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How the Influx of Dividend-Minded Shareholders Will Impact Shareholder Activism

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2016 has been the year of the dividend. Fixed income investors seeking higher yields have moved into dividend-paying common stocks, and dividends have replaced earnings as the primary factor determining the movement of stock prices.[1] As a result public corporations have acquired a sizeable body of new shareholders for whom increased dividends are more important than earnings growth.

This post considers how the influx of dividend-minded shareholders will impact board decision-making and shareholder activism. These dividend-minded shareholders are a potential third force in the contest for influence between institutional investors who want the corporation to be managed to enhance long-term profitability, and shareholder activists who want the board to maximize the current price of the stock. As supporters of higher dividends these new shareholders are natural allies of the activists, but unlike the typical shareholder activist, they have a long term stake in the corporation and an interest in limiting stock buy backs and dividends to a level that does not impair the ability of the corporation to continue paying dividends in the future.

The influence of dividend-minded investors may already be seen in a trend in 2016 for companies to reduce stock buy backs at the same time that they are increasing dividends.[2] While buy backs are desirable for investors seeking a profitable exit from a company's stock, dividends are preferable for investors who want a good yield over an extended period of time.

In the future dividend-minded investors may prove to be a moderating influence on shareholder activists or they may emerge as an independent force, pressing corporations to increase dividends to the extent that they are sustainable. However, it is also possible that dividend-minded investors will fail to have a major influence on corporate policy either because they do not choose to "go-activist" or because a rise in interest rates sends them out of common stocks into other investments.

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[1] Ben Eisen, "Dividends Are What Matter," *The Wall Street Journal*, August 25, 2016.
[2] Mike Bird, Vipal Mongaand and Aaron Kuriloff, "Dividends Eat Up a Bigger Slice of Company Profits," *The Wall Street Journal Online*, August 19, 2016.

Why Have Dividends Come to the Fore in 2016?

Two reasons can be identified for the increased importance of dividends in 2016:

1. Dividends have remained stable, while interest rates have declined, making high-yielding common stocks an attractive investment for some fixed-income investors,[3] and
2. Earnings have declined,[4] thereby increasing the relative contribution of dividends to shareholder returns.

The dominance of dividends could end if the economy goes into high gear, bringing back robust earnings growth and higher interest rates, but as long as earnings growth and interest rates remain low, public companies are likely to have a large constituency of investors who make dividends their top priority. These investors presumably understand that corporations must continue to make capital investments to generate the earnings and cash flow that support dividends, but some may be interested in earnings growth primarily as a basis for dividend increases rather than as an end in itself, and others may make a sustainable dividend stream their top priority, while placing some independent value on earnings growth.

Dividends versus Investment for Long Term Growth

Over the years, shareholder activists have done well at gaining investor support for campaigns to get companies to return more money to shareholders,[5] but their success at winning proxy contests has not won them comparable respect in the corporate governance literature. One reason for their “bad boy” image is the fact that they are short term investors, who run their campaigns for the very purpose of providing themselves with an exit from the stock. If the company scrimps on investment in order to fund the activist’s program, and the business suffers in the long run, it is not the activist who suffers but subsequent owners of the company’s stock. In the words of Chief Justice (then Vice Chancellor) Strine, writing in his capacity as corporate governance commentator, the activists don’t have to “eat their own cooking.”[6] For similar reasons long term investors who criticize boards for underinvesting in the company’s business are often

[3] The dividend yield on the S&P 500 Index was 2.08% on October 13, 2016, compared to 2.11% on December 31, 2015. The dividend yield has generally been stable over the past few years. The yield was 1.92% on December 31, 2013. Chart Showing S&P 500 Dividend Yield, available on the Internet. The 10 year treasury rate declined steeply in the first half of 2016, and by mid-October was still down for the year, despite a modest recovery since the beginning of July. The ten year treasury rate stood at 1.77% on October 11, compared to 2.31% on December 30, 2015 and 1.38% on July 6. Ten year treasury rates have declined over the past several years. The rate was 3.01% on January 8, 2014. Y Charts, Ten Year Treasury Rate.

[4] In the quarter ended June 30, S&P 500 earnings declined for the fifth consecutive quarter. *Factset Insight*, August 26, 2016.

[5] See, Vipal Monga, David Benoit, and Teo Francis “As Activism Rises, U.S. Firms Spend More on Buy Backs Than Factories,” *The Wall Street Journal*, May 26, 2015.

[6] Leo B. Strine, Jr. “One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates also Act and Think Long Term,” 60 *Business Lawyer* (2010), 4.

treated as enlightened business statesmen, rather than as mere spokesmen for one of several contending points of view about what companies should do with their money.[7]

Negative comments about short termism generally do not go as far as to claim that directors have a legal obligation to elevate long term valuation creation over a current return to investors.[8] However, critics of short termism are clearly of the view that it would be preferable for corporations to place greater emphasis on investment for the long term.[9]

The pejorative description "short-term" does not fit the investors who have moved into dividend-paying common stocks in search of higher yields. While they may sell a stock position at any time for the normal reasons, there is nothing inherently short-term about their investment strategy. In fact, a common stock that provides a strong yield over an extended period of time is an investment position they are likely to hold since it has the investment characteristics they are looking for. To the extent that these investors get involved in in disputes about dividend policy on the side of the activists, the description of these controversies as a battle between short term and long term thinking will no longer apply.

Sustainability

One issue on which dividend-minded stockholders may be allied with other long-term investors rather than the typical short-term activist is sustainability: that is, the capacity of the corporation to continue paying dividends at the current level in the future.

An activist who promotes share buy backs and dividend increases to cause a short term increase in the price of the stock is concerned about sustainability of the dividend increases only to the extent that evidence of sustainability is necessary to translate dividend increases into a higher stock price. If the market ignores the sustainability issue, the activist can happily take advantage of the price increase generated by the stock buy backs and higher dividends, and exit the stock before the dividends are subjected to the test of time. A dividend minded investor, on the other hand, is likely to worry about sustainability whether or not the market sees an issue because this investor is buying the stock to hold it and receive dividends for an extended period.

The sustainability of dividends is an issue that has received a lot of attention in 2016. As dividends have risen while earnings have fallen, concern has grown about the sustainability of corporate dividends. The press has focused on companies, such as Exxon Mobil, that have raised dividends in the face of falling earnings and as a result have been paying dividends in excess of earnings per share.[10] A discrepancy between earnings and dividends does not necessarily mean that the dividend is unsustainable. If a company has ample cash reserves, and

[7] See Adi Ignatius, "I'm Not Talking About This to Win a Popularity Contest,": An Interview with Larry Fink, *Harvard Business Review*, November 2015. For a balanced presentation of competing views on these questions, see "As Activism Rises, U.S. Firms Spend More on Buy Backs Than Factories," Footnote 5.
[8] See footnote 13, and related text.
[9] See e.g., Letter dated February 1, 2016 from Laurence D. Fink, Chairman and Chief Executive Officer of BlackRock to corporate CEOs urging resistance to "the powerful forces of short-termism" and "working instead to invest in long-term growth"; Succeeding in the New Paradigm for Corporate Governance posted by Martin Lipton, Wachtell Lipton, Rosen & Katz on March 15, 2016 in the *Harvard Law School Forum on Corporate Governance and Financial Regulation*.
[10] Dividends Are What Matter, Footnote 1.

its earnings are temporarily depressed by a cyclical factor such as the decline in commodity prices, the board may reasonably conclude that it will be able to maintain its dividend rate in the future even if the dividend currently exceeds earnings. However, the discrepancy between earnings and dividends should flag sustainability as an issue for the board to consider in setting dividend policy.

When a company with depressed earnings pays a dividend in excess of earnings, there is little danger that investors and market commentators will miss the sustainability issue. That is not true of corporations that have sufficient current earnings to cover their dividends, but are reducing capital investment to such an extent that the current dividend rate may not be sustainable in the future. The market may fail to detect this issue because the level of capital investment needed to sustain earnings is a question of judgment, which requires information that may not be available to the public. At a time when companies are under pressure from investors to raise dividends there is a particular danger of wishful thinking about how much companies need to reinvest in order to maintain earnings and sustain current dividends.

While this may be a real problem, it would be a mistake to impose a duty on directors to limit dividends to a level that they believe is sustainable. There are numerous legitimate reasons why corporations may choose to pay unsustainably high dividends, including the belief that a temporary high dividend rate is the best use of excess cash, and the board's dissatisfaction with the returns available on investments in the company's business. But as part of their fiduciary duty to be informed and act with care, directors should consider whether the company will be able to pay dividends at the current level in the future and, if they perceive a material risk that dividends are not sustainable, they should also make sure that the market is adequately informed of those risks.

Higher Dividends versus Long Term Growth

Assuming that a corporation has excess cash after investing enough to sustain its current dividend rate, the board may face a choice between investing the excess cash in the company's businesses or distributing it to shareholders. This is an issue on which advocates of long term growth and dividend-hungry investors, who are allies on sustainability, may part company, and the growing influence of dividend-hungry investors may lead corporations to cut back on investment even when the corporation could earn an adequate return on these investments.[11]

Some corporate governance commentators might urge boards of directors not to follow the preferences of dividend-minded stockholders because the economy will suffer if corporations fail

[11] Satisfying demands from investors for higher dividends would not necessarily require a corporation to reduce investment. In one survey directors of companies that bought back their stock said that the share repurchases did not jeopardize growth, because the alternatives to buy backs were uneconomic investments which they would not have wished to pursue anyway. Richard Fields, Tapestry Networks, "Buybacks and the Board: Director Perspective on the Share Repurchase Revolution," Harvard Law School Forum on Forum on Corporate Governance and Financial Regulation, September 20, 2016 posting. A company that wants to maintain capital investment and raise dividends also has the alternative of adding leverage and doing both. Nevertheless, it seems likely that over time, a policy of increasing dividends to the extent feasible will result in a reduction of capital investment, and investors who support this policy may come into conflict with those who put a priority on investing in the company's business to foster long term growth.

to invest for long term growth. This may be a correct statement about the impact of corporate dividend policy on the overall economy, but at least in Delaware the board does not have the right to subordinate shareholder interests to the interests of other constituencies or public policy goals.[12] Furthermore, in a system in which shareholders, and only shareholders, elect the board of directors, a board that defied shareholder will over a sustained period of time would be turned out of office. Therefore, if corporate investment should be encouraged for the good of society rather than shareholder welfare, the way to do it is through economic and social legislation, not corporate governance.

The law appears to give boards discretion to divide the corporation's excess cash between dividends and capital investment, as part of the directors' broader authority to determine the time frame over which to maximize shareholder value.[13] In a corporation with a divided shareholder base—some emphasizing long-term value creation, others wanting a high dividend rate, and a third group looking for an exit from the stock at the highest possible price—there is no all-purpose guiding principle for directors to follow in setting dividend policy. Dividend sustainability can play this role in some circumstances because it is an issue that is germane to the financial health of the corporation and should concern all long-term investors. But if sustainability is not an issue, there is no obvious touchstone for the board to use in setting dividend policy. In these circumstances the board may be inclined to follow a middling course, dividing the company's excess cash flow between increased dividends and capital investment. This has been described as setting "corporate goals and behavior to generate a balance of short term returns and long term returns to respond to conflicting shareholder demands and manage the corporation to increase corporate profitability within these limits."[14]

The rise of dividend-hungry investors may cause corporations to change the mix, replacing share buy-backs with dividends and paying out more to shareholders and investing less than they would have in the past, but it remains to be seen how much influence dividend-minded investors actually exercise over corporate policy. There have been no proxy contests by dividend-minded investors this year, although the trend toward paying out more in dividends and less in share buy backs in 2016 may reflect their indirect influence.[15] If dividend-minded investors are unwilling to "go activist", their role may be limited to serving as a swing vote in proxy contests waged by

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[12] Leo E. Strine, Jr., "The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law," University of Pennsylvania Law School Institute for Law and Economics, Research Paper 15-08. See footnote 7 of this article for the views of corporate governance commentators who deny that directors of public corporations are required to act in the interest of shareholders.

[13] *Smith v. Van Gorkom, 488 A.2d 858, 873 (1985), Paramount Communications Inc. v. Time Inc.,*571 A. 2d, 1140, 1154 (Del 1989). Vice Chancellor J. Travis Laster of the Delaware Chancery Court has been the outstanding proponent of the view that directors have a fiduciary duty to maximize stockholder value over the long term, a position that might limit the board's discretion to raise dividends and reduce capital investment. See *In re Trados Incorporated Shareholder Litigation,*Consol. C.A. No. 1512-VCL (2013); Jack Bodner, Leonard Chazen and Donald Ross, "Vice Chancellor Laster and the Long-Term Rule," March 11, 2015 posting in The Harvard Law School Forum on Corporate Governance and Financial Regulation.

[14] Donald Ross, Responding to Shareholder Directives to Directors, *Harvard Law School Forum on Corporate Governance and Financial Regulation*, May 10, 2016. The share repurchase program initiated by Apple in response to Carl Icahn's activist campaign is sometimes mentioned as an example of this kind of behavior, although the Apple repurchases came very close to the $50 billion advocated by Icahn. William Lazonick, Matt Hopkins, and Ken Jacobson, "Opinion: Carl Icahn's $2 billion Apple stake was a prime example of investment inequality," *Market Watch*, June 7, 2016.

[15] See text at footnote 2

activists seeking to generate an immediate increase in the price of the stock. It is also possible that common stock ownership by dividend-minded investors will decline as interest rates rise and fixed income investors move out of common stocks. In that case the prospect for dividend-minded investors to exercise influence over corporate governance will decline correspondingly.

One complicating factor is the tendency of dividend-minded investors to do their investing through funds that specialize in high-yield stocks or stocks that offer a combination of substantial yield with the prospect of income growth as well. These funds have been flooded with cash in 2016. For example, the Vanguard dividend growth fund, which had doubled in size over the past three years, closed to new investments to assure that it could continue to produce strong returns for investors.[16] Given the support that giant managers like Vanguard and BlackRock have shown for long-term growth as a corporate goal, it is hard to imagine them leading or even supporting an activist campaign to get to reduce investment and increase dividends. On the other hand, these firms can be expected to respond to the preferences of their investor base, and if the people who invest with BlackRock and Vanguard want more current yield in their investment returns, this preference is likely to have some effect on the views that their corporate governance teams express in their meetings with portfolio companies.

In particular cases dividend-minded investors may succeed in electing board majorities devoted to maximizing sustainable dividends. This result might be less than ideal for the economy, but it would not be a failure of corporate governance. Higher dividends and growth in earnings are both legitimate investor objectives, and shareholders are entitled to exercise their voting rights to **[16]**

[16] Coumarianos, "The Problem with Dividend Stocks," *The Wall Street Journal*, September 6, 2016.