Dividend Policy with Controlling Shareholders

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This Article investigates the determinants of dividend policy in firms with concentrated ownership structures. A review of the empirical literature shows that dividend payout ratios are lower in firms with controlling shareholders. We explain this finding as a consequence of the legal rules governing cash distributions, which leave the dividend decision in the hands of the firm insiders, and the lack of monitoring mechanisms for checking the power of controlling shareholders. The analysis of the empirical evidence on dividend policy points to the existence of an unresolved agency conflict between controlling shareholders and outside investors. We conclude that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

Introduction

In this Article we review the literature that studies the determination of dividend policy in firms with concentrated ownership structures. Most of the literature on dividend policy studies the design of an optimal payout policy when managers determine the reinvestment of the shareholders' money. However, in firms with concentrated ownership structures, the large shareholders play a key role in the determination of dividend policy. And this role is not yet well understood.

Company insiders have the information that allows them to determine to which extent cash-flows can be reinvested at an appropriate rate of return inside the firm. Cash-flows in excess of the amount that can be profitably reinvested,

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i.e., free cash-flows, should be paid out as dividends to let shareholders reinvest them optimally outside the firm. However, company insiders have incentives to retain free cash-flows inside the firm, where they can make use of them to generate private benefits for themselves at the expense of outside investors. The term "company insiders" in the case of companies with dispersed ownership structures refers mainly to the managers, whose relative power in such companies creates an agency problem. In companies with concentrated ownership structures the main agency problem is between the controlling shareholders, who are the relevant powerful insiders, and the minority shareholders. The Article focuses on the latter case. The financial literature makes a strong case for the usefulness of a generous dividend policy as a means of reducing this agency conflict by forcing the distribution of free cash-flows. However, it leaves unexplained the issue of why the powerful insiders should choose to give back the money and renounce their private benefits. In this Article we argue that dividend policy only serves to distribute free cash-flows either if the outsiders have real power in its design or if there are complementary corporate governance arrangements that discipline and change the incentives of the insiders.

Our argument proceeds in several steps. First, a careful analysis of the legal rules governing cash distributions leads us to conclude that the law grants the control of dividend policy to the powerful insiders, with weak protection for the interests of outside shareholders in this regard.

Second, when we turn to the relationship between dividend policy and other corporate governance mechanisms, we find that while external and internal monitoring give managers incentives to pay higher dividends, this is not the case for controlling shareholders. Thus we conclude that in firms with dispersed ownership structures, although dividend policy is unlikely to reach the first best, managers, unlike controlling shareholders, are subject to the pressure of different control mechanisms that induce them to select payout policies that increase shareholders' value. However, the lack of control mechanisms to discipline controlling shareholders allows them to select dividend policies that damage minority shareholders and hinder the growth opportunities of firms with concentrated ownership structures.

Third, we find that the empirical evidence is clearly consistent with this argument: there is overwhelming empirical evidence that firms with controlling shareholders have lower payout ratios, and that these ratios are positively correlated to the quality of corporate governance. There is a fundamental conflict of interest between the controlling insiders and the outside investors with respect to the preferred dividend policy, and the empirical evidence shows that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

This Article proceeds as follows. Part I reviews the theory on dividend policy, particularly its role as a tool to reduce the agency cost of free cash-flows. Part II examines the legal determinants of dividend policy and finds that control over dividend policy is mainly awarded to the corporate insiders. Then Part III discusses the role of alternative corporate governance mechanisms to force insiders to pay out free cash-flows, explaining the differences in the functioning of market and internal monitoring in firms with dispersed and concentrated ownership. Finally, Part IV shows that all the empirical evidence on dividend policy points to the existence of an unresolved agency conflict between controlling shareholders and outside investors. We conclude that controlling shareholders are currently using the dividend policy to expropriate minority shareholders.

I. Why Are Dividends Important?

Dividends are a central piece in corporate finance because equity investors receive their payoffs as dividends. The market value of a share is the discounted value of the expected cash-flows in the form of future dividends that the owner is entitled to receive. However, these dividends are uncertain. Every year there will have to be a decision on which percentage of net income is reinvested in the firm and which percentage is paid out as a dividend. Reinvesting income results in lower current cash-flows, but in the expectation of higher future cash-flows. Therefore dividend policy is a key determinant of equity value and firm value.

Dividend policy has been an area of intense research in corporate finance ever since the publication of the seminal irrelevance propositions by Merton Miller and Franco Modigliani.[1] They proved that dividend policy does not affect either equity or firm value (i.e., dividend policy is irrelevant) as long as (i) the firm operates in perfect capital markets and (ii) operating cash-flows are not affected by financial choices. If these two conditions hold, investors are indifferent as to whether profits are distributed or withheld within the corporation. This is a direct consequence of the two assumptions of the model. At the aggregate level, these assumptions guarantee that the investment opportunities of the firm and its overall value do not depend on the availability of retained earnings as a source of funding. Investments can be funded through the issuance of equity or debt at exactly the same cost. And, at the individual level, each shareholder can sell stock at no cost to obtain

1 Franco Modigliani & Merton H. Miller, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. Bus. 411 (1961).

cash-flows from his investment in the firm's shares, i.e., each shareholder can create his preferred "homemade" dividend so as to fit his investment and consumption choices period by period. However, since neither of the two conditions holds in practice, dividend policy is an important determinant of firm value.

Indeed, when we consider more realistic conditions, there are many factors that have to be taken into account in the design of the dividend policy. At the aggregate level, issuance costs, asymmetric information and agency conflicts make security issuance a costly process and imply that investment opportunities depend on the availability of retained earnings. At the individual level, personal and corporate taxes and trading costs make homemade dividends a poor substitute for actual dividends. The question that the finance literature has tried to answer since Modigliani and Miller is whether it is possible to establish an optimal dividend policy in this complex environment.

At the empirical level there exists an ample literature that studies which factors are better predictors of firms' observed dividend policy and how dividend policy impacts firm value. Early empirical evidence showed that dividend policy is considered very important by managers.[2] This initial research found that managers alter the dividend payout ratio so as to smooth dividends and make dividends less volatile than earnings per share, and that managers are very reluctant to cut dividends. Moreover, there is evidence that announcements of dividend initiations and increases are followed by increases in market value, while announcements of dividend reductions and omissions are negatively received by the market.[3] There are also studies of the determinants of dividend policy using very long time series for U.S. firms, which find that the firms that have higher dividend payout ratios are usually the larger, older and more profitable ones, but with fewer growing opportunities.[4] Other scholars have documented the relative use of dividends and share repurchases as alternative ways to distribute cash flows to the shareholders, considering their different tax treatment and the reduction over time in the propensity of firms to pay dividends.[5] Interestingly, these

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2 John Litner, *Distribution of Incomes of Corporations Among Dividends, Retained Earnings, and Taxes*, 46 Am. Econ. Rev. 97 (1956).

3 Franklin Allen & Roni Michaely, *Payout Policy*, *in* 1A Handbook of the Economics of Finance 337 (George M. Constantinides, Milton Harris & René M. Stutz eds., 2003).

4 Suman Banerjee, Vladimir Gatchev & Paul Spindt, *Stock Market Liquidity and Firm Dividend*, J. Fin. & Quantitative Analysis 369 (2007); Eugene Fama & Kenneth French, *Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?*, 60 J. Fin. Econ. 3 (2001).

5 For a discussion of the tax differences between dividends and share repurchases

empirical facts are to some extent consistent with the predictions of several alternative theoretical models that determine which is the optimal dividend policy when one introduces different market imperfections and conflicts of interest to modify the Modigliani and Miller Theorem.[6]

All the different theoretical models trying to explain optimal dividend policy with market imperfections can be grouped into three broad alternative theories of dividends. The first theory has to do with taxes and trading costs that generate heterogeneous dividend clienteles, the so called "dividend clientele" or "catering theory of dividend policy," as proposed by Malcom Baker and Jeffrey Wurgler.[7] Depending on the different tax rates and transaction costs they face when buying and selling securities, different groups of investors will have preferences for different dividend policies, and firms will position themselves to cater to one of these clienteles. According to this theory, at the aggregate level, we will observe higher payout ratios at times when the prices of the shares of firms with high payout ratios are high relative to those of firms that pay no dividends or have low payout ratios. Baker and Wurgler also find that the number of dividend initiations and omissions for U.S. firms is positively related to the so called "dividend premium," the difference between the market-to-book ratios of dividend payers and non-payers in a given year.[8] But their findings have not been confirmed by subsequent research. In particular, David J. Denis and Igor Osobov, using data from several countries, show that there are not enough switches to justify a significant impact of tax clienteles on the determination of dividend policies.[9] Moreover, Henry DeAngelo, Linda DeAngelo and Douglas J. Skinner point out that this theory is inconsistent with the repurchase puzzle, because despite their tax advantages share repurchases

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see Henry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings*, 72 J. Fin. Econ. 425 (2004); and William W. Bratton, *The New Dividend Puzzle*, 93 Geo. L.J. 845 (2005).

6 Three very complete surveys of the finance literature on dividend policy are Allen & Michaely, *supra* note 3; Harry DeAngelo & Linda DeAngelo, *The Irrelevance of the MM Dividend Irrelevance Theorem*, 79 J. Fin. Econ. 293 (2006); and Harry DeAngelo, Linda DeAngelo & Douglas J. Skinner, *Corporate Payout Policy*, 3 Foundations & Trends Fin. 95 (2009).

7 Malcom Baker & Jeffrey Wurgler, *A Catering Theory of Dividends*, 59 J. Fin. 1125 (2004).

8 Malcom Baker & Jeffrey Wurgler, *Appearing and Disappearing Dividends: The Link to Catering Incentives*, 73 J. Fin. Econ. 271 (2004).

9 David J. Denis & Igor Osobov, *Why Do Firms Pay Dividends? International Evidence on the Determinants of Dividend Policy*, 89 J. Fin. Econ. 62 (2008).

have not made dividends disappear.[10] Finally, this theory cannot explain why dividends are concentrated among large, old, profitable firms.

The introduction of asymmetric information into the picture gives rise to the second theory of dividends, the "dividend signaling theory." Several studies developed theoretical models where some firms are undervalued because managers have positive information that they cannot communicate to the market investors in a credible way.[11] In these models dividends are costly and inefficient, but managers of firms that have good news to communicate to the market use them to prove that, unlike less worthy firms, they can afford to burn money. The main prediction of this theory is that the market will react to dividend announcements exactly as it does, with announcements of dividend increases and initiations (decreases and omissions) being perceived as good (bad) news, and that managers will be reluctant to cut dividends.

However, there are important problems with this theory. The first problem is that the signaling theory is inconsistent with the fact that dividends are concentrated among the larger, older, more profitable firms, which are the ones that suffer less asymmetric information problems. The second problem is that if dividends are signals, they seem to be quite inefficient signals, because there is a post-announcement drift for three years after announcement.[12] Therefore the market takes three years to update all the positive or negative information conveyed by the announcement of the dividend change. The third problem is that after the announcement firm performance does not change in the expected way. In particular, return on assets increases (decreases) years before dividend increases (decreases), but it does not increase (decrease) after dividend increases (decreases).[13]

Neither the catering nor the signaling theory of dividends allows for conflicts of interest and agency costs, since they both assume that the company insiders are following an investment and financial policy aimed at maximizing equity value. However, managers will follow their own agenda and their preferred investment policies need not coincide with the policies that would maximize equity value. Jeremy Stein reviews systematically the different costs generated

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10 DeAngelo, DeAngelo & Skinner, *supra* note 6.

11 *See* Sudipto Bhattacharya, *Imperfect Information, Dividend Policy, and "The Bird in the Hand" Fallacy*, 10 Bell J. Econ. 259 (1979); Kose John & Joseph Williams, *Dividends, Dilution, and Taxes: A Signaling Equilibrium*, 40 J. Fin. 1053 (1985); Merton Miller & Kevin Rock, *Dividend Policy Under Asymmetric Information*, 40 J. Fin. 1031 (1985).

12 Roni Michaely, Richard H. Thaler & Kent L. Womack, *Price Reactions to Dividend Initiations and Omissions*, 38 J. Fin. 1597 (1995).

13 Gustavo Grullon, Roni Michaely & Bhaskaran Swaminathan, *Are Dividend Changes a Sign of Firm Maturity?*, J. Bus. 387 (2002).

by the agency problem between managers and shareholders, and shows that managers will generally bias investment policy to obtain private benefits, reduce risk, and favor short-term over long-term projects.[14]

The recognition of the conflict of interest between the insiders that select the firms' investments and the outside investors, who finance those investments, gives rise to the third dividend theory, the "agency cost over the lifecycle" theory of dividend policy. According to this theory, dividends do not convey good news; they are good news by themselves. Some authors argue that in this context dividends will be welcomed by the market because high dividend payout ratios imply that retained earnings will be low relative to investment opportunities.[15] With high dividends, managers will be unable to fund their suboptimal investment projects with free cash-flows and will be forced to issue either debt or equity if they want to raise money for investment. Therefore, although issuing securities is a costly process that could be avoided by retaining earnings, it has the advantage of allowing outside investors to monitor investment policy and reduce agency conflicts.

The main prediction from this theory is that the optimal dividend policy forces firms with agency problems to distribute their free cash-flows as dividends. Moreover, dividend policy is expected to evolve over the lifecycle of the firm, driven by the investment opportunity set and the need to distribute the firm's free cash-flows. Young firms with low retained earnings and highly profitable investment opportunities do not have free cash-flows and do not need to pay dividends to reduce agency problems. Mature firms with high retained earnings and poor investment opportunities generate free cash-flows that could be wasted by the insiders and, therefore, should pay high dividends.

This theory fits very well the accumulated empirical evidence. It explains why larger, older and more profitable firms have higher payout ratios, since they are the ones that will have free cash-flows. It explains the positive (negative) market reaction to dividend increases and initiations (decreases and omissions), since they reduce (increase) the discretion of managers. It also explains the post-announcement drift, since in the medium term market values will increase when better investment decisions are made. It is also consistent with the changes in return on assets (ROA) observed by Gustavo Grullon, Roni Michaely and Bhaskaran Swaminathan, implying that dividends

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14 Jeremy Stein, *Agency, Information and Corporate Investment*, *in* Handbook of the Economics of Finance, *supra* note 3, at 109.

15 *See* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 Am. Econ. Rev. 650 (1984); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am. Econ. Rev. 323 (1986).

should increase (decrease) when profitability has been high (low).[16] Finally, the results of Baker and Wurgler in support of the catering hypothesis can also be interpreted as consistent with the agency theory of dividends.[17] They find that non-payers are more likely to start paying dividends when the market-to-book ratios of dividend payers are high relative to those of non-payers. They interpret market-to-book ratios as a reflection of investors' preferences for some stocks that generate clienteles. But market-to-book ratios are more commonly interpreted in the finance literature as good proxies for the growth opportunities of the firm, with high (low) market-to-book ratios reflecting high (low) growth opportunities. According to agency theory, firms that do not pay dividends will face more pressure to start paying dividends when their growth opportunities deteriorate, i.e., when their market-to-book decreases relative to the market-to-book of firms that pay dividends.

Moreover, the most recent empirical evidence is also consistent with this view: propensity to pay dividends is positively related to the ratio of retained earnings to total equity, which proxies for the firm's lifecycle stage.[18] Denis and Osobov find that the likelihood of paying dividends is strongly associated with the ratio of retained earnings to total equity, and that the fraction of firms that pay dividends is high when firms' equity consists primarily of retained earnings and low when retained earnings are negative.[19]

Summing up, we find that the current view on dividend policy in the financial literature is that optimal dividend policy is mainly determined by the need to reduce the agency problems generated by free cash-flows that appear over the lifecycle of the firm. But one of the issues that this theory leaves unresolved is why the company insiders would voluntarily select a dividend policy that reduces their discretion and prevents them from pursuing their preferred investment strategy. For this reason, we need to investigate the rules governing the distribution of dividends and constraining the dividend policies of the insiders. In the next Part we explore the legal restrictions placed on the insiders for the determination of the dividend policy and discuss whether these rules really protect outside investors and encourage the distribution of free cash-flows.

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16 Grullon, Michaely & Swaminathan, *supra* note 13.

17 Baker & Wurgler, *supra* note 8.

18 Linda DeAngelo, Douglas J. DeAngelo & Rene M. Stulz, *Dividend Policy and the Earned/Contributed Capital Mix: A Test of the Lifecycle Theory*, 81 J. Fin. Econ. 227 (2006).

19 Denis & Osobov, *supra* note 9.

II. The Legal Determinants of Corporate Distributions

In the traditional legal conception, there are two key elements in the ownership of a firm: the right to control the firm and the right to receive the firm's net earnings. The receipt of a dividend is the means by which the shareholder gets the return on his investment in a company. For this reason, dividend payout was categorized in early times by legal scholars as one of the "rights" of the shareholders, in the understanding that the status as shareholders determines an array of demands from the corporation and duties to the corporation. This general conception changes across organizations, being stronger in partnerships and closely held corporations. Nevertheless, in public companies, shareholders have no right to force the distribution of a dividend. It is a discretionary decision of the insiders that control the firm whether to distribute the earnings as a dividend or to reinvest them so as to generate future earnings. In practice, the decision on whether the business surplus is distributed or not, and the amount distributed, is taken by the directors on the board — in those corporations with a dispersed ownership structure — or by the controlling shareholders through the general meeting — typically in the case of corporations with a concentrated ownership structure.[20] So we see that the determination of the dividend policy is in practice left to the firm insiders, but there are some rules that limit their discretion and are aimed at protecting the outside investors.

So why is control of such a critical decision awarded to the insiders? According to the seminal work by Sanford Grossman and Oliver Hart,[21] when arms-length contracts are imperfect control of the decisions should be awarded to the owner of an asset, since he has the incentives to make optimal choices, therefore in our particular case, the investors should be able to control the dividend decision. But when the decision requires expertise it may be necessary to delegate an agent that has a comparative informational advantage. To reduce the conflicts of interest that will appear when the agent has to make the decision on behalf of the principal-owner, the agent will be given performance-related incentives and his contract can be terminated if the owner does not obtain good results.[22] Similarly to other decisions regarding the

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20 For instance, in jurisdictions with controlling shareholders like Italy, Japan or Germany, the general shareholders meeting is required to approve the distribution of the company earnings. *See* Luca Enriques, Henry Hansmann & Reinier Kraakman, *The Basic Governance Structure: The Interests of Shareholders as a Class*, *in* Anatomy of Corporate Law 55, 74 (Reinier Kraakman et al. eds., 2d ed. 2009).

21 Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. Pol. Econ. 691 (1986).

22 The three classic papers that formalized incentive design in an agency relationship

business strategy or investment choices, the dividend policy is discretionary because it requires information and expertise that only insiders have, but the decision will be distorted when there are conflicts of interest between the expert insider making the decision and the outside investors. For dividend policy, the conflict of interest appears when managers or controlling shareholders choose to retain profits instead of distributing them. Interestingly, when the relevant insiders are managers acting as agents of the outside shareholders, we are dealing with the classic agency conflict. But when we are dealing with controlling shareholders we have a more complicated problem, because there is not a formal agency relationship.

What is the answer of the law to this situation? In broad terms, the business judgment rule safeguards the controllers' discretion and precludes bringing a claim against the board or the general meeting.[23] The idea is that courts should not second-guess the controller's decision about dividend policy because they are not more likely to get it right than the board or the general meeting. That is, absent fraud or gross abuse of discretion, the controllers have discretion

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are Milton Harris & Artur Raviv, *Optimal Incentive Contracts with Imperfect Information*, 20 J. Econ. Theory 231 (1979); Bengt Holmstrom, *Moral Hazard and Observability*, 10 Bell J. Econ. 74 (1979); and James A. Mirrlees, *The Optimal Structure of Incentives and Authority Within an Organization*, 7 Bell J. Econ. 105 (1976).

23 Enriques, Hansmann & Kraakman, *supra* note 20. Nevertheless, there are some exceptions. In the close-corporation setting a firm lacks a market for its shares, and the correction of control power should come from the *ex post* judiciary scrutiny of the dividend policy. Disputed dividend suppression is one of the cases labeled under "minority oppression." Shareholders in close corporations are more than mere investors: they invest capital, but they also expect employment and some influence in the management of the corporation. Nevertheless, majority rule and centralized management put the minority in a weak position *vis-à-vis* the majority shareholders, in the case they face a falling-out between them sometime in the future. The block-holder can take actions to harm the interests of the minority — for instance, firing them — and often the purpose of the oppression is to freeze-out the minority shareholders at an unfairly low price in the absence of the possibility of escaping the abuses by selling their stock in a market. *See* Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation*, 24 J. Corp. L. 913 (1999), *reprinted in* Concentrated Corporate Ownership 201 (Randall Morck ed., 2000). For these reasons, corporate law and courts have developed remedies at the courts' disposal to provide relief to the minority shareholders: the traditional way out of this situation in most jurisdictions was the dissolution of the corporation to ensure an exit option for the oppressed shareholder, or its less drastic derivative, the buyout of the oppressed investor's shares.

to declare dividends or to refrain from doing so. Moreover, inasmuch as the minority shareholders get their pro-rata share of any dividend, the decision is labeled as "fair." Again, as happens in other corporate issues that deal with managerial decisions, the legal system is not aimed at identifying some optimal dividend policy, but rather at ensuring inhibition against indiscriminate and disproportionate cash-outs to shareholders.[24] In other words, the question regarding how a particular dividend policy affects a firm's value is beyond the scope of the regulation. From this perspective, efficiency must be achieved by other means. But given the conflict of interest between insiders and outsiders, we would expect that dividend policy will be more efficient if the interests of outside investors are well protected. So we now investigate which degree of protection the law offers to the outside investors under this arrangement.

A. Rules Protecting Creditors

Most jurisdictions impose distribution restrictions in order to prevent asset dilution.[25] The regulation prevents cash distributions to shareholders whenever the company's net assets are lower than the stated value of its capital. But in some countries (in particular in Continental Europe) these regulations are based on accounting values, while in other countries they are based on a solvency test, so that cash cannot be distributed to the shareholders if the distribution will lead to the corporation's insolvency.[26] In either case, it seems rational to admit that the shareholders, as the firm's residual claimants, have the right to receive the residual earnings or net profits. Nevertheless, legal rules limiting distributions are more restrictive in European countries than

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24 Regulation has its limitations. We cannot demand from regulation what is not in its power to ensure. Regulation cannot ensure investment efficiency and welfare in other matters as well, like self-dealing. Again, anti-self-dealing regulations can guarantee, at best, that there is no minority expropriation. Then, contractual solutions are the response to implement an "efficient" rate in each case of private benefits. Maria Gutiérrez Urtiaga & Maria Isabel Sáez Lacave, *A Contractual Approach to Discipline Self-Dealing by Controlling Shareholders* (Working Paper, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2176072.

25 For a description of these rules on distribution restrictions, see Rudiger Veil, *Capital Maintenance*, *in* Legal Capital in Europe 75 (Marcus Lutter ed., 2006).

26 The restrictions vary from the accounting-based profit distribution restrictions to the solvency-based model. Strong capital requirements are a German "product" that has been successfully exported to other European countries through the second Directive. About the rigidity of the system, see Andreas Cahn & David C. Donald, Comparative Company Law 222-26 (2010).

in other legal environments, like the United States.[27] The explanation can be found in path dependence, because traditionally European corporations have relied strongly on debt financing, so creditor protection was a top priority from a governance perspective.[28] As a matter of fact, the problem is especially pronounced in close corporations or non-listed ones, because of the lack of separation between ownership and control: shareholders have incentives to divert a firm's resources to their own pocket and engage in high-risk projects that promise high returns but harm the debt-holders.[29]

The protection of the creditors has been standardized in Europe through the capital maintenance provisions, of mandatory nature, regulated by the Second Company Law Directive.[30] These capital maintenance provisions are creditor-oriented provisions that allow creditors to participate to some degree in control and/or net earnings. More specifically, these provisions limit cash distributions to shareholders when they may hurt creditors. They are intended to reinforce the shareholders' compromise of maintaining their investment in the firm until the debt is repaid. Interestingly, these provisions cover not only dividends but also other forms of "open" distributions, whereby assets are directly or indirectly transferred to shareholders for less than market value — including share repurchases, the giving of financial assistance by a company for the acquisition of its own shares,[31] and other "hidden" distributions

27 An analysis comparing both systems is done by Andreas Engert, *Life Without Legal Capital: Lessons from American Law*, *in* Legal Capital in Europe, *supra* note 25, at 646. *See also* Marcel Kahan, *Legal Capital Rules and the Structure of Corporate Law: Some Observations on the Differences Between European and US Approaches*, *in* Capital Markets and Company Law 145, 145-49 (Klaus J. Hopt & Eddy Wymeersch eds., 2003).

28 The shareholder-creditor agency problem has determined and shaped company law in these jurisdictions. Shareholder-creditor conflicts have the potential to reduce the overall value of the firm's assets. Thus, legislators have introduced provisions in company law to prevent shareholders from siphoning assets out of the corporate pool in favor of themselves and at the expense of the creditors. But the mechanisms put in place to address these inefficiencies vary across countries. *See* John Armour, *Legal Capital: An Outdated Concept?* 7 (Univ. of Cambridge, Working Paper No. 320, 2006).

29 J. Armour, G. Hertig & H. Kanda, *Transactions with Creditors*, *in* Anatomy of Corporate Law, *supra* note 20, at 115.

30 Second Council Directive 77/91/EEC, 1977 O.J. (L 26) (EC) (amended in 2012). The critique comes from the mandatory requirement, not by choice of the firm. *See* Armour, *supra* note 28, at 7; Wolfang Schön, *The Future of Legal Capital*, 5 Eur. Bus. Org. L. Rev. 429, 438-39 (2004).

31 Directive 77/91/EEC, art. 25.

such as transactions between a company and its members at above or below market values.[32]

The most common prohibition is the prohibition on paying dividends if the dividend exceeds the difference between the book value of the company's assets and the amount of its legal capital as stated in the balance sheet (the sum of unsubscribed capital plus non-distributable reserves). Notice that legal capital is a rigid and mechanical (and even naive) approach to governing the distribution policy inside the corporation,[33] and therefore rules which sustain this framework might not be appropriate to protect the creditors.

Rules on mandatory legal capital have been replaced in other countries by other instruments more effective at avoiding fraud against creditors, like claw-back rules in bankruptcy provisions, or wider disclosure rules to provide creditors with information on the company's financial condition, and self-help devices like financial covenants in debt contracts.[34] The common view is that the creation and maintenance of share capital provisions are of little assistance to creditors.[35] Moreover, they are ineffective in ensuring better decisions regarding distribution, or reducing conflicts of interest among shareholders. Capital provisions are aimed at protecting creditors and therefore are useful for preventing "excessive" dividend payments to shareholders. Nonetheless,

32 *Id.* art. 26. In Germany and the United Kingdom, the restrictions cover not only dividends or share repurchase, but also any transaction between the company and its shareholders that has not been dealt with at arm's length. *See* Pierre-Henric Conac, Luca Enriques & Martin Gelter, *Constraining Dominant Shareholders' Self-Dealing: The Legal Framework in France, Germany and Italy*, 4 Eur. Company & Fin. L. Rev. 491 (2007); Ellís Ferran, *The Place for Creditors Protection on the Agenda for Modernization of Company Law in the European Union*, 3 Eur. Company & Fin. L. Rev. 178 (2006); Holguer Fleisher, *Disguised Distributions and Capital Maintenance in European Company Law*, *in* Legal Capital in Europe, *supra* note 25, at 95.

33 American commentators consider legal capital an outdated concept. *See* Stephen M. Bainbridge, Corporate Law and Economics 78, 768-70 (2002); Bayless Manning, Legal Capital 92 (1990).

34 Luca Enriques & Jonathan Macey, *Creditors Versus Capital Formation: The Case Against the European Legal Capital Rules*, 86 Cornell L. Rev. 1165 (2001).

35 Manning, *supra* note 33. The discussion on legal capital is open in Europe. John Armour, *Share Capital and Creditor Protection: Efficient Rules for a Modern Company Law?*, 63 Mod. L. Rev. 355 (2000); Enriques & Macey, *supra* note 34; Peter O. Mülbert & Max Birke, *Legal Capital — Is There a Case Against the European Legal Capital Rules?*, 3 Eur. Bus. Org. L. Rev. 696 (2002); Jonathan Rickford, *Reforming Capital: Report of the Interdisciplinary Group on Capital Maintenance*, 15 Eur. Bus. L. Rev. 919 (2004); Schön, *supra* note 30.

they cannot help when the problem is free cash-flows and insufficient dividend payouts.

B. Rules Protecting Outside Equity

Both the equal treatment norm and the majority rule work to reduce conflicts of interest among shareholders. They protect outside minority shareholders from insiders by requiring that they get their fair share of the dividend and that they have a voice in making the dividend decision. However each of them faces some limitations.

1. The Equal Treatment Norm

According to the equal treatment rule, the distribution of dividends has to be pro-rata. This is premised on the idea that all shareholders are treated equally, which in this context states that they shall receive the payment on profits proportional to the amount of capital contributed to the firm, and that the majority shareholder shall not receive a disproportionate share of the company's profits. This principle works also in the event of dissolution, ensuring that the residual assets of the firm are divided pro-rata among the shareholders.

The equal treatment norm is a fundamental norm in corporate law meant to constrain controlling shareholders' powers. Although there are differences in its implications and enforcement,[36] most jurisdictions embrace the norm more strongly in the area of corporate distributions. The proportionality rule is a simple and useful rule for distributing the firm's earnings based on the capital invested by each shareholder in the firm, which is an objective measure.

Nevertheless, even though each shareholder's contribution to total capital is a homogeneous measure and dividends as such are subject to pro-rata distribution, controlling shareholders can take advantage of their power and expropriate minority shareholders by other means, like self-dealing or excessive perks.[37] The faculty of retaining profits inside the corporation, where they

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36 In some jurisdictions, like the civil law ones, the equal treatment norm is considered a wide-ranging source of law that can trigger any shareholder action. In others, like the common law ones, it is more precise and regards particular issues, rather than being a general provision. *See* Enriques, Hansmann & Kraakman, *supra* note 20, at 96-97. For instance, the principle of equal treatment rules out defensive tactics commonly used in U.S. takeover battles, like greenmail, poison pills, or selective self-tender.

37 Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537 (2004); Simon Johnson, Rafael La Porta, Florencio

control the day-to-day business decisions, gives the majority shareholders control over those resources. In other words, the prohibition of discriminatory dividends does not prevent the controlling shareholders from distributing a lower amount of profits against the interest of the minority, and tunneling those non-distributed profits to themselves.[38] Cash dividends go directly to the shareholders' pockets, while retained profits are mere expectations of future profits and are controlled by the insiders. It is true that good anti-self-dealing regulation would help to discipline the controlling shareholders to make better decisions on the distribution issue,[39] but nevertheless they would still prefer to keep profits as cheap financing resources rather than submit the control power to the discipline of the markets.[40]

2. The Majority Rule

The majority rule tries to limit control power by demanding that the decision to distribute profits shall be taken by the shareholders' general meeting.[41] But the vote on the decision by the majority of shareholders does not discipline controlling shareholders because they have unchecked voting power. This is an endemic limitation of the empowerment strategies in the presence of a controlling shareholder: dominant shareholders can use voice to control management at the expense of the interest of outside shareholders. In this respect, the function of the shareholders' meeting as a mechanism to discipline the insiders is very much in doubt.[42]

López de Silanes & Andrei Schleifer, *Tunneling*, 90 Am. Econ. Rev. 22 (2000).

38 For an explanation of the different ways in which insiders can extract (tunnel) wealth from firms, see Vladimir A. Atanasov, Bernard S. Black & Conrad S. Ciccotello, *Self-Dealing by Corporate Insiders: Legal Constraints and Loopholes*, *in* Research Handbook on the Economics of Corporate Law 419 (Brett McDonnell & Claire Hill eds., 2014).

39 Some jurisdictions try to combat this problem by applying the rules on dividends. Germany and United Kingdom can characterize conflicted transactions as unlawful distribution. In a sense, it pretends to work as an imperfect substitute for anti-self-dealing norms under the aspects of fixed legal capital and creditor protection, the so-called "disguised distributions." *See supra* note 32.

40 Luigi Zingales, *Insider Ownership and the Decision to Go Public*, 62 Rev. Econ. Stud. 425 (1995).

41 Notice that the only limit to shareholders' freedom is the rigorous regime on capital maintenance rules under the Second Council Directive 77/91/EEC, 1977 O.J. (L 26) (EC) (amended in 2012) in the interest of the firm's creditors.

42 Maria I. Sáez & Dámaso Riano, *Corporate Governance and the Shareholders' Meeting: Voting and Litigation*, 14 Eur. Bus. Org. L. Rev. 343 (2013).

Nevertheless, the main advantage of holding a shareholders' meeting to approve the company's accounts and the managers' dividend proposal is that it makes the decision's proceedings public. Publicity by itself can restrain the abuse of control by majority shareholders to some extent (at least in listed companies), but it is unlikely to ensure the efficiency of the decision adopted. As a matter of fact, shareholders usually receive "some" amount of profits to elude bad press and try to look good.[43] This may be the reason why dividend omissions are much less likely in listed firms than in close corporations, where dividends are often omitted several years in a row. It is not surprising that publicity does the job of disciplining controlling shareholders better than other legal mechanisms, like litigation. The general meeting decision can be challenged in court to prevent abuse by the majority, but nullity is rarely enforced. Apart from notorious cases, courts tend to estimate that, unless formal requirements are not fulfilled, the decision is valid as it serves the interest of the corporation (formally represented by the votes of the majority). As long as the corporation gives a meaningful explanation for the non-distribution decision, validity is not questionable.

The overall conclusion we reach from this analysis is that current regulation gives the insiders the power to determine the dividend policy and does not protect minority investors, because they do not have the means to force the distribution of free cash-flows. Especially in jurisdictions with concentrated ownership, the regulation of dividend policy is designed so as to deter opportunistic conduct by the shareholders that may harm creditors.[44] But the majority-minority conflict remains untouched: in these corporations the distribution policy doesn't work as a device to check the managerial powers of the controlling shareholders.

This conclusion is discouraging. Dividend policy is an important determinant of firm value, but the optimal decision may be distorted by conflicts of interest between the informed insiders and the outside investors. We have seen that the law gives control over the dividend decision to the insiders and offers little protection to outside shareholders. Therefore we would expect dividend policy to be inefficient. Nevertheless, even if the insiders have the legal power to fix their preferred dividend policy, there may be other corporate

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43 Interesting anecdotal evidence of this type of behavior is presented in DeAngelo, DeAngelo & Skinner, *supra* note 6. *See also* Sáez & Riano, *supra* note 42.

44 Such actions may take a variety of forms. For instance, the shareholders may siphon assets out of the corporate pool in favor of themselves. Or they might be willing to increase the riskiness of the firm's business through "assets substitution," or creditor's interests may be harmed simply by increasing the firm's overall borrowing.

governance factors that force them to distribute free cash-flows. Dividend policy should be understood as one of the mechanisms available to solve agency problems in the firm. But it has to be analyzed in the broader context of corporate governance.[45] There are several alternative control mechanisms that help outside investors control the insiders' powers. Therefore in the next Part we discuss how other corporate governance arrangements interact with dividend policy.

III. Corporate Governance and Dividend Policy

According to Marco Becht, Patrick Bolton and Alisa Röell, corporate governance refers to the set of policies that help shareholders control managers.[46] This definition includes mechanisms such as leverage, takeovers, independent board members, managerial reputation, concentrated ownership stakes, contingent remuneration, and also dividend policy. An unresolved issue is which of these mechanisms will act as substitutes or as complements with respect to dividend policy, and when. For example, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny think of dividend policy as complementary to corporate governance.[47] They study the dividend policies of listed firms in thirty-three countries and find that in countries where shareholders' rights are well protected, shareholders have the power to force managers to pay dividends. However, other scholars think of dividends as a substitute for other internal corporate governance mechanisms. They find that in the U.S. firms with better governance have lower payout ratios. This is consistent with the idea that better governance ensures that retained earnings will be used optimally inside the firm and it is therefore not necessary to pay high dividends.[48] How can these seemingly contradictory results be reconciled?

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45 If we consider the dividend policy problem in isolation, the only way to solve the conflict would be to change the regulation to put control over dividends in the hands of outsiders. Alternative ways for doing this are discussed in Zohar Goshen, *Shareholders Dividend Options*, 104 Yale L.J. 881 (1995) (proposing an extreme solution through a mandatory option mechanism).

46 Marco Becht, Patrick Bolton & Alisa Röell, *Corporate Governance and Control* (Nat'l Bureau of Econ. Research, Working Paper No. 9371, 2002), *available at* http://www.nber.org/papers/w9371.

47 Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. Fin. Econ. 3 (2000).

48 *See* John Kose & Anzhela Knyazeva, *Payout Policy, Agency Conflicts, and Corporate Governance* (Working Paper, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=841064; John Kose, Anzhela Knyazeva &

We believe that the answer to this puzzle requires an understanding of the procedures for the determination of dividend policy in the firm. These procedures can be controlled by either the outside investors or by the insiders. If outsiders have control over the dividend policy, this policy will be used as a substitute when other corporate governance mechanisms fail. The reasoning is that outside investors will reduce free cash-flows by choosing a dividend policy with high payouts because, even though this is costly, they know that there are no other mechanisms that can reduce the agency conflict. But, if insiders have control over the dividend policy, this policy will be a complement that will work hand in hand with other corporate governance mechanisms. When insiders are in control of the dividend policy and overall corporate governance is weak, dividend policy will fail to reduce agency conflicts. But when insiders are in control of the dividend policy, but other corporate governance mechanisms are functioning well, and they give the insiders the right incentives, dividend policy will be designed so as to reduce free cash-flows. In particular, we would expect that when insiders control dividend policy, they will use the dividend policy to reduce free cash-flows only if there is an incentive to do so, whether it comes from the fear of a takeover, stock options in the remuneration packages of the executives, the pressure of independent board members, the activism of institutional investors, etc.

In the previous Part we have seen that legally dividend policy is controlled by the insiders. We therefore expect that the dividend policy will reflect the overall quality of corporate governance and be complementary. So we now need to establish which alternative corporate governance mechanisms will force managers to distribute cash-flows. We will now briefly analyze how both external and internal monitoring can align the incentives of the insiders with those of the outside investors and modify the dividend policy.

Regarding external monitoring, if the firm is retaining free cash-flows market prices will fall, and this will threaten the position of insiders. Managers will see their stock holdings decrease in value, their options expire worthlessly, and their jobs at risk because of the possibility of hostile takeovers. These threats give them powerful incentives to alter the dividend policy and distribute free cash-flows. However, these market mechanisms will be much less effective in the case of a controlling block-holder. The value of their holdings will be reduced, but the illiquidity of these large stakes and the long-term horizon reduce the influence of market values.

Diana Knyazeva, *Governance and Payout Precommitment: Antitakeover Laws, Structure of Payouts, and the Dividend-Debt Tradeoff* (Working Paper, 2013), *available at* http://ssrn.com/abstract=1101062.

Turning now to internal monitoring, this may be imposed by either activist investors or the board of directors. In firms where managers are in control, activists can improve corporate governance and force high payouts. This is consistent with the evidence on the role that activist shareholders play in corporate governance.[49] For example, in the United States target firms exhibit large positive abnormal stock returns when hedge funds first disclose holdings larger than five percent in their 13D filings.[50] Target firms experience increases in payout and operating performance, and higher CEO turnover after activism. Marco Becht, Julian Franks, Collin Mayer and Stefano Rossi study in detail activism by the Hermes U.K. Focus Fund (HUKFF).[51] They report that their engagement activities are aimed either at restructuring the operations by divesting, replacing the CEO or, more generally, at increasing cash payouts to shareholders. Interestingly, when the fund's engagement objectives are achieved there are positive abnormal returns around the announcement date of the change.

But what role can activist investors play in firms with controlling shareholders? During the last decade, activist investors have started to acquire stakes in European companies with concentrated ownership structures, but there is not yet enough empirical evidence on their role in the corporate governance of these firms. Massimo Belcredi and Luca Enriques provide some anecdotal evidence on the experience of institutional investors in Italy and they find that these funds promote initiatives aimed at curbing the extraction of private benefits by dominant shareholders, with mixed success.[52] Moreover, these activists clearly target dividend policy as an area for improvement. Matteo

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49 For a review of the increasing importance of institutional investors and the different roles played by investment funds and hedge funds in corporate governance, see Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum. L. Rev. 863 (2013). See also Sharon Hannes, *Long Term Activism*, 16 Theoretical Inquiries L. 245 (2015), on how to organize effective activism with a long term view.

50 Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. Fin. 1729 (2008).

51 Marco Becht, Julian Franks, Collin Mayer & Stefano Rossi, *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund*, 22 Rev. Fin. Stud. 3093 (2009).

52 Massimo Belcredi & Luca Enriques, *Institutional Investor Activism in a Context of Concentrated Ownership and High Private Benefits of Control: The Case of Italy* (Eur. Corporate Governance Inst., Working Paper No. 225/2013, 2014), *available at* http://ssrn.com/abstract=2325421.

Erede, who also studies the particular case of Italy, discusses different cases in which hedge funds tried unsuccessfully to increase dividend payouts.[53]

Finally, an alternative internal corporate governance mechanism is the board of directors, especially independent directors. Independents are expected to give voice to outside investors and they could force the insiders to distribute free cash-flows. Unfortunately, the results in the empirical literature on the functioning of corporate boards and the role of independents are mixed and point to important limitations for independents to be effective.[54] Lack of information, lack of incentives and even lack of real (as opposed to formal) independence have been found to reduce the effectiveness of boards in checking insiders' power.

Moreover, the effectiveness of boards is expected to be even lower in companies with controlling shareholders. Notice that, irrespectively of its composition, the board has important tools to check the power of the managers, since they are responsible for appointing the CEO, fixing his remuneration package and approving the accounts. But, when it comes to restricting the power of a controlling shareholder, the board does not even have the right tools. Listing rules and codes of best practice dictate that firms should have remuneration and audit committees composed of a majority of independent directors. But for firms with large shareholders this may not be the right approach, since the role of monitoring managers can be left to the controlling shareholders. In a previous article, we studied this problem and argued that in firms with controlling shareholders boards will be ineffective unless the role of independents is redesigned to give them more power to protect the minority from the private interests of the block-holder.[55]

Our conclusion so far is that insiders have the power to set dividend policy. However, their power will be checked by the corporate mechanisms in place. In companies with dispersed ownership, managers will face several barriers to the retention of free cash-flows. However, in companies with concentrated ownership, there are no powerful market or internal corporate governance mechanisms that can constrain the incentives of controlling shareholders to retain profits and avoid pro-rata distributions. As we will now see in the next

53 Matteo Erede, *Governing Corporations with Concentrated Ownership Structure: Can Hedge Funds Activism Play Any Role in Italy?* (Working Paper, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1397562.

54 Adams Renee, Benjamin Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. Econ. Literature 58 (2010) (providing an in-depth review of the literature on boards).

55 María Gutiérrez & Maribel Sáez, *Deconstructing Independent Directors*, 13 J. Corp. L. Stud. 63 (2013).

Part, this view allows us to explain most of the findings about the differences in dividend policy in firms with different corporate governance structures, and in particular the striking differences in dividend policies between firms with and without controlling shareholders.

IV. Evidence on the Dividend Policy of Firms with Concentrated Ownership

One would expect to observe differences in the payout policies of firms with controlling shareholders even in the absence of expropriation problems.[56] This is because it will usually be more difficult for controlling shareholders to create homemade dividends than for small shareholders. As a general rule, the stakes of controlling shareholders are not liquid and selling a large stake may imply a loss of control that they will try to avoid. Therefore, assuming no expropriation problems, we can expect firms with controlling shareholders to have larger payout ratios. However, these preferences may change over time and also across types of large shareholders, since families, governments and firms may have different preferences. For example, in Germany bank-controlled firms are more likely to omit dividends,[57] and in Austria family-controlled firms are more likely to cut dividends than state-controlled firms.[58]

But when we consider the private benefits that controlling shareholders obtain at the expense of minority shareholders, we get exactly the opposite empirical prediction. As we have already seen, if controlling shareholders can use their unchecked power to extract private benefits from the minority, they are likely to have lower dividend payout ratios. This is because controlling shareholders prefer to avoid pro-rata distributions of profits, where all shareholders are treated equally. Therefore they pay lower dividends and keep retained earnings inside the corporation where they can redistribute a greater part of these earnings to themselves through tunneling, self-dealing and related party transactions. As we will see now, all the empirical evidence for countries with concentrated ownership structures is consistent with this prediction.

The initial evidence for countries with concentrated ownership was provided by La Porta, Lopez-de-Silanes, Shleifer and Vishny, showing that in countries

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56 DeAngelo, DeAngelo & Skinner, *supra* note 6.

57 Marc Goergen, Luc Renneboogb & Luis Correia da Silva, *When Do German Firms Change Their Dividends?*, 11 J. Corp. Fin. 375 (2005).

58 Klaus Gugler, *Corporate Governance, Dividend Payout Policy, and the Interrelation Between Dividends, R&D, and Capital Investment*, 27 J. Banking & Fin. 1297 (2003).

with weak minority protection dividend payout tends to be lower.[59] Posterior studies at the firm level confirm the idea that companies with controlling shareholders have lower payout ratios. For example, Denis and Osobov also find important differences between the dividend policies of firms in Germany, France and Japan, characterized by significant ownership concentration, in contrast to firms in the United States, Canada and the United Kingdom.[60] The larger and more profitable firms are more likely to pay dividends in all countries, but when they look at growth opportunities they find that in the United States, Canada and the United Kingdom the firms with poor growth opportunities are more likely to pay dividends, while in Germany, France and Japan the result is the opposite.

The negative relationship between block ownership and dividends was documented in a sample of European and Asian firms,[61] in Finland,[62] in Germany,[63] in the United Kingdom,[64] in firms in emerging markets,[65] in Japan,[66] and in Italy.[67] Only one study, using a sample drawn from thirty-seven countries, found a positive association between the stake of the largest shareholder and dividend payout, but when they look at the nature of the largest shareholder they find that the magnitude of dividend payout tends to be smaller when the largest shareholder is an insider.[68]

A problem that may appear in these empirical studies is omitted variables, since low dividend payouts and concentrated ownership may be simultaneously caused by other firm characteristics and not linked by causality. In order to identify the causality link, Klaus Gugler and B. Burcin Yurtoglu study market reactions to announcements of dividend decreases in Germany and find that

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59 La Porta, Lopez-de-Silanes, Shleifer & Vishny, *supra* note 47.
60 Denis & Osobov, *supra* note 9.
61 Mara Faccio, Larry H.P. Lang & Leslie Young, *Dividends and Expropriation*, 91 Am. Econ. Rev. 54 (2001).
62 Benjamin Maury & Anete Pajuste, *Controlling Shareholders, Agency Problems, and Dividend Policy in Finland*, 51 Finnish J. Bus. Econ. 15 (2002).
63 Goergen, Renneboog & da Silva, *supra* note 57.
64 Luc Renneboog & Grzegorz Trojanowski, *Control Structures and Payout Policy* (Tilburg Law & Econ. Ctr., Discussion Paper No. 2005-014, 2005).
65 Todd Mitton, *Corporate Governance and Dividend Policy in Emerging Markets*, 5 Emerging Mkt. Rev. 409 (2004).
66 Kimie Harada & Pascal Nguyen, *Dividend Change Context and Signaling Efficiency in Japan*, 13 Pac.-Basin Fin. J. 504 (2005).
67 Luciana Mancinelli & Aydin Ozkan, *Ownership Structure and Dividend Policy: Evidence from Italian Firms*, 12 Eur. J. Fin. 265 (2006).
68 Thanh Truong & Richard Heaney, *Largest Shareholder and Dividend Policy Around the World*, 47 Q. Rev. Econ. & Fin. 667 (2007).

the negative effects are larger for companies where corporate insiders have more power.[69] Rongrong Zhang finds the same result for a large sample of firms from over twenty countries.[70] Also investigating causality, Steen Thomsen finds that increases in block ownership are correlated with posterior decreases in dividend payouts.[71]

A few studies have gone further in investigating not only whether ownership concentration has a negative impact on dividends, but also whether the structure of concentrated ownership matters. In particular, they have analyzed the effect of other large shareholders, besides the largest shareholder, on dividend policy. The idea is that the presence of a second large shareholder can act as a corporate governance mechanism that constrains the power of the largest block-holder to expropriate the minority. Some develop theoretical models where other large shareholders have a positive impact because they monitor the controlling shareholder.[72] But there are also cases where several shareholders do share control. The impact on corporate governance of a controlling group with several shareholders was initially studied by Morten Bennedsen and Daniel Wolfenzon, who develop a theoretical model showing that these control structures may reduce expropriation but also reduce efficiency by generating deadlocks in decision-making.[73]

In the case of dividend policy, the available evidence is somehow mixed. Mara Faccio, Larry H.P. Lang and Leslie Young find that the presence of multiple large shareholders in Europe minimizes the expropriation activity of the controlling shareholder, thus resulting in higher dividend payments, consistent with the idea of a monitoring effect.[74] However, they find that in Asia, the presence of several shareholders leads to lower dividend rates. They

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69 Klaus Gugler & B. Burcin Yurtoglu, *Corporate Governance and Dividend Pay-Out Policy in Germany*, 47 Eur. Econ. Rev. 731 (2003).

70 Rongrong Zhang, *The Effects of Firm- and Country-level Governance Mechanisms on Dividend Policy, Cash Holdings, and Firm Value: A Cross-country Study* (Working Paper, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=652090.

71 Steen Thomsen, *Conflicts of Interest or Aligned Incentives? Blockholder Ownership, Dividends and Firm Value in the US and the EU*, 6 Eur. Bus. Org. L. Rev. 201 (2005).

72 Patrick Bolton & Ernst-Ludwig Von Thadden, *Blocks, Liquidity, and Corporate Control*, 53 J. Fin. 1 (1998); Marco Pagano & Alisa Röell, *The Choice of Stock Ownership Structure: Agency Costs, Monitoring, and the Decision to Go Public*, 113 Q.J. Econ. 187 (1998).

73 Morten Bennedsen & Daniel Wolfenzon, *The Balance of Power in Closely Held Corporations*, 58 J. Fin. Econ. 113 (2000).

74 Faccio, Lang & Young, *supra* note 61.

interpret it as evidence of collusion among large shareholders to expropriate the minority shareholders in Asia, where minority protection is especially weak. In Finland, dividend payouts are negatively related to the second-largest shareholder.[75] However, in Germany there is a positive relationship between the second-largest shareholder and dividend payouts.[76] The lack of a clear guide to what constitutes a controlling group and the differences across countries and firms in the minimum stake that guarantees control could explain these different results. But, in any case, they all highlight the existence of a conflict between the preferred dividend policies of different shareholders, whether it refers to different preferences among the group of significant shareholders or to different preferences of the controlling group and the small shareholders.

Overall, the empirical literature on dividend policy with controlling shareholders is consistent with our argument, i.e., that controlling shareholders can use their unchecked power to keep lower dividend payout ratios, retain earnings and extract private benefits from the minority.

Conclusion

In this Article we have studied the determinants of dividend policy, with a focus on firms with concentrated ownership structures. A careful analysis of the legal rules on the subject shows that these rules are designed to protect debt-holders, but within those limits they leave the power to choose dividends in the hands of the insiders. Because of this, insiders can retain free cash-flows inside the firm and use them to extract private benefits at the expense of outside shareholders. However, when we place dividend policy in the context of overall corporate governance, we observe that there exist alternative and complementary monitoring tools that can alter the insiders' incentives and induce them to raise payout ratios. Nevertheless, the effectiveness of these alternative mechanisms seems much reduced in companies with controlling shareholders. And therefore it is not surprising to find that payout ratios are lower in companies and countries with controlling shareholders. This is a problem that makes it more difficult for these companies to raise capital and grow. Therefore, it is worthwhile to explore in future research the possibility of designing commitment mechanisms that allow controlling shareholders to credibly commit to an optimal dividend policy in order to protect and attract minority investors.

75 Maury & Pajuste, *supra* note 62.
76 Gugler & Yurtoglu, *supra* note 69.