Pacific-Basin Finance Journal 24 (2013) 179–198

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Corporate governance and payout policy: Evidence from Korean business groups☆

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ARTICLE INFO

Article history:
Received 27 July 2012
Accepted 26 April 2013
Available online 5 May 2013

JEL classification:
G34
G35

Keywords:
Dividends
Payout policies
Corporate governance
Business group

ABSTRACT

Using a unique, comprehensive data set from a survey on corporate governance practices among Korean listed firms, this paper shows that business group (*chaebol*) firms have overall stronger governance practices but weaker shareholder rights and lower dividend payout ratios than independent firms do. We also find that the adverse effect of *chaebol* firms' weak shareholder rights on dividend payout ratios appears to exemplify with the onset of the global financial crisis in 2008. In addition, our regression results show that the positive correlation between corporate governance practices and dividend payout ratios is weaker among *chaebol* firms. Finally, we find that improving corporate governance enhances payout policies over time but is statistically significant only for independent firms. Our results suggest that the entrenched control by *chaebol* firm owners that stems from their control rights much above the cash flow rights puts less weight on protecting minority shareholders, resulting in smaller distributions of dividend payments.

1. Introduction

Rich discussion in the literature has concluded that dividends can be employed to prevent managers from using free cash flows in wasteful activities when conflicts of interest between shareholders and managers are

☆ We are grateful to the Editor (S. Ghon Rhee), Stuart Gillan, Jeffery Netter, Randall Morck, Mike Weisbach, and seminar participants at Hong Kong Baptist University and Hitotsubashi University for their valuable comments and suggestions. We also acknowledge a research grant from the Korea Corporate Governance Service by providing us with the corporate governance data for this study. Hwang appreciates the financial support from the Institute of Management Research of Seoul National University. Park is grateful for the generous research support from KAIST.

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0927-538X/$ – see front matter
http://dx.doi.org/10.1016/j.pacfin.2013.04.006

not resolved. Jensen's (1986) classic paper on agency costs argues that, in the absence of attractive investment opportunities, firms can alleviate conflicts between corporate insiders and external stockholders by distributing excess cash flows to shareholders. This point of view suggests that shareholders can use a payout policy to discipline managers. Easterbrook (1984) and Zwiebel (1996) present a similar claim: that dividend payouts to shareholders reduce the power of managers who might otherwise use the free cash flow at their disposal unwisely.[1]

However, empirical evidence provides mixed results on the propositions related to the disciplining role of dividend policy that is suggested in theory. Rozeff (1982) claims that higher dividend payouts can reduce agency problems under information asymmetry, while it can raise firms' external financing costs at a later stage, suggesting both positive and negative aspects of dividend payouts. Faccio et al. (2001) provide international evidence that controlling shareholders use dividends as a device to expropriate funds from outside shareholders. Faccio et al. (2001) report that, when there are multiple large shareholders, dividend payout ratios are higher in Europe and lower in Asia. They suggest that the practices of these payout policies reduce the expropriation of funds from minority shareholders in Europe but exacerbate it in Asia.

The line of research in our paper is categorized in the fairly recent literature on the relationship between corporate governance and payout policy. Chae et al. (2009) use US data to show that firms with higher (lower) external financing constraints tend to decrease (increase) their payout ratios when there is an improvement in their corporate governance.[2] In this paper, we give particular attention to the role of insiders in business groups (*chaebols*) in Korea, and empirically examine whether listed firms with sound corporate governance practices distribute more of their corporate income to shareholders with the onset of a financial crisis and over time. Almeida et al. (2011) suggest that the pyramiding of business groups in Korea has led the listed group firms, which are usually in the pyramidal structure, to experience significant discounts in market valuation and lower payout rates. Almeida et al. (2011) present a theoretical framework and an anecdotal example documenting that firms with good corporate governance have higher firm value and better payout policy than do those with poor corporate governance. The extant literature however lacks in discussing the relationship between corporate governance and payout policies with the role of business groups.

Using a unique, comprehensive data set on the corporate governance practices of listed Korean firms, this paper shows that *chaebol* firms have overall stronger governance practices but lower dividend payout ratios than independent firms do. We also find that *chaebol* firms have much weaker shareholder rights than independent firms do, which appears to drive the lower level of payout ratios for *chaebol* firms. Our difference-in-differences test result shows that *chaebol* firms' dividend payout policy worsened after the global financial crisis in 2008 confirming that the adverse effect of *chaebol* firms' weak shareholder rights on dividend payout ratios appears to exemplify with the onset of the crisis. Our regression results further show that the positive correlation between good corporate governance and dividend payout ratios is weaker among *chaebol* firms. Finally, this paper finds that improving corporate governance enhances payout policies over time but is statistically significant only for independent firms. We suggest that the entrenched control by *chaebol* firm owners that stems from their control rights much above the cash flow rights puts less weight on protecting minority shareholders with lowered dividend payout ratios.

Only a few studies have examined the economic consequences on firms and investors of good corporate governance. Research has shown that firms with good corporate governance systems are likely to experience lower borrowing costs. For example, among the few studies on this issue, Bhojraj and Sengupta (2003) find that firms with higher levels of institutional ownership and stronger outside board control enjoy lower bond yields and higher ratings on their new bond issues. This evidence suggests that governance mechanisms

[1] Myers (2000) also provides theoretical justification for the self-interested behavior of managers and entrepreneurs who make corporate finance decisions when they have excess cash flow. Myers' theory suggests that, because insiders share in the firm's added value, they have to coinvest with outside equity. Similarly, Gomes' (2000) model shows an implicit commitment by insiders not to exploit minority shareholders when there are no explicit corporate governance mechanisms. Because of the resulting "reputation effect" (Gomes, 2000), such firms have higher stock valuation and are more likely to go public.

[2] The results from Chae et al. (2009) support the notion that the relationship between payout and corporate governance is reversed, depending on the relative sizes of agency costs and external financing costs. Using a difference-in-differences approach, Francis et al. (2011) show that dividend payout ratios decreased significantly (by 1.7%) after the enactment of anti-takeover legislation by states in the U.S. during the 1980s and that the likelihood of dividend payouts decreased significantly (by 8.9%) in response to the laws' enactment.