding external monitoring, if the firm is retaining free cash-flows market prices will fall, and this will threaten the position of insiders. Managers will see their stock holdings decrease in value, their options expire worthless and their jobs at risk because of the possibility of hostile takeovers. These threats give them powerful incentives to alter the dividend policy and distribute free cash-flows. However these market mechanisms will be much less effective in the case of a controlling block-holder. The value of their holdings will be reduced but, the illiquidity of these large stakes and the long term horizon reduce the influence of market values.

Turning now to internal monitoring, this may be imposed by either activist investors or by the board of directors.

In firms where managers are in control, activists can improve corporate governance and force high payouts. This is consistent with the evidence on the role that activist shareholders play in corporate governance⁴⁶. For example for the US, Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas (2008)⁴⁷ find large positive abnormal stock returns to target firms when hedge funds first disclose holdings larger than 5% in their 13D filings. Target firms experience

⁴⁶ For a review of the increasing importance of institutional investors and the different role played by investment funds and hedge funds in corporate governance, see Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUMBIA LAW REVIEW, 863 (2013).

⁴⁷ Alon Brav, Wei Jiang, Frank Partnoy, and Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 (4) JOURNAL OF FINANCE, 1729-1775 (2008).

increases in payout, operating performance, and higher CEO turnover after activism. Marco Becht, Julian Franks, Collin Mayer and Stefano Rossi (2008)⁴⁸ study in detail activism by the Hermes U.K. Focus Fund (HUKFF). They report that their engagement activities are aimed either at restructuring of the operations by divesting, replacing the CEO or, more generally, at increasing cash payouts to shareholders. Interestingly when the fund's engagement objectives are achieved there are positive abnormal returns around the announcement date of the change.

But which is the role that activists investors can play in firms with controlling shareholders? During the last decade activist investors have started to acquire stakes in European companies with concentrated ownership structures but there is not yet enough empirical evidence on their role in the corporate governance of these firms. Massimo Belcredi, and Luca Enriques (2013)⁴⁹ provide some anecdotic evidence on the experience of institutional investors in Italy and they find that these funds promote initiatives aimed to curb the extraction of private benefits by dominant shareholders, with mixed success. Moreover, these activists clearly target dividend policy as an area for improvement. Matteo Erede (2009)⁵⁰, who also studies the particular case of Italy, discusses different cases in which hedge funds tried to increase dividend payouts, but in most of these cases they were unsuccessful.

Finally, an alternative internal corporate governance mechanism is the board of directors, and especially independent directors. Independents are expected to give voice to outside investors and they could force the insiders to distribute free cash-flows. Unfortunately the results on the empirical literature on the functioning of corporate boards and the role of independents are mixed and they point out to important limitations that independents will face⁵¹. Lack of

⁴⁸ Marco Becht, Julian Franks, Collin Mayer and Stefano Rossi, *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 22 REVIEW OF FINANCIAL STUDIES, 3093-3129 (2009).

⁴⁹ Massimo Belcredi, and Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* (January 31, 2014). European Corporate Governance Institute (ECGI) - Law Working Paper No. 225/2013. Available at SSRN: <http://ssrn.com/abstract=2325421> or <http://dx.doi.org/10.2139/ssrn.2325421>

⁵⁰ Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: Can Hedge Funds Activism Play Any Role in Italy?*, working paper, available at www.ssrn.com (2009).

⁵¹ Adams, Hermalin and Weisbach 2010 provide an in-depth review of the literature on boards. Adams Renee, Benjamin Hermalin and Michael S. Weisbach, *The Role of Boards of Directors in Corporate*

information, lack of incentives and even lack of real (as opposed to formal independence) have been found to reduce the effectiveness of boards in checking insiders' power.

But the effectiveness of boards is expected to be even lower in companies with controlling shareholders. Notice that, irrespectively of its composition, the board has important tools to check the power of the managers, since they are responsible for appointing the CEO, fixing his remuneration package and approving the accounts. But, when it comes to restricting the power of a controlling shareholder, the board does not even have the right tools. Listing rules and codes of best practice dictate that firms should have remuneration and audit committees composed by a majority of independent directors. But for firms with large shareholders this may not be the right approach, since the role of monitoring managers can be left to the controlling shareholders. María Gutiérrez and Maribel Sáez (2013)⁵² study this problem and argue that in firms with controlling shareholders boards will be ineffective unless the role of independents is redesigned to give them more power to protect the minority from the private interests of the block-holder.

Our conclusion so far is that insiders have the power to set dividend policy. However their power will be checked by the corporate mechanisms in place. In companies with dispersed ownership managers will face several barriers for the retention of free cash-flows. However, in companies with concentrated ownership, there are no powerful market or internal corporate governance mechanisms that can constrain the incentives of controlling shareholders to retain profits and avoid pro-rata distributions.

As we will now see in the next section this view allows us to explain most of the findings about the differences in dividend policy in firms with different corporate governance structures and in particular the striking differences in dividend policies between firms with and without controlling shareholders.

Governance: A Conceptual Framework and Survey, vol. 48(1), JOURNAL OF ECONOMIC LITERATURE pp. 58-107, (2010).

⁵² María Gutiérrez and Maribel Sáez, *Deconstructing Independent Directors*, 13 JOURNAL OF CORPORATE LAW STUDIES, 63-94, (2013)

IV. Evidence On The Dividend Policy Of Firms With Concentrated Ownership

Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner (2009)⁵³ argue that one would expect to observe differences in the payout policies of firms with controlling shareholders even in the absence of expropriation problems. This is because it will usually be more difficult for controlling shareholders to create homemade dividends than for small shareholders. As a general rule the stakes of controlling shareholders are not liquid and selling a large stake may imply a loss of control that they will try to avoid. Therefore, assuming no expropriation problems, we could expect firms with controlling shareholders to have larger payout ratios. However these preferences may change over time and also across types of large shareholders since families, governments and firms may have different preferences. For example Goergen, M., Renneboog, L. and Correia da Silva (2005)⁵⁴ finds that in Germany bank controlled firms are more likely to omit dividends and Klaus Gugler (2003)⁵⁵ finds that in Austria family controlled firms are more likely to cut dividends than state-controlled firms.

But when we consider the private benefits that controlling shareholders obtain at the expense of minority shareholders we get exactly the opposite empirical prediction. As we have already seen if controlling shareholders can use their unchecked power to extract private benefits from the minority, they are likely to have lower dividend payout ratios. This is because controlling shareholders prefer to avoid pro-rata distributions of profits, where all shareholders are treated equally. Therefore they pay lower dividends and keep retained earnings inside the corporation where they can redistribute a greater part of these earnings to themselves through tunneling, self-dealing and related party transactions. As we will see now all the empirical evidence for countries with concentrated ownership structures is consistent with this prediction.

⁵³ Harry DeAngelo, Linda DeAngelo, and Douglas J. Skinner, *supra* note 8.

⁵⁴ Goergen, M., Renneboog, L. and Correia da Silva, L.. *When do German Firms Change their Dividends?* 11(1-2), JOURNAL OF CORPORATE FINANCE pp. 375-399, (2005).

⁵⁵ Klaus Gugler, *Corporate governance, dividend payout policy, and the interrelation between dividends, R&D, and capital investment*, 27 JOURNAL OF BANKING & FINANCE 1297-1321 (2003).

The initial evidence for countries with concentrated ownership was provided by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (2000)⁵⁶ showing that in countries with weak minority protection dividend payout tends to be lower. Posterior studies at firm level confirm the idea that companies with controlling shareholders have lower payout ratios.

For example Danid J. Denis and Igor Osobov (2005)⁵⁷ also find important differences between the dividend policies of firms in Germany, France and Japan, characterized by significant ownership concentration, in contrast with firms in U.S., Canada and the UK. The larger and more profitable firms are more likely to pay dividends in all countries but when they look at growth opportunities they find that in the U.S., Canada and the UK the firms with poor growth opportunities are more likely to pay dividends, while in Germany, France and Japan the result is the opposite.

The negative relationship between block ownership and dividends is documented by Mara Faccio, Larry H. P. Lang, and Leslie Young (2001)⁵⁸ for a sample of European and Asian firms, Benjamin Maury and Anete Pajuste (2002)⁵⁹ for Finland, Marc Goergen, Luis Correia da Silva and Luc Renneboog (2004)⁶⁰ for Germany, Luc Renneboog and Grzegorz Trojanowski (2005)⁶¹ for the UK, Todd Mitton (2005)⁶² for firms in emerging markets, Kimie Harada and Pascal Nguyen (2006)⁶³ for Japan and Luciana Mancinelli and Aydin Ozkan (2006)⁶⁴ for Italy. Only Thanh Truong and Richard Heaney (2007) using a sample drawn from 37 countries find a positive association between the stake of the largest shareholder and dividend payout, but when they look at the nature of

⁵⁶ Rafael La Porta, et al, supra note 43.

⁵⁷ Danid J. Denis and Igor Osobov, supra note 10.

⁵⁸ Mara Faccio, Larry H. P. Lang, and Leslie Young, *Dividends and Expropriation*, AMERICAN ECONOMIC REVIEW 91, 54–78 (2001).

⁵⁹ Benjamin Maury and Anete Pajuste, *Controlling Shareholders, Agency Problems, and Dividend Policy in Finland*, FINNISH JOURNAL OF BUSINESS ECONOMICS, 51, 15-45.

⁶⁰ Marc Goergen, Luis Correia da Silva and Luc Renneboog, supra note 54.

⁶¹ Luc Renneboog and Grzegorz Trojanowski, *Control Structures and Payout Policy*, Discussion Paper 2005-014, Tilburg University, Tilburg Law and Economic Center.

⁶² Todd Mitton, *Corporate Governance and Dividend Policy in Emerging Markets*, 5 EMERGING MARKETS REVIEW, pp. 409-426, (2004)

⁶³ Kimie Harada and Pascal Nguyen, *Dividend Change Context and Signaling Efficiency in Japan*, vol. 13(5), PACIFIC-BASIN FINANCE JOURNAL, 504-522, (2005).

⁶⁴ Luciana Mancinelli and Aydin Ozkan, *Ownership Structure and Dividend Policy: Evidence from Italian Firms*, 12 THE EUROPEAN JOURNAL OF FINANCE, 265-282, (2006).

the largest shareholder they find that the magnitude of dividend payout tends to be smaller when the largest shareholder is an insider.⁶⁵

A problem that may appear in these empirical studies is omitted variables, since low dividend payouts and concentrated ownership may be simultaneously caused by other firm characteristics and not linked by causality. In order to identify the causality link Klaus Gugler, B. Burcin Yurtoglu (2003)⁶⁶ study market reactions to announcements of dividend decreases in Germany and find that the negative effects are larger for companies where corporate insiders have more power. Rongrong Zhang (2005)⁶⁷ finds the same result for a large sample of firms from over 20 countries. Also investigating causality Steen Thomsen (2005)⁶⁸ finds that increases in block ownership are correlated with posterior decreases in dividend payouts.

A few studies have gone further in investigating not only if ownership concentration has a negative impact on dividends but also if the structure of concentrated ownership matters. According to our theory, since controlling shareholders have the power to determine the dividend policy, they will only use dividend policy to give back free-cash flows if there are other corporate governance mechanisms that are constraining their power.

Some studies have analyzed the effect of other large shareholders, beside the largest shareholder on dividend policy. Patrick Bolton and Ernst-Ludwig Von Thadden (1998)⁶⁹ and Marco Pagano and Alisa Röell (1998)⁷⁰ develop theoretical models where other large shareholders have a positive impact because they monitor the controlling shareholder. But there are also cases where several shareholders do share control. The impact on corporate

65 Thanh Truong and Richard Heaney, *Largest Shareholder and Dividend Policy Around the World*, 47-5 QUARTERLY REVIEW OF ECONOMICS AND FINANCE, 667-687, (2007).

66 Klaus Gugler, B. Burcin Yurtoglu, *Corporate Governance and Dividend Pay-Out Policy in Germany* EUROPEAN ECONOMIC REVIEW 47, 731 – 758(2003)

67 Rongrong Zhang, *The Effects of Firm- and Country-level Governance Mechanisms on Dividend Policy, Cash Holdings, and Firm Value: A Cross-country Study* (January 2005). Available at SSRN: <http://ssrn.com/abstract=652090> or <http://dx.doi.org/10.2139/ssrn.652090>

68 Steen Thomsen, *Conflicts of Interest or Aligned Incentives? Blockholder Ownership, Dividends and Firm Value in the US and the EU*, EUROPEAN BUSINESS ORGANIZATION LAW REVIEW, 6 (2), pp. 201–226 (2005).

69 Patrick Bolton and Ernst-Ludwig Von Thadden, *Blocks, Liquidity, and Corporate Control*, 53-1 THE JOURNAL OF FINANCE, 1-25 (1998).

70 Marco Pagano and Alisa Röell, *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public*, 113 QUARTERLY JOURNAL OF ECONOMICS, 187–225 (1998).

governance of presence of several shareholders on the controlling group was initially studied by Morten Bennesen and Daniel Wolfenzon (2000)⁷¹ who develop a theoretical model showing that these control structures may reduce expropriation but also reduce efficiency by generating deadlocks in decision making. In the case of dividend policy the available evidence is somehow mixed. Mara Faccio, Larry H. P. Lang, and Leslie Young (2001)⁷² find that the presence of multiple large shareholders in Europe minimizes the expropriation activity of the controlling shareholder, thus resulting in higher dividend payments, consistent with the idea of a monitoring effect. However they find that in Asia, the presence of several shareholders leads to lower dividend rates, which they interpret as evidence of collusion among large shareholders to expropriate the minority shareholders in Asia, where minority protection is especially weak. For Finland, Benjamin Maury and Anete Pajuste (2002)⁷³ show that dividend payouts are negatively related to the second largest shareholder. However, Klaus Gugler and B. Burcin Yurtoglu (2003)⁷⁴ find a positive relationship between the second largest shareholder and dividend payouts in Germany. The lack of a clear guide of what constitutes a controlling group and the differences across countries and firms in the minimum stake that guarantees control could explain these different results. But, in any case, they all highlight the existence of a conflict between the preferred dividend policies of different shareholders, whether it refers to different preferences among the group of significant shareholders or to different preferences of the controlling group and the small shareholders.

Conclusion

In this Article we have studied the determinants of dividend policy in firms with concentrated ownership structure. A careful analyses of the legal rules on the subject shows that these rules are designed to protect debt-holders but, within those limits, they leave the power to choose dividends in the hands of the

⁷¹ Morten Bennesen and Daniel Wolfenzon, *The Balance of Power in Closely Held Corporations*, 58 (1-2), JOURNAL OF FINANCIAL ECONOMICS 113-139 (2000).

⁷² *Supra* Note 58.

⁷³ Benjamin Maury and Anete Pajuste, *supra* note 59.

⁷⁴ Klaus Gugler and B. Burcin Yurtoglu, *supra* note 66.

insiders. Because of this insiders can retain free cash-flows inside the firm and use them to extract private benefits at the expense of outside shareholders. However, when we place dividend policy in the context of overall corporate governance, we observe that there exist alternative and complementary monitoring tools that can alter the insiders' incentives and induce them to raise payout ratios. Nevertheless, the effectiveness of these alternative mechanisms seems much reduced in companies with controlling shareholders. And therefore it is not surprising to find that payout ratios are lower in companies and countries with controlling shareholders. This is a problem that makes it more difficult for these companies to raise capital and to grow. Therefore, it is worthwhile to explore in future research the possibility of designing commitment mechanisms that could allow controlling shareholders to credibly commit to an optimal dividend policy in order to protect and attract minority investors.

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