G A _ P

Gómez-Acebo & Pombo

New legal regime governing the right to exit in the event of a failure to pay dividends

Alberto Díaz Moreno
Professor of Corporate & Commercial Law, Universidad de Sevilla
Academic Counsel, Gómez-Acebo & Pombo

Act 11/2018, of 28 December, has reworded art. 348 bis of the Companies Act. This paper sets out to identify the most significant changes and to briefly explain their meaning and purpose.

1. *Preamble*

1.1. Act 11/2018, of 28 December, has profoundly altered art. 348 bis of the Companies Act ('LSC'), the new wording of which is as follows:

> 1. *Unless otherwise provided in the articles of association, as from the fifth financial year since the company's date of registration with the Register of Companies, the shareholder who has recorded his protest in the minutes against the insufficiency of the recognised dividends will have the right to exit in the event that the general meeting does not resolve to distribute as a dividend at least twenty-five per cent of the profits earned during the previous financial year that are legally distributable when profits have been earned over the previous three financial years. However, even in the foregoing circumstances, the right to exit will not arise if the total dividends paid over the last five years make up at least twenty-five percent of the legally distributable profits recorded in that period.*

The provisions of the foregoing paragraph shall be without prejudice to the bringing of actions to contest company resolutions or the filing of derivative claims that may lie.

2. *For the removal or alteration of the exit event referred to in the previous paragraph, the consent of all the shareholders shall be necessary, unless the right to exit the company is recognised in respect of a shareholder who has not voted in favour of such resolution.*

3. *The time limit for exercising the right to exit shall be one month from the date on which the ordinary general meeting of shareholders was held.*

4. *When the company is obliged to prepare consolidated accounts, the same right to exit must be recognised in respect of the shareholder of the controlling company, even if the requirement provided in the first paragraph of this article is not met, if the general meeting of the aforementioned company does not resolve to distribute as a dividend at least twenty-five per cent of the previous financial year's consolidated profits attributed to the controlling company, provided that they are legally distributable and, in addition, consolidated profits attributed to the controlling company have been earned over the previous three financial years.*

5. *The provisions of this article shall not apply in the following cases:*

   a) *In the case of listed companies or companies whose shares are admitted to trading on a multilateral trading system.*

   b) *When the company has entered insolvency proceedings.*

   c) *When, under insolvency legislation, the company has notified the competent court for the opening of insolvency proceedings of the commencement of negotiations to conclude a refinancing arrangement or to gain acceptance of an early composition with creditors, or when said court has been notified of the opening of negotiations to reach a mediated settlement agreement.*

   d) *When the company has concluded a refinancing arrangement that satisfies the conditions of transactional unavoidability laid down in insolvency legislation.*

   e) *In the case of public limited sports companies.*

1.2. According to the Transitory Provision of Act 11/2018, this amendment will apply "to general meetings held as from the same day of its entry into force" (i.e. as from 30 December 2018). Although the wording is not entirely fortunate, this means that, if the conditions provided for in the new wording of art. 348 bis apply (and only if they actually apply), shareholders will have the right to exit under the terms provided for in that new wording when the resolution on the payment of dividends giving rise to it is passed at a meeting subsequent to the date indicated. In the case of meetings of shareholders held up to 30 December 2018, the conditions for exercising the right to exit will be those previously provided, even if such exercise takes place (within one month) with the new legal regime already in force.

1.3. The purpose of this paper is to give a brief account of the most significant alterations to the legal regime by the change in the wording of art. 348 bis LSC.

2. *'Repealability' of the statutory rule in the articles of association*

2.1. With the previous wording of art. 348 bis, it was the subject of debate whether it would be possible to agree within articles of association on rules different from the statutory ones or even whether it would be possible simply to exclude under said articles the statutory right to exit.

In the text already in force, it is stated that the new legal regime will apply "unless the articles of association provide otherwise", which seems to resolve the question in the sense that the articles of association may eliminate this statutory exit event or may recognise it modifying (tightening or loosening) the conditions to be met for its exercise. In this regard, it should be noted that the possibility of establishing a different regulation under the articles of association could ensure that the right to exit will not arise when the resolution of the meeting of shareholders against the payment of dividends (or determining a payment below a certain percentage) is based on the concurrence of economic or financial circumstances that justify it.

2.2. The inclusion in the articles of association of a clause that eliminates or alters the statutory exit event requires the consent of all shareholders, unless the shareholder who did not vote in favour of such a resolution is recognised the right to exit the company (art. 348 bis(2) LSC). This provision, however, causes some perplexity. It can be assumed that the recognition of the right to exit would have to be recorded in the articles and agreed in accordance with the general rules (see art. 347 (2) LSC). If such is the case, it would appear that the shareholder who does not agree with the elimination of the right to exit provided in art. 348 bis LSC would be in a position to block a majority passage of the relevant resolution (that altering or eliminating the statutory event) simply by not consenting to the other (the one by means of which the recognition of a right of exit is sought) since, in recognising the right to exit, assent to the former would be necessary through the application of art. 348 bis(2). This would deprive the statutory exception of practical scope. For this reason, another reading of the legal system is feasible and it is possible to consider that, for this specific case, the Act provides that the majority (as per the law or the articles of association) may agree to the alteration or elimination of the statutory right to exit if, also by majority, the dissatisfied shareholder is granted a right to exit.

2.3. In any event, although the conclusion would literally be otherwise, it does not seem to make sense for the special rule in art. 348 bis LSC to apply when the amending rule of the articles of association has the effect of facilitating the exercise of the right to exit (by eliminating or simplifying any of the legal requirements). In these cases, the effect would be similar to that derived from the inclusion in the articles of association of an exit event (this would be the case throughout the scope where the right is recognised beyond the scope of the law, since there would be an extension of the right to exit) and the regime of art. 347(2) LSC should prevail (see also art. 204(2) of the Register of Companies' Rules), which do not make any proviso to the need for consent of all shareholders (as a matter that affects all of them individually).

3. *Factual requirements of the rule*

The factual requirements of art. 348 bis LSC (determining the commencement of the dissatisfied shareholder's right to exit of) retains in its new wording, as a basic element, the general meeting not approving the payment of a certain percentage of the legally distributable profits made over the previous financial year. However, below follow some relevant changes that have been introduced in this general framework:

3.1. For the avoidance of any doubt in this respect, the words *"as from the fifth financial year"* are replaced by the words *"after the fifth financial year"*. This is so as to make it clear in the new text that the right to exit will not arise on the occasion of the meeting that decides on the distribution of profits generated in the fourth financial year since registration, but - at the earliest – on the occasion of the meeting that deliberates on the profits earned in the fifth financial year. In any case, this period continues to be calculated from the time the company is registered (whether this is the consequence of its "ordinary" formation, or of a merger with the incorporation of a new company, or of a division with the transfer of the divided assets to a new company).

3.2. The percentage of the legally distributable profits for the financial year, the distribution of which must actually be agreed in order to prevent the right to exit from arising, is reduced from one third to one quarter.

It is important to remember, following this amendment, that Act 11/2018 has also added a new third paragraph to art. 276 LSC, according to which *"the maximum time limit for full payment of dividends shall be twelve months from the date of the general meeting resolution approving the distribution"*. In the context of the legal regime we are now commenting on, this rule has an obvious consequence: it prevents a majority from passing a dividend distribution resolution that, because of its content, may prevent the commencement of the right to exit under art. 348 bis but that, at the same time, imposes disproportionate waiting on the minority (which, in short, by substantially affecting the shareholders' right, would end up diminishing the practical enforceability of art. 348 bis itself).

3.3. The basis for calculating the 25 per cent distribution to be agreed will henceforth be *"the profits earned during the previous financial year that are legally distributable"*. Thus, the reference -whose correct interpretation had generated not a few headaches and certain controversy- to the fact that the profits were those *"earned in the pursuance of the company's objects"* is deleted. In this manner, under the new wording of art. 348 bis, in order for the right to exit not to arise, a quarter of all distributable profits made in the previous financial year must be distributed, whether they are classifiable as ordinary or extraordinary.

3.4. Two new conditions are introduced for the right to exit to arise:

a) Profits must have been made (the Act does not expressly require them to be legally distributable) during the previous three financial years. It is not clear whether the Act refers to the three financial years prior to that in respect of which the insufficient distribution resolution has been passed (which would mean that four consecutive years of profits are required) or to the three financial years prior to that in which the relevant general meeting resolution is passed. That is to say, the doubt lies in whether the three previous financial years should be, in turn, with respect to the "previous" one mentioned in art. 348 bis itself (in which the profits on the distribution of which is discussed have been generated). In any case, it is clear that a year with losses will make it necessary to restart the counting.

b) It is also necessary (even if the previous condition is met) that in the last five years no dividends have been distributed equivalent in total to at least a quarter of the legally distributable profits made in that period. Thus, a single and isolated resolution to not distribute profits (or to not distribute them in the required percentage) will not give rise to the right to exit if the previous "trajectory" of the company evidences that, in previous years, dividends had been paid in a proportion that can be considered, overall, as "reasonable" (which is intended to correct that "ruthless automatism" of the rule that has sometimes been criticised).

3.5. In order for the right to exit to arise, it is also necessary for the dissatisfied shareholder to have recorded in the minutes his protest at the insufficiency of the dividends that the general meeting has resolved to pay. The following paragraph is specifically devoted to this issue.

4. Right to exit, the direction of the shareholder's vote and record of his protest in the minutes

As has just been pointed out, the new art. 348 bis grants the right to exit to the shareholder *"who has recorded his protest in the minutes against the insufficiency of the recognised dividends"*.

This formula is intended to put an end to the doubts raised by the rule's previous unfortunate wording, which granted the right to exit to the shareholder *"who has voted in favour of the distribution of company profits"*. Indeed, it should be noted that the rule did not pose excessive problems of interpretation when the majority resolution was contrary to any distribution of profits (in that case, the right to exit could be granted to the shareholders who vote in support of the distribution, either by voting favourably to an alternative proposal - in the sense of instigating the payment of dividends - to the one finally passed, or by voting against the - finally victorious - proposal to not distribute). However, certain doubts arose when the general meeting's resolution was favourable to carrying out a distribution of profits in an amount lower than the marked minimum. In these cases it was evident that it was not reasonable to pay attention only to the direction of the vote in order to determine whether or not the right to exit existed (because this would lead, in the extreme, to the absurdity of granting it to those who - within the majority group - voted in favour of a minimum distribution - below one third - considering it adequate; and, conversely, to deny it to those who, considering the proposed distribution to be insufficient, voted against it). In short, it seemed logical to think that the right to exit should be granted to those who voted against the distribution resolution passed (if they did so because the distribution did not reach the minimum of one third) and also to those who voted in favour of a resolution with said content in order to ensure some minimum distribution, even if they did not agree with its amount and did not wish to renounce a greater distribution.

Now, as is evident, the problem has shifted from the foregoing premises towards the "reason" for the vote (for or against the resolution finally passed) and the need for this reason to be expressed and verified in some way. That is why the Act now links the granting of the right to exit to not the direction of the vote cast, but to the recording in the minutes of the general meeting of the protest against the insufficiency of the dividends agreed upon (a solution that, to a certain extent, was already anticipated in the Judgment of the Barcelona *Audiencia Provincial* (Fifteenth Chamber) of 26 March 2015 [JUR 2015\188060]).

Moreover, the letter of the Act leads one to consider, both in the wording already in force and in the previous one, that shareholders who did not attend the meeting will not be able to enjoy the right to exit.

5. *Personal scope of art. 348 bis*

5.1. As was already the case with the previous wording of art. 348 bis, the right to exit in the event of a failure to pay dividends will not exist in listed companies (that is, in those whose shares are admitted to trading on an official secondary securities market: cf. art. 495(1) LSC and art. 43 of the Securities Market Act ['LMV']). The reason for this exception is that in this type of company the existence of an organised market and the consequent liquidity of the securities makes unnecessary remedies such as the granting of a right to exit (which seems appropriate, on the other hand, when there is no such liquidity and the shareholder's option of "voting with their feet" is reduced or simply non-existent in practical terms - as will presumably happen, due to its normally "closed-ended" nature, in private limited companies and in many non-listed public limited companies). Listed companies are now equated for this purpose with companies whose shares are admitted to trading on a multilateral trading system (e.g. on the Spanish alternative investment market MAB), implying that the legislator has accepted that these systems offer a sufficient degree of liquidity to also justify the inapplicability of the rule.

5.2. Nor will the provision apply to public limited sports companies. The inclusion of this exception means recognising that in this type of companies limited by shares, profit seeking (i.e. the intention to earn profits and share them among the shareholders - arts. 1665 of the Civil Code and 116 of the Code of Commerce) is, to put it mildly, less relevant than in other companies limited by shares, to the extent that a rule that seeks to guarantee (by means of an instrument as powerful as the recognition of the right to exit) a minimum periodic distribution of the profits made can be dispensed with (although it may be excessive to extract from this provision the consequence that the Act has taken it for granted that there is no real profit seeking in these companies).

5.3. In the two cases mentioned above, the exclusion of the rule's scope of application ratione personae is due to the specific characteristics of the company in question (being a listed company or a public limited sports company). However, art. 348 bis(5) LSC adds other exceptions, applicable to any company (unlisted and not a public limited sports company) that is in certain circumstances capable of evidencing the existence of a situation of financial distress. Thus, the provision discussed above will not apply when the company has entered insolvency proceedings or when the company (or the notary, the registrar or the Chamber of Commerce, as the case may be - art. 233(3) of the Insolvency Act ['LC']) has made any of the communications provided for in art. 5 bis LC. Nor will it be when the company has concluded a refinancing arrangement that satisfies the conditions of art. 71 bis LC (whether those included in its first para. - "collective" agreements - or second para. - "singular" agreements -) or that has been judicially approved under the 4th additional provision of the LC (it is striking that art. 348 bis has not envisaged the conclusion of a mediated settlement agreement, which may be requested by companies limited by shares when certain conditions are met - art. 231(2) LC -). With regard to the cases included in art. 348 bis(5)(c) and (d), it should be pointed out that the Act has not established a temporal scope during which the inapplicability of the new legal regime will have to be prolonged. In this sense it could be ventured that this inapplicability will be contracted to the time granted by the Act to carry out the announced negotiations (art. 5 bis(5) LC) or to the time during which the retention of distributable profits has been provided for in the refinancing arrangement itself (foreseeably to propitiate the solution to the financial distress).

6. *The right to exit within groups of companies*

6.1. The previous wording of art. 348 bis LSC did not take into account the peculiarities of companies that are integrated into groups and, consequently, do not address the problems that the lack of payment of dividends poses for minority shareholders within groups. Conversely, in its current wording, the provision in question deals to a certain extent with this issue.

6.2. Maintaining the parallelism with the provisions of the first paragraph of article 348 bis (supra, 3.4), the commencement of this right is made conditional on having earned consolidated profits attributed to the parent company over the previous three financial years. However, it is of no relevance (at least in the literal sense of the rule) that in the last five years dividends have been distributed that are equivalent overall to at least a quarter of the legally distributable profits calculated on a consolidated basis earned in that period.

7. "Other remedies" for the oppressive actions of the majority

7.1. It was already being held that the previous wording of art. 348 bis did not preclude the use of other means of protection for shareholders whose interests might be harmed by a constant policy of not paying dividends. The second subparagraph of the first paragraph of the aforementioned provision now expressly welcomes this idea by providing that the provisions of the first subparagraph "shall be without prejudice to the bringing of actions to contest and the filing of derivative claims that may lie".

7.2. It is now clear, therefore, that there is nothing that prevents contesting a resolution contrary to the distribution of profits when the circumstances allow it to be considered unconscionably imposed by the majority (i.e. when the decision to retain profits does not meet a reasonable need for the company and is taken by the majority to the unjustified detriment of the other shareholders (art. 204 LSC); especially when, because of its repetition, the shareholders' right to share in the company's profits can be considered to have been violated). There is also the possibility of filing derivative claims against directors if they have carried out actions that, in fact, have prevented minority shareholders from participating proportionally in the profits (e.g. by covertly distributing "dividends" through unbalanced contracts with related persons).