Retained dividends reignite debate over the allocation of corporate profits

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During the AGM season, how companies intend to treat their profits is a common topic of discussion. This year, however, the matter has captured the public's attention because of the different reactions of Petrobras stakeholders to the proposal to retain a portion of the company's earnings in a "capital remuneration" reserve created by the Petrobras's bylaws, even though Brazil's federal government (and the company's largest shareholder) later changed the original proposal, to approve distribution to shareholders of 50% of the net profit remaining after required allocations.

Under the Brazilian Corporations Law (Law 6.404/1976) shareholders' right to share in their company's profit is an essential right. This does not mean, however, that they can demand the distribution of all the company's profits. The Law recognizes that financing the company's business and fulfilling its obligations may require that a portion of its profits be retained, and that it is up to the company's management to propose, and the shareholders to decide, on the annual allocation of the company's profits.

As a rule, shareholders are only entitled to a portion of the net profit (after allocations to the reserves established by law and reserves for contingencies) established in the bylaws, known as the mandatory dividend. This portion, often set at 25% of adjusted net profit, must be distributed to shareholders whenever there is a profit. Retention of the mandatory dividend is exceptional, and limited to cases in which the company's financial situation is incompatible with payment of the mandatory dividend.

The main differences of opinion, however, arise over the allocation of the remaining earnings – that is, earnings that exceed the mandatory dividend. Shareholders, and especially minority shareholders, generally favor distribution of this remaining profit as dividends. The controlling shareholder and the company's management, in contrast, usually prefer to retain the profit to be reinvested in the business. With this in mind, the Brazilian legislator established a system for the distribution of corporate earning, in which the retention of profits is permitted only in a limited number of situations, which are provided for in the Corporations Law itself.

Very briefly, profits can be retained to form reserves:

1. provided for in the bylaws, which must establish the purpose, amount and limit of such reserves,
2. to provide for probable contingent liabilities;
3. for profit resulting from donations or government subsidies for investments;
4. for unrealized earnings.

Profits may also be retained on the basis of a capital budget approved at a general shareholders' meeting, which must set out the sources of funds and fixed or current capital investments for a period of up to five fiscal years.

At the same time it allows profits in excess of the mandatory dividend to be retained, the Corporations Law also set limits on the freedom of management and controlling shareholders to reinvest company profits. First, the Law gives the shareholders themselves the final say on how the company's profits will be allocated, and the shareholders can make changes to management's proposal. Second, the Law provides that the amount of profit reserves, except those for contingent liabilities, tax incentives and unrealized profits, may not exceed the company's share capital. Last, the Law requires that any profits which have not been retained in the circumstances described above must be distributed as dividends. Since the reform of the Corporations Law in 2007, the retained earnings account, which historically served to retain earnings that had no specific allocation, is no longer allowed.

Given this strict system of checks and balances on the allocation of corporate profits, it seems clear that the recent public disputes over the distribution of profits by companies like Petrobras are not due to a lack of legal rules, but perhaps reflect a need for more effective governance mechanisms that can offer shareholders greater transparency and predictability with respect to the distribution of profits of the companies in which they invest.

One alternative, which has been adopted by companies such as Petrobras itself, is the creation of policies to govern payment of dividends to shareholders. In such policies, it is common for management to establish payment periods and financial metrics to be used to decide when and how much of the company's profits should be distributed.

Although they promote greater predictability about the distribution of profits, by establishing objective criteria for management's decisions, for the most part these policies are approved by companies' boards of directors, and so do not allay some shareholder concerns. First, management itself can decide, in the light of the circumstances and based on the company's interest, not to follow the policy, or to adjust it. Second, if dividend policies are not approved by the shareholders, they do not bind the controlling shareholder, who is then free to allocate profits in a way that differs from the policy.

Recent disputes show that there is no simple solution to the problem. The coexistence of shareholders with different perspectives and visions – short, medium and long term – only highlights the complexity of the question, and underlines the importance of developing governance rules that offer greater clarity and predictability to non-controlling shareholders while at the same time give management the flexibility to retain the profits when the company's interests require it.

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