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Shareholders' right of separation due to a failure to distribute dividends

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As the period in which the annual accounts for the 2011 financial year are drawn up gets closer, it is worth considering potential implications of the new Article 348 bis of the Spanish Companies' Act (*Ley de Sociedades de Capital* or "**LSC**"). This rule states that, in companies incorporated more than five years ago, any shareholder may demand the distribution of dividends consisting of a minimum of the company's earnings. A failure to do so will enable the shareholder to exercise its right of separation and demand that its stake be acquired or redeemed by the company. This is of particular interest for private equity investors, who should consider implementing certain structural and contractual schemes to properly address how to deal with this legal obligation.

1. Executive summary

- The companies affected by this recent amendment in the law are all non-listed capital companies, either newly created or existing prior to the entry into force of the law on 2 October 2011, and that have existed for at least five years.
- The minimum dividend to be distributed consists of a third of the company's operating profit derived from the corporate object from the preceding financial year.
- The management body will be in charge of performing a specific calculation of what the corresponding "operating profit derived from the corporate object" would be.
- The company may refuse to distribute the dividend, but the shareholder affected by this lack of distribution will be entitled to exercise its right of separation at a reasonable value, to be determined by a third party if no agreement is reached between the parties.
- The companies affected by this rule will have to review whether the dividend is compatible with the contractual rights recognised in favour of third parties, such as lenders or shareholders with preferred rights.
- This obligation may be neutralised by express waiver of the shareholders or, in certain cases, by alleging exceptional circumstances related to the primacy of the company's interests *vis-à-vis* the right of the shareholder.

2. Background

Under Spanish law, the Shareholders' General Meeting traditionally had complete freedom to decide on the application of the results and, consequently, on the dividend policy, which implied that the right to dividends was subject to a majority decision of the shareholders.

However, the decision on whether or not to distribute dividends by the majority had, in practice, been subjected to certain control by Spanish courts in recent times. The courts have often declared that company resolutions refusing to distribute dividends, systematically and without justification, were abusive. Nevertheless, despite this trend to protect minorities against "economic strangulation", the slowness of judicial proceedings and the difficulties for judges to calculate the payment of dividends limited the effectiveness of the same in practical terms.

With the recent reform of the LSC, the legislator tried to reinforce this protection by establishing that a shareholder's right to the company's earnings is blatantly violated if, year after year, despite there being earnings, the General Shareholders' Meeting decides not to distribute them. The rationale behind this is the fact that the failure to distribute dividends is seen not only as a means to block the shareholder's rights within the company, thwarting the purpose with which it acquired a stake in the same, but also due to the fact that it constitutes one of the main causes of conflicts.

The above reasoning has led to the establishment of a privilege on the distribution of dividends: it is not an absolute obligation to distribute as such, but provides a mechanism of compensation for the shareholder affected by the failure to distribute profits.

3. The applicable regime

Companies affected

All companies incorporated in Spain are affected by the new regime laid down in the LSC, be they newly created or existing prior to the entry into force of the rule on 2 October 2011.

However, an exception is made in the case of listed companies, due to the ability of the shareholder affected by a failure to distribute dividends to sell its shares on the market without the need to exercise a separation right.

Temporal criterion

This regime will be applicable as of the fifth financial year following the recording of the company at the corresponding Mercantile Registry and may be exercised each year as of that point.

Quantitative criteria

The quantitative elements that trigger this right are the following:

- A failure to distribute a minimum dividend equivalent to a third of the company's operating profit derived from the corporate object from the preceding financial year.
- As such, extraordinary profits are excluded from the calculation.
- The profits must be eligible for distribution, pursuant to the requirements for the allocation of profits envisaged by law. Profits will be allocated preferentially to offset net losses and make up legal or statutory reserves.
- Under no circumstances will available reserves due to the application of results from previous financial years be included in the figure.

Express declaration and intention to distribute

The current regime states that the right is attributed exclusively to a shareholder who voted in favour of distributing profits. However, we are of the opinion that, in the absence of a proposal to distribute dividends, any shareholder who expressly stated for the record its wish to receive dividends, should enjoy the same protection.

Compensation mechanism

The legislator has considered that the appropriate compensation mechanism for the affected shareholder in the case of a failure to distribute dividends is the power to exercise the right of separation.

Accordingly, the shareholder in question may, within one month as of the date of the General Meeting that failed to resolve to distribute dividends (or that resolved to distribute less than a third of the company's operating profit derived from the corporate object from the corresponding financial year), demand that the company acquire or redeem its stake in the share capital of the former at the price agreed by the parties.

In the absence of an agreement on the value of the shares, the price will consist of a reasonable value determined by an auditor other than the one who audits the company's accounts, appointed by the Mercantile Registrar.

4. Problematic points and possible solutions

The new regime set forth in the LSC leads us to reflect on the scope and interpretation of the some of its elements.

Problems of interpretation

- #### Calculation of the five-year term

Overall, there is no doubt regarding the calculation of the grace period of five years in relation to newly created companies once recorded.

Likewise, we consider that a shareholder joining a five-year-old company by virtue of a share capital increase will be entitled to exercise its right as of the moment it subscribes the shares (i.e. the five-year grace period is based on the date on which the company was incorporated and not on the date each individual or entity became a shareholder in the same). The same criterion should apply to the shareholders of the surviving company following a process of structural modification (mergers and de-mergers), provided that the five-year requirement is met.

Nevertheless, the matter is less clear in the case of newly created companies resulting from a process of structural modification (merger or de-merger involving the creation of a new company), although it could be understood that the right of separation would apply since day one after such modification if all the companies involved in it previously met the five-year requirement.

- #### Concept of company's operating profit

The legislator opted to apply the rules on the liquidation of a usufruct over shares to determine the accounting concept to be used for calculation of the minimum amount to be distributed to the shareholders.

As stated earlier, in order to rule out the risk of a shareholder demanding its separation from the company, the General Shareholders' Meeting must resolve to distribute at least a third of the company's operating profit derived from the corporate object in the corresponding financial year.

In relation to the amount to be distributed, it is worth pointing out the following:

- First of all, it will be necessary to determine whether the company has generated a profit to justify the distribution of dividends in the corresponding financial year, in accordance with the applicable rules on company profit.
- If so, it will be necessary to break down the "profit from the financial year" in order determine what part of said amount is to be taken into account for the purposes of the dividend distribution.
- Thus, of the different elements comprising the company's' profit, the starting point for calculation should be the "operating profit" in the profit and loss account. Moreover, it would also be worth considering if the amount of the "financial profit" should be treated as part of the profits corresponding to the operation of the company's business.
- Amounts corresponding to income and/or loss caused by or arising from exceptional or extraordinary company activities must be excluded for the purposes of calculation.
- Insofar as the "operating profit" (or even if we add to it the debatable "financial profit") is a pre-tax amount, there is doubt as to whether, after deducting the extraordinary profits, the theoretical taxation attributable to the resulting amount should be deducted for calculation purposes. If so, this would imply that the above-mentioned one-third quotient would apply to a net amount, not a gross one, which seems reasonable considering that the law states that, in general terms, the distributable profits are net of taxation.

Hence, it seems that from now on the management body, when drawing up the annual accounts, could be forced to make an additional calculation in order to inform its shareholders of what the "operating profit derived from the corporate object" would be each financial year. A failure to distribute dividends of at least a third of this last amount would entitle a shareholder to exercise its right of separation.

Mandatory nature

Although the new regime is mandatory, there are certain legitimate alternatives available to avoid its application:

- Exclusion or waiver of the right

  - Although there are differing interpretations on this point, our understanding is that the Mercantile Registrar will reject any attempt to record a statutory provision expressly establishing the non-application of the new regime (i.e. Article 348 bis of the LSC) on a general basis, as it is an individual right of each shareholder.
  - On the other hand, a waiver of this right would be lawful if each shareholder individually executed a shareholders' agreement with the remaining shareholders or by virtue of unilateral waivers from each shareholder in favour of the company.
  - It should also be noted that an amendment of the by-laws adopted unanimously by the shareholders would probably not be a valid alternative either, due to the objective nature of the by-laws and the fact that they do not take into account the shareholding of the company at each point in time.

- Limitations

  In addition to the above, there might be other practical limitations that prevent this right from being exercised and which do not necessarily depend on a contractual arrangement between the relevant parties.

  In this context, the creation of statutory reserves, the change of appropriate accounting policies or even some corporate or financing restructuring could in some cases lead to a reduction of the profit, which may imply that no operating profit would be available and that, accordingly the right of separation will not be triggered.

  Notwithstanding this, given that the key purpose of Article 348 bis of the LSC is to protect minority shareholders against the "economic dictatorship" of the majority, if the actions mentioned above are adopted with the sole justification of rendering the shareholder's right ineffective, we cannot rule out such actions being challenged.

Absolute nature of the right

Another characteristic of the right to demand distribution of dividends or, in the event of refusal, separation from the company, would be its absolute nature, which may have undesirable consequences for the company, as we will now explain.

- Irrelevance of the actual context

  The right could be exercised regardless of the shareholding context of the company, without distinction between capital structures with only two shareholders in possession of similar stakes (51% and 49% of the shares, for example), and others with genuinely minority shareholders; or even without taking into account the financial situation of the company, in which there could be demands on the treasury resources even if profits have been made according to the accounts due to the company's investment plans, its long-term strategy or other sector-specific or macroeconomic threats.

  Thus, in certain cases, we understand that the company should be entitled to object to the mandatory distribution of dividends when such refusal is made in the company's interests, provided that the distribution would entail a serious risk or damage to the same.

- Third-party commitments

  Another question that was raised upon approval of the LSC is how to make the new regime on distribution compatible with the existence of contractual restrictions on the distribution of dividends or on the buyback or redemption of shares under any financing agreements that the company may have entered into.

  Here it is necessary to differentiate between agreements signed before and after the entry into force of Article 348 bis of the LSC:

  - Undertakings predating the reform

    In this context, the first question that should be asked is whether the company could allege the protection of the company's interests, in relation to complying with the financing agreements to which it is a party, when faced with a request from a shareholder who wants to receive its minimum dividends.

    Likewise, if the company interprets that the new regime prevails over any previous third-party undertakings, the question is whether credit institutions will be entitled to terminate the financing agreement, either due

to a direct breach by the company (by distributing dividends or acquiring the shares or participations of the member who decides to separate) or alleging an adverse modification of the circumstances in relation to the preferred use of the treasury resources of the company as a result of an unforeseen regulatory change (*rebus sic stantibus*).

We can also ask ourselves about the reasonable value of the shares to be acquired in exercising the right of separation in the event that the financing entity triggers the termination of the financing agreement for the reasons set out above. That is, whether or not the imminent repayment of the financing by the company should be taken into account for the purposes of calculating said value.

Notwithstanding the above, it is likely that the risks set out above would probably not apply to financing in which all the minority shareholders have given the corresponding commitments in favour of the credit institutions, or even granted pledges over their shares.

- Undertakings that postdate the reform

  As for undertakings given after the new rule entered into force, they will most likely include the appropriate mechanisms to prevent triggering of such right. This will often include, when the identity and structure of the shareholding so allows, an express waiver by the shareholders of their individual right.

- Complex statutory structures

  Finally, we should also keep in mind that a company whose share capital is represented by different classes of shares with different rights may find itself obliged by its by-laws to first attend to preferred economic rights that certain shareholders may have and which may be incompatible with the new regime laid down in the LSC as to distribution of dividends.

  Thus, it would be worth analysing how to coordinate the privileged nature of certain shares with preferred dividend or other economic rights, as well as any incentive plans granted to management teams, with the right of separation due to a failure to distribute dividends.

5. Conclusions

- We are dealing with a rule that is rigid in terms of its conception, and that despite responding to a genuine need to protect minorities, could on occasion lead to a possible imbalance of power in favour of the latter.
- We recommend revising the by-laws, shareholders' agreements and any other arrangements between the company and its shareholders in order to assess what the impact of the new regime could be in practical terms.
- From now own, it will be necessary to prepare additional accounting calculations in order to determine the profit obtained by the company that will serve as a point of reference for the shareholders with a view to the potential exercise of their right to minimum dividend distribution.
- Lack of knowledge of the scope of the rule could potentially lead to conflicts.
- Reasonable technical solutions should be implemented in order to avoid or mitigate possible problems in the future.

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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