

Corporate Governance: Dividends, and Value

Malek Lashgari
University of Hartford

As fair value of a business enterprise is a function of its earnings power, the more confident owners of equity are about their rights in controlling re-investment or distribution of earnings, the higher is expected to be the equity value. Confidence will be high when managers provide full information about investments of the firm and equitable distribution of cash inflows to the stockholders. This is reinforced by business laws of the country. When investors are not well protected by the laws of the country, combined with a weak corporate governance, the market value of the internally generated cash and the stock value will decline, and investors would require an above average payout. Corporate governance structure of the firm, thereby, provides an explanation about the role of dividend policy of the firm and its impact on the value of equity. This is important as the role of dividend payment in determination of value of equity has been controversial.

Keywords: corporate governance, dividend policy, enterprise value

INTRODUCTION

The fair value of the common equity of a business enterprise can be assessed by its sustainable earnings in the foreseeable future at a discount rate that is commensurate for the level of its uncertainty. When a stable percentage of such earnings are distributed to owners of common equity as dividend, its fair value may also be assessed by the discounted value of the stream of dividends. Myron Gordon (1962), provides a theory of fair value of common equity that depends on present value of future stream of dividends. He shows that with a constant discount rate and a sustained growth in earnings, fair value of common equity is a function of expected dividends, and its growth. According to the Gordon model, a constant portion of earnings is invested in financing the investments of the firm, and the remainder is paid out as cash dividend. In such a scenario, the growth in earnings and dividends will be the same. Business enterprises may further repurchase their outstanding shares from the market, thereby increasing the value of expected dividends.

The total value of a business enterprise depends on the combined values of equity and debt. Subsequently, earnings would be shared by both the creditors and equity holders. In a perfect and frictionless market with no transaction costs and taxes, Miller and Modigliani (1961), provide a theory of valuation of the firm showing that value of the firm depends solely on its earnings power. Thereby, the division of earnings into dividend and retained earnings for reinvestments, plays no part in determination of value of the firm. As a result, a vast literature in finance is devoted in resolving the controversy about the role of dividend in valuation of common equity. The original model of Modigliani and Miller is adjusted for differential taxes, showing that due to the tax benefit on borrowing, the value of the levered firm will be higher. Thereby, there is a benefit to common equity holders as a result of leverage. It is further shown that other factors such as the desire and needs of investors to receive dividend, information content and

signaling effects of dividend play an important role in valuation of common equity, and are among the reasons for stockholders to prefer receiving dividend.

Another area in which dividend plays an important role in valuation of equity is the principal-agent relation. It is generally assumed that the agent follows the best interest of the principal, choosing investments that would provide the highest wealth for the owners of capital, and that the agent and principal have the same interest and goal in optimization of the total firm value. When such assumptions are violated, and the agent is using the internally generated funds for gaining private benefits at the expense of the owner of the capital, or when the agent has other goals and intentions, the faster all internally generated funds is distributed as dividend, the better off is the principal as the equity holder. As the principal is assumed to be able to remove the agent, it is reasonable for the agent to estimate the cost of not acting in the best interest of the principal, and at the same time the principal to design a framework for proper incentives for the agent to function in the best interest of the principal. The goal of this paper is to show the cost-benefit analysis in the context of corporate governance in regards to dividend policy, considering the potential benefits and costs to both the agent and owners of the capital. One assumption underlying the Modigliani and Miller is the transaction costs that may be viewed on a very broad basis, as shown in this paper.

TRANSACTION COST ECONOMICS

The supply of goods and services must be evaluated in conjunction with its transaction costs, as is stated by Williamson (1988), who analyzes corporate governance in the context of transaction-cost economics, in which, as per Coase (1937), firms may either design their production and services by way of forming a vertical or horizontal integration, or may produce based on the needs the market, depending on the comparison of their respective transaction costs. Thus, the transaction cost differences will play an important role in the formation of organizational structure. In the context of transaction cost economics, a firm is viewed as a governance structure, where agents act in a bounded rationality of Simon (1947), behaving intendedly rational, leading to incomplete contracting, and contractual hazards may result as agents act in self-interest. Thus, within the framework of transaction cost economics, dividend policy of the firm is viewed as a governance structure. Similarly, the relation between the common equity holders of the firm and its creditors, resulting from the policy of the mix of debt and equity in the balance sheets of the firm, is a governance structure. Thereby, Williamson states that one needs to “craft governance structures that economize on bounded rationality, while simultaneously safeguarding the transactions in question against the hazards of opportunism.”

For example, Hu and Kumar (2004), find that in an organizational structure identified with managerial control, agents who do not pursue investments for the sole purpose of maximizing shareholders interest, choose to pay higher dividends, especially if they can easily be disciplined by shareholders. They examine the association of dividend policy of the firm and its corporate governance structure. By using data on 2081 firms during 1992-2000, they find significant relation between managerial entrenchment and dividend policy. Controlling for factors such as size, leverage, and tangible/assets ratio, they find a significant and positive relation between managerial entrenchment and corporate distributions in the form of cash dividend and repurchase of the outstanding shares. Furthermore, distribution of corporate cash to shareholders is affected when corporate managers are free from the threat of takeovers.

Meanwhile, Francis, Hassan, John, and Song (2011), find association between antitakeover laws passed in states, and the decline of dividend payout ratio and its propensity, especially for firms with a weak corporate governance. The change in corporate governance structure was found to be as a result of the passage of the anti-takeover laws, protecting the agents from activist stockholders. As a result of this exogenous shock to corporate governance, their univariate test shows that during 1981-1993, for over 6000 firms dividend payout ratio decreased by 1.7 percent, and the likelihood of dividend payment declined by 8.9 percent. In multivariate analysis, Francis, Hassan, John, and Song use an interaction variable showing firms that are incorporated in a state that had passed business combination laws, as “threat,” and companies in the years in which the laws had passed as “post law.” Thus, the interaction variable is “threat*post law,” which captures the effects of such laws in the associated years on dividend payout. They controlled for

numerous variables that could affect dividend payouts, such as: the firm size; market to book ratio; growth rate of assets; profitability; and the ratio of retained earnings to total capital to control for the firm life cycle.

Dividend and the Transaction Cost of Debt

The mix of debt and equity in financing the assets of the firm is a policy decision, leading to a governance relationship between the agents, lenders to the firm and the stockholders. Allen, Gottesman, Saunders, and Tang (2012), examine the role of banks in dividend policy, casting light on the impact of governance structure of debt and dividend policy of the firm. They hypothesize that in the presence of a lending bank that can monitor and control the activities of the firm, dividend payment tends to diminish. Further, their results show the difference between the role of dividend policy in resolving the conflict between public creditor and the private one. Banks, as private lenders, can limit or reduce dividend payment to ensure adequate availability of cash for the payment of interest. They find that a rise of one standard deviation in bank lending leads to a 27.97 percent decline in dividend payouts. Their data include 3512 borrowers containing 14742 observations during 1990-2006, with control variables of: free cash flow/net sales; a dummy variable of one if the firm does not have an outstanding debt with S&P credit rating as a measure of public debt; book value of debt/total assets; a debt issue as a dummy variable of one if public borrowing has occurred in a year as well; logarithm of (book value/total assets); net income/assets; book value/market value; risk measured as the standard deviation of monthly stock returns; taxes/net sales; growth as changes in net sales; intangibles/total assets; managerial or insider holding, measured as the squared value of the total market value of shares held by a firm's managers divided by its market capitalization; and quarterly institutional holdings. Given that as per Lintner, dividend policy is stable over time, the lagged value of dividend is further included as a control variable.

By controlling all the variables that may have an impact on dividend policy, as stated above, Allen, Gottesman, Saunders, and Tang, conclude that "the more reliant a firm is on bank loans, the lower would be their payout." That is, banks appear to act as an effective corporate control mechanism, and that banks limit dividend payout to stockholders to protect their senior claims on assets of the firm. The decline in dividend is thereby, a transaction cost of borrowing to the common equity holders.

The structure of corporate control in Japan is a concentrated one as about two thirds of Japanese publicly traded firms are owned by other companies in the form of a block. A group of block holders are known as "stable shareholders," with long horizon, and are known as Keiretsu. When a bank is in control of a Keiretsu, it is called a bank group or financial Keiretsu. The Keiretsu is historically formed to prohibit hostile takeover of Japanese publicly held firms. Prior to this institutional form, Japanese firms were owned in a highly concentrated form by families, forming a Zaibatsu in a cross-holding manner.

Morck and Nakamura (1999), study the role of banks in corporate management in Japan, and find that stock prices of firms in the Keiretsu bank group rise after a banker is appointed to the board. In contrast, the stock price of the firm that is not in the Keiretsu bank group falls after the appointment of the banker in the board. It appears that appointment of the banker on the group is a sign of bailout. Morck and Nakamura, use data on the large manufacturing companies during 1981-1987, and form two measures of stock performance: total return measured as a compounded monthly cumulative dividend returns; and Tobin's Q ratio, as the market value of assets to its replacement value. Prowse (1992), examines the role of dividend in Japanese business enterprises and states that as the bank in Keiretsu is at the same time both a large stockholder of the firm and its lender, it may mitigate the transfer of wealth between the creditor and the stockholder, by limiting the payment of dividend.

Dewenter, and Warther (1998), find that because of the vast flow of information between Keiretsu firms, and reasonably good and ongoing communication between the firm and its major shareholders in Japan, dividends do not possess new information to shareholders and tend to lead to much smaller price reactions than in U.S. Firms. The findings support the role of corporate governance in dividend policy of the firm. In this regard, due to the full flow of information, Japanese shareholders have complete knowledge about the cash flow stream of the firm and its investment opportunities. Their time horizon for the empirical analysis includes 1982-1993, and they find that Japanese firms, and in particular Keiretsu firms, face less

information asymmetry and agency conflicts than U.S. firms. As a result, Japanese stocks show less reaction to changes in dividends, and their dividends change in line with changes in earnings.

Dewenter and Warther (1998), test for information asymmetry and agency conflicts for dividend policy by using the Linter's model as follows.

$$d_t = d_{t-1} + c(r^*e_t - d_{t-1}) \quad (1)$$

where "d" is dividend, "r" is the payout ratio, "e" is earnings and "c" is the speed of adjustment of dividends to earning. In testing for the information content of dividend, they use the following model.

$$ER_{j(a,b)} = \prod_{t=a}^b (1 + R_{jt}) - \prod_{t=a}^b (1 + MR_t) \quad (2)$$

where $ER_{j(a,b)}$ is excess return for firm j over time period a to b, R_{jt} is return for the firm j, and MR_t is the return for the market index. They use a 2-day window (0, +1), and 62-day window (-60, +1). For dividend omission and initiation, for U.S. firms, the wide window shows -17 percent for U.S. firms and a -6.5 percent for Japanese firms. The narrow window shows -4.89 percent for omission and 2.38 percent for initiation. Thereby, U.S. stock prices react more strongly to changes in dividends than the Japanese. Dewenter and Warther further perform a multivariate test for controlling earnings, tax clientele and time horizon that dividend was paid before omission, or not paid before initiation. For tax clientele, the normalized dividend yield for the company was measured as the dividend yield for the company divided by the median dividend yield for the sample companies. In multivariate tests, the coefficient of dividend yield is -0.056 for U.S., and for the Japanese firm it is -0.013. Thereby, dividend yield announcements and surprises are more informative in U.S. than in Japan. For the Lintner model, the speed of adjustments for the U.S. is 0.055, and for all the Japanese firms it is 0.094. The Keiretsu firms have a speed of adjustments of 0.117. Thereby, Keiretsu firms show a faster adjustment for dividends to earnings. Keiretsu firms appear to omit or initiate dividends more frequently than U.S. firms.

The Cost of Divergence in Control Rights

An investment in a share of common stock ordinarily provides a cash flow right, to receive a part of earnings of the company, and a control right to vote on the general direction of the company. Claessens, Djankov, Fan, and Lang (2002), provide extensive empirical tests in finding evidence that when large shareholders have control over the cash flow rights, firm value will be higher and it would have proper corporate governance. This is because, as the largest recipient of the firm's cash flow, their wealth will rise in line with the minority shareholders. They would also have less incentives to seek private benefits at the expense of the individual shareholders. On the contrary, when the largest shareholders have concentrated control right, they are able to extract private benefits, and extract value at the expense of shareholders, and the firm value will decline. They conclude that firm value will increase when large shareholders have concentrated cash flow ownership. This is stronger for firms controlled by family. The opposite is the case for the concentrated control rights: value will decline, with poor corporate governance.

Large concentrated cash flow ownership shareholding leads to profit maximization and higher corporate value due to control over corporate managers. They study non-U.S. firms for which there is a large divergence between cash flow rights and control rights. That is, in the East Asian firms, due to cross shareholdings, pyramid structures, and dual class share ownership, selected shareholders may have full control over the firm with a small share of cash flow rights. The larger is the control rights over the cash flow rights, the lower would be the value of the firm for the minority shareholders and the higher would be the private benefit for the controlling groups. Claessens, Djankov, Fan, and Lang use data covering East Asian firms, excluding Japan, for 1996. The value is measured as the market to book value ratio. If a family owns 11 percent of firm A, which owns 21 percent of firm B, the cash flow right of B is calculated as about 2 percent (i.e., $0.11 * 0.21$), while the control right over B is 11 percent (the weakest link). When the control right of the largest shareholder is greater by 35 percentage points of cash flow rights, the value of the firm

will be the lowest. The firm value begins its deterioration from deviations of 15 percentage points. Their regression tests include control independent variables of sales growth, capital spending to sales ratio, and age of the firm, measured as years since inception.

Lemon and Lee (2003), study the corporate governance mechanisms in East Asian countries during the East Asian Financial crisis of 1997. They provide an empirical finding about the relation between value of the firm and concentrated control ownership. The belief is that, as shown by various examples, a large concentrated control shareholdings without proportional cash flow rights, may result in expropriation of resources, for the benefit of the controlling shareholders, and at the expense of the minority shareholders. As ownership structure, investment opportunities, and firm value are jointly determined, they believe that the financial crisis provides an exogenous shock.

Lemon and Lee use data on 800 East Asian firms from eight countries and find that the mean ratio of control rights to cash flow rights is greater than 2. Further, the management group has the largest control rights averaging 26 percent, with the block holding control rights in two-thirds of the sample companies. These firms show a valuation which is 10 to 20 percentage points lower than companies with equal share of control and cash flow rights. Thereby, firm value is negatively correlated with the separation of control and cash flow rights. The regression is the cumulative stock return during the financial crisis onto an indicator variable equal to one for measuring cash flow rights greater than one, and an indicator variable equal to one when managers have above median control rights, as well as the interaction variable for these two variables. They further include the logarithm of firm size, leverage, logarithm of book-to-market value ratio, stock's beta, and countries' rule of law. It should be noted that NYSE prohibits firms from issuing new stock with voting rights greater than 20 percent of total votes without shareholder approval.

Governance and Control by Institutional Shareholders

Barclay, Holderness and Sheehan (2009), examine the impact of corporate block holders on the dividend policy of the firm. As dividends received by corporations has a special tax treatment resulting in less taxes, then corporate ownership and control of a firm should lead to an increase in its dividend. They examine large transfer of stock from individuals to corporations, hypothesizing that it should lead to an increase in dividend. Further they examine dividend policy at 376 randomly selected companies in 1998, 2001, and 2004. They find that there is no relation between corporate ownership and dividend policy. They show that 68 percent of corporations that are held by large institutional block holders do not pay dividend. That is, corporate block holders have no special preference for dividend paying stocks.

Barclay, Holderness and Sheehan calculate the ratios of dividends to market price; dividends to assets; dividends to earnings, before and after the equity of the firm is controlled by institutional block holders; and find a decrease in such ratios after such ownership. They find that the ratio of dividend to price is more influenced by the variance in stock price, while the ratio of dividends to assets is influenced by changes in dividend, as the book value of assets is relatively stable over time. The use of the ratio of dividend to earnings is further a control variable for changes in financial conditions.

Lewellen, and Lewellen (2022), provide detailed empirical evidence on the incentives of institutions to be active in improving corporate governance in their portfolio of investments. They show that as of 2017 about 73 percent of publicly traded companies were owned by institutional investors. For the case of investment companies investing in several firms, they show improvements in corporate governance leading to a 1 percent increase in quarterly return in a firm value, leads to a statistically highly significant 1.39 percentage points increase in net inflows during the subsequent 12 quarters.

Lewellen, and Lewellen, calculate the average weight of firm in an institutional portfolio as 1.56 percent and the weight of the same firm in other institutions' portfolio as 0.44 percent. The incentive of an institutional investor is 3.12 percent. As the portfolio of investments is value weighted, larger shareholders have greater incentives to be engaged in managing governance of an investment firm. The large degree of incentives, appear to reduce the concern for the "free rider" cost. Lewellen, and Lewellen (2022), estimate that a 1 percent increase in a firm value held in the institutions' portfolio, leads to an average annualized gain of \$520,600, assuming a management fee of 0.5 percent. Given that smaller institutions place a higher weight of 4.11 percent of their assets to a firm, their incentives to be engaged in corporate governance is

much stronger of 9.32 percent. However, it is much smaller in dollar amounts as \$31,300. Well diversified institutions with an average weight of 0.73 percent invested in a firm, realize an extra \$219,500 in annual cash flow. Index funds, with average management fee of 0.11 percent realized \$133,000. Assuming that institutions may invest in several firms in the same industry, the authors show that with two to six firms in an industry, the average gain is \$78,100 for the main firm and \$31,400 if every competitor firm gains 1 percent. However, with an overweight in the engaged firm, the rival firms' gain is \$8,100. An institution's investment in multiple firms in an industry reduces the incentives to be engaged in the corporate governance by 30 percent because the firm with improved governance and value may take away market share from other firms in the same industry, thus reducing the benefits of the rival firms in the institution's portfolio. The reduction in benefit to index funds is 73 percent. Overall, they show the gain in being an active investor in management of a firm. An institution's engagement in its governance, voting in shareholder proposals, and taking actions in monitoring a firm, is likely to affect its value. Data for an institution's holdings of corporate equity are taken from 13F by Thomson Reuters' Wharton Research Data Services.

The Effect of Co-opted Directors

Co-opted directors are appointed after the incumbent CEO assumes office, which is measured as the percentage of co-opted directors to the total directors. Jiraporn, and Lee (2018), study the role of co-opted directors on dividend policy. They show that co-opted directors tend to reduce the propensity of dividend payments, and significantly lower dividend payout ratio. They show that the percentage rise in co-opted directors by one standard deviation tends to a decline of 4.62 percent in the propensity to pay dividend. For firms that already pay dividend, an increase by one standard deviation in co-opted directors, reduce the dividend payout by 6.16 percent. An increase in co-opted directors by one standard deviation, results in a reduction of dividend payouts by 0.0298 or 6.16 percent of average dividend per share. They include both dividend and share repurchase, to measure total payouts. In their empirical testing procedures, Jiraporn, and Lee include the lagged value of payouts to control for endogeneity, as both are affected by unobserved variables. And further they include the Sarbane-Oxley Act, as a "natural experiment," which represents as exogenous shock that raises board co-opted directors. They find that rise in co-opted directors as a result of the Sarbane-Oxley rules, leads to a lower dividend payout. Thereby, revealing a causal effect. Their data include 2572 firms during 1996-2014. Data for directors are collected from Risk Metrics. They use the ratio of sum of the tenure of co-opted directors/total tenure of all directors, which has a range of zero to one.

Jiraporn, and Lee, further include the percentage of independent directors as a control variable. Other control variables are: dividend/price; dividend/assets; dividend/sales; repurchase/sales; repurchase/price; Tobin's Q ratio; free cash flow/assets; sales growth rate; leverage; and the percentage of outstanding share by the CEO. For the board characteristics, they use: board size; percentage of independent directors; female directors; and post Sarbane-Oxley. They, further show that managers may prefer share repurchases to dividends, as it is flexible compared to dividends, and it is under the control of managers. They also note that the CEO turnover does not change the results.

The Legal and Regulatory Benefits

LaPorta, Lopez-De-Silanes and Shleifer (1999), review and empirically test the ownership structure of 20 large publicly traded corporation in the U.S., and 27 international firms to identify the nature of owners and their voting power in control of the firm. Specifically, they are looking for cross-holdings, pyramids and the identity of owners: banks, government, or families. That is, they are identifying the nature of the legal system of the country as to its effectiveness in protecting the minority shareholders. In the countries with good legal protection, the cash flow rights and share of ownership of minority shareholders are well protected. Data are taken from World Scope Annual Reports, and 20-F filings for ADRs, during 1995 and 1996. LaPorta, Lopez-De-Silanes and Shleifer use a complex set of rules to classify for the nature of control in the firm. These result for a firm as being widely-held, family-controlled, state-controlled, controlled by a widely held financial institutions, controlled by a widely held corporation, or miscellaneous. In the countries with good legal protection, widely held shareholdings is most common. When legal protection is not strong, family controlled and state controlled prevail. Using a 10 percent ownership to define control,

shows that 90 percent of U.K. firms and 80 percent of U.S. corporations as well as 50 percent of Japanese firms are classified as widely held. Furthermore, the deviation from one share, one vote is small: on average, 18.6 percent ownership is needed for control of 20 percent voting rights. It is 19.7 percent ownership with good legal protection and 17.7 percent when shareholder protection is weak.

In addition, on average, 26 percent have pyramid owners, 18 percent in good legal protection and 31 percent in poor ones. Bank ownership and control is primarily limited to Belgium and Germany. Overall, LaPorta, Lopez-De-Silanes, and Shleifer findings do not appear to be consistent with Berle and Means (1932), for a case of widely held shareholdings and control. In countries outside of U.S., especially in those with poor legal protection, there is a concentration in shareholding and control, usually by families who also are the controlling managers. Li, Moshirian, Pham and Zein (2006), use data on 19,833 firms across 45 countries and find that countries with strong shareholder rights, legal rights, and corporate disclosure, appear to have large institutional equity investments. They further find this to be stronger for the fund managers than banks.

Pinkowitz, Stulz and Williamson (2006), show that in countries with good corporate governance the controlling shareholders have interest in raising corporate value, but when corporate governance is poor, those in control have the power and incentives to increase their private benefits at the cost of the minority shareholders. At the same time, risk is higher in such countries with poor corporate governance and thereby, the controlling shareholders tend to maintain excess cash and liquid assets. Thereby the minority shareholders should not include the cash position of the company in valuation of the firm.

Pinkowitz, Stulz and Williamson (2006) show that in countries with above medium investor protection, a dollar in their liquid assets is worth 91 cents. Whereas, in countries with poor investor protection—below median—a dollar in liquid assets is worth 33 cents. Consequently, in countries with poor investor protection, the minority shareholders are better off in receiving the corporate cash as dividends. They further show that a dividend payment equal to one percent of firm assets results in 9.8 percent in firm value in countries with poor investor protection, but 4.07 percent in the other countries. They also find that a one dollar increase in cash holdings increases firm value by 33 cents in countries with high corruption and by 91 cents with low corruption. A one dollar increase in non-cash assets increases the firm value by 21 cents in countries with high corruption, but by 54 cents in countries with low corruption.

Faulkender and Wang (2006), examine the value of corporate cash to shareholders across firms. They find that marginal value of a dollar in cash is 94 cents on average. In their empirical study, the value of a dollar in cash to shareholders depends on its effect on incoming distributions to shareholders, its use in funding investment projects and in servicing corporate liabilities. A higher degree of leverage, however reduces the marginal value of cash to equity holders. The marginal value of a dollar of cash however may exceed \$1 for firms with value enhancing projects when raising outside financing entails substantial transactions costs. For such constrained firms the value of a dollar in cash ranges from 28 to 63 cents more than those unconstrained firms. The marginal value of cash is also 13 cents higher if it is distributed as a share repurchase as compared to dividends due to the differential tax between the two.

Faulkender and Wang examine the way variations in value of a dollar in cash relates to financial structure of the firm in generating excess return to equity holder. Their independent variables are normalized by dividing on equity. Thereby, their regression coefficients denote the change in the value of equity as a result of \$1 in cash. Without taxes and payouts, cash grows at an interest rate R , as the risk-free return,

$dc_t = R C_t dt$. If corporate cash is taxed at a rate T_c and a portion β of the after-tax earnings is distributed to shareholders as dividend, then: $dc_t = R C_t (1 - T_c) (1 - \beta) dt$ and $C_t = C_0 e^{Rt(1 - T_c)(1 - \beta)}$ and the distribution “ x ” to shareholders in interval “ dt ” is $dx = R C_t (1 - T_c) \beta dt$

They then formulate the marginal value of cash as follows.

$$\frac{\delta E}{\delta C} = (1 - T_d) \frac{(1 - T_c)(\beta)}{(1 - T_i) - (1 - T_c)(1 - \beta)} \quad (3)$$

For example, if $T_d = 0.25$ as the corporate tax on dividend, $T_c = 0.35$ as the tax on corporate cash holdings and $T_i = 0.30$ as personal tax rate and $\beta = 0.25$ then $\frac{\delta E}{\delta C} = 0.57$ as the marginal value of cash. They further show that the presence of agency cost of cash would reduce this value.

The Outcome and the Agency Model of Dividend Policy

LaPorta, Lopez-De-Silanes, Shleifer, and Vishney (2000), show empirical testing for the “outcome model of dividend policy,” and the “substitute agency model of dividend.” According to the “outcome model of dividend policy,” the payment of dividend is an outcome of an effective protection of outside, minority, shareholders, as shareholders have the voting right to elect board members who may act in their best interest. Investors with good legal protection may also vote for lower dividends if they know that the funds are invested in projects with good growth opportunities, resulting in a higher dividend at a later time. The alternative agency theory of dividend, the “substitute agency model of dividend,” views dividend payment as a signal for fair dealing with outside investors and gain a reputation for distribution of profit to all shareholders. This reputation is most important in civil law countries where protection for minority shareholders may be weak. According to the substitute agency model of dividend, high growth firms would also pay a high dividend than the low growth firms because they want to gain reputation for fair dealing with outside investors due to their future needs for external capital. This model, however, did not receive adequate empirical support.

LaPorta, Lopez-De-Silanes, Shleifer, and Vishney (2000), use regression analysis on 4103 firms from 33 countries in order to test agency model of dividend payment. They find that firms operating in common law countries in which the interest of the minority shareholders are better protected (as compared to the civil law countries), pay higher dividends. In addition, high growth firms pay a lower dividend than low growth firms. They refer to this as the “outcome agency model of dividend.” There appears to be conflict of interest between outside or minority shareholders with insiders such as corporate executives and the controlling shareholders regarding the distribution and sharing of the corporate profit. This is because the insiders may invest such internally generated funds for their private benefits, such as sales growth or diversification with no added profit. In common law countries such as the U.S., minority shareholders are well protected, leading to lower agency problem. In the agency model of dividend payment, the cash in the hand is viewed as better than the promise of future gains on the stock price. Further, as the firm will have to issue new shares of common stock to finance its future investments, more, or additional outside shareholders will gain the opportunity to exert control of the firm.

The agency model of dividend policy may help in resolving the dividend puzzle, as according to the theoretically sound model of Modigliani and Miller (1958), given an investment policy of the firm, dividend policy does not matter, as it cannot add value to the firm in a frictionless market with no differential taxes. The agency model assumes that investment policy of the firm may not be independent of its dividend policy, and one cannot assume that all profits will be given on a pro-rata basis to all shareholders. Firms in common law countries, due to legal protection of investors, pay a higher dividend payout ratio than firms in civil law countries. In civil law countries, due to a weaker protection of individual shareholders, shareholdings may be highly concentrated, or family controlled. Thereby, they can take proper decision on the payout policy.

The Benefit of Good Governance on the Firm Value

Chharia and Grinstein (2007), find that announcement of the Sarbanes-Oxley Act of 2002 had a significant effect on corporate market value of the firms that were categorized as non-compliant prior to this Act. That is, effective corporate governance helps in increasing the market value of the firm. Their methodology includes the four-factor model as shown here. They test for the behavior of alpha, the excess risk adjusted return, while comparing a portfolio of compliant, versus non-compliant firms.

$$R_{At} - R_{ft} = \alpha_A + \beta_{1A}(R_{mt} - R_{ft}) + \beta_{2A}SMB_t + \beta_{3A}HML_t + \beta_{4A}MOM_t + e_t \quad (4)$$

Here R_{ft} is the risk free return, $R_{mt} - R_{ft}$ controls for the excess return of the asset return that is correlated with the market excess return, and SMB controls for the excess return of the asset return that is correlated with the difference in returns between portfolios of small and large firms, and HML controls for the excess return of the asset return that is correlated with the difference in returns of portfolio of high and low book to market ratios, and MOM denotes momentum factor, α_a measures the excess return of portfolio, relative to the four factors. Market value of the firm's equity + (Book value of the firm's assets - Book value of the firm's equity), denotes the market value of a firm. Book value of the assets denotes the book value of firm. They design two portfolios: compliant as A, and non-compliant as NA, and construct a portfolio that is long A, and short NA; They then calculate $\Delta = R_A - R_{NA}$, the mean and standard deviation of Δ , and its coefficient of variation, σ_{Δ}^2 .

CONCLUSIONS

The nature of governance and control in a business enterprise appears to play an important role in its financing policies including the distribution of cash to stockholders and the use of leverage, affecting its value in the market. In the context of the transaction cost economics, decisions on the composition of the capital for financing the assets of the firm, as well as the amount of dividends and repurchasing of shares are tied to their respective costs. The payment of dividend reduces funds that may be needed for financing investment projects, and may lead to borrowing. Further, an agent who is not acting in the best interest of stockholders, may pay excessive dividend when the power and threat of removal by shareholders is high. Such a dividend payment reduces the cash available to the agent for private benefits, as a transaction cost. In terms of the use of debt in financing the investments of the firm, as the use of borrowed money may enhance the value of the firm due to its tax benefits, its cost may be the gain in a partial control of the company by outside bankers who may limit the payment of dividend to stockholders.

Violation of the one share, one vote, creating unequal voting rights, resulting in divergence of control and cash flow rights, is another case of transaction cost due to its negative impact on the value of the firm. On the other hand, the availability of complete information between the principal and agents tends to reduce the transaction cost. For example, in the case of Keiretsu in Japan, due to the continuous flow of information, market value of the firm is not adversely affected by changes in dividend policy, and the market reacts positively to the membership of a banker on the board of directors.

In contrast, Modigliani and Miller established an elegant theory of the firm, explaining the role of leverage and dividend policies in the determination of value of the firm. They show that the value of the firm is independent of the mix of debt and equity in its capital structure, and further that the market value of the firm is independent of its dividend policy. In effect the market value of a firm, in its basic form, is based on its risk-class discount rate applied to its earnings. Consequently, the value of the firm is not affected on how the firm is financed or how much of the earnings are paid out as dividend.

This paper shows selected empirical studies by scholars in finance measuring the impacts of leverage and dividend payment on the value of the firm. As the Modigliani and Miller's theories are in the context of perfect market conditions, it is shown here that in the context of the transaction cost economics, dividend policy of a business enterprise may have varying effects on the value of the firm. Such transaction costs may be actual or opportunity costs, and are affected, among other things, by factors such as the nature of corporate governance of the firm, the composition of the board or directors of the company, the nature of the control rights by shareholders, and the state of business laws of the home country. In the agency model of dividend payment, the cash in the hand is viewed as better than the promise of future gains on the stock price.

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