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Dividend Payments and Protection of Minority Shareholders^{*1}

1. Introduction

The minority protection is one of the central problems of company law. The objective of this article is to examine whether the Estonian law in force (above all, the Commercial Code^{*2}, CC) provides minority shareholders with efficient remedies, while the analysis also serves as the basis for formulating potential future solutions.

Contemporary company law presumes that the resolutions of shareholders are passed by a majority vote. Although the notion of the majority vote may have a different content, it in principle refers to a result in which case the persons holding more votes actually form the content of the shareholder's resolutions. There are exceptions to this principle, and for certain resolutions the law prescribes a bigger majority; however, the requirement does not apply to ordinary resolutions but issues on fundamental changes in the company (e.g., amendment of the articles of association, increase and reduction of share capital, merger, division, and transformation of legal form). As the objective of a company is to earn profit, then the distribution of profit is an ordinary resolution due to the nature of the company, and consequently it is essentially not allowed to impose a greater majority requirement on profit distribution resolutions by law. Yet the requirement does not prohibit imposing a higher majority requirement by the articles of association. It must also be taken into account that the imposition of a greater majority requirement by law must ensure that the company remains a going concern, so the requirement of a greater majority never means a 100% majority vote.^{*3}

The requirement of a majority vote leaves always a possibility that the majority adopts a resolution based solely on their interests. The minority shareholders face the biggest risk from the fact that they are not protected by voting rights. Instead, the minority must depend on other legal strategies for protection, such as the sharing norms, rules and standards.^{*4} This concerns, above all, the fundamental rights of shareholders and may give rise to a question whether and to what extent the right to receive a dividend is a fundamental right of a shareholder. The dividend policy should be decided by every company and therefore the situations in

¹ This article was published with support from ESF Grant No. 6747.

² RT I 1995, 26–28, 355; 2009, 12, 71 (in Estonian). Translation of the Code into English is available at <http://www.just.ee/23295> (1.05.2009).

³ In Estonia, the limits are either 2/3 (e.g., CC § 300 (1), § 341 (1), § 356 (1)) or 3/4 of the votes represented at the general meeting (e.g., CC § 345 (1)). The agreement of a particular shareholder (e.g., CC § 356 (2¹)) or the agreement of all shareholders (CC § 440 (4)) in certain resolutions is only required as a total exception.

⁴ E. Rock, H. Kanda, R. Kraakman. Significant Corporate Actions. – R. Kraakman *et al.* The Anatomy of Corporate Law. Oxford: OUP 2004, p. 147.

which the company does not pay dividends are not excluded. There is basically no problem if the shares of the company are listed on a stock exchange, as in such a situation a shareholder is able to obtain profit and money by selling part of his or her shares, since (if to leave the general processes affecting the securities market aside) the share prices should increase when the company earns profit and does not distribute it to shareholders. However, the situation is different when the shares of the company are not listed because in that case, the shares are not marketable.⁵ In this situation a shareholder does not have an opportunity to sell his or her shares, while the shares do not have an actual market price and as a result, it is not possible to say that the resolution not to pay dividends could increase share prices. In such a situation, the only potential buyer of the minority shares is, in practice, a majority shareholder, i.e., a person whose votes determine the position of the minority and consequently, there is no sales option that would give the minority an actual opportunity to benefit from the profit earned by the company. Considering these arguments, the special situation in Estonia has to be taken into account, as only few companies have been listed here⁶, and that fact has to be kept in mind when developing any provisions.

It is certainly another question, should the shareholders have at all any power to decide the payment of dividends, as the payment of dividends by a company to its shareholders should be determined by the management board's investment strategy. The management board should retain for the company only the capital that yields more against justified risks than the shareholders would be able to make elsewhere.⁷ In principle, the payment of dividends does not to be decided by the general meeting, yet this does not affect the need to establish rules for the protection of the minority.

2. Estonian law in force

The payment of dividends is regulated by CC § 278, which sets out the following provisions:

- the amount of a dividend shall be approved by the general meeting (CC § 278, the first sentence);
- the management board shall present a proposal co-ordinated with the supervisory board (CC § 278, the second sentence).

CC § 277 (2) is also relevant; according to that, the procedure for payment of dividends shall be prescribed in the articles of association or by a resolution of the general meeting.

The first sentence of CC § 278 is essential, as it gives a power to make a decision on the size of the dividend clearly to the shareholders (the same is prescribed by CC § 298 (1) 7)). The only exception are interim dividends whose payment can be decided by the management board (§ 277 (3)). Since the possibility to pay interim dividends has to be provided by the articles of association, the management board does not derive that right automatically from law but gets it from shareholders. The payment of interim dividends is rather an exception.

CC § 278 does not allow different interpretations regarding the powers of company organs. The payment of dividends is the power of the general meeting and the only limitation that may give rise to questions is the legal effect of the management board's proposal. Firstly, it is probably not entirely correct to refer to the proposal as the management board's proposal, as the requirement that the proposal has to be co-ordinated with the supervisory board implies that the proposal must also be approved by the supervisory board. As co-ordination is a rather ambiguous notion from the legal point of view, it should be understood that if the supervisory board does not agree to the management board's proposal, the management board must draft a new proposal. Otherwise, the requirement that the proposal presented to shareholders has to be co-ordinated by the supervisory board is not met. It must be noted that the sole requirement in law is that the management board's proposal has to be presented to the general meeting. Therefore, the proposal has no legal effect and the corresponding provision has to be interpreted in the way that the management board's proposal is only informative. It gives the shareholders the information about the potential investment plans of the management board, of their vision for the dividends, etc., but the proposal does not impose any restrictions on the resolution of the shareholders.

It can be concluded that the general meeting is free to decide any amount of the dividends, while the only upper limit is the general amount of permitted distributions (the third sentence of CC § 278, which directly derives from Article 15 of the 2nd company law directive⁸). However, such regulation also means that the law

⁵ G. Morse *et al.* *Charlesworth's Company Law*. 17th ed. London: Sweet & Maxwell 2005, p. 481.

⁶ As of 1.03.2009, there were 5307 public limited companies in Estonia (see http://www.rik.ee/stat/9_3mk.phtml), the shares of 18 companies were listed on a stock exchange (see <http://www.nasdaqomxbaltic.com/market/?pg=mainlist&lang=en>).

⁷ G. Morse (Note 5), p. 481.

⁸ Second Council Directive of 13 December 1976 on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, with a view to making such safeguards equivalent (77/91/EEC). – OJ L 26, 31.01.1977, pp. 1–13.

does not prescribe the minimum dividend but leaves the decision on the size of a dividend entirely up to the shareholders. The resolution to pay dividends is an ordinary resolution requiring that over one-half of the votes represented at the meeting are given in favour (CC § 299 (1)). The size of a dividend is therefore determined by the majority shareholders votes and there is not any restriction.

It could be asked whether it is possible to prescribe the size of a dividend in the articles of association. The formative freedom of the articles of association is limited by the imperative provision of law (CC § 244 (2)). Consequently, the question is: Does the first sentence of CC § 278 contain an imperative provision or not? The text of the provision does not allow for any interpretations regarding other solutions, which gives good grounds to regard the provision as imperative. In addition, we should examine other similar legal regulations. One example might be CC § 345 (2), which allows to bar the pre-emptive rights of subscription of the existing shareholders for the new shares upon increasing share capital by a resolution of a general meeting. The wording of both provisions is essentially the same — a resolution of a general meeting has been prescribed as the form for resolving the issue. CC § 345 (2) is based on Article 29 of the 2nd company law directive, which sets out that the right of pre-emption may not be withdrawn by the articles of association but requires an *ad hoc* decision of shareholders. Our relevant provision proceeds from the presumption that it is not necessary to establish a direct prohibition in the situation, whereas the law contains an exhaustive permitting rule and following this presumption § 345 (2) makes it impossible to provide for such a limitation in the articles of association. It means that the prohibition has been expressed in a positive way — the manner of deviation from law is prescribed and any other possibilities have been excluded. As these two comparable provisions have the same wording, it is probably not correct to interpret them differently. Consequently, we must infer that the size of a dividend should be also determined by an *ad hoc* resolution.

It should be noted in addition that the payment of dividends is ruled by a provision that refers to the articles of association (CC § 277 (2)), giving the opportunity to set the procedure for the payment of dividends in the articles of association. Since according to this provision the articles of association can be used to settle one issue regarding the payment of dividends, this gives rise to doubts that if the legislator had intended to allow for providing the size of dividend in the articles of association, it would have been provided as such in law. The Supreme Court has also stated, when applying this provision, that the provision, above all, governs the procedure for making payments (including the term of making the payment).⁹ Hence, this does not imply the contrary; the first sentence of CC § 278 is an imperative provision whose scope of application does not include the determination of the amount of a dividend, while the articles of association consequently cannot prescribe the amount of dividend.

3. Estonian previous law and proposed amendments

Besides the current law, the provisions of earlier law in force and proposed amendments have to be analysed to find the answers. Starting the historical approach from the re-establishment of the independence of Estonia, we must first note that the Statute on Limited Liability Companies¹⁰, which regulated companies initially, contained only one provision regarding the payment of a dividend — a shareholder is entitled to the part of the net profit proportional to his or her shares (dividend), to be distributed to shareholders pursuant to the articles of association of the company. Considering that generally the statute did not contain almost any provisions on legal capital¹¹, a provision with such substance appears even more surprising. This norm imposed imperatively the principle of proportionality upon the payment of dividends. Indeed the provision was not applied in practice like that. On the contrary, the shares of different classes carried commonly various dividend rights. The statute contained regarding to the dividends no minority protection rules.

Let us proceed with the discussion of the drafts of the Commercial Code. Their initial texts contained rules that were in principle based on the Swedish law of that time.¹² In the draft submitted for the second reading in the *Riigikogu*, § 290 provided that the shareholders having at least 1/10 of the votes represented by shares have a right to request the distribution of at least one-half of the net profit remaining after the deduction of the amounts prescribed by law or in the articles of association, if this sum does not exceed 1/20 of the total of the share capital, legal reserve and share premium.¹³ This provision was removed under unclear circumstances from the text of the draft submitted for the third reading.¹⁴ There have been later attempts to change the pro-

⁹ CCSCd, 10.02.2004, 3-2-1-16-04. – RT III, 2004, 6, 64 (in Estonian).

¹⁰ ENSV ÜVT 1989, 37, 573; RT I 1994, 62, 1043 (in Estonian).

¹¹ See A. Vutt. Aktsiakapitali õiguslik reguleerimine: eesmärgid ja moodustamine (Legal Regulation of Share Capital: Objectives and Formation). MA thesis. Tartu 2005, p. 9 (in Estonian).

¹² Aktiebolagslag (1975:1385), § 12:3. Available at <http://www.notisum.se/rnp/SLS/LAG/19751385.HTM>.

¹³ Äriühingute ja nende registreerimise seadus (Companies and Their Registration Act). Draft 733 SE II. 30.01.1995. Unpublished.

¹⁴ Äriseadustik (Commercial Code). Draft 733 SE II. 8.02.1995. Unpublished.

cedure for passing the resolution on dividends but they have not been successful. The amendments submitted in 2004 were discussed on a wider scale and strongly opposed by entrepreneurs. The arguments presented by them were rather peculiar. For example, it was pointed out that minority shareholders could protect themselves by other means (e.g., shareholders' agreement) and it was even stated that 'the minority shareholders are not so incapable that they are unable to protect themselves'.^{*15}

The draft of 2004 contained the following amendment to CC § 276 (1): a public limited company must distribute to shareholders at least one-half of the amount applicable for distribution to the shareholders as a profit. The distribution of profit may be precluded or limited by a resolution of the general meeting, if at least 3/4 of the votes represented at the general meeting have been given in favour.^{*16} The explanatory memorandum of the draft substantiated that this provision is necessary for protection of minority shareholders and referred to the inadequacy of the former wording that allowed for withholding the payments from net profit for an indefinite period by a relevant resolution of the general meeting.^{*17} The draft presented to the *Riigikogu* did not already contain this provision.^{*18}

If one compares the drafts of 1995 and 2004, one has to admit that the first one was better. It did not set out the payment of dividends as an obligation of the company but rather as a claim of the minority. The latter is not that burdensome for a public limited company because it does not oblige the company to pay dividends always in a certain amount, but forces it to take into account the minority interest. Another difference is that the draft of 1995 limited the maximum amount of a dividend. Thirdly, the draft of 2004 allowed for a possibility not to pay dividends if the relevant resolution had been adopted by a qualified majority. Therefore the opinion that the draft enabled a majority shareholder to refuse to pay dividends, whereas the minority lacked any remedies in such a situation^{*19}, has to be agreed with. It has to be admitted that whereas the draft of 2004 expressed the right principle as such, the provision failed to take into account important circumstances and as a result the failure to adopt the draft in the form it was presented was obviously justified.

4. Law of other countries

Different countries have used different methods to regulate the rights of the minority upon the payment of dividends. It has to be mentioned for a start that regardless of the pursuit of the 2nd company law directive to regulate issues related to legal capital very strictly, the directive does not handle the payment of the so-called minimum dividends.

It was referred above to the previous Swedish law that had served as the main model for developing Estonian capital rules. It has to be admitted that regardless of the adoption of a new Companies Act^{*20}, no principal changes of these rules have been made in Sweden. ABL § 18:11 provides that at the request of the holders of at least 1/10 shares, the general meeting must adopt a resolution to pay dividends from the profit of the financial year which remains after making assignments to cover previous losses, if there are no other available reserves, into mandatory and other reserves that have to be used for purposes other than distributing to the shareholders according to the articles of association. The articles of association may prescribe that minority shareholders may also submit such a request. The request must be submitted before the special general meeting deciding on the distribution of profit. A general meeting is not obliged to decide to pay dividends that exceed 5% of the owners' equity.

Germany applies a considerably different approach. AktG^{*21} § 58 I provides that if the management or supervisory board approves the annual report, they may transfer part of the net profit, but not over one-half, to other reserves. There is also a possibility that the transfer of profit to reserves has been provided differently from the above in the articles of association and in that case, it is not permitted to pass a different resolution, while the general meeting is not allowed to adopt a resolution that differs from the articles of association either.

¹⁵ S. Männik, A. Hundimägi. Parts toetab kohustuslikku dividendi (Parts Supports the Obligatory Dividend). – Äripäev, 1.06.2004 (in Estonian).

¹⁶ Äriseadustiku muutmise seadus (Commercial Code Amendment Act). Draft 21.05.2003. Available at http://eogus.just.ee/?act=6&subact=1&OTSIDOC_W=17168 (in Estonian).

¹⁷ Seletuskiri äriseadustiku muutmise seaduse eelnõu juurde (Explanatory Memorandum to the Draft Commercial Code Amendment Act). 26.01.2004. Available at http://eogus.just.ee/?act=6&subact=1&OTSIDOC_W=17168 (in Estonian).

¹⁸ Äriseadustiku muutmise seadus (Commercial Code Amendment Act). Draft SE 552 I. 16.12.2004. Available at <http://web.riigikogu.ee/ems/saros-bin/mgetdoc?itemid=043510004&login=proov&password=&system=ems&server=ragne11> (in Estonian).

¹⁹ P. Sander. Dividendipoliitika seadusandlik regulatsioon väikeaktioonäride õiguste kaitsel (Legal Regulation of Dividend Policy in Protecting Minority Shareholders' Rights). – XIII majanduspoliitika teaduskonverents (13th Academic Conference on Economic Policy). Berliner Wissenschafts-Verlag, Mattimar 2005, pp. 314 (in Estonian).

²⁰ Aktiebolagslag 2005:551. Available at <http://www.notisum.se/rnp/sls/LAG/20050551.htm>.

²¹ Aktiengesetz vom 6. September 1965 (BGBI. Is.1089 ff). Available at <http://bundesrecht.juris.de/bundesrecht/aktg/>.

The objective of this provision is to protect the minority from the majority's resolution to pay dividends that are too large. In addition, it is not precluded that the articles of association provide the transfer of all profit to reserves. In a similar way, the articles of association may preclude the transfer of the profit to reserves.^{*22} If a general meeting adopts a resolution that is in contradiction with the articles of association, a shareholder may challenge it (AktG § 254).

In the United Kingdom, the principles of paying dividends have also been left to the domain of the articles of association (See Table A, 1 October 2007^{*23} 102 ff.). Yet there are no rules protecting the minority, and in the case of inadequate dividends the courts have taken as the basis a provision that gives a shareholder the right to challenge the decision of the general meeting on grounds of unfair prejudice. A central case here is *Re Sam Weller & Sons Ltd.*, in which shareholders who were not involved in the management of the company were dissatisfied with the dividend which had remained at the same level for 37 years. In this case, the court established that the situation could amount to conduct unfairly prejudicial to the interest of those shareholders who did not participate in management; yet it also noted that this position should not be construed so that a shareholder who does not receive any other benefits from the company besides the dividends is automatically entitled to comply, but the claim must be founded on unfairly prejudicial conduct.^{*24}

5. Future of Estonian law

As it was mentioned above, the European Union does not regulate the remedies available upon the payment of dividends and therefore there are not any restrictions for modelling of our law. This gives rise to the question whether it would be reasonable to change the current law or is the present situation satisfactory. It is impossible to give an answer on the basis of the case law because the lack of relevant provisions also means the lack of legal disputes. Yet it would be incorrect to reach a conclusion that the lack of court cases indicates the absence of problems.

The laws of the three countries described above are using different ways of solving the problems and it would probably be reasonable to take them as examples.

Application of the principles of the United Kingdom presumes the amendment of current law by adding a regulation the content of which would correspond to Companies Act 2006 § 994. The Estonian current law does not give a shareholder a clear option to challenge the unfair prejudice of a company. Assuming that we could rely on such an approach, the grounds for challenging the resolutions should also be amended accordingly. According to the law in force, a shareholder may contest a resolution of the general meeting of a company which is in conflict with the law or the articles of association (CC § 302 (1)). Such a claim has always to be based on a specific provision of the law or the articles of association, whereas the shareholder has to be able to prove the breach of the law by the company. It cannot be naturally ruled out that the court would also regard the violation of general principles as a breach of law; however, it is complicated and there is no case law available, so far.

Such a claim could *per se* be based on § 32 of the General Part of the Civil Code Act^{*25}, which provides that the shareholders or members of a legal person and the members of the directing bodies of a legal person shall act in accordance with the principle of good faith and consider each other's legitimate interests in their mutual relations. It is the elaboration of the general principle of good faith in company law: that is why one should behave upon the application of that provision in the same manner as upon the general application of the principle of good faith. It has been clearly pointed out that the principle of good faith can be applied only after the other possibilities prescribed by law for deriving an appropriate maxime have been exhausted.^{*26} In relation to the abuse of minority interests upon the payment of dividends, this provision could be taken as the basis because the law simply does not grant any other options. Although such an approach by the court should not be ruled out, it is still doubtful whether the courts would actually rely on the principle of good faith in a situation in which the dividends are not paid, and the company justifies such a behaviour by its investment and development plans. In such a situation, the court should at least have doubts that it is too excessive interven-

²² U. Hüffer. Aktiengesetz: Beckliche Kurzkommentare. Band 53. 8., neuarbeitete Auflage. München: Verlag C. H. Beck 2008, paragraphs 6, 7.

²³ Companies (Tables A to F) Regulations 1985 as amended by SI 2007/2541 and SI 2007/2826. Available at <http://www.companieshouse.gov.uk/companiesAct/implementations/TableAPublicOct2007.pdf>. For the area of application, see P. Davies. Gower and Davies' Principles of Modern Company Law. 7th ed. London: Sweet & Maxwell 2003, pp. 55–56.

²⁴ E. Ferran. Company Law and Corporate Finance. Oxford: OUP 1999, pp. 415–416. In current law, the claim may be based on Companies Act 2006 § 994.

²⁵ RT I 2002, 35, 216; 2008, 59, 330 (in Estonian). Translation into English available at <http://www.just.ee/23295>.

²⁶ P. Varul *et al.* Võlaõigusseadus I. Üldosa (§§ 1–207). Kommenteeritud väljaanne (Law of Obligations Act I. General Part (§§ 1–207). Commented edition). Tallinn: Juura 2006, § 6 comment 4.2.1 (in Estonian).

tion to the business of a company. Also, in addition to the establishment of facts, an unfair prejudice towards shareholders must be identified, which is likely to imply long-term activity and benefits to other shareholders in any other manner (remuneration of directors, agreements, etc.).

The fact that we are a part of continental European law has to be taken into account also, as the provisions of statutes are according to our legal tradition the primary source of the law. Hence, it is important in perceiving and applying the law that the indicators be included in it. If the law does not state the rights or obligations, this leads to doubts whether such rights or obligations exist at all. Also, consideration should be given to the failed attempt to amend the code in 2004, since the factual situation *inter alia* implies that since the code did not prescribe obligatory minimum dividends, they do not exist either. We cannot agree to the latter interpretation but there is a clear threat that the court may assume such a position.

Based on the above, we can infer that although the minority may be entitled to request dividends under Estonian law, the possibility is ambiguous, its application problematic and it does not offer adequate opportunities for the minority.

As a second option, it is possible to take Germany as a model for the payment of dividends. This would mean that the law should prescribe the obligatory size of a dividend. However, German law grants unlimited opportunities for changing the limit in the articles of association, which may lead to a failure to apply the relevant provisions (including the minimum dividend). A positive effect of this regulation would be the obligation to pay dividends, which would entitle the shareholders to clear expectations upon acquisition of shares. The determination of the *ex ante* regulation protects a shareholder from arbitrary *ad hoc* resolutions. Such a situation resembles an agreement, the performance of which a shareholder can claim. A negative effect would be the rigidity of the regulation as the *ex ante* provisions of the law or the articles of association could not permit resolutions that might be reasonable due to the changes in the financial situation of a company. Besides, such a regulation would make the company law rules less flexible and it is probably in nobody's interests. In addition to that, the majority of companies may be expected to amend their articles of association after the establishment of such regulations and preclude the payment of dividends unless a general meeting decides otherwise, etc., which would actually not change the present situation. It must also be taken into account that the German approach proceeds from the fact that decision on the payment of dividends is not the power of shareholders and these *ex ante* regulations are inevitable in such a case (a body deciding on the distribution of profit only observes the articles of association adopting the resolution on the distribution of profit). In our law the decision on the payment of dividends is a power of the general meeting and if we adopt the German system then this requirement could be changed as it makes ultimately no difference who performs the agreements set out in the articles of association.

The third solution (Swedish), which entitles the minority to request the payment of a minimum dividend, is in some respects the clearest. The main value of this regulation is that it does not oblige the company to adopt certain resolutions but grants the right of request to the minority which they are free to use. Hence, a company is not by default bound by prescribed solutions but the obligatory dividends deriving from law must only be paid if a relevant request is submitted. In addition, the amount of obligatory dividends prescribed by law in Sweden is smaller than the one in German law. A disadvantage of such a solution (and any other solutions directly deriving from law) is the fact that the amount of dividends would completely depend on the amount of profit reported in the balance sheet and since the application of the accounting rules is not unambiguously prescribed, the management board may take measures that reduce the profit. However, this problem is inevitable as the legal capital rules are directly related to accounting rules, while the latter will always allow for various interpretations and the management board cannot be blamed on any grounds as long as it acts within that framework.

In summary, it should be noted that the Estonian current law does not grant the minority an explicit right to request the payment of dividends. Although the possibility to submit such a request can be found from valid law, this is too ambiguous; also, the relevant legal remedies could be used only under very exceptional circumstances. Consequently, Estonian law should be amended and the minority should have a clear right to receive dividends. Comparing the German and Swedish approaches, the author of the article considers the latter to be more appropriate. It means basically that we could return to the preliminary sources and resume with the draft Commercial Code submitted to the second reading in the *Riigikogu* in 1995.