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The impact of technical defaults on dividend policy

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ABSTRACT

This paper examines how loan covenant violations impact firm dividend policy. Using contract-level loan data for nonfinancial firms in the US, this study provides evidence that the occurrence of a covenant violation significantly increases the likelihood of a dividend reduction in the subsequent quarter. Moreover, we show that the degree of creditor–shareholder conflict and firm financial constraints are important determinants of dividend cuts upon technical default. Additionally, this paper finds the tendency of dividend cuts upon technical default weakened after the repeal of the Glass–Steagall Act. These findings suggest that loan covenants serve a critical role in mitigating creditor–shareholder conflicts.
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1. Introduction

Violations of financial covenants, also known as technical defaults, are prevalent among firms. Several recent studies have found that more than 25% of publicly traded firms in the United States violated a financial covenant at some point between 1994 and 2005.[1] Once financial covenants are violated, control rights shift from shareholders to creditors who can threaten borrowers with the acceleration of loan repayments. This shift of power gives creditors additional control over a firm's operations, even outside of bankruptcy. In this paper, we explore how the violation of a financial covenant leads to bondholder-protective changes in a firm's dividend policy.

An important empirical question, which is still open to debate, is why do firms cut dividends? This paper sheds light on this issue by examining one particular channel through which dividend policy may be affected: that of creditor control rights.[2] As a firm approaches default, the firm has a greater incentive to pay unwarranted dividends and so benefit shareholders at the expense of the bondholders (Fan and Sundaresan, 2000). Given this tendency creditors have every incentive to stop superfluous dividend payments. At the time of a financial covenant violation creditors may gain the power to influence dividend policy.

To be able to explore the impact that a change in control rights has on dividend policy, we collect detailed information on private loan contracts from Dealscan for 622 US firms from 1994 to 2004. We match this data with dividend and financial firm data from the CRSP-Compustat merged database. From this matched dataset, we examine how violations of loan-embedded financial covenants influence the payout policy of the borrowing firms.

Additionally, we ask in which situations do loan covenant violations not affect dividend policy? Gârleanu and Zwiebel (2009) show that creditors use financial covenants as a "trip-wire" to extract information regarding the borrower's financial health and according to Dichev and Skinner (2002), financial covenant thresholds are set tightly, just below normal operating performance levels. These studies suggest that violations occur frequently even among healthy firms and are not necessarily an indicator of financial distress. If a firm is not in financial distress, but is in violation of their financial covenants, a forced dividend reduction may put unnecessary strain on the lending relationship or even exacerbate the firm's ability to repay loans given the accompanying negative market reaction. Creditors may be less concerned about covenant violations if they are sufficiently confident about the firm's ability to repay their loans. For this reason, we test if covenant violating firms which do not have a conflict of interest between creditors and shareholders will be less likely to make subsequent dividend reductions. Similarly, we expect covenant violating firms that are financially unconstrained to be less likely to make dividend reductions. On the other

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[1] Dichev and Skinner (2002), Chava and Roberts (2008), Nini et al. (2009) and Roberts and Sufi (2009).

[2] Bulan et al. (2007) and Stepanyan (2009) study this issue from the perspective of a firm's financial flexibility (financial slack). Bulan et al. (2007) argue that some dividend omissions are strategically motivated to preserve financial flexibility within the firm. Stepanyan finds that the propensity to cut a dividend is inversely related to financial slack.

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hand, for firms with large conflicts of interest between creditors and shareholders or that are financially constrained, we expect a more aggressive push by creditors to cut dividends. We analyze these issues in our data using two indices, the Gompers et al. (2003) governance index and the Kaplan and Zingales (1997) index. The first index, measures the strength of corporate governance and the second, the severity of financial constraints.

Furthermore, we wish to show that our findings are not simply the result of spurious correlations between firm dividend policies and the occurrence of financial covenant violations. To do this we use the repeal of the Glass–Steagall Act in 1999 as an exogenous change which should diminish the ability of creditors to influence firm policy at the time of technical default. After the repeal, commercial and investment banks were allowed to consolidate and so increase competition among financial intermediaries. This surge in competition increased the bargaining power of the borrower at the time of a technical default. Given the strong reluctance firms have to commit dividend reductions this should entail fewer dividend reductions as the result of a covenant violation after the law change. Studies suggest one of the main effects of this repeal was greater competition and subsequently less stringent credit constraints for the purpose of maintaining current and future banking relationships (Drucker and Puri, 2005; Yasuda, 2005). This is further supported by anecdotal evidence which suggests the repeal weakened overall lender discipline.[3] Lastly, related to the repeal of the Glass–Steagall Act, we explore the affect that potential and past concurrent lending has on banks' willingness to restrict dividend policy following a technical default.

Our main result indicates that the occurrence of a covenant violation increases the likelihood of a dividend reduction in the next fiscal quarter by 90%. In contrast, we find a one standard deviation decrease in profitability (return-on-assets) increases the likelihood of a dividend reduction by only 34%. In analyzing the question of which situations do loan covenant violations not affect dividend policy, we find that creditors force firms to cut dividends significantly upon violations of financial covenants only among firms with strong shareholder rights or that are financially constrained. The occurrence of a violation nearly doubles the likelihood of a dividend reduction for the sample of financially constrained firms and more than triples the likelihood of a dividend reduction for firms with strong shareholder rights. Using the exogenous change of the repeal of the Glass–Steagall Act, we find that creditors force a significant reduction in dividends upon violation of a financial covenant only in the period before the repeal and not after. This result is consistent with the overall conditions of greater competition in the post-repeal period. We also provide support that past concurrent lending and potential future concurrent lending decrease the likelihood that a dividend reduction will follow a covenant violation.

As an additional robustness check we also show that dividend reductions that follow covenant violations are not more prevalent among growth firms. As we are exploring one potential reason for making a dividend reduction it is important to rule out the possibility that the dividend reduction is actually occurring for the purpose of taking advantage of growth opportunities. Robustness tests show that the link between covenant violations and dividend reductions is significantly stronger for non-growth firms, suggesting growth firms do not make dividend reductions in connection with covenant violations.

The remainder of the paper proceeds as follows. Section 2 further explores the relevant literature. Section 3 includes the description of the dataset used for this study and provides summary statistics of the key variables we use in our analysis. Section 4 describes the paper's methodology. Section 5 presents evidence on the impact of covenant violations on dividend policy and Section 6 concludes.

2. Literature review

This paper is first related to the literature on changes in dividend policy. There are many reasons why firms reduce their dividends. The literature suggests a relationship between a firm's dividend policy and its private information regarding future performance. In general, investors view disruptions in dividend payments negatively.[4] The negative market reaction to dividend cuts and omissions is often attributed to current and expected financial difficulties (DeAngelo et al., 1992). Additionally, survey evidence from Brav et al. (2005), suggests that managers have a strong reluctance to cut dividends, a finding further supported by DeAngelo and DeAngelo (1990) and Daniel et al. (2008). For these reasons managers consider dividend reductions as policy options only in extreme circumstances. However, even though dividend reductions occur when a firm's earnings have been deteriorating, there is little evidence to suggest that the deterioration persists after dividends are cut (Benartzi et al., 1997; Grullon et al., 2002; and Lie, 2005).

There are very few empirical studies that relate debt covenants and dividend policy. Of those found in the literature, the empirical evidence has been mixed about the actual effect that a covenant violation has over dividend policy. Kalay (1980) suggests that only 5% of observed dividend reductions can be explained by binding debt covenants, while DeAngelo and DeAngelo (1990) study 80 financially distressed NYSE firms and find that a majority of these firms faced binding debt covenants in the year they reduced their dividend. Additionally, Healy and Palepu (1988) find, outside of covenant violations, firms reduce their dividends because of dividend restrictions in debt covenants.[5] This paper differs from the literature cited above in that we use a more comprehensive loan covenant dataset, a larger time horizon, and control for a greater variety of financial covenants.

This paper is also related to the broader literature on loan covenants and agency conflicts. Smith and Warner (1979), Kalay (1982) and Cremers et al. (2007), among others, argue that covenants are required to align shareholder and bondholders' interests. Literature also suggests that the presence of restricting covenants results in limiting investment, even without the breach of a contract (Nini et al., 2009; Chava and Roberts, 2008). Related to this, Roberts and Sufi (2009) observe the effect of covenant violations on financial policy, focusing specifically on net debt issuance.

Our paper links the literature on dividend policy and loan covenants by exploring the impact of a change in control rights from shareholders to creditors on a firm's dividend policy. We find evidence that creditors do not necessarily terminate dividend payments upon violation of financial covenants in order to secure their repayment in the event of further deterioration of the firm's financial health. Instead, they actively use information gained after the technical violation, and only force firms to cut dividends when it is necessary to secure their repayments.

3. Data and key variables

We gather data from three main sources: Firm financial data from Compustat quarterly industrial files, dividend payment information from CRSP, and detailed information on private (primarily

[3] For example, Bank of America (BoA) approved loans to Adelphia which BoA knew Aldephia was going to use for a spurious purpose and deceive investors. One of the main reasons for approving this spurious loan was because Adelphia promised BoA future underwriting assignments in return for the approval of this loan. – "The Company They Kept," *New York Times*, February 1, 2004 by Roger Lowenstein.

[4] Aharony and Swary (1980), Dielman and Oppenheimer (1984), Healy and Palepu (1988), Ghosh and Wooldridge (1988).

[5] In a related paper, Brockman and Unlu (2009) examine cross-country variation in creditor rights. They find that in countries with weaker creditor rights, firms adopt more restrictive payout policies in order to mitigate the agency costs of debt.

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