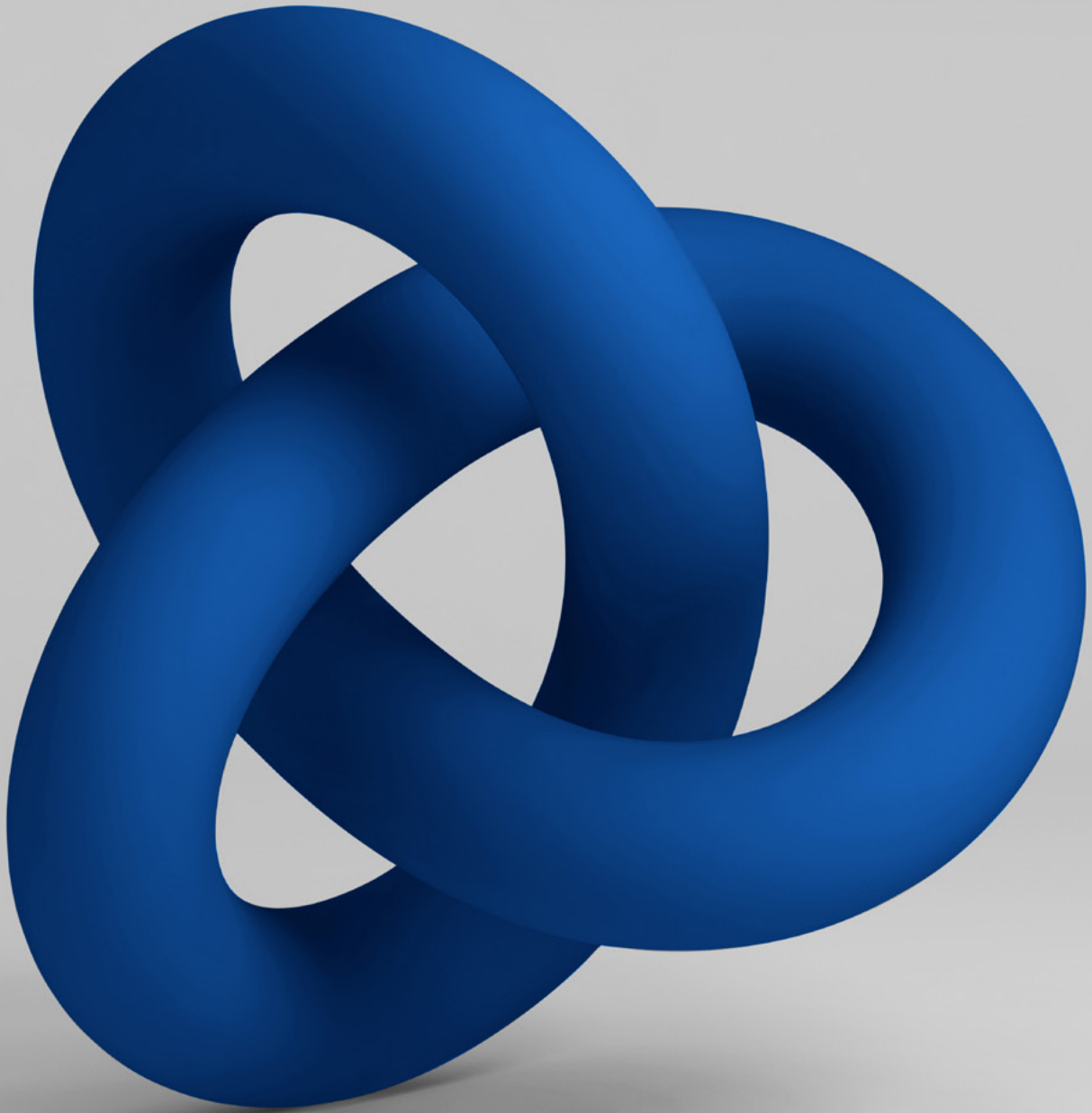


**Baker
McKenzie.**



Trust Continuum

Stakeholder Capitalism & Dividends

Much has been written about the dawn of a new era of “stakeholder capitalism” and the role that boards must play in managing the interests of a wider group of stakeholders beyond their company’s shareholders. However, the challenge for boards is that they will inevitably encounter competing needs and priorities, and a decision that may be in the best interests of one stakeholder group may not serve the interests of another.

During periods of scarce liquidity — as in the current pandemic that continues to rock the global economy — the concept of stakeholder capitalism finds itself tested in real time as businesses attempt to preserve trust with all stakeholders (including their shareholders, workforce, lenders, customers and suppliers), all while responding to an unfolding crisis. Decisions taken now may carry far-reaching reputational and commercial risks, particularly — but not only — for listed companies. How do boards navigate the question of what business priorities outweigh the others? And, where there are no perfect answers, how do they guard against the erosion of stakeholder trust?

When viewed from this lens, the discretion that boards have as to the payment of dividends and their legal duty to make a decision in good faith as to the best course of action for the company can present a heavy burden. A board decision around dividends that addresses short-term demands may carry a risk of long-term harm to the company. Many boards are currently having to make difficult choices between returning value to shareholders and preserving cash that might be used to minimize redundancies, support the company's supply chain or make strategic investments.

The history of the dividend

It is 1610, and you are a modestly wealthy Dutch merchant. You hear of an opportunity to significantly increase your wealth by investing in an organization, called the Dutch East India Company, to finance ships that will travel to unknown lands and bring back riches beyond your imagination. You couldn’t afford to fund your own ship, but this opportunity only requires to you invest in a portion of the company. If all is lost at sea? Well, you can lose no more than your investment. As it happens, the ships return, and you are the recipient of your share of the spoils, divided up in proportion to how much you invested. A “dividend.”

Fast forward a few centuries, to a fully mapped-out world whose resources are being harnessed increasingly close to their maximum. You are now in charge of one of these “companies” and need to decide whether profits on activities made possible by the funds put in by the shareholders should be “divided” up between them now. Or, instead, should employees instead be paid higher wages, to increase the loyalty of the workforce and attract new talent? Or should the funds be invested in measures that improve the company’s environmental footprint (and thereby long-term sustainability)?

DIVIDENDS & COVID-19

During the COVID-19 crisis, board decisions around dividends have become a lightning rod for polarizing opinion as certain companies have faced criticism for paying out dividends with one hand while cutting costs and jobs with the other. Some companies continued to honor their past dividend policy, citing their responsibility to investors (including institutional investors such as pension funds), where others have cancelled or reduced their dividends significantly. According to research published in October by the Link Group¹, most UK listed companies have found themselves in the latter camp of late, with three-quarters of surveyed companies having cut or cancelled their dividends in Q2 2020 and two-thirds having done so in Q3. The trend was most pronounced in relation to financial institutions, energy companies and those in the "consumer discretionary" sectors². In the US, on the other hand, the emerging picture looks arguably different; an article published in Forbes in September of this year posited that, "during economic downturns, public companies frequently lower or eliminate dividend payments. In the Great Recession, for example, the S&P 500 saw an average dividend payout decrease of over 37% from 2008 to 2009. That was the biggest decrease in S&P 500 dividend payments since

1938. The good news for investors is that the current COVID-19 recession will likely have less of a negative impact on dividends overall."³

But across geographies and industries, it is increasingly the case that both investors and wider society are focused on long-term value creation rather than short-term returns. Even before COVID-19, there was a growing pressure on companies to embrace their environmental and societal responsibilities and embed sustainable business practices that address those responsibilities. In the "Great Reset," triggered by the perfect storm of COVID-19, the climate emergency and social activism, decisions that betray short-term thinking are likely to come under question more readily than ever before. Dividends and other returns of value to shareholders need to be tested against this backdrop as part of a strategy of long-term value creation.

Public and media scrutiny of dividends in recent months has been particularly intense for those companies that have opted to receive government support in response to COVID-19 pressures. In some jurisdictions, certain COVID-19 support has come with strings attached that specifically restrict

dividends and other returns of value to shareholders by companies who have benefitted from that public money. In some cases, even intra-group cash repatriation has been caught by such restrictions.

Key legal principles around dividends

Although the legal rules vary from jurisdiction to jurisdiction, the following principles often apply:

- Dividends may only be paid from freely available profits.
- Share capital and capital reserves may not be distributed.
- The board must decide that paying a dividend is in the best interests of the company, taking into account both its current financial position and its likely future needs.

Dividends in times of crisis

While boards cannot be not expected to gaze into a crystal ball to predict the future and can only base decisions on the information available at the time of the dividend, it may be uncomfortable for directors to come to a conclusion on the future needs of a business in the current volatile trading conditions.

Following the sudden economic shock after 9/11 and in the immediate aftermath of the Lehman Brothers collapse in 2008, companies that had declared dividends in the immediately preceding days were not considered to have made unlawful or ill-advised dividends on the basis that they somehow failed to foresee catastrophic circumstances. However, the COVID-19 pandemic may be distinguished, as the economic impact is felt more like a slow burn rather than (or in addition to) a sharp shock. Boards considering the payment of dividends at this point will need to take account of the bumpy road ahead and do their best to factor this into any decisions around the payment of dividends.

BOARD DELIBERATIONS

Boards facing a decision about whether to declare a dividend must of course comply with the requirements of applicable law to ensure that the dividend is lawful. In the UK, this will include confirming with the accounting team the available profits of the company on the basis of annual accounts or detailed management accounts and assessing the likely future needs of the company (taking into account all relevant matters, including off balance-sheet contingent liabilities and future trading prospects).

But the legal rules are not a prescription – the board must ultimately assess whether a dividend, even if it would be lawful, is in the best interests of the company to declare at present. This will include careful consideration of the impact of such a decision on the company's key stakeholders, including shareholders, workforce, suppliers and other creditors, in particular, when looking at the longer-term prospects of the company.

To see the decision as being a simple one of shareholders vs. other stakeholders would be misinformed; director duties are not binary in that sense. At the heart of board decision-making is the need to assess the best interests of the company overall. This by its nature implies looking at both its short-term and its long-term prospects, and in doing so, appropriately exercising judgement⁴.

For example, one could easily imagine the following thought process unfolding in board deliberations: if the board decides not to pay (or to reduce) a dividend now and instead use the funds to hold on to employees, accelerate payments to vulnerable but strategic suppliers or enable better payment terms to be offered to customers, then the company will be more likely to be able to emerge from the pandemic ahead of its competitors, thereby creating long-term value for shareholders and putting the company in a position to pay bigger dividends in the future.

Finally, well-advised boards should also be considering how these issues will play out in their annual reporting for the relevant period. In the UK, for example, consideration should be given to what will be disclosed in the s172 Companies Act 2006 (Director Duties) section of the next strategic report as to how the board approached the decision around paying a dividend and their assessment of the appropriate amount. Did the board base its decision on good quality information from the business (not only the Finance team) and how did they have regard to the interests of wider stakeholders in the context of the current crisis and its anticipated aftermath?

What are the implications of getting this wrong?

In the UK, if a shareholder knows or has reasonable grounds for believing that a distribution is made contrary to the relevant legal provisions, then they have a liability to repay the amount of the unlawful part of the distribution to the company. This is a relatively low bar as the shareholder only needs to know the general circumstances surrounding the dividend, not specifically that the dividend was unlawful at the time it was made.

If the directors are found to have been in breach of their duties during the dividend declaration process, they may be liable to the company for any loss suffered as a result. This would normally be the amount of the unlawful part of the dividend.

Beyond the legal risks, though, boards must keep in mind the potential reputational damage of being found to have made an unlawful dividend and the costs of putting the situation right. Reputations may even be damaged by the payment of a lawful dividend, if it is considered to be an unreasonable use of the company's cash reserves at the relevant time.

CONCLUSION

The current public health emergency and its macro-economic impact throw into sharp relief the obligation on boards to take extreme care when making decisions around dividends. Boards need not only to adhere to the legal and accounting rules, but also to take into account the future needs of the company to navigate the rocky path ahead and the interests of (potentially vulnerable) stakeholders.

Groups availing themselves of COVID-related relief from government schemes need to take particular care to ensure that they do not fall foul of legal restrictions arising from their acceptance of that assistance or – even if no legal restriction is triggered – the reputational risks of having been seen to accept public money with one hand while rewarding shareholders with the other.

As ever, boards considering dividends are well advised to:

- plan early;
- involve the full range of functions (Accounting, Tax and Legal, as well as Operations, HR, Treasury, the Communications team and others, as appropriate); and
- engage in transparent and strategic decision-making with the ultimate focus on long-term value creation.



References

¹ UK Dividend Monitor Q2 2020, Link Asset Services

² UK Dividend Monitor Q3 2020, Link Asset Services

³ E. Napolitano, Forbes, September 8, 2020

⁴ "Business judgement" in the US; to act "reasonably," "in good faith" or "with reasonable care" in most other jurisdictions



Joanna Hewitt

Partner

Jo.Hewitt@bakermckenzie.com



Beatriz Araujo

Partner

Beatriz.Araujo@bakermckenzie.com



Alistair Foley

Senior Associate

Alistair.Foley@bakermckenzie.com
