The Quarterly Review of Economics and Finance 52 (2012) 227–242

Contents lists available at SciVerse ScienceDirect

The Quarterly Review of Economics and Finance

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

Creditor rights and the outcome model of dividends☆

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ARTICLE INFO

Article history:
Received 23 May 2011
Received in revised form
19 December 2011
Accepted 6 April 2012
Available online 21 April 2012

JEL classification:
G15
G35

Keywords:
Dividend policy
Creditor rights
Shareholder rights
Corporate governance

ABSTRACT

Using a sample of 22,374 firms from 35 countries, we examine the role of creditor rights, shareholder rights, and corporate governance in determining corporate dividend policy. We find that, while all three variables play a significant role in determining both the likelihood and the dividend amount, the effect of country-level creditor rights dominate. In subsequent analysis, we show that the outcome model is most effective in countries with strong creditor rights. When creditor rights are weak, creditors demand, and firms consent to lower dividends. These findings show that creditors, and not shareholders, exert the greatest influence over corporate dividend policy.

1. Introduction

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000), and more recently Brockman and Unlu (2009), show how corporate dividend policy is influenced by the strength of the legal rights afforded to the providers of external capital to corporations. The former relate shareholder rights, measured at the country-level to corporate dividend payout, and test two competing agency models of dividends, namely the outcome and substitution models. The outcome model, built on Jensen's (1986) free cash flow hypothesis suggests that shareholders can exercise their legal rights to force firms to pay dividends, in turn reducing the agency costs associated with free cash flow. The ability of shareholders to extract dividends from firms increases in the strength of their legal rights. Hence, dividends are an outcome of shareholder rights; the likelihood of paying a dividend, and the dividend amount increase in the strength of shareholder rights. The substitution model suggests otherwise. Under the predictions of the substitution model, firms use dividends as a bonding device. Firms substitute poor shareholder rights for high dividends. In doing so, firms establish a reputation for fair treatment of their minority shareholders, which in turn should lower their cost of capital, and relax their financing constraints. As a result, the incidence of paying a dividend, and the amount of the dividend paid should decrease in the strength of shareholder rights, since firms with the most severe agency problems are more likely to pay higher dividends.[1] La Porta et al. (2000) find support in favor of the outcome model of dividends; dividend payout increases in the level of shareholder rights. Subsequent work also shows that shareholder rights, but now measured at the firm-level (i.e., corporate governance) also

☆ The paper was previously circulated under the heading "Shareholder and creditor legal rights and the outcome model of dividends". We thank an anonymous referee for helpful comments on an earlier version of the paper. We accept responsibility for any remaining errors.

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[1] In recent work, Chae, Kim, and Lee (2009) show that total payout (dividends and share repurchases) is higher in firms where corporate governance is strong and when external financing costs are low (and/or when there is no need for external financing). When corporate governance is strong, but sizable external financing constraints exist, total payout tends to be much lower. Their findings suggest that in determining payout policy, managers balance the benefit of paying dividends, i.e., a reduction in the agency costs of free cash flow a la Jensen (1986) against the costs of external financing. Their results are thus in line with Rozeff (1982). This line of reasoning would then suggest that the tendency on the part of firms with sizable agency costs to pay higher dividends is likely to be very much a function of the joint effect of agency costs and their external financing need. Firms with sizable agency costs *and* external financing costs are more likely to pay higher dividends according to the substitution hypothesis. Mansi and Wald (2010) highlight the prevalence of dividends as a bonding mechanism to guard against the free cash flow problem when firms face limitations on the use of debt, and when managerial ownership is low.

1062-9769/$ – see front matter
http://dx.doi.org/10.1016/j.qref.2012.04.002

influences corporate dividend policy. With some exceptions, much of the empirical evidence finds support in favor of the outcome model (Bartram, Brown, How, & Verhoeven, 2008; Jiraporn, Kim, & Kim, 2011; Mitton, 2004); the likelihood of paying a dividend, and the dividend amount tends to increase in the strength of shareholder rights, i.e., corporate governance.[2] In turn, in an emerging market setting, Mitton (2004) shows that while shareholder rights measured at the country- and firm-level both influence corporate dividend payout, the country effect dominates. Furthermore, he finds that they tend to complement one another, resulting in higher dividend payouts where country *and* corporate governance are strong. More recent work explores the link between creditor rights, shareholder rights (only measured at the country-level), and corporate dividend payout. Brockman and Unlu (2009) show that the likelihood of paying a dividend and the dividend amount increase in both shareholder and creditor rights. However, the latter effect dominates.

In this paper, we explore an issue left unresolved given the findings of La Porta et al. (2000), and Brockman and Unlu (2009).[3] It is as follows. We examine whether shareholders are, through their legal rights measured at the country- *and* firm-level, better able to extract larger dividends from firms, even when creditors are likely to demand otherwise. Creditors are likely to demand otherwise when their legal rights are weak. Brockman and Unlu (2009) suggest that creditors and not shareholders exert the greatest influence over corporate dividend payout. Hence, if creditors do in fact exert the greatest influence over corporate dividend payout as Brockman and Unlu (2009) suggest they do, then the likelihood of, and the dividend amount is likely to be much lower given poor creditor rights, even when shareholder rights are strong. This suggests that the ability of shareholders with strong legal rights to extract dividends from firms is diminished when creditor rights are weak. In other words, a priori, we expect that the outcome model of dividends be much less relevant given poor creditor protection. In this paper, we test this proposition.

To do so, we form a panel of 22,374 firms from 35 countries to test the legitimacy of the outcome model of dividends by examining the influence of creditor and shareholder rights, with the latter measured at both the firm- (corporate governance) and country-level on corporate dividend payout policy. In a series of pooled logit and Tobit regressions, we show that while creditor rights, shareholder rights and corporate governance all influence both the level and likelihood of dividend payouts, creditors exert the greatest influence. This finding is in line with Brockman and Unlu (2009). Next, and consistent with Mitton (2004), we find that shareholder rights measured both at the firm- and country-level influence corporate dividend payout, with the latter country-effect again dominating. In turn, we show that both shareholder rights measures still matter, and the same hierarchy is maintained, even with the inclusion of creditor rights. However, when all three measures are included simultaneously, the effect of creditor rights dominates.[4] Second, and different to both Mitton (2004) and Brockman and Unlu (2009), we repeat our initial analysis, but now by level of creditor rights. Our findings are in line with our prior expectations. We find that the outcome model is most effective in countries with strong creditor rights. We find that the coefficient estimates on the shareholder rights measures (i.e., firm- and country-level), are positive, large, and invariably statistically significant, when creditor rights are strong. In contrast, where creditor rights are weak, the coefficient estimates on the shareholder rights measures are much lower, surprisingly sometimes negative, and at times statistically insignificant. Our findings suggest that the *outcome* model of dividends is much less relevant under poor creditor rights. When creditors are poorly protected, they demand and firms consent to lower dividends. In effect, creditors *substitute* poor legal standing with lower dividends.

These findings serve to reinforce the conclusions reached by Brockman and Unlu (2009). Creditors exert a much greater influence on dividend payout policy than do shareholders. The likelihood of, and the dividend amount are much lower when creditor rights are weak, regardless of the strength of shareholder rights. Furthermore, and in addition to the findings of Brockman and Unlu (2009), we show that creditor rights dominate shareholder rights, even when shareholder rights are measured at the firm- and country-level. In this regard, neither firm nor country-level shareholder rights are able to dominate creditor rights. Furthermore, we find that while the outcome model remains relevant under poor creditor rights when shareholder rights are measured at the firm-level, the substitute model prevails when shareholder rights are measured at the country-level. This latter finding suggests that when creditor rights are weak, dividend payouts *decrease* with country-level shareholder rights. Our analysis suggests that the findings of La Porta et al. (2000), and Mitton (2004), which do not account for the strength of creditor rights, are in retrospect, largely contingent on both shareholders *and* creditors enjoying substantial legal rights. When the latter are not well-protected under the legal regime, the number of firms paying dividends, and the dividend amounts are much lower.

Finally, in a series of robustness tests, we show that our results are not sensitive to our measure of corporate governance. We extend the analysis originally undertaken by Mitton (2004). Using Credit Lyonnais Securities Asia (CLSA, 2001) corporate governance data for 304 emerging market firms, we show that the ability of shareholders to extract dividends from firms using their firm-level legal rights is contingent on strong shareholder *and* creditor rights.[5] When creditors do not enjoy sizable legal rights, the outcome model of dividends becomes less relevant, irrespective of the strength of shareholder rights. The likelihood and the dividend amount are highest when both shareholders *and* creditors enjoy sizable legal rights.

Our work extends the literature in a number of ways. First, our findings serve to reinforce the findings of Brockman and Unlu (2009), and demonstrate the persuasive effect that creditors have

[2] Jiraporn and Ning (2006), Chae et al. (2009), and Mitton (2004) in civil law countries only, all find support in favour of the substitution model of dividends. Both Jiraporn and Ning (2006) and Chae et al. (2009) use a sample of firms from the U.S. Mitton (2004) uses a sample of emerging market firms. Sawicki (2009) finds support in favour of the substitute model in Asia pre-Asian crisis, and the outcome model post-crisis. Interestingly, using the G-Index of Gompers, Ishii, and Metrick (2003) to measure the strength of corporate governance of U.S. firms, Jiraporn and Ning (2006) find in favour of the substitution model. Again using U.S. firms, but now using governance data from the Institutional Shareholder Services (ISS), Jiraporn et al. (2011) find in favour of the outcome model. The ISS data is a much broader corporate governance measure than the G-Index, which in turn, likely explains the conflicting findings. Brockman and Unlu (2011) show that the substitution model prevails in countries where disclosure environments are opaque and the outcome model in countries where disclosure environments are transparent.

[3] A second fundamental question that arises, but which we do not examine in this paper relates to instances in which shareholders are not well-protected, but creditors are. Brockman and Unlu (2009) show that dividend payout increases in both creditor and shareholder protection. However, what we do not know is whether creditors force firms to pay higher dividends (i.e., when creditor rights are strong) when shareholder rights are weak. In unreported results, we show that creditors do not use their legal rights to force firms to pay higher dividends when shareholder rights are weak. These findings are available from the corresponding author upon request. In closely related work, Shao et al. (2009) explore this issue in great detail in their paper.

[4] The exceptions occur when we use different measures of country-level shareholder rights. We return to this issue in much greater detail later in the paper.

[5] Our sample size is not identical to that of Mitton (2004), but less than his.