Dividend payout, corporate governance, and the enforcement of creditor rights in emerging markets

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Abstract

In this paper I examine the relationship between the strength of creditor rights, their enforcement, corporate governance and corporate dividend payout in a sample of 281 emerging market firms. I show that the *outcome* model of dividends, which states that corporate dividend payout increases in the strength of corporate governance, holds in emerging markets, but only where the legal enforcement of creditor rights is strong. Where legal enforcement is weak, the shareholders of better-governed firms are not able to use their legal rights to extract large dividends from firms. The shareholders of better-governed firms are unable to extract large dividends from firms irrespective of the strength of creditor rights. That is, differences in creditor rights are not systematically related to dividend payout in the way predicted by the agency costs of debt and equity version of the *outcome* model of dividends.

Key words: Corporate governance; Creditor rights; Legal enforcement; Agency models of dividends; Dividend payout; Emerging markets.

1. Introduction

In their 2000 publication, La Porta et al. (2000) present two agency costs of equity models of dividends, namely the *outcome* and *substitution* models. The *outcome* model suggests that dividends are an outcome of effective governance, where governance can be either country and/or corporate governance (see Mitton, 2004; and Bartram et al., 2012). Given the agency costs associated with free cash flow, shareholders prefer dividends to retained earnings since dividends reduce the pool of funds which can be consumed privately by controlling insiders (see Jensen, 1986; Easterbrook, 1984). In turn, the *outcome* model suggests that it is the shareholders with the greatest legal rights (and/or belonging to better-governed firms) whom can extract the largest dividends from firms. Hence, the theoretical prediction of the outcome model is that, all else equal, dividend payout *increases* in the strength of shareholder rights.

On the contrary, the *substitution* model predicts that corporate dividend payout *decreases* in the strength of shareholder rights. In emerging markets where firm-level bonding mechanisms are few, the *substitution* model suggests that financially-constrained poorly-governed firms pay large dividends in the hope that these reputationally-enhancing dividends reduce their cost of external finance (see Benos and Weisbach, 2004).[1] In contrast, well-governed firms, presumably less financially-constrained, pay much lower dividends. In the period since the publication of La Porta et al. (2000), the extant literature has found empirical support in favour of both models. For example, Mitton (2004), Chae et al. (2009), Jiraporn et al. (2011), Adjaoud and Ben-Amar (2010), Bartram et al. (2012), Brockman and Unlu (2009, 2011), Byrne and O'Connor (2012), Shao et al. (2009), and Sawicki (2009) in post-Asian crisis Asia, all support the view that dividend payouts *increase* in shareholder rights. On the other hand, John and Knyazeva (2006), Officer (2007), Jo and Pan (2009), Jiraporn and Ning (2006), Chae et al. (2009), and Sawicki (2009) (in pre-Asian crisis Asia), uncover evidence which supports the *substitution* model i.e. dividend payouts *decrease* in shareholder rights.

Brockman and Unlu (2009) extend the agency costs of equity version of the *outcome* and *substitution* models by incorporating the agency costs of debt. The result is that the theoretical predictions of the agency costs of equity and debt version of the *outcome* model of dividends are different. Now, given the agency costs of debt, the *outcome* model predicts that dividend payout increases in the strength of

[1] Other bonding mechanisms in emerging markets include international cross-listings (Coffee, 1999; Doidge et al., 2004, 2009; Ferris et al., 2009) and strategic alliances (see Siegel, 2009).

shareholder *and* creditor rights. However, where creditor rights are weak, and even where shareholder rights are strong, creditors demand and firms consent to lower dividends. In effect, creditors *substitute* poor legal rights for lower dividends. Using country-level measures of shareholder rights, both Shao et al. (2009) and Byrne and O'Connor (2012) find support in favour of this prediction; the *outcome* model of dividends holds where shareholder *and* creditor rights are strong.

In this paper, I test the theoretical predictions of the agency costs of debt inclusive version of the *outcome* model of dividends. My paper differs to others in a number of crucial respects. First, I do so using firm-level measures of shareholder rights i.e. corporate governance, in contrast to the country-level measures employed by Shao et al. (2009) and Byrne and O'Connor (2012). Since we already know that dividend payout is an *outcome* of strong corporate governance in emerging markets (Mitton, 2004), I examine whether this relationship is altered given cross-country differences in the strength of creditor rights. To ensure that my work is consistent with that of Mitton (2004), I use the same Credit Lyonnais Securities Asia (CLSA, 2001) corporate governance scores that he uses. Second, I account for cross-country differences in the extent to which the legal rights of creditor rights are enforced. This is important since, in some countries, creditor rights as written in statute appear strong, but are poorly enforced.[2] Hence, in these countries, given the poor enforceability of contracts, creditors may demand lower and not larger dividends, as the 'strong' creditor rights measure would otherwise suggest. In fact, recent evidence from the loan-contracting literature supports the view that it is the enforcement of creditor rights, and not creditor rights per se which matters the most ((see Bae and Goyal, 2009; and Bhattacharya and Daouk, 2002, 2005). Hence, I hypothesize and proceed to formally test that in emerging markets, dividend payout is an *outcome* of strong corporate governance *and* strong enforcement of creditor rights.[3]

To perform these tests, I collect a sample of 281 firms from 21 emerging market countries. Like Mitton (2004), I test the agency models of dividends using shareholder rights measured at the corporate level (i.e. corporate governance) by employing the corporate governance scores complied by Credit

[2] For example, in Hungary creditor rights are weak but their enforcement much stronger.
[3] Byrne and O'Connor (2012) do explore the relationship between corporate governance, the strength of creditor rights and corporate dividend payout, but find no evidence to support the prediction that dividend payout is an outcome of strong corporate governance *and* creditor rights. The considerable variation in the enforcement of creditor rights in strong creditor rights regimes, which they fail to account for may explain their findings.

Lyonnais Securities Asia (CLSA, 2001). I begin by reconfirming the findings of Mitton (2004), that is, the agency cost of equity version of the *outcome* model of dividends prevails in emerging markets. The shareholders of better-governed firms extract the largest dividends from firms. To see if they can still do so given the strength of creditor rights, I test the agency costs of debt inclusive version of the *outcome* model by estimating regressions by the strength of creditor rights and the strength of the legal enforcement of these rights. The results from these tests suggest that creditors do exert a significant influence on corporate dividend policy, over and above the influence exerted by shareholders. As a result, shareholders can only use their legal rights to extract dividends from firms where the legal enforcement of creditor rights is strong. Like Byrne and O'Connor (2012), I show that differences in creditor rights are not systematically related to dividend payout in the way predicted by the agency costs of debt and equity version of the *outcome* model of dividends i.e., the outcome model of dividends does not hold given strong creditor rights. These findings suggest that it is the enforcement of (creditor) legal rights, and not creditor rights per se, which permit the *outcome* model to prevail in emerging markets. These findings are in line with the loan-contracting literature which also demonstrates that it is the enforcement of creditor rights which matters the most (see Bae and Goyal, 2009; and Bhattacharya and Daouk, 2002, 2005).[4]

The paper proceeds as follows. In the next section, I present a brief review of the literature and develop a number of testable hypotheses. In section 3, I describe the data. In section 4, I outline the test procedure, and then present and discuss the empirical findings. Section 5 concludes.

2. Literature Review & Hypotheses Development

In this paper I empirically test two agency costs of equity models of dividends, namely the *outcome* and *substitution* models of La Porta et al. (2000) inclusive of the agency costs of debt by incorporating the strength, and enforcement of creditor rights. The agency cost of equity version of the *outcome* model which is theoretically grounded in Jensen's (1986) free cash flow hypothesis, states that dividends can reduce the agency costs associated with free cash flow. Since expropriation of free cash flow by self-serving insiders is value-decreasing for minority shareholders, shareholders prefer dividends to retained

[4] This is not necessarily the consensus view. Qian and Strahan (2007) suggest that creditor rights matter more than their legal enforcement.

earnings. In turn, efficient corporate governance makes it possible for shareholders to extract dividends from firms. As a result, the prediction of the *outcome* model is that dividend payouts are largest when free cash flow exists *and* where shareholder rights are strong i.e. dividends are an *outcome* of strong corporate governance. In the intervening period since the publication of the La Porta et al. (2000) paper, numerous studies have found support in favour of the *outcome* model using shareholder rights proxies measured at the country and/or corporate level (see for example, Mitton, 2004; Chae et al, 2009; Jiraporn et al, 2011; Adjaoud and Ben-Amar, 2010; and Sawicki, 2009, for Asian firms in post-Asian crisis Asia).

On the other hand, the *substitution* model predicts a negative relationship between governance (country and/or corporate) and corporate dividend payout. In effect, dividends in their agency role *substitute* for poor corporate governance. Furthermore, the willingness on the part of firms, or more precisely the managers of those firms to pay large dividends given poor governance, is a function of the firms' external financing need. The *substitution* model predicts that poorly-governed firms wishing to enhance their reputation (presumably to raise external capital at lower cost) pay dividends. Since the cost of (equity) capital decreases in corporate governance (Chen et al., 2009), the *substitution* model predicts that firms substitute poor governance for (higher) dividend in the hope that reputationally-enhancing higher dividends reduces their cost of capital. In contrast, firms already with a sound reputation for fair treatment of their minority shareholders, that is well-governed firms, will pay fewer dividends. Consequently, the *substitution* model predicts that all else equal, dividend payouts decrease in shareholder rights.[5] There also exists plenty of empirical support for the *substitution* model (see for example, John and Knyazeva, 2006; Officer, 2007; Jo and Pan, 2009; Jiraporn and Ning, 2006; Chae et al, 2009; Sawicki, 2009, in pre-Asian crisis Asia), Mitton (2004) in civil law countries only, all find support in favour of the

[5] Of course an alternative to paying large dividends would be to improve corporate governance, which in turn would reduce the firms cost of capital. However, in some countries, most notably those with poorly developed financial markets, the net benefit (i.e. benefits less costs) of governance improvements even for firms with an external financing need is negative (Doidge et al, 2007). Hence, for these firms, increased dividends may represent a much less costly bonding mechanism when compared to the costs of improving their corporate governance practices. The short-term costs of paying large dividends for poorly governed firms are the costs associated with forgone positive NPV projects and costly external finance (which presumably will decrease once reputation has been established). Alternatively, these same firms could improve their governance by cross-listing as an exchange-traded ADR in the U.S. The costs are large and tend to result in enhanced governance through reputational as opposed to legal bonding. Interestingly, when firms cross-list as Level 2/3 ADRs, they pay less dividends (O'Connor, 2006; and Adjaoud and Ben-Amar, 2010), which suggests that enhanced governance substitutes for dividends for these firms.

substitution model of dividends).[6] Brockman and Unlu (2011) show that the *substitution* model prevails in countries where disclosure environments are opaque and the *outcome* model in countries where disclosure environments are transparent.

Brockman and Unlu (2009) extend the agency cost of equity version of the agency models of dividends, originally proposed by La Porta et al. (2000). They outline and test an agency cost of debt *and* equity version of the original agency models of dividends. In doing so, they present an alternative *substitution* model. This model suggests creditors *substitute* poor legal rights for lower dividends, which has important consequences for the 'original' *outcome* model of dividends. If shareholder and creditor rights are strong, then the predictions of the agency cost of debt inclusive *outcome* model of dividends is amended, and now predicts that dividend payouts are greatest, where shareholder *and* creditor rights are strong, all else equal. Where shareholder rights are strong, but creditor rights weak, dividend payouts are expected to be much lower. Hence, lower dividends *substitute* for poor creditor rights, and the *outcome* model is less effective under weak creditor rights.

Shao et al. (2009) and Byrne and O'Connor (2012) find support in favour of this prediction. Both show that the *outcome* model of dividends prevails where shareholders *and* creditors enjoy substantial legal rights.[7] In both studies, shareholder rights are measured at the country-level. In this paper, I test the predictions of the agency costs of debt and equity version of the *outcome* model of dividends using firm-level shareholder rights measures. My first hypothesis simply states that:

Hypothesis 1: The *outcome* model of dividends is more effective under strong creditor rights.

Next, I utilize cross-section differences in the legal enforcement of creditor rights across countries, and hypothesize:

Hypothesis 2: The *outcome* model of dividends is more effective under strong enforcement of creditor rights.

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[6] The results of these tests using U.S. firms are mixed. Using the anti-takeover governance index of Gompers et al. (2003) to measure the strength of corporate governance of U.S. firms, John and Knyazeva (2006), Officer (2007), Jo and Pan (2009), and Jiraporn and Ning (2006) find in favour of the *substitution* model. Again using U.S. firms, but now using governance data from the Institutional Shareholder Services, Jiraporn et al. (2011) find evidence in favour of the outcome model. The ISS data is a much broader corporate governance measure than the G-Index, which in turn, likely explains the conflicting findings.

[7] Interestingly and at least till now, without explanation, Shao et al. (2009) and Byrne and O'Connor (2012) demonstrate where creditor rights are weak, the original agency costs of equity version of the *substitution* model prevails i.e. dividend payout decreases in the strength of shareholder rights. Thus, the *outcome* model is ineffective given weak creditor rights.

Finally, I examine whether the *outcome* model is more effective under strong creditor rights or the strong enforcement of these creditor rights. Recent evidence from a related literature (i.e. the loan-contracting literature) supports the view that it is the enforcement of creditor rights, and not creditor rights per se which matter the most ((see Bae and Goyal, 2009; and Bhattacharya and Daouk, 2002, 2005). For example, Bae and Goyal (2009) show that loans amounts and maturities are much lower given poor enforceability of creditor rights. In contrast, creditor rights do not influence loan amounts or maturities. In this paper, I examine whether it is creditor rights, or the enforcement of these creditor rights which are more important for the effectiveness of the *outcome* model of dividends. Hence, the final hypothesis is:

Hypothesis 3: The *outcome* model of dividends is more effective under strong enforcement of creditor rights than under strong creditor rights.

3. Data

In this paper I examine the relationship between the strength of creditor rights, their legal enforcement, and the *outcome* model of dividends. The equity-only version of the *outcome* model of dividends contends that dividend payouts increase in the strength of shareholder rights, where shareholder rights can be measured either at the country and/or firm-level (i.e. corporate governance). In this paper, I focus on shareholder rights measured at the firm-level. To measure the strength of corporate governance, I follow Mitton (2004), and others, and use the corporate governance scores developed by Credit Lyonnais Securities Asia (CLSA, 2001).[8] The CLSA governance ratings range from 0 to 100 with higher values suggesting higher quality corporate governance practices. The rating for each individual firm, for which there is 495 firms in total across 25 emerging market countries, is a aggregate measure of 57 qualitative, binary (Yes/No) questions which span seven distinct governance categories, namely management discipline, transparency, independence, accountability, responsibility, fairness, and social awareness. The first six governance provisions have a 15% weighting in the composite index, while social awareness has a 10% weighting.[9] The rating for each firm is constructed by CLSA analysts. In this paper,

[8] For example, Klapper and Love (2004) explore the relationship between governance and firm performance, Durnev and Kim (2005) governance and firm value, and more recently Chen et al. (2009) governance and firm value via the cost of equity capital, all using CLSA governance data.

[9] The CLSA (2001) governance measures are far from perfect. Two of the major criticisms of the scores are, first, they suffer from subjectivity bias since some of the answers to the questions are not "matter-of-fact", but instead

I use only the first six governance provisions to construct the composite governance measure since dividend payout is unlikely to be related to social awareness. Consequently, the composite corporate governance score that I use in this paper is an equally weighed average of the first six corporate governance provisions.[10] A sample of some of the questions in each governance category is listed below.

1. **Discipline**. Has the company issued a "mission statement" that explicitly places a priority on good corporate governance? Does the company's annual report include a section devoted to the company's performance in implementing corporate governance principles?
2. **Transparency**. Are accounts presented according to IGAAP? Does the company consistently disclose major and market sensitive information punctually?
3. **Independence**. Is the chairman an independent, nonexecutive director? Does the company have an audit committee? Is it (the audit committee) chaired by a perceived genuine independent director?
4. **Accountability.** Are the board members and members of the executive/management committee substantially different? Do independent, nonexecutive directors account for more than 50% of the board?
5. **Responsibility.** Are there mechanisms to allow punishment of the executive/management committee in the event of mismanagement? Is the board small enough to be efficient and effective? (If more than 12 answer "No").
6. **Fairness.** Do all equity holders have the right to call General Meetings? Are voting methods easily accessible?

I use three different dividend payout measures, namely dividends-to-earnings (%), measured as dividends per share divided by earnings per share, dividends-to-cashflow (%), measured as dividends per share divided by cashflow per share, and dividends-to-sales (%), measured as cash dividends (paid to common and preferred shareholders) divided by net sales.[11] All data is sourced from Worldscope at the end of year 2001, which is the same year in which the governance data was compiled by the CLSA analysts.

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completed based on the experiences of the analyst who covers each firm. Durnev and Kim (2007) do show that the bias is likely to be low since they find that firms reported for corporate misdemeanors do score low in the CLSA (2001) governance measure. Second, there is some overlap in the different categories. For example, the question "Are the board members and members of the executive/management committee substantially different?" is placed in the accountability section but could easily, without controversy be placed under the independence heading.

[10] My results are qualitatively unchanged when I use the corporate governance variable inclusive of social awareness. The results are available from me upon request.

[11] Others focus on testing the outcome and substitute models of dividends using total corporate payout i.e. dividends and share repurchases (Chae et al., 2009; Bartram et al., 2012). I cannot do likewise since I don't have access to share repurchase data.

In all regressions, I control for firm size, firm profitability, firm growth, and corporate cash holdings.[12] Size is measured as the log of book assets in US$, growth is the logarithmic one-year asset growth, profitability is earnings before interest and taxation (EBIT) to book assets, and cash holdings is cash scaled by book assets. Size and profitability are expected to positively influence dividend policy. In contrast, high growth firms typically pay smaller dividends. Finally, the expected relationship between cash holdings and dividend payout is ambiguous. On the one hand, firms with high cash reserves but with little or no demand for external finance are likely to pay a dividend. On the other hand, firms with anticipated future growth opportunities may finance this growth with their cash reserves, and refrain from paying a dividend. [13] All firm level variables are winsorized at the 1st and 99th percentiles.

I include three country level determinants of dividend policy, namely shareholder and creditor rights, and the strength of enforcement of these rights. I use the revised version of the anti-director rights measure from Spamann (2010) to account for the strength of shareholder rights at the country-level. Since this data is missing for China, Hungary, and Poland, I use the Djankov et al. (2008) measure of shareholder rights, also a revised anti-director rights measure, for these countries. The creditor rights measure is taken from Djankov et al. (2007), and ranges from a low of zero to a high of four, where higher values represent stronger creditor rights. A priori, the sign on the shareholder and creditor rights variables are expected to be positive (see La Porta et al, 2000; Brockman and Unlu, 2009; Byrne and O'Connor, 2012). The legal enforcement variable is also taken from Djankov et al. (2007). It is a measure of "the number of calendar days to enforce a contract of unpaid debt worth 50% of the country's GDP per capita", where low values imply strong contract enforcement.

The final sample, comprised of 281 firms from 21 countries, is presented in Table 1. The twenty-one countries are Argentina, Brazil, Chile, China, Colombia, Hong Kong, Hungary, India, Indonesia, Korea (Republic), Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Singapore, South Africa, Taiwan,

[12] In unreported results, I show that my findings are qualitatively unaffected by the inclusion of two other control variables, namely retained equity to total assets and total equity and total assets (DeAngelo et al., 2006). The primary drawback of including these additional control variables is that they reduce the final sample of firms to 220. Hence, I exclude them in order to maximize the sample size at 281 firms.

[13] The ambiguity surrounding the relationship between cash holdings and dividend payout is grounded in how one perceives the nature of the relationship between corporate cash holdings and firm-level financing constraints. Fazzari et al. (2000) and the proponents of the cash flow sensitivity of cash approach to estimating firm-level financing constraints (Almeida et al, 2004) suggest that financial-constrained firms hoard cash (and pay little or no dividends). In contrast, others (Cleary, 2005) suggest that the very existence of cash reserves suggests that firms are not financially-constrained, since these firms can finance internally rather than externally. These firms can, and presumably pay a dividend.

Thailand, and Turkey. The number of firms varies sizably by country. India (48 firms), followed by Taiwan (31) and Hong Kong (27) provide the greatest number of firms. Together these three countries contribute 106 or 37.7% of the entire sample of firms. In contrast, there is just a single firm from Argentina, Colombia, and Peru. Columns three and four of Table 1 present the median and standard deviation corporate governance score by country. The median firm is best governed in Peru (Corporate governance score is 76.48), followed closely by Mexico (66.99), Argentina (66.67), and Singapore (66.45). In contrast, corporations tend to be less well-governed in, amongst others, Pakistan (26.83), Indonesia (36.33) and Korea (39.73). Interestingly, the greatest variation in governance practices occurs in Pakistan, where the median firm, at least in this sample, is the least well-governed of all firms.[14] The standard deviation of governance practices in Pakistan (16.71) suggests that not all firms in Pakistan are as poorly-governed as their median counterpart. The variation in corporate governance practices is much lower in Mexico (3.97), Chile (4.18), and Korea (5.73). [15]

Insert Table 1 about here

The median and standard deviation dividend payout for each payout measure are contained in columns six to ten. They suggest that the median firm in Colombia (dividends to earnings (cashflow) (%) is 66.00 (82.20)), Pakistan (dividends to earnings (cashflow) (%) are 64.90 (67.30)), and Hong Kong ((dividends to earnings (cashflow) (%) are 43.10 (45.10)) pay large dividends. In contrast, dividend payouts are much lower in Korea (dividends to earnings (cashflow) (%) are 5.55 (2.35)), and the Philippines (dividends to earnings (cashflow) (%) is 5.30 (0.40)). The median firm from Turkey does not

[14] A large literature exists which examines the firm and country-level factors which promote firms to practice better corporate governance (Klapper and Love, 2004; and Durnev and Kim, 2005). These 'governance-predictions' , as they are commonly referred to, find that large firms, firms with a need for external finance, and firms with large proportion of 'soft/intangible' assets practice good corporate governance. Also, corporate governance quality improves with ownership concentration, provided there is no deviation from one-share-one-vote (i.e., dual-class firms typically have poorer governance than single-class share firms). Cross-listing firms and firms domiciled where country governance (e.g., shareholder rights strong, efficient judiciary) is strong also tend to be better governed. However, Doidge et al. (2007) show that some firms with these 'desirable' characteristics may not necessarily practice better governance, since the costs of doing so can outweigh the perceived benefits. The costs of doing so are greater where financial development weak. Aggarwal et al. (2009) highlight the differences in governance practices between U.S. and non-U.S. firms, and show that amongst others, differences in financial development between the U.S. and non-U.S. countries can explain part of the superior governance practices of U.S. firms. Furthermore, recent work suggests that some firms do not adopt 'desirable' aspects of corporate governance since their adoption can prove to be value-decreasing (Black et al. (2011)).

[15] Klapper and Love (2004) show that the variation in corporate governance ratings (using CLSA corporate governance scores) decreases as country level investor protection increases.

pay a dividend, but there is considerable variation in corporate dividend payouts here (the standard deviation of dividends to earnings (%) is 20.03). Dividend payouts tend to be low, and consistently so across firms in Korea, which is consistent with the cultural norm for Korean firms to hoard cash rather than pay dividends. The median and variation (around the mean payout) is low across all three payout measures (the median (standard deviation) of dividends to earnings, dividends to cashflow, and dividends to sales are 5.55 (8.92), 2.35 (4.70), and 0.30 (0.75), respectively).

The remaining columns of Table 1 contain the shareholder (SR), creditor rights (CR), and legal enforcement data (ENF). Shareholders tend to enjoy considerable legal rights in Brazil (Revised ADR is 5), Chile (5), Pakistan (5), South Africa (5), and Taiwan (5). In contrast, shareholder rights are much lower in China (1). Creditor rights (CR) are strong in Hong Kong (Creditor Rights is 4) and Hong Kong (4), but the weakest in Colombia (0), Mexico (0), and Peru (0). Interestingly, while on the face of it the legal rights afforded to shareholders and creditors appear strong in theory, in practice, many of these laws are poorly enforced. For example, the laws as written in statute, and their legal enforcement (ENF) tend to complement one another in some countries (e.g. creditor rights and their legal enforcement are strong in Singapore (CR is 4 and ENF is 4.23), South Africa (CR is 3 and ENF is 5.62), and Hong Kong (CR is 4 and ENF is 5.35), while in others, poor creditor rights coincide with strong legal enforcement (e.g. Turkey (CR is 2 and ENF is 5.80), Hungary (CR is 1 and ENF is 5.90).[16]

4. Results

In this section I seek to examine whether the *outcome* model of dividends is most likely to hold given either strong creditor rights and/or strong enforcement of these creditor rights. First, I begin by establishing the prevalence of the *outcome* model of dividends in emerging markets, as has previously been done by Mitton (2004) using CLSA data. To do so, and like him, I estimate ordinary least squares regressions (OLS) of the following form:

$$DIV_i = \alpha + \beta_1 GOV_i + \beta_2 Size_i + \beta_3 Growth_i + \beta_4 Profitability_i + \beta_5 Cash_i + \beta_6 SR_C + Industry_i + \varepsilon_i \quad (1)$$

[16] The correlation between creditor rights and the enforcement of creditor rights is (0.463).

$$DIV_i = \alpha + \beta_1 GOV_i + \beta_2 Size_i + \beta_3 Growth_i + \beta_4 Profitability_i + \beta_5 Cash_i + \beta_6 SR_c + \beta_7 CR_c + \beta_8 ENF_c + Industry_i + \varepsilon_i \quad (2)$$

Where DIV_i is either dividends-to-earnings (%), dividends-to-cashflow (%), or dividends-to-sales (%), and GOV_i is the CLSA corporate governance score for each firm. Size, growth, profitability, and cash, are firm size, firm growth, firm profitability, and firm cash holdings, respectively. $Industry_i$ are industry dummies, and SR_C, CR_C, and ENF_C are shareholder rights, creditor rights, and legal enforcement, respectively.[17] Financial firms are excluded. All regressions are estimated with White (1980) standard errors. The coefficient estimates from estimating equations 1 and 2 are presented in Table 2.

The findings presented in Table 2 are in line with Mitton (2004), and others, and provide empirical support in favour of the *outcome* model of dividends. The coefficient estimates on the corporate governance variable are always positive and statistically different to zero. They range from a low of 0.048 (*t*-stat is 2.04) (using dividends to sales (%)) to a high of 0.392 (*t*-stat is 3.32) using dividends to earnings (%). Using dividends to cashflow (%), the coefficient estimates on the corporate governance variable resulting from estimating equations 1 and 2 are 0.228 (*t*-stat is 2.23) and 0.186 (*t*-stat is 1.79), respectively. These coefficient estimates imply that a one standard deviation increase (improvement) in corporate governance standards (which is 14.3), which is close to the difference in the median corporate governance score for firms from China (48.17) and Chile (62.4) would imply an increase in dividend payout (dividends to earnings (%)) by 5.61 percentage points (i.e. 0.392 * 14.3), which incidentally is almost the difference in median dividends to earnings (%) payout between firms from China (28.8%) and Chile (34.8%) (I.e. 34.8% less 28.8% is 6%). Using dividends to cashflow (%), and dividends to sales (%), the implied change in dividend arising from a one-standard deviation change in corporate governance is 3.26 percentage points (i.e. 0.228 * 14.3), and 0.79 percentage points (i.e. 0.055 * 14.3), respectively. While not always statistically significant, the firm-level control variables are almost always of the correct sign. Consistent with the life-cycle model of dividends, large and profitable firms pay large dividends, while

[17] Firms are designated into one of thirteen industries based on the following classifications using 4-digit SIC codes: Agriculture and Food (0100-0999 & 2000-2111); Mining and Construction (1000-1999, excluding 1300-1399); Textiles and Printing/Publishing (2200-2799); Chemicals (2800-2824, 2840-2899); Pharmaceuticals (2830-2836); Extractive (2900-2999, 1300-1399); Durable Manufacturers (3000-3999, excluding 3570-3579); Transportation (4000-4899); Utilities (4900-4999); Retail (5000-5999); Services (7000-8999, excluding 7370-7379); Computers (7370-7379, 3570-3579, 3670-3679); Public Administration (9000+).

growth firms tend to pay small dividends (Grullon et al., 2002; De Angelo et al., 2006; Bulan et al., 2007; and Denis and Osobov, 2008). Cash rich firms pay large dividends.

Insert Table 2 about here

In columns 2, 4, and 6, I find evidence to suggest that corporate dividend payouts are influenced by the strength of creditor rights, but not shareholder rights nor legal enforcement. In line with Brockman and Unlu (2009), Shao et al. (2009), and Byrne and O'Connor (2012), the coefficient estimates on the creditor rights variable are positive and statistically different to zero. This suggests that dividend payouts are large when creditor are well protected, but much less so, when creditor rights are not so well protected. Contradicting earlier work from La Porta et al. (2000) and Mitton (2004), the shareholder rights variable is statistically insignificant, and surprisingly, the coefficient estimate is negative in four of the six regressions (albeit always statistically insignificant).[18] Finally, the enforcement variable is incorrectly signed in all regressions, but always statistically insignificant.

In the next section, I examine whether the ability of shareholders to extract dividends from firms using their legal rights (here defined at the firm-level) is contingent on the strength of creditor rights per se, and/or the enforcement of these same creditor rights. To do so, I estimate equation 1 separately for firms from countries with above and below-median creditor rights and legal enforcement, respectively. If both creditor rights and their enforcement matter, that is, to the ability of shareholders to extract dividends from firms (i.e. Hypotheses 1 and 2), then the coefficient estimate for the corporate governance variable should be positive, statistically significant, but more importantly, larger in countries where creditor rights (and legal enforcement) are strong. In turn, if legal enforcement is more important than creditor rights (i.e. Hypothesis 3), the coefficient estimate on the corporate governance variable should be greater in above-median enforcement jurisdictions than compared to countries with above-median creditor rights. As a precursor, consider Table 3.

In Table 3, I outline the average and median dividend payout using all three dividend payout measures for well (High Governance) and poorly-governed (Low Governance) firms, and for both sets of firms by level of creditor rights (High and Low Creditor Rights) and legal enforcement (High and Low

[18] Bartram et al. (2012) do find support for the equity-only version of the *outcome* model when they use Spamann's (2010) anti-director rights measure.

Enforcement). A firm is deemed to have high (low) corporate governance if their governance score is above (below) the sample median (which is 54.93). Likewise, firms belong in high (low) creditor rights countries if the country-level creditor rights score is above (below) the sample median (which is 2). Since legal enforcement decreases in the number of days taken to resolve a dispute, firms belong in high (low) enforcement countries if the country-level enforcement is below (above) the sample median (which is 5.90).

The summary measures outlined in Table 3 suggest the following. First, and in line with the analysis presented in Table 2, dividends are an *outcome* of corporate governance. All else equal, better-governed firms always pay larger dividends. For example, as a percentage of earnings, cashflow, and sales, the median well-governed (High Governance) firm pays out 4.80, 7.75, and 1.25 more of its' earnings, cashflow, and sales in the form of a dividend when compared to less well-governed firms (Low Governance). Second, the *outcome* model is much more prevalent where creditor rights are strong, but not so legal enforcement. For example, the difference in average dividend payout between well-governed firms, but operating in different creditor rights regimes, as a percentage of earnings, cashflow, and sales is 15.24, 13.03, and 2.78, respectively. Furthermore, all three differences are statistically significant. When I perform the same analysis using legal enforcement, the differences are much lower (i.e. 4.83, 0.65, and 0.54) and never statistically different to zero. In summary, these findings support hypothesis 1, but not hypothesis 2. Finally, these findings suggest that if anything, it is creditor rights, and not how these rights are enforced which has greater relevance for the *outcome* model of dividends. Thus, these summary measures reject hypothesis 3.

In the next section, I examine whether these same conclusions remain when I control for other determinates of corporate dividend payout.

Insert Table 3 about here

To do so, I estimate equation 1, but now by level of creditor rights and legal enforcement, respectively. A priori, if hypothesis 1 holds, then the coefficient estimate on the corporate governance variable should be statistically significant and larger where creditor rights are strong. If hypothesis 2 holds, then the coefficient estimate on the corporate governance variable should be statistically significant and

larger where the enforcement of creditor rights is strong. Finally, to test hypothesis 3, I must compare the coefficient estimates on the corporate governance variable across strong creditor rights and strong legal enforcement. If hypothesis 3 holds, then the coefficient estimate on the corporate governance variable should be statistically significant and larger where the enforcement of creditor rights is strong, compared to the coefficient estimate on the corporate governance variable where creditor rights are strong.

The coefficient estimates are presented in Tables 4 and 5. For brevity sake, I only report the coefficient estimates for the corporate governance variable. The results using the enforcement of creditor rights are outlined in Table 5 and Table 5 the coefficient estimates for the regressions by the strength of creditor rights. What is most striking from Tables 4 and 5 is that the conclusions from the summary statistics outlined in Table 3 are reversed. In Table 4, and once I control for other determinants of corporate dividend payout, the *outcome* model prevails only where legal enforcement of creditor rights is strong. For example, when legal enforcement is strong, the coefficient estimates on the corporate governance variable range from a low of 0.088 (*t*-stat is 2.53) (Using dividends to sales (%)) to a high of 0.447 (*t*-stat is 2.56) (Using dividends to cashflow (%)). In contrast, where legal enforcement is weak, the coefficient estimates are much lower (they range from 0.01 to 0.108), and are always statistically indifferent to zero (*t*-stats range from 0.15 to 0.52).

Insert Table 4 about here

When I partition the full sample of firms by strength of creditor rights (Table 5), the coefficient estimates on the corporate governance variable are with one exception larger where creditor rights are strong (for example using dividends to earnings (%), the coefficient estimates on the corporate governance variable for high and low creditor rights are 0.231 and 0.158, respectively), but they are always statistically indifferent to zero (*t*-stats range from 0.39 to 1.04).

In summary, these findings suggest that creditors exert a profound influence on corporate dividend policy. All else equal, creditor demand, and firms consent to lower dividends, where creditor rights are poorly enforced. Consequently, these findings support hypotheses 2 and 3. Like Byrne and O'Connor (2012), I reject hypothesis 1, since differences in creditor rights are not systematically related to

dividend payout in the way predicted by the agency costs of debt and equity version of the *outcome* model of dividends.

Insert Table 5 about here

5. Concluding remarks

In this paper I test the agency costs of equity and debt version of the *outcome* model of dividends using a sample of 281 firms from 21 emerging market countries. Using firm-level measures of shareholder rights (i.e. corporate governance), the agency costs of equity and debt version of the *outcome* model of dividends, as outlined by Brockman and Unlu (2009), predicts that the *outcome* model is more effective under strong creditor rights. Where creditor rights are weak, shareholders can better use their legal rights to extract dividends from firms.

I find no evidence to support this prediction. Like Byrne and O'Connor (2012), my results suggest that the *outcome* model fails to hold irrespective of the strength of creditor rights. However, I do find that the *outcome* model prevails under strong enforcement of creditor rights. Where the enforcement of their legal rights is weak, creditors demand, and firms consent to lower dividends. Hence, creditors, and not shareholders exert the greatest influence over corporate dividend policy. The extent of their influence is a function of the legal enforcement of their legal rights, and not their legal rights per se.

These findings are in line with a large volume of recent literature which highlights the profound influence that creditors exert in corporations. For example, Nini et al. (2009) show that creditors restrict firm-level investment (capital expenditures) when borrower credit quality deteriorates, while Roberts and Sufi (2009) show that the ability to finance firm-level investment using debt financing is significantly reduced following debt covenant violations.

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Table 1

Sample Description

		Corporate Governance		Dividend Payout Measure						Legal Variables		
		Corporate Governance		Dividends to Earnings (%)		Dividends to Cashflow (%)		Dividends to Sales (%)		Shareholder & Creditor Rights & Legal Enforcement		
Country	# Firm	MD	SD	MD	SD	MD	SD	MD	SD	SR	CR	ENF
Argentina	1	66.67	-	0.00	-	0.00	-	0.00	-	3	1	6.25
Brazil	17	61.68	9.14	36.60	33.10	12.10	25.21	3.40	5.41	5	1	6.34
Chile	7	62.40	4.18	34.80	16.49	11.70	10.50	1.30	1.69	5	2	5.72
China	11	48.17	11.56	28.80	24.67	15.90	17.54	5.80	7.94	1	2	5.48
Colombia	1	53.18	-	66.00	-	82.20	-	6.00	-	4	0	5.89
Hong Kong	27	62.60	13.87	43.10	31.45	45.10	30.95	9.90	9.06	4	4	5.35
Hungary	1	48.45	-	85.50	-	10.60	-	0.50	-	2	1	5.90
India	48	52.49	11.04	24.05	21.99	16.55	20.34	3.40	2.31	4	2	6.05
Indonesia	12	36.33	13.59	23.65	25.96	20.30	26.64	1.95	4.78	4	2	6.35
Korea	14	39.73	5.73	5.55	8.92	2.35	4.70	0.30	0.75	4	3	4.32
Malaysia	24	60.00	12.49	36.70	31.40	29.50	27.28	4.45	4.93	4	3	5.70
Mexico	4	66.99	3.97	28.05	14.94	15.40	8.04	3.95	2.83	2	0	6.04
Pakistan	7	26.83	16.71	64.90	30.32	67.30	30.68	6.60	7.45	5	1	5.98
Peru	1	76.48	-	18.90	-	33.00	-	8.00	-	4	0	6.09
Philippines	12	40.58	12.22	5.30	19.61	0.40	18.61	0.15	1.61	4	1	5.94
Poland	1	37.73	-	0.00	-	0.00	-	0.00	-	2	1	6.91
Singapore	26	66.45	7.99	43.80	29.66	24.80	29.47	2.55	6.05	4	3	4.23
Sth Africa	16	64.27	16.09	27.50	33.01	22.60	23.25	2.85	7.21	5	3	5.62
Taiwan	31	54.93	9.08	17.40	25.42	9.30	20.19	1.10	3.51	5	2	5.35
Thailand	13	51.07	14.21	47.40	37.38	27.90	30.64	6.30	7.14	4	2	5.97
Turkey	7	46.58	10.56	0.00	20.03	0.00	6.69	0.00	0.60	4	2	5.80
	Total	MD	SD	MD	SD	MD	SD	MD	SD	Median		
	281	54.93	14.30	27.90	28.99	17.00	25.88	2.50	5.83	4	2	5.90

Notes: This table describes the sample by country. # Firms is the number of firms. For each country, I report the median (MD) and standard deviation (SD) of corporate governance, dividends to earnings (%), dividends to cashflow (%), and dividends to sales (%), respectively. In the remaining columns, I report shareholder rights (SR) data from Spamann (2009) and Djankov et al. (2008) (for China, Hungary, and Poland), and creditor rights (CR) and legal enforcement (ENF) data are from Djankov, McLeish, and Shleifer (2007). All firm-level data is sourced from Worldscope. Corporate governance measures are from CLSA (2001).

Table 2

Regression Estimates

	Dividend Payout Measure					
	Dividends to Cashflow (%)		Dividends to Earnings (%)		Dividends to Sales (%)	
	(1)	(2)	(3)	(4)	(5)	(6)
Corporate Governance	0.228**	0.186*	0.392***	0.389***	0.055**	0.048**
	(2.23)	(1.79)	(3.32)	(3.36)	(2.37)	(2.04)
Size	-0.401	-0.557	0.233	0.468	0.212	0.215
	(0.39)	(0.49)	(0.19)	(0.36)	(1.04)	(0.98)
Growth	-1.386	-1.424	-25.890**	-26.769**	-3.087	-3.199
	(0.15)	(0.16)	(2.45)	(2.52)	(1.42)	(1.48)
Profitability	24.310*	25.663*	21.500	18.940	12.658***	12.571***
	(1.80)	(1.74)	(1.33)	(1.10)	(4.13)	(3.92)
Cash	27.629**	22.672*	21.643	21.598	8.109**	7.297**
	(2.26)	(1.75)	(1.50)	(1.42)	(2.47)	(2.15)
Shareholder Rights	0.781	0.565	-0.441	-0.728	-0.561	-0.631
	(0.48)	(0.35)	(0.21)	(0.34)	(1.20)	(1.35)
Creditor Rights		4.001*		2.504		0.952*
		(1.80)		(1.02)		(1.94)
Enforcement		0.728		3.290		0.513
		(0.24)		(1.04)		(0.94)
Industry Dummies	Included	Included	Included	Included	Included	Included
# Firms	281	281	281	281	281	281
R-Squared	0.285	0.298	0.217	0.222	0.353	0.366

Notes: This table reports coefficient estimates from ordinary least squares with heteroscedastic consistent t-stats presented underneath in parenthesis. The sample period is for the year 2001. The dependent variable is dividends to cashflow (%), dividends to earnings (%), and dividends to sales (%), as indicated. Size is the log of book assets in US$, growth is logarithmic one-year asset growth, profitability is earnings before interest and taxation to book assets, and cash is cash to assets. In columns (1), (3), and (5) a full set of country and industry dummies are included, but not reported. The country dummies are excluded from columns (2), (4), and (6). Shareholder rights data is from Spamann (2009) and Djankov et al. (2008) (for China, Hungary, and Poland), and creditor rights (CR) and legal enforcement (ENF) data are from Djankov, McLeish, and Shleifer (2007). All firm-level data is sourced from Worldscope. Corporate governance measures are from CLSA (2001). # Firms is the number of firms, and ***, **, and * denotes significance at the 1, 5, and 10% level, respectively.

Table 3

Univariate Statistics

	Average Dividend Payout (%)		
	Corporate Governance		
	High Governance	Low Governance	Difference (High – Low)
Dividends-to-Cashflow (%)	27.74	22.36	5.38*
Dividends-to-Earnings (%)	36.91	29.55	7.36**
Dividends-to-Sales (%)	5.44	3.87	1.57**
	High Corporate Governance & Creditor Rights		
	High Creditor Rights	Low Creditor Rights	Difference (High – Low)
Dividends-to-Cashflow (%)	35.42	20.18	15.24***
Dividends-to-Earnings (%)	43.47	30.44	13.03***
Dividends-to-Sales (%)	6.84	4.06	2.78***
	High Corporate Governance & Enforcement		
	High Enforcement	Low Enforcement	Difference (High – Low)
Dividends-to-Cashflow (%)	29.29	24.46	4.83
Dividends-to-Earnings (%)	37.12	36.47	0.65
Dividends-to-Sales (%)	5.61	5.07	0.54
	Median Dividend Payout (%)		
	Corporate Governance		
	High Governance	Low Governance	Difference (High – Low)
Dividends-to-Cashflow (%)	19.40	14.60	4.80**
Dividends-to-Earnings (%)	31.10	23.35	7.75**
Dividends-to-Sales (%)	3.00	1.75	1.25***
	High Corporate Governance & Creditor Rights		
	High Creditor Rights	Low Creditor Rights	Difference (High – Low)
Dividends-to-Cashflow (%)	31.15	13.70	17.45***
Dividends-to-Earnings (%)	39.65	25.10	14.55**
Dividends-to-Sales (%)	3.90	2.80	1.10*
	High Corporate Governance & Enforcement		
	High Enforcement	Low Enforcement	Difference (High – Low)
Dividends-to-Cashflow (%)	21.80	15.20	6.60
Dividends-to-Earnings (%)	34.95	28.60	6.35
Dividends-to-Sales (%)	2.70	3.50	(0.80)

Notes: This table present average and median dividend payouts by strength of corporate governance. Median dividend payout is presented for firms with high and low corporate governance and for high corporate governance firms in countries with high and low creditor rights and legal enforcement, respectively. Dividend payout is measured using either dividends to cashflow (%), dividends to earnings (%), and dividends to sales (%), as indicated. Corporate governance measures are from CLSA (2001), and dividend payout measures are sourced from Worldscope. Creditor rights (CR) and legal enforcement (ENF) data are from Djankov, McLeish, and Shleifer (2007). ***, **, and * denotes significance at the 1, 5, and 10% level, respectively.

Table 4

Regression Estimates by Strength of Legal Enforcement

	Enforcement of Creditor Rights		
	Strong Enforcement		
	Dividend Payout Measure		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
	(1)	(2)	(3)
Corporate Governance	0.284**	0.447**	0.088**
	(2.02)	(2.56)	(2.53)
Industry Dummies	Included	Included	Included
Firm Controls	Included	Included	Included
# Firms	164	164	164
R-Squared	0.363	0.302	0.398
	Weak Enforcement		
	Dividend Payout Measure		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
	(1)	(2)	(3)
Corporate Governance	0.093	0.108	0.010
	(0.57)	(0.52)	(0.15)
Industry Dummies	Included	Included	Included
Firm Controls	Included	Included	Included
# Firms	117	117	117
R-Squared	0.381	0.281	0.400
	Hypothesis 2 Difference in Corporate Governance Coefficient Estimates (High less Low Enforcement of Creditor Rights)		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
Hypothesis 2	0.191	0.339	0.078
	Hypothesis 3 Difference in Corporate Governance Coefficient Estimates (High Enforcement of Creditor Rights less High Creditor Rights)		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
Hypothesis 3	0.207	0.216	0.036

Notes: This table reports coefficient estimates from ordinary least squares with heteroscedastic consistent t-stats presented underneath in parenthesis. The sample period is for the year 2001. Separate regressions are estimated for firms from countries with above and below-median legal enforcement. The dependent variable is dividends to cashflow (%), dividends to earnings (%), and dividends to sales (%), as indicated. Size is the log of book assets in US$, growth is logarithmic one-year asset growth, profitability is earnings before interest and taxation to book assets, and cash is cash to assets. Legal enforcement (ENF) data is from Djankov, McLeish, and Shleifer (2007). The bottom panel reports the difference in coefficient estimates for the corporate governance variable by strength of the enforcement of creditor rights (Hypothesis 2) and the difference in coefficient estimates for the corporate governance variable by strength of the enforcement of creditor rights and creditor rights (Hypothesis 3). All firm-level data is sourced from Worldscope. Corporate governance measures are from CLSA (2001). # Firms is the number of firms, and ***, **, and * denotes significance at the 1, 5, and 10% level, respectively.

Table 5

Regression Estimates by Strength of Creditor Rights

	Creditor Rights		
	High Creditor Rights		
	Dividend Payout Measure		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
	(1)	(2)	(3)
Corporate Governance	0.077	0.231	0.052
	(0.39)	(0.92)	(0.95)
Industry Dummies	Included	Included	Included
Firm Controls	Included	Included	Included
# Firms	93	93	93
R-Squared	0.346	0.335	0.489
	Low Creditor Rights		
	Dividend Payout Measure		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
	(1)	(2)	(3)
Corporate Governance	0.117	0.158	0.023
	(0.89)	(1.04)	(0.89)
Industry Dummies	Included	Included	Included
Firm Controls	Included	Included	Included
# Firms	188	188	188
R-Squared	0.282	0.203	0.255
	Hypothesis 1 Difference in Corporate Governance Coefficient Estimates (High less Low Creditor Rights)		
	Dividends to Cashflow (%)	Dividends to Earnings (%)	Dividends to Sales (%)
Hypothesis 1	(0.04)	0.073	0.029

Notes: This table reports coefficient estimates from ordinary least squares with heteroscedastic consistent t-stats presented underneath in parenthesis. The sample period is for the year 2001. Separate regressions are estimated for firms from countries with above and below-median creditor rights. The dependent variable is dividends to cashflow (%), dividends to earnings (%), and dividends to sales (%), as indicated. Size is the log of book assets in US$, growth is logarithmic one-year asset growth, profitability is earnings before interest and taxation to book assets, and cash is cash to assets. Creditor rights (CR) is from Djankov, McLeish, and Shleifer (2007). The bottom panel reports the difference in coefficient estimates for the corporate governance variable by strength of creditor rights (Hypothesis 1). All firm-level data is sourced from Worldscope. Corporate governance measures are from CLSA (2001). # Firms is the number of firms, and ***, **, and * denotes significance at the 1, 5, and 10% level, respectively.