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The relationship between judicial efficiency and corporate cash holdings: An international study

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ABSTRACT

This study investigates the relationship between a nation's judicial efficiency – how quickly and inexpensively business cases are handled in that nation's courts – and its corporations' cash holdings over 43,644 firms in 66 countries between 1997 and 2012. We find that improved judicial efficiency is associated with higher levels of corporate cash holdings. This finding supports the managerial-fear hypothesis, where managers consider improvements in judicial efficiency as increasing the probability of bankruptcy and loss of their jobs, responding to this fear by hoarding extra cash as a buffer against bankruptcy. As added support to this conclusion, we find that the positive impact of judicial efficiency on cash holdings further increases for riskier firms (e.g., firms that are smaller, have less collateral, have greater research and development expenditures, and are faster-growing). The results also show that strengthening creditor rights increases corporate cash holdings, subject to the availability of efficient enforcement through the judicial systems. Our results are robust when using different estimation techniques, alternative measures of cash holdings and judicial efficiency, changing the sample period, and different samples, such as excluding countries with a higher density of observations.

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1. Introduction

The protection of shareholders and creditors by a legal system is central to understanding corporate finance practices in different countries. Agency theory predicts that opportunistic managers accumulate more cash at the expense of investors to maintain flexibility and to avoid the disciplining pressure that external capital markets might put on managers when they seek external financing. These excessive cash balances are more likely to be used sub-optimally and, hence, negatively affect firm value (Jensen and Meckling, 1976). This phenomenon is referred to as the agency costs of free-cash flows. When investor protection is low, self-interested managers will have an incentive to accumulate cash to gain discretionary power over the firm's investment decisions. Moreover, Fama and Jensen (1983) argue that managers exhibit more risk-averse behavior when they perceive a survival threat to their firm or their jobs. Thus, it is expected that they accumulate more cash to ensure firm survival. However, these excessive cash balances are usually at odds with the shareholders' wealth maximization principle. Several studies on corporate cash holdings and shareholder protection have established a negative relationship between cash holdings and measures of shareholders' protection (Harford, 1999; Dittmar et al., 2003; Harford et al., 2008). Dittmar and Mahrt-Smith (2007) and Pinkowitz et al. (2006) both found that investors discount firm values in countries where shareholder protections are lower and agency costs are higher. However, not all empirical work supports this agency costs perspective; for example, Opler et al. (1999) reported that transaction costs and asymmetric information costs were significant determinants of corporate cash holdings while these agency costs did not significantly explain variations in corporate cash holdings around the world. Even within this somewhat dissenting research, there is evidence that entrenched managers hold more cash, which is consistent with the agency costs perspective. More recent studies on the topic, found that the agency costs of debt induced by stronger creditor rights are the prime determinants of corporate cash holdings (Kyröläinen et al., 2013; Yung and Nafar, 2014). They argued that better protecting creditor rights makes managers more risk averse. In the presence of stronger creditor rights, managers fear that defaulting on loans can actually lead to their firms' bankruptcy and to a subsequent loss of their jobs. As a safeguard, managers respond by holding more cash than what shareholders would desire.

This study contributes to the above literature by exploring the role of judicial efficiency in determining corporate cash holdings while controlling for creditor rights, shareholders' protection and other well-known determinants of corporate cash holdings. We argue that the efficiency of judicial systems empowers creditors to easily and cheaply recover their loans, seize collateral, or gain control of firms in event of default. *Ex ante*, managers can foresee all these possibilities and would consider defaulting on a loan as a serious threat to continuing in their positions.

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In order to safeguard against job loss, they respond by accumulating more cash to avoid defaulting on loans. Thus, we establish a theoretical link between judicial efficiency and corporate cash holdings using the *managerial-fear hypothesis*. Extant literature on the nexus between law and cash holdings has largely focused on the *content* of the law (e.g., investor and creditor rights protection), while the *enforcement* of these laws through judicial efficiency has received relatively less attention; the few notable exceptions include Yung and Nafar (2014); Kyröläinen et al. (2013), and Seifert and Gonenc (2016). The first two paper used proxies related to contract enforcement in their robustness checks, while the last paper used wider proxies for contract enforcement such as rule of law and corruption index in a country. Our study differs from these studies in several respects.

First, unlike previous studies that have used judicial efficiency only as a control variable, we keep our primary theoretical focus on judicial efficiency in explaining corporate cash holdings around the world. Moreover, we use narrow, more refined, and several alternative measures of judicial efficiency to ensure that our results are not driven by any specific definition of judicial efficiency. For example, we define judicial efficiency (i) in terms of days spent in resolving a judicial case by a court; (ii) in terms of procedures followed from the point of instituting a judicial case until implementation of a final decision by a court; and, (iii) in terms of cost involved in resolution of a judicial case as a percentage of total claim. We believe that these proxies of judicial efficiency should impact more on behaviors of the borrowers and creditors. On the other hand, previous studies such as Seifert and Gonenc (2016) use wider proxies for judicial efficiency. One such proxy is rule of law which is a composite index of the quality of contract enforcement, property rights, the police, the courts, and the likelihood of crime and violence. Such wider proxy of contract enforcement might not be immediate concern of agents (e.g., general crime rate, efficiency of police, and property rights). However, the agents are expected to be more concerned with how much time the judicial process will take should the borrower default? How much cost will be incurred in recovering a loan from a defaulting borrower? How many procedures will be followed from the point of instituting a case till implementation of a final decision of the court? We have included additional analysis in Section 4.6 to see how the wider and narrow proxies of contract enforcement can affect corporate cash holdings. The analysis reported in Section 4.6 lead us to conclude that the narrow (time taken in resolving a judicial case) and wider (rule of law) proxies for contract enforcement do not represent similar information. Our results show that the rule of law can substitute for creditor rights (content of law), not judicial efficiency, rather rule of law complements judicial efficiency.

Second, we conduct extensive analyses and investigate both the direct and indirect effects of judicial efficiency on corporate cash holdings. Previous studies have largely ignored the possibility that firm-specific features might moderate the effect of judicial efficiency on corporate cash holdings. If judicial efficiency increases fear of bankruptcy among firms, then it is reasonable to expect that this fear might be higher among small firms, firms with volatile cash flows, and firms with higher levels of debt financing than other firms. We test these hypotheses in a separate set of regressions.

Third, we jointly investigate the effects of creditor rights and judicial efficiency on corporate cash holdings to find if these two are complementary, substitutive, or independent in nature in influencing corporate cash holding decisions. We find that the creditor rights (content of law) positively influence corporate cash holdings given that these rights are backed by efficient judicial systems (enforcement of the law). On the other hand, the positive influence of judicial efficiency on cash holdings is pervasive, regardless of the fact that creditor rights (content of law) are weaker or stronger.

Fourth, our sample of years, firms and countries is much richer compared to the existing studies on the given subject. For example, we use data from 43,644 firms in 66 countries over the period 1997 to 2012. Previous studies have used data sets from a relatively small number of countries (e.g., Dittmar et al., 2003, used data from 39 countries; Kyröläinen et al., 2013, used data from 48 countries; and Yung and Nafar, 2014, used data from 57 countries).

The rest of the paper is organized as follows. In Section 2, we develop hypothesis and review the theoretical and empirical literature on the association of enforcement of law, content of law, and corporate cash holdings. Section 3 presents details of the sample used, choice of variables, and statistical methods. Section 4 presents results and discussion on the results. Section 5 concludes the paper.

2. Hypothesis development

There are two main opposing views concerning the impact of creditors' rights on the supply of external debt financing. Earlier studies have primarily studied how better protecting legal rights can change the behavior of firms supplying debt. Theories of debt and creditor rights in general imply that stronger creditor rights should increase the supply of funds in a country (La Porta et al., 1998)[1] thus making external financing more easily acquired and cheaper. According to Djankov et al. (2007), creditor rights are a significant determinant of the total private credit provided by the financial sector to firms. From this perspective, increasing creditor rights should increase the supply of external financing and hence *reduce* the need for firms to hoard more cash. As an example, Qian and Strahan (2007) find that the cost of bank debt is lower and debt-maturities are longer in countries where creditor rights are stronger. Almeida et al. (2011) also support the view that the cost of debt financing decreases with improvements in creditor protection.

However, several recent papers have taken an opposing view that highlights how stronger creditor rights are likely to increase the fear of bankruptcy among managers, who then respond to this fear by employing a less-than-optimal level of leverage or holding unnecessarily large piles of cash to avoid costly premature liquidation of their firms (Acharya et al., 2011; Cho et al., 2014; Fan et al., 2012; Vig, 2013; Yung and Nafar, 2014). Since most of the human capital a manager accumulates in firms is firm-specific, its value is lost to a greater extent when the manager loses his or her job due to insolvency or firm liquidation. This makes managers risk averse by nature as they cannot diversify their human capital investment in their firms, which in turn means a preference for lower debt ratios (Amihud and Lev, 1981; Friend and Lang, 1988). The trade-off theory of capital structure suggests that excessive leverage can increase the probability of premature default; hence managers may see leverage as a threat to the existence of their firms, and therefore to their positions. Indeed, Berk et al. (2010) suggested that optimal capital structure is determined by trading off the debt-tax shield benefits against the human costs of bankruptcy.

We consider judicial efficiency as a particular aspect of creditor rights. Earlier studies have primarily focused and defined creditor rights based on the content of laws on the nation's books (e.g., Kyröläinen et al., 2013: p. 278, defined creditor rights as "*the laws of a country that provide protection for creditors in the event of default.*"). However, we argue that while writing better law contents might empower creditors, the efficiency of enforcing those laws (e.g., the cost of the judicial process, the number of procedures involved, the time taken by a court in deciding a case) is also crucial toward understanding corporate financing and investment decisions for several reasons. First, the time value of punishment decreases for the party in breach of the contract if a court takes too long in deciding a case (Chemin, 2010). Second, if a judicial system is inefficient in terms of cost and time, even a solvent borrower might choose to default as the cost of loan recovery through the judicial system might not make economic sense for the lender (Jappelli et al., 2005).

If strengthening creditor rights causes managers to fear losing their position with the firm in the event of default, we argue that efficient judicial systems should further intensify this fear. Efficient judicial

[1] More evidence in this regard can be found in Eaton and Gersovitz (1981); Jappelli et al. (2005)

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