



# Majority support of shareholders, monitoring incentive, and dividend policy



Naoya Mori <sup>a,\*</sup>, Naoshi Ikeda <sup>b,1</sup>

<sup>a</sup> Nihon University, College of Commerce, 5-2-1 #429 Kinuta, Setagaya-ku, Tokyo 157-8570, Japan

<sup>b</sup> Tokyo Institute of Technology, Department of Industrial Engineering and Management, 2-12-1 W9-51 Ookayama, Meguro-ku, Tokyo 152-8552, Japan

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## ABSTRACT

As an alternative version of the side-payment model, this paper presents a demonstration of how the necessity of winning majority support of shareholders influences the relation between a blockholder's monitoring incentive and a firm's dividend policy. When dividend-averse individuals collectively hold a majority stake in a dispersed ownership structure, a dividend-seeking blockholder might be compelled to propose lower dividends than the tax-optimum to dominate the zero-dividend proposal. Under such circumstances, the blockholder has an incentive to provide unprofitable monitoring activity as long as the private benefits of tax-saving are greater than the pecuniary loss from the monitoring activity.

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## 1. Introduction

The existence of a blockholder can be an effective corporate governance mechanism for resolving free-rider problems among shareholders. [Grossman and Hart \(1980\)](#) argue that a small investor has insufficient incentive to monitor the firm managers' discretion because collecting monitoring costs on personal accounts is usually impossible. Therefore, investors with small shareholdings have a strong incentive to *free-ride* the benefits of other shareholders' monitoring activities in a dispersed ownership structure. In contrast, holders of sufficiently large stakes find it profitable to discipline managers to enhance the firm's value.<sup>2</sup>

Individual investors with small shareholdings and corporate and institutional investors with large shareholdings are mutually complementary because these two players are expected to have different capabilities. Individuals as a group typically have a majority stake in a dispersed ownership structure. For that reason, they can force the firm to distribute favored amounts of dividends. Furthermore, they can remove managers for lack of concern. Nevertheless, they have insufficient capability of evaluating managers' performance properly. In contrast, corporations and institutions have excellent monitoring capability and hold sufficiently large stakes to collect monitoring costs on personal accounts. Nevertheless, it is impossible for them to affect the payout policy without depending on individuals' voting power in a dispersed ownership structure.

\* Corresponding author. Tel.: +81 3 3749 6833; fax: +81 3 3417 1681.

E-mail addresses: [mori.naoya@nihon-u.ac.jp](mailto:mori.naoya@nihon-u.ac.jp) (N. Mori), [ikedan.ab@m.titech.ac.jp](mailto:ikedan.ab@m.titech.ac.jp) (N. Ikeda).

<sup>1</sup> Tel.: +81 3 5734 3606.

<sup>2</sup> According to [Shleifer and Vishny \(1997\)](#), a minority shareholder whose stake in a firm is 10–20% has sufficient incentive to gather information and to act as a monitor of management. [Admati et al. \(1994\)](#) and [Maug \(1998\)](#) argue that investors with large shareholdings tend to engage in monitoring activities in spite of the fact that investors with small shareholdings enjoy the benefits as free-riders.

In this line of argument, two important models are useful to examine the relation between dividend policy and monitoring incentives of corporate and institutional investors. Shleifer and Vishny (1986) hypothesize that small individual investors compel the firm to distribute dividends as inducements to large corporate investors to become owners of the firm as monitors. Similarly, Allen et al. (2000) present a model including the assumption that institutional investors who are attracted to dividend-paying stocks mitigate agency conflicts between shareholders and managers. Within these models, based on corporate/institutional investors' tax preferences, positive dividends serve as a side payment from individuals who delegate monitoring tasks to the blockholder. Benefits from monitoring activities are distributed among all shareholders.

However, these models incorporate the assumption that individual investors are homogeneous. Shleifer and Vishny (1986) demonstrate that positive dividend policy is acceptable as long as the individuals' tax burden, considered collectively, is less than the added value attributable to a blockholder's monitoring service. Allen et al. (2000) assume two groups of investors (i.e., individuals and institutions), and consider dividend policy from the perspective of two representative investors. In each group, all investors are identical.

In reality, individual investors are heterogeneous in the sense that they have different marginal tax rates, although their tax-optimal dividends are unanimously zero. Because of the difference of tax status, as our model reveals, the dividend level at which an individual investor switches her approval from the zero-dividend proposal to the monitoring-based dividend proposal is not identical to the dividend level at which another individual investor switches. Given a proposal with a certain level of dividend payment, some individuals support this, but other individuals do not. To control dividend policy, a dividend-seeking blockholder must win the majority support of shareholders.

Earlier models have not examined the effects of internal conflicts among individual investors on the size of monitoring activity provided to a firm. Shleifer and Vishny (1986) regard the added value as exogenous, and do not derive the optimization condition of a blockholder's monitoring service. Although Allen et al. (2000) demonstrate the optimum, they do not consider the influence that the necessity of winning the majority support of shareholders exercises on it. Eckbo and Verma (1994) show that shareholders with large holdings use voting power on dividend policy in an attempt to impose costs on other shareholders. The level of dividend payments varies with the relative voting power of different shareholders (corporations/institutions versus manager-owners in their analysis) who have opposite preferences (i.e., higher dividends versus lower dividends). Nevertheless, their concern is not the blockholder's monitoring incentive.

This paper presents an alternative version of the side-payment model of dividend policy. Our concern is to examine how the necessity of obtaining majority support of shareholders influences the relation between a blockholder's monitoring incentive and the level of dividend payment. The model development presented in this paper reveals that the optimal level of monitoring activity depends not only on the blockholder's monitoring efficiency, but also on the tax status of the median shareholder, who casts the deciding vote on the blockholder's dividend proposal.

First, the model presented herein formulates that the winning proposal in a majority-rule voting contest determines the level of dividend payment. Assuming conditions of dispersed ownership, a dividend-seeking blockholder competes against the zero-dividend proposal for tax-savings benefits. To increase the number of votes they receive from dividend-averse individual investors, the blockholder might be compelled to propose lower dividends than the tax-optimum level. Such a concession engenders lower dividend payments under the assumption that individual investors as a group have a majority stake in the firm.

Second, we examine the blockholder's incentive compatibility condition. It makes no sense for a blockholder to compromise on the dividend level if accepting the zero-dividend proposal becomes the better alternative. On such an occasion, the blockholder loses an incentive to offer monitoring services for the benefit of all shareholders. An inefficient blockholder gives up controlling dividend policy, but an efficient blockholder dominates the zero-dividend proposal.

Third, we derive the maximization condition of a blockholder's after-tax return from monitoring activity and dividend policy. The analysis demonstrates that monitoring activity not only adds market value to the firm; it also alters individual investors' voting behavior, and thereby influences a blockholder's tax burden. The dividend-seeking blockholder has an incentive to provide unprofitable monitoring activity if the private benefits of tax-saving are greater than the pecuniary loss from the monitoring activity. Therefore, the optimal degree of monitoring activity becomes greater.

The remainder of this paper is organized as follows. Section 2 presents the model structure. Section 3 describes development of the model. Section 4 shows some theoretical and empirical implications of our model for future studies. Finally, Section 5 concludes this paper with a summary of these arguments.

## 2. Model structure

We assume that investors hold all types of stocks to benefit fully from risk diversification. Generally speaking, a portfolio with fewer assets implies a higher-risk portfolio. The complete exclusion of sub-optimal dividend-paying stocks therefore engenders ineffective diversification. Risk-averse investors would be expected to assign priority to risk-sharing rather than single-mindedly pursuing tax-saving opportunities. This tendency is expected to be the central cause of insufficient clientele effects of dividends.<sup>3</sup>

By assumption, heterogeneous shareholders, who are expected to have different tax preferences, are expected to hold shares in a firm. Therefore, internal disagreement would emerge around the issue of the dividend payment level. In such a situation, investors might pursue minimization of tax burden to the greatest degree possible. Nevertheless, preventing the waste of resources attributable to inefficient corporate governance might pose a more severe problem than tax saving. Our concern is to consider the effects of

<sup>3</sup> For example, Richardson et al. (1986) investigate trading volume around the announcement date of changes in dividend policy. They conclude that shareholder clientele adjustments are small. Eckbo and Verma (1994) present evidence of stable shareholder clientele over time using data of Canadian firms.

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