Chapter 10
Dividends

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Successful companies produce profits that can either be retained in the company or distributed to shareholders as dividends. In Russia, there is an expectation, in particular among minority shareholders with small holdings, for companies to make (a reasonable amount of) dividend payments, and not exclusively retain its earnings. The vast majority of Russian companies need additional capital, for which there is no immediately alternate source other than company earnings. Since internally generated financing is one of the few viable sources of funding, the decision to pay dividends is often difficult for Russian companies.

This chapter discusses dividends from both the shareholder and creditor protection perspectives, the procedure for declaring and paying dividends, as well as a company's dividend policy.

A. General Provisions on Dividends

1. The Definition of Dividends

Shareholders have a right to share in the profits of the company. They may do so by enjoying capital gains (an increase in the market value of shares they hold in the company) and/or through receiving dividend payments. From this perspective, dividends are an important shareholder right.

In addition, the payment of dividends means paying out cash to shareholders, which may decrease the company's cash and assets needed to service debt on a timely basis. From this vantage point, dividends are also viewed in light of preserving creditor rights by following certain rules. To protect creditor rights, legislation imposes certain limitations on the types and payment of dividends.

2. Distributable Profit

The accounting treatment of dividend payments is determined both by the Company Law and accounting standards. Dividends can only be paid out of the net profits of the company.[339] Dividends on preferred shares can, however, be paid out of funds that are specifically established for that purpose. Under no circumstances can dividends be paid out of the charter capital.

3. Dividend Rights

Owners of common and preferred shares have different dividend rights. Distributing dividends on common shares is solely at the discretion of the company.[340] On the other hand, owners of preferred shares have a right to dividend payments.

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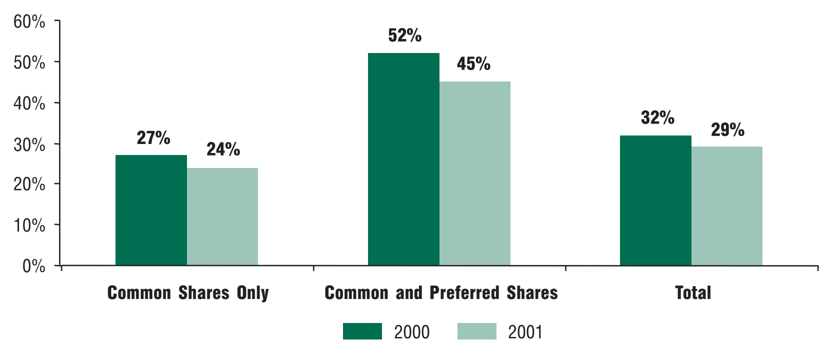
[339] Law on Joint Stock Companies (LJSC), Article 42, Clause 2.

[340] LJSC, Article 31, Clause 2.

If the company does not declare dividends, or declares only a partial payment of dividends to owners of preferred shares, these shares are automatically granted voting rights.

Company Practices in Russia: Figure 1 indicates that companies experience considerable difficulties in making dividend payments on both common and preferred shares in Russia's regions.[341] Only 45% of companies with preferred shareholders paid dividends in 2001, a decrease of more than 7% in comparison with 2000. The percentage of companies with common shares only that paid dividends decreased slightly from 27% in 2000 to 24% in 2001.

Figure 1: Percentage of Companies that Paid Dividends



Source: IFC, Regional Survey on Corporate Governance Practices, August 2003

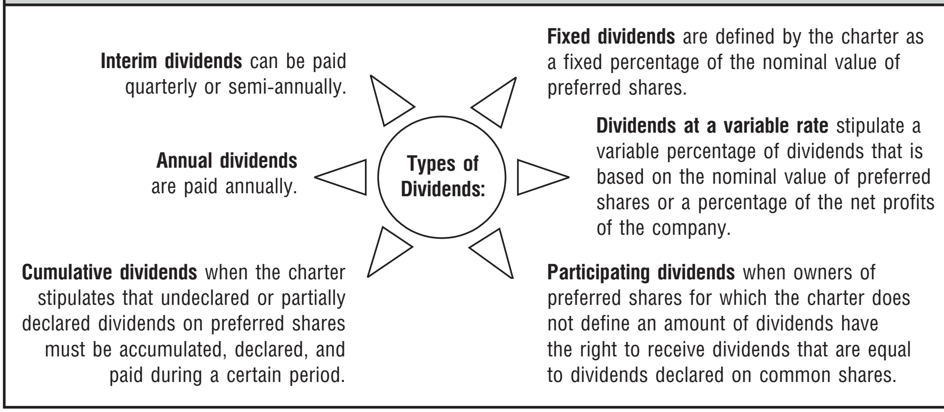
4. Types of Dividends

A company may declare dividends for common and preferred shares as shown in Figure 2.[342]

[341] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

[342] LJSC, Article 32, Clause 2, Paragraphs 1 and 3.

Figure 2: Types of Dividends



Source: IFC, March 2004

5. Forms of Dividend Payments

As a rule, dividends are paid in cash, though the charter may allow other forms of payment.[343]

> **Best Practices:** Companies should pay dividends in cash, since non-cash transactions are generally unsuited for dividend payments.[344]

6. Decision-Making Authority Regarding Dividends

The Supervisory Board has the authority to recommend the amount of dividends to pay out to the General Meeting of Shareholders (GMS). The authority to approve dividends, however, rests with the GMS. The GMS approves or disapproves the Supervisory Board's recommendation by a simple majority vote of participating shareholders.[345] The amount of dividends declared by the GMS may not exceed that recommended by the Supervisory Board.[346]

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[343] LJSC, Article 42, Clause 1, Paragraph 2.

[344] Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), Chapter 9, Section 2.1.1.

[345] LJSC, Article 42, Clause 3; Article 49, Clause 2.

[346] LJSC, Article 42, Clause 3.

The following rules apply to the payment of dividends on preferred shares:

- If the amount of dividends on preferred shares is less than that required by the charter, the owners of preferred shares receive voting rights;
- Dividends on preferred shares may not exceed the amount specified in the charter; and
- If the amount of dividends on preferred shares is not specified in the charter, the amount of dividends is the same as that paid on common shares.

7. The Amount of Dividends

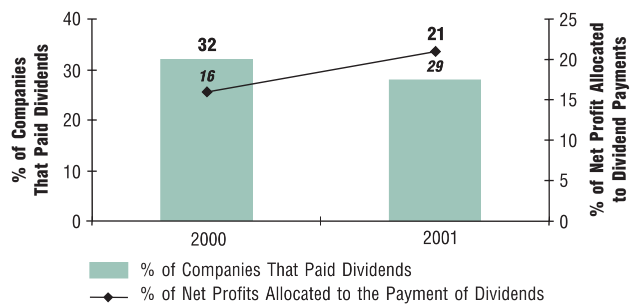
The Supervisory Board should seek to maximize shareholder value when formulating its recommendation on the amount of dividends to be distributed. The target payout ratio — defined as the percentage of net income to be paid out as cash dividends — should be based on shareholder preferences. More specifically, the Supervisory Board will want to determine shareholder preferences for capital gains (for example, using excess cash to buyback shares or re-invest in the company) *versus* receiving dividends. The Supervisory Board will then need to define its optimal dividend policy, which ideally should strike a balance between current dividends and future growth. For any given company, the optimal payout ratio is determined by four factors:

1. Investor preference for capital gains *versus* dividends;
2. The company's investment opportunities (for example, companies with excess cash but limited investment opportunities would typically distribute a large percentage of their income to shareholders via dividends, while companies in high-growth sectors typically reinvest their earnings in the business);
3. The company's target capital structure; and
4. The availability and cost of external capital.

Company Practices in Russia: The results of a 2003 IFC Survey[347] show a slight decline in dividend payments among companies in Russia's regions between 2000 and 2001. This decrease occurred mainly among companies with over 300 employees. In contrast, the percentage of companies paying dividends with less than 300 employees has remained stable. Although fewer companies paid dividends, the percentage of net profits allocated to dividend payment increased from an average of 16% in 2000, to 21% in 2001 (see Figure 3).

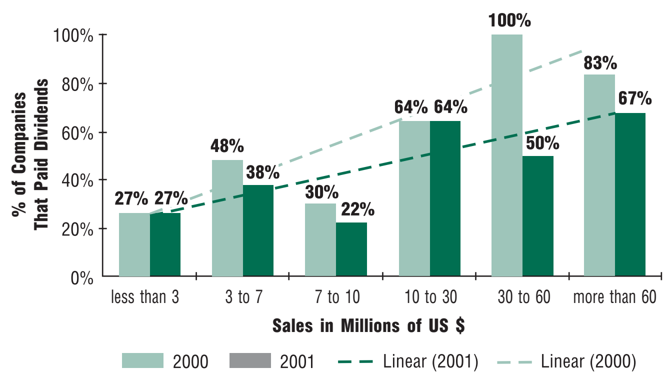
[347] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

Figure 3: Percentage of Companies that Paid Dividends and an Average Percentage of Net Profits Allocated to Dividend Payments



Source: IFC, Regional Survey on Corporate Governance Practices, August 2003

Figure 4: Correlation Between the Percentage of Companies in Russia's Regions that Paid Dividends and Company Sales



Source: IFC, Regional Survey on Corporate Governance Practices, August 2003

8. The Importance of Receiving Stable Dividends

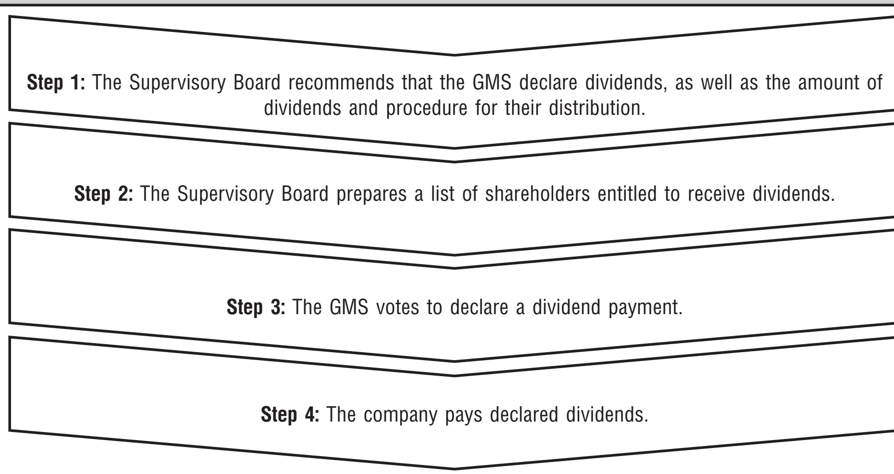
The stability of dividends is important to shareholders. Dividend payments tend to vary over time, since company cash flows may fluctuate. Many shareholders rely on dividends to meet expenses, however, and would consequently suffer from unstable dividend streams. A company needs to carefully balance between the stability and dependability of its dividend policy.

Best Practices: Ideally, the company should formulate and communicate a dividend policy to its shareholders, for example to "pay approximately 30% of its current year's earnings as dividends, which will permit the company to retain sufficient capital to provide for future growth."

B. Procedures for Declaring and Paying Dividends

To declare and pay dividends, the company must follow specific steps, summarized in Figure 5.

Figure 5: The Procedure for Declaring and Paying Dividends



Source: IFC, March 2004

1. How Dividends Are Declared

A company may declare dividends annually, or more frequently if stipulated in its charter.[348] The decision to declare interim dividends, based on quarterly results,

[348] LJSC, Article 42, Clause 1, Paragraph 1. The text of this provision contains the phrase "unless the law provides otherwise" which refers to circumstances when the company cannot declare dividends that are specified by LJSC, Article 43.

must be made within three months of the end of the dividend period.[349] The decision to declare annual dividends is based on the decision regarding the distribution of profits (losses) of the company and can be taken by a simple majority vote of shareholders participating in the GMS.[350]

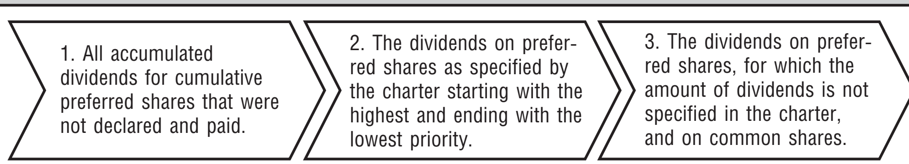
Best Practices: In order to help shareholders properly assess a company's capacity to make dividend payments, companies are advised to:[351]

- Establish a transparent and shareholder-friendly mechanism for evaluating the payment of dividends;
- Provide sufficient information to shareholders to enable them to understand the conditions that must be met before the company will pay dividends;
- Provide sufficient information to shareholders to enable them to understand the procedures for the payment of dividends;
- Prevent the dissemination of any misleading information on the company that might influence shareholders' assessment of policies governing dividend payments;
- Provide simple dividend payment procedures; and
- Impose (financial) sanctions on the General Director and Executive Board members for incomplete or delayed payments of declared dividends.

Dividend reports are a useful tool for assessing a company's dividend policy and its dividend payment record. Dividend reports are published by commercial firms that track the dividend performance of companies. These reports are usually available for a fee.

The Company Law also stipulates a certain sequence for declaring dividends when the company has issued shares of different types and classes as illustrated in Figure 6.

Figure 6: Order of Declaring and Paying Dividends



Source: IFC, March 2004

349 LJSC, Article 42, Clause 1, Paragraph 1.

350 LJSC, Article 48, Clause 1, Section 11; Article 49, Clause 2.

351 FCSM Code, Chapter 1, Section 1.3.

In other words, until the company has declared and paid all dividends (including accumulated dividends) for preferred shares in full, as specified by the charter, it cannot declare and pay dividends for other preferred or common shares.[352] Further, the company cannot declare dividends if the claims of a higher priority shareholder are not satisfied in full.[353]

Company Practices in Russia: The Company Law is not clear as to whether the distribution of annual dividends must be a separate agenda item of the Annual General Meeting of Shareholders (AGM) or a part of the decision on the distribution of profits (and losses). Russian companies commonly treat these decisions separately. However, there is a risk of making conflicting decisions on the amount of dividends as part of the decision on dividend payments and the decision on the distribution of profits. As long as shareholders agree with the recommendation of the Supervisory Board on the amount of dividends, there should be no conflict. However, voting on the dividend payment as part of the more general decision on the distribution of profits appears to be a safer solution. Interim dividends do not present a problem as there is no requirement for approving the distribution of interim profits.

2. The Shareholder List for Dividends

The list of shareholders entitled to receive dividends for a specific period includes shareholders of record entitled to participate in the GMS.[354] This date upon which such record is to be compiled is called the "ex-dividend date". Shareholders included on this list as of the ex-dividend date are entitled to receive any dividends that the company pays out to shareholders. Consequently, shareholders who own shares on the ex-dividend date, and who sell them after that date, retain the right to receive dividends; shareholders who purchased shares after the ex-dividend date are not entitled to receive dividends until the next declaration of dividends. However, the contract of sale for the shares may provide that the right to receive declared dividends shall be transferred to the new owner of shares.

352 LJSC, Article 43, Clause 2.

353 LJSC, Article 43, Clause 3.

354 LJSC, Article 42, Clause 4, Paragraph 2.

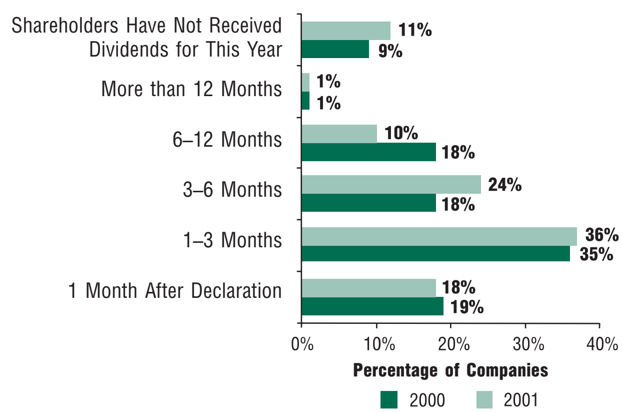
In the event that dividends on shares of a specified type and class are declared, each shareholder must receive dividends in accordance with the number of shares of the type and class he owns.

3. When Declared Dividends Are Paid

A company is obliged to pay dividends once they have been declared.[355] The period for paying dividends is established either in the charter or by decision of the GMS. If not specified, companies must pay dividends no later than 60 days after they are declared.[356]

Company Practices in Russia: The results of a 2003 IFC survey show that arrears on dividend payments are an enormous problem among Russian companies (see Figure 7). According to the Company Law, and as recommended by the Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code), companies are required to pay declared dividends within 60 days. However, in 2001, only 18% of companies paid dividends within one month after their declaration, and only 36% paid within three months.[357]

Figure 7: Timeliness of Dividend Payments



Source: IFC, Regional Survey on Corporate Governance Practices, August 2003

[355] LJSC, Article 42, Clause 1.

[356] LJSC, Article 42, Clause 4, Paragraph 1.

[357] IFC Survey on Corporate Governance Practices in Russia's Regions, Section 2.3.2, page 36, August 2003 (see www.ifc.org/rcgp).

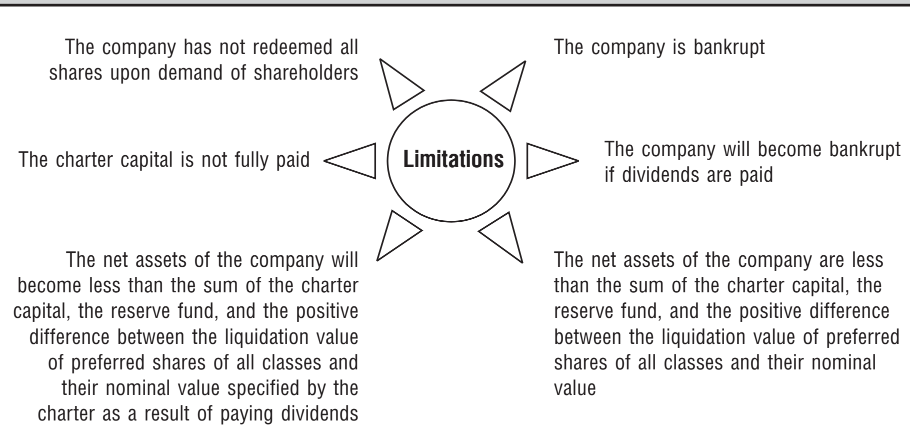
The accumulation of declared but unpaid dividends gives shareholders the right to file a claim in court against the company demanding payment.

Best Practices: The FCSM Code recommends that companies penalize the General Director, Executive Board members, or the External Manager when dividend payments are incomplete or in arrears. In particular, it is recommended that the Supervisory Board have the authority to reduce the remuneration of the General Director, Executive Board members, and/or the External Manager, or to terminate their authorities, when the company fails to pay declared dividends in full and/or on time.[358]

4. When the Company Cannot Declare Dividends

The company is prohibited from declaring dividends under the circumstances illustrated in Figure 8.[359]

Figure 8: When the Company Cannot Declare Dividends



Source: IFC, March 2004

[358] FCSM Code, Chapter 9, Section 3.

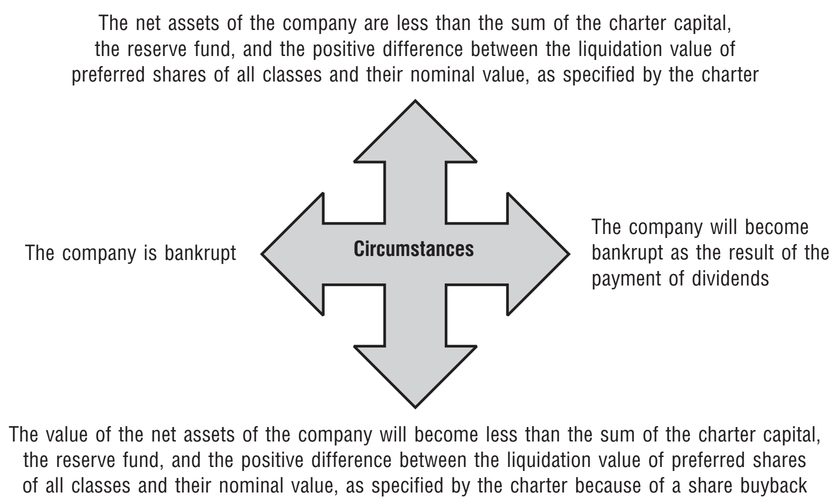
[359] LJSC, Article 43, Clause 1.

This list of circumstances is not exhaustive. The Company Law stipulates that legislation may specify further circumstances under which the company cannot declare dividends. In addition, both the charter and the company's debt instruments can specify circumstances under which the company is prohibited from declaring dividends.

5. When the Company Cannot Pay Declared Dividends

As some time may pass between the decision to declare dividends and the actual payment, the company may find itself in contravention of some of the requirements for the declaration of dividends noted above. The company may not pay declared dividends under the circumstances illustrated in Figure 9.[360]

Figure 9: When the Company Cannot Pay Declared Dividends



Source: IFC, March 2004

[360] LJSC, Article 43, Clause 4, Paragraph 1. Note that a court decision declaring the company bankrupt is not required; the factual features of the company's bankruptcy suffices to prohibit the payment of dividends.

This list of circumstances is not exhaustive. As mentioned above, legislation may specify further grounds, as can the charter and corporate debt instruments. As soon as the specified conditions cease to exist, the company is obliged to pay declared dividends.[361]

C. The Disclosure of Information on Dividends

Securities legislation regulates the information disclosure as pertaining to dividends. A company must make available to all its shareholders the recommendations of the Supervisory Board regarding the distribution of profits, including the amount of proposed dividends on all types of shares, and the procedure for the payment of such dividends.[362]

A company needs to address two basic issues in deciding to declare dividends:

1) The percentage of profits to be distributed; and
2) The frequency of payments, i.e. should the dividends vary from year to year, or remain stable over time.

A company is also required to provide a report on its dividend payment record in its annual report.[363]

Best Practices: The FCSM Code recommends that the company adopt a by-law on information disclosure, and that this by-law include a list of information, documents, and materials that must be submitted to shareholders to enable them to make decisions regarding dividends. The information should refer to agenda items for the GMS, such as:[364]

- Recommendations of the Supervisory Board regarding the distribution of profits;
- Recommendations of the Supervisory Board on the payment of dividends; and

[361] LJSC, Article 43, Clause 4, Paragraph 2.

[362] FCSM Regulation No. 17/ps on Additional Requirements for the Procedure of Preparing, Calling and Conducting the General Meeting of Shareholders (FCSM Regulation No 17/ps), 31 May 2002, Section 3.2.

[363] FCSM Regulation No. 17/ps, Section 3.6.

[364] FCSM Code, Chapter 7, Section 3.2.1.

- Reasons for each recommendation.

Companies should also disclose information on dividend payments, or when dividends have not been paid, the reasons for dividend non-payment.[365]

Companies are required to include the following information on dividends in the prospectus and quarterly reports:[366]

- The amount of dividends declared within the last five years or, if the company has been in operation for less than five years, during each year of operation; and
- The procedure for dividend payment.

D. Dividend Policy

Companies are best served by adopting a clearly stated and rational dividend policy, in-line with shareholder preferences.

Best Practices: Companies should inform the markets of their dividend policy, for example, through the print media. This disclosure should be in the same publication specified by the charter for publishing notice for the GMS. The company should also consider using the internet for this purpose.[367]

It is essential that shareholders receive information — at a very minimum — on the following issues:[368]

- The method the company uses in determining the portion of profits that may be paid as dividends;
- The conditions under which dividends may be paid;
- The minimum amount of dividends payable for shares of each type and class;

[365] FCSM Code, Chapter 7, Section 3.3.2.

[366] FCSM Regulation No. 03-32/ps on the Disclosure of Information by Security Issuers, 2 July 2003, Annexes 4 and 11.

[367] FCSM Code, Chapter 9, Section 1.1.3.

[368] FCSM Code, Chapter 7, Section 2.1.3.

- The criteria the Supervisory Board uses in deciding on the recommendation to declare dividends; and
- The procedure for dividend payment, including the time, place, and form of payment.

Companies should further implement a transparent and easy-to-understand mechanism for determining dividends. To do so, the company should approve a by-law on dividends that includes information on:[369]

- The percentage of net profits for dividend payments;
- The terms and conditions for dividend payments;
- The amount of dividends payable for shares of a specific type and class if this amount is not specified by the charter;
- The minimum amount of dividends payable for shares of each type and class;
- The procedure for the payment of dividends, including the schedule, place, and methods; and
- Circumstances when dividends will not be declared, or when dividends may be partially declared on preferred shares.

Companies are free to change their dividend policies at any time; however, corporate officers should be aware that this may cause inconveniences for their shareholders and send adverse, if unintended, signals to the markets.

[369] FCSM Code, Chapter 9, Section 1.1.2.