International Review of Economics and Finance 32 (2014) 143–158

Contents lists available at ScienceDirect

International Review of Economics and Finance

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

Controlling shareholder entrenchment: Bonuses versus dividends

Jin-Ying Wang *

Department of Risk Management and Insurance, Ming Chuan University, 250 Zhong-Shan N. Rd., Sec.5, Taipei, Taiwan

ARTICLE INFO

Available online 24 January 2014

JEL classification:
G32
G34

Keywords:
Deviation between control rights and cash flow rights
Controlling shareholder entrenchment
Minority shareholder expropriation
Employee bonus
Dividend policy

ABSTRACT

An excess of control rights over cash flow rights (deviation), resulting in controlling shareholder entrenchment, is a common corporate governance problem in East Asian companies. This study examines whether control rights and cash flow rights deviations affect companies' earnings distribution policies in Taiwan. The results indicate that, regardless of whether voting rights or the number of directors on company boards are used to measure control rights, companies with higher degrees of deviation between control and cash flow rights pay disproportionately large shares of company earnings in employee bonuses relative to shareholder dividends. Severe deviation companies are biased in favor of employee compensation at the expense of minority shareholders. These companies are more likely to expropriate minority shareholders through controlling the boards of directors and paying cash bonuses to employees.

1. Introduction

The employee bonus system is a double-edged sword for shareholders. Through use of a bonus system, an enterprise can retain excellent employees while ensuring continued wealth generation for shareholders. However, if a company values employee interests above shareholder interests in earnings allocations, an unfair situation arises, and shareholders benefit less from company profits.

What type of company is more likely to pay larger bonuses to its employees and smaller dividends to its stockholders? Many previous studies[1] of dividend policy have focused on the corporate governance perspective. As dividends and employee bonuses are both methods companies use to distribute earnings,[2] I suggest that company governance quality affects earnings distribution.

Claessens, Djankov, and Lang (2000) indicate that a common corporate governance problem in East Asian countries is the deviation between control rights and cash flow rights of companies' controlling shareholders. Controlling shareholders often have an excess of control rights over cash flow rights through the use of cross-shareholdings, pyramid structures, and participation in management (Claessens, Djankov, Fan, & Lang, 1999; Claessens, Djankov, & Lang, 2002; La Porta, Lopez-De-Silanes, & Shleifer, 1999). If Company A holds 30% of the stock rights of Company B, and Company B holds 40% of the stock rights of Company C, then Company A holds 40% of the control rights of Company C, which exceeds the cash flow rights of 12% (30% × 40%).[3] Hence, cash flow rights and control rights diverge. When control rights and cash flow rights diverge significantly, controlling shareholders

* Tel.: +886 2 2882 4564x2115; fax: +886 2 2880 9755.
E-mail address: jyw203@yahoo.com.tw.

[1] See La Porta et al. (2000), Jiraporn et al. (2011), Julio and Ikenberry (2004), Moh'd, Perry, and Rimbey (1995), Claessens et al. (1999), Setia-Atmaja et al. (2009), and Gugler and Yurtoglu (2003).

[2] Although repurchases are now the dominant form of payout (Skinner, 2008), certain repurchase motives do not relate to a firm's payout, for example, anti-takeovers (Bagwell, 1991; Dittmar, 2000) or misleading investors (Chan, Ikenberry, Lee, & Wang, 2010). Therefore, repurchases are not examined in this paper.

[3] These definitions of cash flow rights and control rights are proposed in La Porta, Lopez-De-Silanes, Shleifer, and Vishny (2002).

1059-0560/$ – see front matter © 2014 Elsevier Inc. All rights reserved.
http://dx.doi.org/10.1016/j.iref.2014.01.012

have incentives to expropriate minority shareholders, causing a conflict of interest between controlling and minority shareholders (Bozec & Laurin, 2008; Claessens et al., 1999; Denis & McConnell, 2003; Lins, 2003; Shleifer & Vishny, 1997). This dynamic relationship fosters a substantial agency problem, i.e., controlling shareholder entrenchment.

Gugler and Yurtoglu (2003) argue that in companies exhibiting severe cash flow and control rights deviations, controlling shareholders have the power and incentive to pursue private interests because they receive additional benefits while paying only part of the costs. Because controlling shareholders of severe deviation firms are often major company employees, and because lower cash flow rights limit the dividends which controlling shareholders can claim, I propose that controlling shareholders of severe deviation firms may choose to abandon small dividends in exchange for large employee bonuses. Thus, severe deviation companies tend to pay larger employee bonuses and smaller shareholder dividends.

Using a sample of listed companies in Taiwan, I draw the following implications. First, Taiwan is a civil-law country, which has relatively few legal mechanisms in place that favor minority shareholders.[4] It is meaningful to study company-level data in Taiwan because individual companies may have means of reducing controlling shareholder entrenchment in an environment of inadequate legal protection (Klapper & Love, 2004; Mitton, 2002). Second, Faccio, Lang, and Young (2001) find that the expropriation of minority shareholders by controlling shareholders is evident in Western European and Asian countries but European companies pay out more dividends than Asian corporations, thereby alleviating the problem of expropriation of minority shareholders. Additionally, Pinkowitz, Stulz, and Williamson (2006) suggest that dividends contribute more to corporate value in countries with poor investor protections. As an East Asian country with poor investor protection, the dividend policies of Taiwanese companies merit examination. Third, The Taiwan Stock Exchange requires enterprises to publicly disclose "having or having not paid employee bonuses without paying shareholder dividends" as part of their earnings distribution. Hence, whether employee bonuses infringe on shareholder interests has been an issue of concern in Taiwan.

Boards of directors are often major decision-making bodies in determining earnings distributions in companies. Yeh and Woidtke (2005) argue that the proportion of board directors represented by a controlling family appears to be a reasonable proxy for the quality of corporate governance quality at the firm level in countries with inadequate investor protection. Through possession of seats on boards of directors, controlling shareholders obtain the excess control rights. Therefore, in addition to the voting rights described by La Porta et al. (1999), this study incorporates board rights. Specifically, company control rights are categorized into voting rights and board rights.[5]

Both cash and stock are methods of distributing earnings, but they have different characteristics. Stock value is related to the expected future business performance of a company, whereas cash value has no such determinant. Therefore, in an analysis of earnings distribution, it is necessary to discuss cash and stock separately. In this study, employee bonuses are divided into cash and stock bonuses, and stockholder dividends are also divided into cash and stock dividends. The proportion of cash bonuses relative to cash dividends and the proportion of stock bonuses relative to stock dividends are calculated to distinguish the differing distribution effects of cash and stock.

In the traditional dividend theory, stock dividends do not affect shareholders' wealth, except for the unique tax effect in Taiwan. Hu and Tseng (2006) examine order flows around ex-dividend dates on the Taiwan Stock Exchange and investigate the source of stock dividend payments to distinguish taxable and nontaxable samples, finding differing behavior between tax-disadvantaged and tax-neutral investors around ex-dividend dates. Thus, under the Taiwanese tax code, stock dividends can significantly impact shareholders' wealth. This study explores the proportion of Taiwanese company earnings paid as stock dividends, in an effort to supplement academic studies of stock dividends.

I find that whether voting or board rights are used to represent control rights, companies exhibiting higher deviations between control rights and cash flow rights pay out higher proportions of profits as bonuses compared to dividends. In particular, companies may expropriate minority shareholders by controlling their boards of directors and paying cash bonuses to employees. These results hold even when I consider possible endogeneity in the relationship between corporate governance and payments. Thus, the results show that companies with severe control and cash flow rights deviations favor employees at the expense of minority shareholders.

The remainder of the study is organized as follows. Section 2 presents a literature review and derives the research hypothesis. Section 3 describes the Taiwanese earnings distribution system and the data used in this study. Section 4 presents the empirical analysis, including the research models, the variables used, and verification of the research hypothesis. Lastly, Section 5 provides concluding remarks.

2. Literature review and research hypothesis

2.1. Literature review

2.1.1. Corporate governance and dividend payments

La Porta, Lopez-De-Silanes, Shleifer, and Vishny (2000) classify dividend-policy agency models into outcome and substitution models. According to the outcome model, dividends are paid owing to pressure exerted by minority shareholders; thus, corporate governance and dividend payments are positively correlated. According to the substitution model, dividends are paid to establish

[4] La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1998) and La Porta et al. (2000) indicate that common-law countries have better investor protection than civil-law countries.

[5] Kuan, Li, and Liu (2012) also develop the notion of excess control rights by focusing on the difference between voting and cash flow rights and the difference between seat control and cash flow rights.