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Expropriation of minority shareholders and payout policy

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A B S T R A C T

This paper studies the payout policy of Italian firms controlled by large majority shareholders (controlled firms). The paper reports that a firm's share of dividends in total payout (dividends plus repurchases) is negatively related to the size of the cash flow stake of the firm's controlling shareholder and positively associated with the wedge between the controlling shareholder's control rights and cash flow rights. These findings are consistent with the substitute model of payout. One of the implications of this model is that controlled firms with weak corporate governance set-ups, in which controlling shareholders have strong incentives to expropriate minority shareholders, tend to prefer dividends over repurchases when disgorging cash.

1. Introduction

The main objective of this study is to investigate whether the payout policy of Italian controlled firms is affected by the agency conflicts between controlling and minority shareholders. These conflicts arise because controlling shareholders can expropriate minority shareholders by using firm cash and resources to pursue private interests. Expropriation of minority shareholders is likely to be common in Italy. The existing literature in fact shows that Italian corporations are often characterized by concentrated ownership structures, significant private benefits accruing to controlling shareholders, and the usage of control-enhancing devices to magnify control rights relative to cash flow rights (e.g., Bianchi, Bianco, & Enriques, 2001; Faccio & Lang, 2002).

Payouts can be effective control mechanisms to reduce minority shareholder expropriation because they draw down the corporate cash reserves available to controlling shareholders. A key goal of this study is to analyse whether Italian controlled firms actually use payouts to protect minority shareholders from expropriation. Both payout levels and the choice between dividends and stock repurchases are studied to test the validity of the two alternative agency payout models of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) (LLSV (2000)).

In LLSV's (2000) outcome model, corporate outsiders utilise their legal powers to force firms and insiders to disgorge cash. In contrast, in their substitute model, firms distribute cash to shareholders to mitigate agency conflicts between corporate insiders and outsiders and payouts are seen as one of several alternative governance mechanisms that can be used to reduce agency costs. While the outcome model is consistent with a negative relation between the magnitude of payouts and the depth of the agency conflicts, the substitute model implies that firms facing higher agency costs and characterised by weaker corporate governance set-ups should pay out more.

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John and Knyazeva (2006) extend the substitute model by suggesting that, besides the level of payout, the composition of total pay out also has an influence on agency costs. They argue that dividend payouts, unlike stock repurchases, carry implicit commitments to similar or larger payouts in future periods. They conclude that dividend payments, owing to the conveyed pre-commitment signal to future cash distributions, are more powerful mechanisms than repurchases to attenuate agency conflicts.

The view that the governance of Italian corporations is plagued by agency conflicts is quite common and has received clear support from the academic literature. The most compelling evidence is that Italy scores low in international studies of shareholder protection (e.g., La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998). Also, the premium attached to voting shares is particularly large in Italy (e.g., Nenova, 2003; Zingales, 1994) probably because large private benefits can be gained through voting rights and corporate control. Mancinelli and Ozkan (2006) find that an Italian firm's largest shareholder has significantly more voting rights than other major shareholders. This finding is in line with the idea that minority shareholders are unlikely to have the power to curb controlling shareholders' attempts to engage in self-serving behaviours.

Apart from weak shareholder protection, another feature of Italian corporations is ownership concentration and the existence of a controlling shareholder (e.g., Bianchi et al., 2001). In the sample period of this study, 86% of Italian listed companies have a controlling shareholder. It can be hypothesised that Italian controlled firms affected by serious agency conflicts have two main features. First, their controlling shareholders hold a small fraction of cash flow rights. A controlling shareholder with a small cash flow stake receives a small part of the cash paid out by its firm to shareholders. They, therefore, have a strong incentive to divert firm resources. Second, the difference between the control rights and the cash flow rights held by their controlling shareholders is large. When the wedge between a controlling shareholder's control and cash flow stakes is large, controlling shareholders have the power to expropriate minority shareholders owing to their significant control stake and their small cash flow stake does not curb their tendency to indulge in self-serving behaviours.

A sample of observations for Italian non-financial controlled firms listed on the Milan stock exchange (sample period 1999–2004) is analysed to test the validity of the two competing LLSV's (2000) agency models of payout. These analyses essentially aim to test the joint hypothesis that the protection of minority shareholders is weak in the Italian corporate governance system and that the payout policies of Italian controlled firms can be explained by one of the two agency explanations.

Evidence is found that is consistent with the substitute model and in favour of the notion that a firm's payout policy is designed to reduce agency conflicts and costs. The key reported finding is that, when choosing between dividends and repurchases, firms with lower cash flow stakes held by their controlling shareholders and higher wedges between controlling shareholders' control and cash flow rights are more likely to prefer dividends. This result indicates that firms adjust their dividend–repurchase mix to lower agency costs. In contrast, there is no strong evidence that firms increase payouts to mitigate agency conflicts. Firms with deeper governance problems seem reluctant to raise payouts possibly because the costs of higher cash disbursements outweigh the benefits in terms of reduced agency costs.

This paper offers several significant contributions to the existing literature. First, the paper sheds light on the association between payouts and both the share of cash flow rights held by a firm's controlling shareholder and the wedge between the controlling shareholder's control and cash flow rights. There is very limited prior evidence on this issue (e.g., Faccio, Lang, & Young, 2001; Gugler & Yurtoglu, 2003). Second, contrary to most previous literature (e.g., Faccio et al., 2001; Gugler & Yurtoglu, 2003; LLSV, 2000), the study uses both dividend and repurchase data and shows that misleading conclusions can be drawn on the validity of the agency explanations of payout policy if researchers rely only on dividend data. Also, it shows that more comprehensive tests of these explanations should entail analyses of a firm's choice between dividends and repurchases. Third, there are no previously published studies documenting that firms with controlling shareholders with small cash flow stakes and large differences between their control and cash flow rights are characterized by larger fractions of dividend payout in total payout. Finally, the research complements and extends Mancinelli and Ozkan's (2006) study on the impact of ownership structure on dividend policy in Italy.[1]

2. Literature review and research questions

2.1. Agency problems and payout policy

LLSV (2000) suggest two competing agency views of payout policy. In their outcome model of payout they posit that corporate outsiders use their legal powers to force their firms to distribute cash in order to prevent insiders from using firm cash to pursue private interests. In contrast, in LLSV's (2000) substitute model, payouts are seen as a corporate governance control mechanism that can substitute alternative mechanisms. Firms distribute cash to shareholders to mitigate agency conflicts between corporate insiders and outsiders, especially when the latter group of investors is not already protected by other governance mechanisms. Insiders may want to alleviate agency conflicts by paying out cash possibly because firms affected by serious governance problems need to establish a reputation of fair treatment of corporate outsiders in order to raise external capital on favourable terms.

[1] This study extends their work by also considering stock repurchases besides cash dividends, by using alternative ownership structure variables that fully reflect the impact of the control-enhancing mechanisms used by controlling shareholders, and by analysing data from a longer sample period.