Dividend policy, dividend initiations, and governance

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Abstract: Dividend policy can either be an outcome of strong governance or a substitute for weak governance. This paper provides evidence that dividend policy is a substitute for weak internal and external governance by focusing on a sample of firms that *should* pay dividends. Specifically, predicted dividend payers with weak governance are significantly more likely to pay dividends than are predicted dividend payers with strong governance. Firms with weak governance also have significantly higher dividend initiation announcement abnormal returns than other firms, consistent with the notion that dividend policy is a substitute for other governance attributes and that the market prices the decrease in agency costs resulting from the initiation of dividends.

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Introduction

While finance academics have long wondered why firms pay dividends when cash distributions in the form of dividends are tax disadvantaged relative to retention or stock repurchases (e.g. Black (1976)), recent theoretical and empirical work significantly expands our understanding of whether, when, and why firms pay dividends (Fama and French (2001), DeAngelo, DeAngelo, and Skinner (2004), DeAngelo and DeAngelo (2006), and DeAngelo, DeAngelo, and Stulz (2006)).

The interaction of dividend policy and governance is central to the debate about the agency costs of free-cash-flow (Easterbrook (1984) and Jensen (1986)). In particular, Easterbrook (1984) argues that a policy of paying dividends reduces agency costs by improving the monitoring and risk-taking incentives of managers. While the initiation of a policy of paying dividends should reduce the agency costs of free-cash-flow *ex post*, the relation between *ex ante* agency problems and the decision to pay dividends is not as clear.

La Porta *et al* (2000) discuss two models of the relation between *ex ante* agency problems and dividend policy: the "outcome model" and the "substitute model."[1] In the outcome model, the payment of dividends is the *result* of effective governance – well-governed firms pay dividends because strong governance makes expropriation from shareholders (the worst manifestation of the agency problems of free-cash-flow) more difficult and shareholders successfully pressure managers to distribute excess cash.[2] In the substitute model, the payment of dividends replaces other governance characteristics in the portfolio of policies that firms employ to convince shareholders that they will not be expropriated.[3] The substitute model predicts that poorly-

[1] La Porta *et al* (2000) discuss dividend policy in the context of shareholder protection in various legal regimes around the world. In this paper I take that discussion and apply it to differences in governance characteristics between firms in the *same* legal regime (United States).

[2] Tse (2004) questions the logic of the relation between agency costs and dividend policy in the outcome model – if well-governed firms are more likely to pay dividends, then shareholders shouldn't need to rely on the payment of dividends to reduce the agency costs of free-cash-flow because such costs should already be low for well-governed firms.

[3] Also see Rozeff (1982).

managers, and low ownership by institutional investors and activist public pension funds) have significantly more positive initiation announcement abnormal returns than do dividend initiators with characteristics suggestive of strong governance. These results are consistent with the notion that dividend policy is one component of the package of policies that firms use to bond with stockholders, and that the abnormal returns to initiating a policy of paying dividends reflect an anticipated reduction in the agency costs of external equity.

IV. Conclusion

This paper provides evidence that corporate governance affects both the willingness of firms to pay dividends and the market reaction to dividend initiation announcements. Firms with characteristics that are thought to proxy for weak internal and external governance (large, insider dominated boards, entrenched managers, and low ownership levels by insiders and important external monitors) are more likely to pay cash out to stockholders in the form of dividends, although there is some evidence that these firms are also less likely to pay cash out to stockholders in the form of stock repurchases. Such firms also experience significantly more positive stock price reactions to dividend initiation announcements. Taken together, these results suggest that firms use dividend policy to compensate for other characteristics that have the potential to create agency problems between managers and outside equity holders. Dividend policy, therefore, appears to be a substitute for other control mechanisms in the equilibrium monitoring/bonding package chosen by firms, and the market values the anticipated reduction in agency costs resulting from the choice to begin paying dividends.

The results in this paper suggest several avenues for future research. While initiation announcement returns are significantly more positive for firms with weak governance, initiation returns are significantly different from zero (and positive) even for firms that traditional proxies suggest have strong internal and external governance mechanisms. Clearly, something other than an anticipated reduction in agency costs also drives abnormal equity returns around dividend initiation announcements. Given that most empirical evidence in the literature does not support a signaling explanation (Watts, 1973; DeAngelo, DeAngelo, and Skinner, 1996), a more thorough analysis of dividend initiation announcement returns appears warranted. One possibility, suggested by Grullon, Michaely, and Swaminathan (2002), is that abnormal stock price appreciations around dividend initiation announcements are driven by lower risk premiums: initiating dividend payments may signal financial maturity and therefore lower risk. However, dividend initiations also frequently signal *operating* maturity, in terms of lower future growth, earnings (Grullon, Michaely, and Swaminathan (2002)), and cash flows. An analysis of how maturity (both financial and operational) interacts with the governance implications of dividend initiations, and the fact that the governance implications will be different for growing firms than for "harvesting" firms, has the potential to significantly expand our understanding of dividend policy and the market reaction to dividend policy changes.