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Dividend policy: Shareholder rights and creditor rights under the impact of the global financial crisis

Quoc Trung Tran[a,b,*], Pascal Alphonse[c], Xuan Minh Nguyen[b]

[a] University of Lille 2, Lille, France
[b] Foreign Trade University, Vietnam
[c] Skema Business School-LSMRC, Lille, France

ABSTRACT

The extant literature shows that shareholder and creditor rights positively affect corporate payout policy in a static macroeconomic environment. This study examines how the effects of shareholder and creditor rights on dividend policy change under the impact of the global financial crisis. We posit that this exogenous shock increases agency costs of both shareholders and creditors. With a sample of 133,631 firm-year observations from 23,890 firms incorporated in 41 countries, we find that both shareholder and creditor rights are less effective in dividend decisions in the post-crisis period and the extent of shareholder (creditor) expropriation in the post-crisis period is larger when creditors (shareholders) are adequately protected.

1. Introduction

The extant literature on agency theory shows that there are two types of agency costs including agency costs of shareholders and agency costs of creditors. La Porta et al. (2000) initially suggest two competing dividend models based on agency costs of shareholders, namely the outcome model and the substitute model. The former predicts that stronger protection of minority shareholders results in higher dividend level whilst the latter argues that dividends are paid as a means to earn a reputation of fair treatment of minority shareholders and weaker minority shareholder protection leads to higher payout ratio. La Porta et al. (2000) find that the outcome model is supported empirically. Then, Brockman and Unlu (2009) extend this line of research with an argument that dividend restriction is a compensation for weak creditor rights under private credit agreements and they find supporting evidence of the substitute model based on agency costs of creditors. Recent studies continue to examine dividend policy with the interactions between shareholder and creditor rights (Byrne and O'Connor, 2012; Shao et al., 2013).

While prior studies investigate how shareholder and creditor protection affects payout policy in a static macroeconomic environment, this study examines how the effects of shareholder and creditor rights on dividend policy change under the impact of the global financial crisis. We posit that the financial crisis is an exogenous shock to all firms and it makes agency costs of both equity and debt tend to increase. According to Johnson et al. (2000), a financial crisis is an exogenous shock lowering expected return on investment opportunities. Ceteris paribus, this shock to returns reduces the marginal cost that managers incur to divert firm resources away from positive NPV projects and they are more likely to expropriate minority shareholders (Lemmon and Lins, 2003). Therefore, agency costs of equity increase. Besides, we posit that agency costs of debt also increase due to the two following reasons: Firstly, the financial crisis leads to external financial constraints. When firms are not able to raise external funds easily, they are less willing to establish a reputation of fair treatment of creditors. Therefore, ceteris paribus firms tend to pay more dividends and creditors are expropriated more severely. Secondly, when profitable investment opportunities are less available, firms tend to use dividends as a means to build up a good reputation on their performance and prevent rapid decreases in their stock prices. As a result, they are less willing to meet creditor demand to restrict dividends as a substitute of weak creditor rights under private credit agreements.

We begin the study by comparing the effects of shareholder and creditor rights on both dividend paying propensity and dividend magnitude across 41 countries between the pre-crisis period from 2003 to 2007 and the post-crisis period from 2008 to 2012. After firm characteristics (i.e. profitability, cash holdings, firm growth, debt ratio, asset tangibility, firm size and maturity) and country-level variables (i.e. GDP growth rate, national culture and legal origin dummy) are controlled, we find that both shareholder and creditor rights are less effective in the post-crisis period. Then, we classify countries into groups based on level of shareholder (creditor) protection and replicate

* Correspondence to: Foreign Trade University, 15 D5 Street, Ward 25, Binh Thanh District, Ho Chi Minh City, Vietnam.
E-mail addresses: tranquoctrung.cs2@ftu.edu.vn, quoctrungftu@gmail.com (Q.T. Tran).

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the regression models for each group. The findings show that creditors (shareholders) are expropriated more severely in the post-crisis period if shareholders (creditors) are sufficiently protected. In addition, our robustness checks with panel data regression, the reduced sample, alternative measures of shareholder and creditor protection and additional country-level control variables also indicate consistent findings. This paper contributes to the extant literature by showing that the financial crisis leads to more expropriation of both shareholders and creditors and the extent of expropriation of shareholders (creditors) is larger when creditors (shareholders) are adequately protected.

The remaining of this paper is organized as follows: Section 2 presents relevant literature review, Section 3 shows research methodology, Section 4 reports empirical findings, Section 5 is robustnest checks and Section 6 presents conclusions.

2. Literature review

Jensen and Meckling (1976) define agency relationship as an agreement under which agents perform some service on behalf of principals and posit that the principal-agent relation leads to agency costs. Later studies develop the agency model in broad terms with two kinds of interest conflicts: the conflicts of interest among equity claimants, and the conflicts of interest between equity and debt holders (Brockman and Unlu, 2009). Accordingly, there are two types of agency costs including agency costs of equity and agency costs of debt. The agency costs of equity are commonly utilized to explain incentive problems in corporate dividend policy at firm level. Jensen (1986) posits that excessive funds which are available to managers are a source of agency costs. If firms' cash flow exceeds that required to finance profitable business projects, corporate managers are motivated to invest in negative net present value projects. Therefore, firms pay cash dividend to mitigate agency costs. When investigating the impact of shareholder rights on dividend policies around the world, La Porta et al. (2000) develop two opposite agency models including outcome model and substitute model. The former considers dividend payment as an outcome of effective legal protection of shareholders. When legal protection of minority shareholders is strong, outsiders use their legal rights to force insiders to pay dividends. The latter argues that if firms want to raise external funds with favorable conditions, they must earn a reputation of fair treatment of minority shareholders. One way to establish a good reputation is reducing excessive free cash flow which is available to insiders by paying dividends. Consequently, weaker minority shareholder protection results in higher payout ratio. Using a sample of 4000 companies from 33 countries, La Porta et al. (2000) find that the outcome model is supported, stronger shareholder rights result in higher dividend payout. In addition, Jiraporn et al. (2011) and Mitton (2004) find support in favor of the outcome model based on agency cost of shareholders at firm level in the U.S market and 33 emerging markets respectively. O'Connor (2013) also finds that dividend payment is the outcome of effective corporate governance with a research sample of 220 firms listed in 21 emerging stock markets. They also find that dividend payment is likely to be a substitute for a lack of transparency in these markets.

Furthermore, Brockman and Unlu (2009) extend the line of research at country level with an argument that country-level creditor protection also affects dividend policies. They claim that beside the reputation-building mechanism, dividend constraints are also determined by credit contracts. Under a legal regime of weak creditor protection, creditors have stronger incentives to demand control over the corporate decision-making process via private credit agreements. Consequently, the two contracting parties are more likely to consent to restrict dividends as a compensation for poor creditor rights. Using a research sample of 120,507 observations across 52 countries, they find that creditor rights are positively related to both the likelihood of dividend payment and payout ratio. Byrne and O'Connor (2012) investigate whether shareholder rights at both country-level and firm-level affect corporate dividend policy when creditors demand. With a sample of 22,374 firms listed in 35 countries, they find that creditor rights, both country-level and firm-level shareholder rights play a significant role in payout policy. Creditors have the greatest impact dividend payment decisions. The outcome model based on agency costs of equity is most effective when creditor protection is strong. In countries of weak creditor protection, creditors are demanding and firms pay lower dividends. Shao et al. (2013) continue to examine the impact of power balance between equity and debt claimants on the optimal dividend policy around the world. They argue that optimal dividend policy is obtained when the marginal agency cost of equity is equal to the marginal agency cost of debt. When shareholder rights are sufficiently strong, firms have more discretion to use dividends as means to improve the relationship between firms and creditors and dividend policy is more sensitive to creditor rights. Conversely, when creditors are adequately protected, firms are more flexible to adjust dividends by the quality of shareholder protection. With a sample of 139,168 observations collected from 39 countries from 1991 to 2010, their empirical research shows that creditor (shareholder) rights are more effective when shareholders (creditors) are strongly protected. Furthermore, Boţoc and Pirtea (2014) analyze behavior of 2636 companies listed in 16 emerging stock markets to examine drivers of dividend policy. Their sensitivity analysis shows that cash needs are more significant to explain payout policy in countries of strong investor protection while liquidity is more important in explaining dividend policy in countries of weak investor protection.

Moreover, the extant literature also shows that a financial crisis is a good opportunity to examine corporate governance. Johnson et al. (2000) argue that the Asian financial crisis reduces the available return on investment opportunities and insiders incur lower marginal costs of diverting resources away from profitable investment projects. Therefore, expropriation of minority shareholders becomes more severe. With a sample of 25 emerging markets, they find that more expropriation of shareholders by managers during the crisis can explain the decline in stock markets more effectively than standard macroeconomic measures. Mitton (2002) finds that individual firms can preclude expropriation of minority shareholders when they are not sufficiently protected by law during the East Asian financial crisis. Firms with higher disclosure quality and outside ownership concentration tend to have better performance over the crisis period. Lemmon and Lins (2003) examining the impact of ownership structure on firm value during the East Asian financial crisis and also find that firms where managers and their families separate their control rights and cash flow ownership have lower cumulative stock returns than other firms.

Recently, Al-Malkawi et al. (2014) investigate dividend smoothing of firms listed on the Muscat Securities Market under the impact of the global financial crisis. They add a dummy variable to the Lintner's (1956) partial adjustment model to compare dividend smoothing in the pre-crisis period and the post-crisis period. The research findings show that there is no significant effect of the financial crisis on dividend stability.

While prior studies examine how legal protection of shareholders and creditors affect dividend policy in a static macroeconomic environment, this paper investigates this relationship under the impact of the global financial crisis which is considered as an exogenous shock increasing agency costs of both shareholders and creditors. We hypothesize that shareholder and creditor rights are less effective in the post-crisis period.