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Analysis of dividend policy of dual and single class U.S corporations

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ABSTRACT

Despite the extensive literature on dividend policy, little is known about the relationship between controlling shareholders and the determination of dividend policy, especially in dual class companies. Three potential dividend policy hypotheses are examined. We show that dual class companies pay out less cash dividends and repurchase fewer shares and that cash distributions decrease as the divergence of voting and cash flow rights widens. This is consistent with both the private benefits and family legacy hypotheses. However, an examination of executive compensation and family participation on the board indicates that lower dividends are consistent with the private benefits hypothesis.

1. Introduction

Finance research has struggled with the question as to why corporations pay dividends. This question referred to as the "Dividend Puzzle" by Black (1976) has challenged finance researchers since

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the irrelevance of dividend policy paper by Modigliani and Miller (1961). Various reasons have been used to explain dividend payout. Among the papers which use taxes to explain dividends are Brennan (1970), Elton and Gruber (1970), Miller and Scholes (1978), Litzenberger and Ramaswamy (1979), Poterba and Summers (1984), Masulis and Trueman (1988), and Morck and Yeung (2005). Another line of research tries to explain the dividend puzzle in terms of information asymmetry between management and outside shareholders. This stream of research includes Easterbrook (1984), Miller and Rock (1985), and DeAngelo and DeAngelo (1990). Others, such as Fama and French (2001), and DeAngelo, DeAngelo, and Stulz (2006) use the life cycle hypothesis to explain that large and mature corporations tend to pay more dividends than smaller and younger corporations.

Despite the extensive empirical research into the dividend puzzle, there has been limited research into the role played by controlling shareholders—the parties expected to have the most influence over the board of directors who serve as the final arbiters in the dividend decision. In particular, there is concern that controlling shareholders prefer to retain cash within the corporation for their own purposes and thus prefer a smaller payout than do outside shareholders. This concern is widespread given the evidence from La Porta, Lopez-de-Silanes, and Shleifer (1999) and Anderson, Mansi, and Reeb (2003) that most of the companies outside the U.S. and a significant minority of companies in the U.S. are closely controlled. Faccio, Lang, and Young (2001) compare Western European group affiliated corporations with those in Asia which have concentrated ownership and conclude that the European corporations pay higher dividends which dampens expropriation of outside shareholders' wealth in Europe compared to Asia. In a study of single class Hong Kong listed firms, Chen, Cheung, Stouraitis, and Wong (2005) find a weak non-linear relationship between family ownership and dividend policy.[3] Gugler and Yurtoglu (2003), and Mancinelli and Ozkan (2006) show that in German and Italian dual class firms, respectively, the greater the deviation of voting and equity interests of the controlling shareholder, the lower the dividend payout. The above studies suggest that the type of control structure matters to dividend policy.

The purpose of this research is to investigate how cash distribution policy in closely controlled firms in the U.S. is affected by dual compared to single class structure.[4] In the U.S., concentrated control is usually achieved through a significant equity interest in a single class company or through holding a large portion of the superior voting shares in a dual class firm. The controlling shareholder's advantage in a dual class firm is that her equity interest can be proportionately less than her voting interest.

We examine three competing explanations why the dividend policy should differ between the two ownership structures: private benefits of control, family legacy, and managerial reputation. The private benefits explanation asserts that controlling shareholders in dual class firms set a low dividend payout policy in order to retain and use firms' resources for their own benefits. The separation of voting from cash flow rights allows a controlling shareholder in a dual class firm to extract private benefits without facing the proportionate cash flow consequences that a controlling shareholder with significant equity ownership in a single class firm would face (see Bebchuk, Kraakman, & Triantis, 2000; Correia da Silva, Goergen, & Renneboog, 2004; Grossman & Hart, 1988). Alternatively, in firms with family control, the family identity and wealth are attached to the firm. Therefore, in order to ensure intergenerational transfer of wealth, control and the family legacy to their heirs, controlling shareholders may set a low dividend payout policy. The resources retained within the firm are then used to grow the wealth in the firm.

Managerial reputation is also argued to affect dividend policy. Investors know that managers of dual class firms may expropriate resources from the firm and as a result, they discount the value of

[3] Chen et al. (2005) provide evidence that in small market capitalization firms there is a negative relationship between dividends and family ownership up to 10% of the company's stock and a positive relationship for family ownership between 10% and 35%. They examine cash flow ownership not voting rights.

[4] We define a closely controlled firm as a firm in which 15% of the votes is held by an individual, a family or an institution. La Porta et al. (1999) and Claessens et al. (2000) utilize two alternative definitions of control of a firm: 10% and 20% control of voting rights. Using 10% or 20% does not significantly change the percentage of firms in the U.S that are classified as widely held. In addition, utilizing 20% of voting rights as a cutoff point dramatically reduces our potential matching sample of single class firms. Nevertheless, we use a 20% cutoff as an alternative definition of closely controlled firms. As discussed in the robustness section of the paper, the results are similar to those we present with a 15% cutoff.