DOI 10.2478/sbe-2021-0001

SBE no. 16(1) 2021

THE IMPACT OF LEGAL SYSTEMS ON DIVIDEND PAYMENTS

ALIKAJ Albi

Jacksonville State University, USA

LIMAYE Aditya

Arkansas Tech University, USA

Abstract:

This paper focuses on the amount of dividends paid to shareholders by companies in different countries and examines whether being in a country where the legal system offers weak shareholder protection affects dividend payments distributed to shareholders. The sample used for this study comprises 8,045 companies from 46 countries. Seven individual factors affecting shareholder protection were examined. Out of the seven factors, only two of them provide a significant relationship with dividend payments, and more specifically, the mechanisms put in place by companies to protect oppressed minority shareholders as well as minimum percentage share of capital in order for the shareholders to be eligible to call an extraordinary shareholder meeting.

Key words: *Dividend Payments, Shareholder Protection, Legal System, Corporate Governance, Minority Shareholders*

1. Introduction

The importance of dividend payments by companies has been widely examined by researchers. Scholars have tried to link dividend payouts to firm value, although this has proven to be quite a difficult task (Albrecher and Ivanovs, 2018). A number of authors (e.g. Brown and Caylor, 2009; Gordon, 1959) argues that dividend payments are a key determinant of a company's overall value, while others (e.g. Iturriaga and Crisóstomo, 2010; Modigliani and Miller, 1958) state that in a perfect market, dividend payments are not relevant to firm value, as the amount of money distributed as dividends gets reduced from a firm's capital gains. Such theories have also led to the dividend puzzle, which states that even though dividends should not be an important factor in measuring firm value, investors value firms that pay dividends (Black, 1976), as there are various factors that may determine dividend payments (Floyd, Li, and Skinner, 2015; Gill, Biger, and Tibrewala, 2010; Hail, Tahoun, and Wang, 2014). Therefore, scholars have stressed the need to

further examine different factors that may influence the decision of firms to issue dividend payments (Moortgat, Annaert, and Deloof, 2017).

As such, the purpose of this study is to examine such determinants, and more specifically, it focuses on the impact of the legal system on the companies' dividend payments. The motivation for this paper is derived from the work of La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) who categorized several countries based on the origin of their legal systems (French civil law, common law, German civil law, and Scandinavian civil law). They concluded that shareholder protection in these countries differ based on various rules imposed by their legal systems. They also listed various factors that would affect shareholder protection in a large number of countries.

Policies on dividend payments are determined by the board of directors. While shareholders cannot directly force the board to distribute dividends, they use their voting rights to elect out members and elect in new members. However, the rights of the shareholders differ from country to country based on their respective legal systems. La Porta et al. (1998) examined the following factors: one share-one vote rule, voting by mail, giving minorities a right of proportional board representation, giving minority shareholders a preemptive right to purchase new shares, minimum percentage share required to hold extraordinary meetings, having some type of mechanism to protect oppressed minority shareholders and the policy of blocking shares before meetings.

This paper focuses on the amount of dividends paid to shareholders by companies in different countries and examines whether being in a country where the legal system offers weak shareholder protection will affect the dividend payments distributed to shareholders. The study will use 46 countries used by La Porta et al. (1998). It is expected that the individual factors that affect shareholder protection will also influence dividend payments. Therefore, this study aims to better understand which factors related to the legal system and considered to affect shareholder protection also influence dividend payments.

The following section includes the literature review related to dividend payments and factors affecting shareholder protection. The third section covers the methodology used in this study. The fourth section provides the results of the study. The paper ends with a section covering the discussion of the results and concluding remarks.

2. Literature Review

Companies impose different policies on dividend payments based on various factors. Several scholars have found that taxation significantly affects dividend payments (e.g. Bolster and Janjigian, 1991; Chetty and Saez, 2005). The size of the firm is another factor. The larger the firm, the more dividends it distributes (Fama and French, 2001). Also, Denis and Osobov (2008) empirically found that when firms have a large ratio of retained earnings to total equity, they distribute larger amounts of dividends. Another, but less studied, factor is the protection of shareholders as determined by the legal systems.

La Porta et al. (1998) summarized several factors that affect shareholder protection as determined by a country's legal system. They found that shareholders of companies incorporated in common law countries are more protected by the law, while in

French civil law countries they are the least protected, with the German and Scandinavian standing in between. They further examined and found support that firms in common law countries (with stronger shareholder protection) pay more dividends than those in civil law countries (with weaker shareholder protection) (La Porta, Lopez-De-Silanes, Shleifer, and Vishny, 2000). However, they do not explain which individual shareholder-protective factors directly influence payout policies. Such information is important to current and prospective shareholders as these individual factors vary widely from country to country, regardless of the legal system in each country.

In order to examine the full scope of the impact of shareholder protection on dividend payments by firms, I base my study on that of by La Porta et al. (1998) to enlist seven factors that affect such shareholder protection. One important factor of shareholder protection is the one share – one vote policy. This policy ensures that all shareholders have equal voting rights based on their share in the firm. Deviations from such policy can lead to agency problems, such as alterations in investment decisions (Bebchuk, Kraakman, and Triantis, 2000). When it comes to dividend payments, firms with limited internal funds are more affected by this issue as they have to decide between paying dividends and using funds to finance future projects (Ramalingegowda, Chuan-San, and Yong, 2013).

Another factor that may affect shareholder protection is the right to vote by mail. Voting by mail seems to not be allowed in several countries, which limits a shareholder from casting his or her vote. One of the reasons deals with identity issues (Baums, 1997). However, many shareholders are allowed to transmit their vote through a proxy, usually a bank. Cumulative voting and proportional board representation for minority shareholders is also a factor representing shareholder protection. Such a rule, however, is not allowed in every country.

A fourth factor representing the degree of shareholder protection is the non-blocking of shares around the shareholders' meeting. Such a measure is taken not only to account for the shareholders that have the right to vote, but also to prevent any transactions that might occur based on confidential information. However, the requirement to block shares around the time of the meeting can be bypassed through various measures such as "forward" sales or off-exchange transactions (Spamann, 2010).

Another important factor deals with the requirement to give minority shareholders preemptive rights to purchase new shares. Such a policy is important in preventing any unconsented dilution of the relative voting powers of minority shareholders (Drinker Jr, 1930). Similarly, several countries impose a minimum percentage share of capital in order to be eligible to call an extraordinary shareholder meeting. The higher this limit, the lower the power of minority shareholders.

The last factor that is covered in this paper is the mechanisms put in place by companies that protect oppressed minority shareholders. These mechanisms can include the right for the minority shareholder to challenge the decisions taken by director. Also, if the shareholder does not agree with important decisions such as mergers or acquisitions, the company is forced to repurchase that minority shareholder's shares (La Porta et al., 1998). Such protection, including the other factors as well, can also affect dividend payout

policies because as the protection of minority shareholders increases, asset diversion becomes more difficult and more expensive to insiders (La Porta et al., 2000).

3. Methodology

3.1. Sample

The sample used to test whether individual shareholder protective factors affect dividend payments by companies is taken from the COMPUSTAT Global database. The year of study is 2014. Initially the sample consisted of 28,390 firms. Since the classification of shareholder protection for each country was based on the study by La Porta et al. (1998), I deleted the firms from countries for which the study did not have data. After this step, the sample size was reduced to 21,533. Since the dependent variable is dividend payments, I deleted the firms that did not have a value for this variable. More than half of the firms did not have a value for dividend payments. Therefore, the final sample size was 8,045 companies from 46 countries. Appendix A shows the list of these countries and the respective number of firms for each country.

3.2. Variables

The dependent variable for this study is annual dividend payments. This variable is the amount paid by firms to shareholders in the form of dividends. This variable is taken from COMPUSTAT Global for each of the 8,045 companies. The independent variables include the seven individual shareholder-protection variables as listed by La Porta et al. (1998). The values for each country are included in Appendix A. I also examine whether the country's legal origin as a whole affects dividend payments by firms. The four legal systems are the common law, French civil law, German civil law and Scandinavian civil law. Control variables include profitability, as the main driver of dividend payments, country GDP, and firm size to account for the finding of Fama and French (2001) that firm size is positively related to dividend payments. Profitability is measured as the firm's Net Income, while firm size is measured as the number of employees for each firm.

Based on the variables described above, the model is as follows:

$$DIV = \alpha + \beta_1 Proxy + \beta_2 CV + \beta_3 OMM + \beta_4 PR + \beta_5 EXT + \beta_6 Block + \beta_7 OSOV + \beta_8 LO + \beta_9 Profitability + \beta_{10} Size + \beta_{11} GDP + \varepsilon$$

where *DIV* is the amount of dividend payment, α is a constant, *proxy* is a dummy variable which shows whether proxy by mail is allowed, *CV* shows whether the company allows cumulative voting and proportional representation of minority shareholders, *OMM* represents the presence of any mechanisms protecting oppressed minority shareholders, *PR* represents the presence of a policy which gives minority shareholders preemptive rights to purchase new issued shares, *EXT* shows the minimum percentage of share capital required to hold extraordinary shareholder meetings, *OSOV* shows the presence of a true one share-one vote policy in the firm, *LO* shows the legal system of the country in

which the firm is incorporated, *profitability* represents the profitability of the firm indicated by the amount of net income, *Size* is the firm's size indicated by the number of employees, and ε is the error term.

4. Results

The model is tested by using the statistics software StataSE 13. The results of the analysis are shown in Table 1:

Table 1: Regression model. Dependent Variable: Dividend Payments					
	Coef.	Std. Err.	P> t 	[95% Confidence Interval]	
Legal Origin	0.30***	0.087	0.000	0.134	0.475
Proxy by mail Allowed	0.07	0.066	0.281	-0.058	0.201
Cumulative voting/proportional representation	0.08	0.062	0.181	-0.039	0.208
Oppressed Minority Mechanisms	0.25**	0.086	0.004	0.082	0.418
Preemptive rights to new shares	-0.06	0.057	0.246	-0.178	0.046
% Share capital to hold extraordinary meetings	-0.36***	0.086	0.000	-0.291	-0.629
Shares not blocked before meetings	-0.10	0.057	0.167	-0.191	0.033
One Share-One vote policy	0.10	0.069	0.192	-0.046	0.227
Profitability	0.42***	0.044	0.000	0.407	0.425
Firm Size	0.17*	0.076	0.023	0.024	0.323
Country GDP	0.13*	0.082	0.031	0.101	0.240
Constant	0.03	0.047	0.463	-0.057	0.126

Significance level: * <0.05 , ** <0.01 , *** <0.001

The results of this model provide some interesting findings. It should be noted that the coefficient of a country's legal system ($\beta=0.30$) is statistically significant ($p<0.001$). However, when factors influencing shareholder protection are examined individually, differences arise. Out of the seven factors affecting shareholder protection, only two of them have coefficients that are statistically significant. More specifically, the presence of mechanisms protecting oppressed minority shareholders ($\beta=0.25$) and the minimum percentage of share capital required to hold extraordinary shareholder meetings ($\beta=-0.36$) have coefficients that are statistically significant at (coefficients are $p<0.01$ and $p<0.001$, respectively). The other five factors affecting shareholder protection do not have statistically significant coefficients. The R squared of the model is 0.74.

5. Discussion and Conclusion

This paper examined the individual factors that affect shareholder protection and tested their effect on dividend payments. While other influencing factors such as profitability, firm size, and taxation have been well studied by scholars, factors related to shareholder protection have not been deeply exploited. While La Porta et al. (2000) suggest that a firm with higher shareholder protection pays more dividends, they do not focus on individual factors and how they affect dividend payments.

The results of this paper unveil some insightful findings. Seven individual factors affecting shareholder protection were examined. Out of the seven factors, only two of them provide a significant relationship with dividend payments. More specifically, when firms provide mechanisms that aim to protect oppressed minority shareholders, asset diversion becomes more difficult for insiders, and thus the amount of dividend that should be distributed is less likely to be altered. Also, the minimum percentage of share capital required to hold an extraordinary meeting was found to be related to dividend payments. La Porta et al. (1998) state that the higher this percentage, the lower the shareholder protection. This is because such a policy limits the power of minority shareholders. Similarly, this study found that the lower the minimum percentage of share capital to hold extraordinary shareholder meetings, the higher is the dividend distribution by the firm. The remaining five factors (one share-one vote rule, voting by mail, giving minorities a right of proportional board representation, giving minority shareholders a preemptive right to purchase new shares, and the policy of blocking shares before meetings) were not found to be significant. Therefore, future research should further examine these factors to provide a better understanding of how legal systems affect company dividend payouts.

Dividend distribution is an important topic to many shareholders. By examining the factors related to shareholder protection, this paper aimed at better understanding influencing variables on dividend distribution from a corporate governance point of view. This area requires more extensive research because corporate governance policies, and more specifically, policies related to shareholder protection, vary widely from country to country.

6. References

- Albrecher, H., Ivanovs, J., (2018), *Linking dividends and capital injections—a probabilistic approach*, Scandinavian Actuarial Journal, Vol. 2018 no. 1, pp. 76-83.
- Baums, T. (1997). Shareholder representation and proxy voting in the European Union: a comparative study. In K. J. Hopt, H. Kanda, M. J. Roe, E. Wymeersch, & S. Prigge (Eds.), *Comparative Corporate Governance. The State of the Art and Emerging Research* (pp. 545-564). Oxford: Clarendon Press.
- Bebchuk, L. A., Kraakman, R., Triantis, G. (2000). Stock pyramids, cross-ownership, and dual class equity: The mechanisms and agency costs of separating control from cash-flow rights. In R. K. Morck (Ed.), *Concentrated corporate ownership* (pp. 295-318): University of Chicago Press.
- Black, F., (1976), *The dividend puzzle*, The Journal of Portfolio Management, Vol. 2 no. 2, pp. 5-8.
- Bolster, P. J., Janjigian, V., (1991), *Dividend policy and valuation effects of the Tax Reform Act of 1986*, National Tax Journal, Vol. 44 no. 4, pp. 511-518.

- Brown, L. D., Caylor, M. L., (2009), *Corporate governance and firm operating performance*, Review of quantitative finance and accounting, Vol. 32 no. 2, pp. 129-144.
- Chetty, R., Saez, E., (2005), *Dividend taxes and corporate behavior: Evidence from the 2003 dividend tax cut*, The Quarterly Journal of Economics, Vol. 120 no. 3, pp. 791-833.
- Denis, D. J., Osobov, I., (2008), *Why do firms pay dividends? International evidence on the determinants of dividend policy*, Journal of Financial Economics, Vol. 89 no. 1, pp. 62-82.
- Drinker Jr, H. S., (1930), *The preemptive right of shareholders to subscribe to new shares*, Harvard Law Review, Vol. 43 no. 4, pp. 586-616.
- Fama, E. F., French, K. R., (2001), *Disappearing dividends: changing firm characteristics or lower propensity to pay?*, Journal of Financial Economics, Vol. 60 no. 1, pp. 3-43.
- Floyd, E., Li, N., Skinner, D. J., (2015), *Payout policy through the financial crisis: The growth of repurchases and the resilience of dividends*, Journal of Financial Economics, Vol. 118 no. 2, pp. 299-316.
- Gill, A., Biger, N., Tibrewala, R., (2010), *Determinants of dividend payout ratios: evidence from United States*, The Open Business Journal, Vol. 3, pp. 8-14.
- Gordon, M. J., (1959), *Dividends, earnings, and stock prices*, The Review of Economics and Statistics, Vol. 41 no. 2, pp. 99-105.
- Hail, L., Tahoun, A., Wang, C., (2014), *Dividend payouts and information shocks*, Journal of Accounting Research, Vol. 52 no. 2, pp. 403-456.
- Iturriaga, F. J. L., Crisóstomo, V. L., (2010), *Do leverage, dividend payout, and ownership concentration influence firms' value creation? An analysis of Brazilian firms*, Emerging Markets Finance and Trade, Vol. 46 no. 3, pp. 80-94.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R. W., (1998), *Law and finance*, Journal of Political Economy, Vol. 106 no. 6, pp. 1113-1155.
- La Porta, R., Lopez-De-Silanes, F., Shleifer, A., Vishny, R. W., (2000), *Agency problems and dividend policies around the world*, Journal of Finance, Vol. 55 no. 1, pp. 1-33.
- Modigliani, F., Miller, M. H., (1958), *The cost of capital, corporation finance and the theory of investment*, The American Economic Review, Vol. 48, pp. 261-297.
- Moortgat, L., Annaert, J., Deloof, M., (2017), *Investor protection, taxation and dividend policy: Long-run evidence, 1838–2012*, Journal of Banking & Finance, Vol. 85, pp. 113-131.
- Ramalingegowda, S., Chuan-San, W., Yong, Y., (2013), *The Role of Financial Reporting Quality in Mitigating the Constraining Effect of Dividend Policy on Investment Decisions*, Accounting Review, Vol. 88 no. 3, pp. 1007-1039.
- Spamann, H., (2010), *The "antidirector rights index" revisited*, Review of Financial Studies, Vol. 23 no. 2, pp. 467-486.