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Stakeholder conflicts and dividend policy

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ABSTRACT

This paper compares the dividend policy of owner-controlled firms with that of firms where the owners are a minority relative to non-owner employees, customers, and community citizens. We find that regardless of whether owners or non-owners control the firm, the strong stakeholder uses the dividend payout decision to mitigate rather than to intensify the conflict of interest with the weak stakeholder. Hence, the higher the potential agency cost as reflected in the firm's stakeholder structure, the more the actual agency cost is reduced by the strong stakeholder's dividend payout decision. These findings are consistent with a dividend policy in which opportunistic power abuse in stakeholder conflicts is discouraged by costly consequences for the abuser at a later stage. Indirect evidence supports this interpretation.

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1. Introduction

Stockholders invest in firms to obtain returns on their money. Conflicts of interest between the stakeholders might reduce these returns. For instance, the stockholders might worry that the employees use the firm's resources to produce private benefits at the stockholders' expense. If this agency problem appears threatening to the stockholders, they might hesitate to put more money at the firm's disposal. This reluctance to finance the firm might adversely affect the real economy by increasing the firm's cost of capital and decreasing its investment in labor and productive assets (Jensen and Meckling, 1976).

Our paper analyzes empirically how dividend policy influences the seriousness of this conflict of interest, focusing on the relationship between the firm's owners (the stockholders) and its non-owners (the employees, customers, and community citizens). In particular, we study whether the dividend payout decision is used to mitigate or to intensify the agency problem inherent in the firm's stakeholder structure. We find that firms controlled by the non-owner stakeholders pay out significantly more of their earnings than firms controlled by the owners do. This result supports the notion that reducing agency costs through lowering free cash flow is an important concern when non-owner stakeholders have the power to determine the firm's dividend policy.

Conflicts of interest in a firm might be framed as tensions between insiders and outsiders. The firm's resources are controlled by the insiders, who might lack the incentives to abstain from making self-serving decisions at the outsiders' expense (Jensen and Meckling, 1976; La Porta et al., 1997). We study an unusual combination of insiders and outsiders. The insiders in one of the two firm types we analyze are neither the owners, the majority owners, nor the CEO, who have received almost all the attention in existing research (Becht et al., 2003). Rather, the majority control rights are held by the employees, customers, and community citizens. In contrast, the second firm type in our sample represents a classic situation where the insiders are owners. Finally, and importantly, regulation ensures that there is no insider–outsider issue between majority and minority owners in either firm type.

This setting allows us to study a clean and unexplored setting where dividend policy can be used to influence only one particular insider–outsider conflict, and one that is not classic in nature. There is no majority–minority issue among the owners, the owners might be both insiders and outsiders, and the non-owner stakeholders constitute a heterogeneous set whose preferences might deviate strongly from those of the stockholders. The key question is how the insiders in these firms use dividend policy to handle the potential conflict of interest with the outsiders. We address this question by testing the two existing theories of how dividends

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interact with stakeholder conflicts. These theories are the outcome model and the substitute model (La Porta et al., 2000; Cheffins, 2006; Ostergaard and Smith, 2011).

The outcome model predicts that when given the chance, non-owner stakeholders will opportunistically use the dividend policy to capture private benefits. Therefore, firms controlled by non-owner insiders will pay lower dividends per unit of earnings and allocate correspondingly more to private benefits for the non-owners than firms controlled by owners will. In contrast, the substitute model argues that non-owners will benefit later if they choose a dividend policy now that reduces potential conflicts with the owners. Our finding that dividend payout increases with decreasing owner control supports the substitute model, which posits that owner control and dividend payout are alternative ways of disciplining the firm's non-owners. That is, close monitoring and low free cash flow are substitutes.

Existing studies of agency problems and dividend policy do not directly test the predictions of the two competing dividend theories. Moreover, they tend to capture a wide variety of insider–outsider conflicts, regressing the firm's dividend payout on its ownership concentration in samples where ownership concentration varies widely in the cross section (Rozeff, 1982; Moh'd et al., 1995; Khan, 2006; Renneboog and Szilagyi, 2006; Renneboog and Trojanowski, 2007).[1] We test the two dividend theories directly, and we study an environment where potential conflicts between large and small owners are negligible because a binding legal constraint makes ownership concentration low in every firm. In contrast, the potential seriousness of the conflict between owners and non-owners varies more than usual. This variation is not driven by cross-sectional differences in ownership concentration, however, but rather by differences in organizational form, which allocate majority control to the owners in one firm type and to non-owners in the other. Thus, ownership concentration is low in every sample firm, and the owners are strong relative to the non-owners in one firm type and weak in the other.

Our sample is the population of listed Norwegian commercial banks and savings banks. Commercial banks are regular stock companies that are controlled by their stockholders. In contrast, the stockholders of a savings bank hold only one fourth of the control rights. The remaining three quarters of the control rights are split equally between the employees, the depositors, and community citizens. The residual cash-flow rights are held by the stockholders in both bank types.

Since non-owners are the insiders in the savings bank, they determine its dividend policy. When making this decision, they know that their interests might be in conflict with those of the owners (the outsiders). For instance, the employees on the board might want less monitoring of their effort and more moderate restructuring than the owners might want. Depositors might vote for higher interest rates and lower risk on their savings than the owners might vote for. The community representatives might be more negative to reduced employment and more positive to cheap lending to local businesses than the owners might be.

Given this lack of interest alignment between owners and non-owners, the governance structure might also make it particularly easy for the CEOs of savings banks to make decisions that are better aligned with their interests than with those of the owners. For instance, the CEO might be less aggressive than owners might in wage negotiations with employees, more lenient than owners might when downsizing operations, and more interested than owners might in financing growth with retained earnings rather than with new debt. Such a tendency to pursue a so-called quiet life has been documented as a CEO response to reduced owner pressure in US firms (Bertrand and Mullainathan, 2003).

Hence, non-owner stakeholders can only informally influence the decisions of the owner-controlled commercial banks. In contrast, they have formal control in the savings banks, where the owners constitute a minority. The potential agency cost in the savings banks is due to conflicts of interest between the owners as outsiders and the non-owner stakeholders (including management) as insiders. In either organizational form, no single owner or alliance of owners can own or vote for more than one tenth of the equity. Both organizational forms face the same product market opportunities and the same regulatory constraints.

We test the predictions of the two competing dividend models for how the potential insider–outsider conflict interacts with the bank's dividend policy. The outcome model predicts that commercial banks will pay higher dividends per unit of earnings than savings banks will. This happens because the owners of commercial banks will use their control to reduce the retained earnings and hence the free cash flow that is under the non-owner stakeholders' discretion. Such a dividend policy will offer fewer opportunities for non-owners to finance perks for managers, to overprotect employees, to underprice output to customers, or to sponsor community projects. Correspondingly, the outcome model predicts that the non-owner stakeholders in savings banks will myopically use their control to ensure financing of their private benefits by paying out low dividends to the owners.

The substitute model assumes more sophisticated stakeholders and makes a prediction opposite to that made by the outcome model: Commercial banks will pay lower dividends than savings banks will. This happens because the owners of commercial banks will use their control rights to influence the firm as directors in the boardroom and as discussion partners with management rather than by bluntly blocking management's access to a high free cash flow. Similarly, the substitute model posits that the non-owners who control the savings banks will benefit later by using their power to pay high dividends now. This happens because a high dividend reduces the owners' fear of subsequent expropriation. Thus, the dividend payout decision is disciplined by potentially adverse effects for the insider at a later stage. For instance, paying out high dividends might be a way for growing firms to build reputation for subsequent equity issues (La Porta et al., 2000; Cheffins, 2006). Paying out high dividends might also reduce information asymmetry costs for small firms in particular by forcing them more often to the issue market (Easterbrook, 1984). Moreover, management's compensation in savings banks might fall and their career opportunities might deteriorate if the stock price drops after a shift towards retaining a higher percentage of earnings. This all suggests that the non-owner-controlled savings bank with high growth and small size will pay particularly high dividends.

Our major finding is that savings banks pay significantly higher dividends than commercial banks do. Also, more is paid out when the bank is small and grows fast. These results survive when we control for dividend persistence, financial leverage, stock liquidity, and for unobservable firm and industry effects. The findings are also robust to using alternative data sets and econometric techniques, to peculiarities of the ownership structure, and to alternative dividend payout measures.

[1] Higher ownership concentration reduces the potential conflict between owners and non-owners, while increasing the conflict between large and small owners. The former agency problem is considered the more serious in common law countries, whereas the latter is thought to dominate under civil law, where ownership concentration tends to be higher (Shleifer and Vishny, 1997). The relationship between owners and non-owners has traditionally been analyzed as conflicts of interest between owners and the CEO or between owners and creditors (Becht et al., 2003). There is hardly any study on conflicts between owners and stakeholders such as employees (Fauver and Fuerst (2006) is a rare exception), customers, and society at large. The empirical literature on the conflict between large and small owners has focused on the majority stockholder's expropriation of the minority (Faccio et al., 2001).

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