PUBLIC COMPANIES AND UNREALISTIC SHAREHOLDERS – HOW TO SURVIVE 50% YIELDS

By Gary Wolfe, Partner, Seward & Kissel LLP

Perhaps the most amazing consequence of the recent precipitous drop in the drybulk markets and the related drop in the stock prices of the publicly traded drybulk companies has been the extraordinary yields at which the full and high dividend payout companies are now trading. As of this writing, Yahoo Finance shows one of the full dividend payout companies as trading at a 73% yield while one of the partial dividend companies is trading at "only" a 60% yield.

In this context, some investors have demanded assurances from the full and partial dividend payout companies that their dividends are "sacrosanct". At the same time, when the prices of their shares have fallen as much as 90%, company managements have begun to ask themselves why they should not take their companies private.

The common, unstated factor, in both the amazingly high yields currently prevailing in the market and the attraction of going private is that shares of publicly traded drybulk and container shipping companies are trading at a fraction of net asset value (NAV). That is what makes them potential targets for either going private or unfriendly acquisitions. The "absurd" relationship of NAV to current cash flow is also reflected in the high yields that the full and partial dividend payout companies are producing.

Presumably, the time will come when the market returns to focusing on cash flow or income at decent multiples. However, until then, the publicly traded shipping companies need to ask themselves the following:

Do we have effective antitakeover devices?

The cynic's view of antitakeover devices is that they "entrench management". The counter to that claim is that antitakeover devices enhance a Board's ability to do what it is supposed to do when confronted by a third-party offer. That is, decide in an educated manner what course of action benefits the shareholders as a whole. That course of action may involve a sale, or may not involve a sale. The Board will decide. In either case, having effective antitakeover measures enables the Board to make the required analysis without risk that the third party will complete a purchase of a controlling interest, and therefore force the Board to surrender the Company's independence, without the Board's approval. In short, the antitakeover devices enhance the Board's power to negotiate or to choose not to negotiate.

The best antitakeover device, of course, at least in the shipping world, is to trade at a positive multiple of NAV. Absent that, the two most effective antitakeover devices are "staggered Boards" and "poison pills".

STAGGERED BOARDS

Staggered Boards are usually divided into three classes, with one-third of the members elected each year for three-year terms. Ultimately, having a staggered Board means that it will take a hostile third party two years to acquire control of a target's Board of Directors even if the acquirer purchases a majority of the shares. The prospect of such delay provides the acquirer with a substantial incentive to negotiate with the target's Board in order to reach an acceptable deal.

POISON PILLS

Poison pills, more formally known as shareholder rights plans, are mechanisms that assure that an unwanted third party cannot exceed a certain threshold of ownership without Board approval. If the hostile third party crosses the line, it automatically "swallows the poison pill". The result is that the hostile party is tremendously diluted both economically and in voting power, as all the other shareholders get the opportunity to buy shares at a significant discount.

There are a number of other antitakeover measures that companies can build into their constitutive documents.

To whom will our antitakeover devices apply?

Interestingly enough, most

antitakeover measures apply not only to outsiders but also to insiders.[1]

Suppose a company's CEO wants to organize a group to buy the company at a premium to the current very depressed stock market price, but at a fraction of NAV? If the Board is of the view that the company will do better for its shareholders by staying independent, antitakeover measures will enable the Board to resist the offer—whether it comes from management or from an unfriendly "predator". In this connection, the Board's duty is the same whether the offer comes from management or the predator. The Board needs to determine in either case what is in the best interests of the shareholders as a whole. The Board must also act in accord with its duty of care to the company and its shareholders. For this reason, most Boards will establish a committee of independent directors to consider an unsolicited offer, whether from outside or inside.

Attached to this article is a matrix of publicly traded shipping companies that have poison pills and staggered Boards. Remember, there is a whole panoply of antitakeover devices aside from these two measures. In addition, different standards may apply across the typical shipping jurisdictions (Marshall Islands, Bermuda, Liberia, United States, Norway, Denmark, Hong Kong, Panama, Netherlands) to the adoption and use of these devices.

One common theme, at least in the United States: It is always better to adopt an antitakeover device when a company is not under a threat. When a company has adopted an antitakeover device in response to a hostile offer, the courts exercise a higher level of scrutiny.

Suppose we want to lower or eliminate our dividend?

This is a question that companies have only begun to pose with the fall in the stock markets and the yields that the fall has produced.

Thinking about lowering or eliminating a dividend raises a number of issues:

- Does the Board have the power to lower or eliminate the dividend?
- Does that Board owe a duty to its shareholders to keep its dividend "sacrosanct"?
- Will the Board get into trouble with the securities regulators if it eliminates its dividend?

As a threshold matter, nothing is "bullet proof" in the world of publicly traded companies. In the U.S., anyone can sue. The question is whether the plaintiff has a case that can survive the Company's motion to dismiss for summary judgment.

A Board that approaches the question of lowering or eliminating the dividend in the proper way can minimize its litigation risk tremendously.

Does the Board have the power?

In Delaware, Liberia, Marshall Islands and Bermuda, the payment of dividends on common shares is strictly within the discretion of the Board of Directors. A disclosure to that effect appears in virtually every IPO prospectus for a public company that offers common shares in the U.S. markets. If an IPO prospectus for an offering of common shares in the U.S. lacks that disclosure, there is either something special, or something wrong going on. Even the quasi-master limited partnership, or MLP-like public companies that are corporations make clear to their investors that payments of dividends are completely a matter for the Board and that the company is not promising the shareholders that dividends will be paid. (MLPs that are structured as partnerships may be different, but we are not addressing those here.)

Are dividends "sacrosanct"?

The short answer is: No. The Board is free to exercise its business judgment in determining whether it is in the best interests of a company and its shareholders to maintain a dividend paying a 60% yield.

Generally, the U.S. courts do not interfere with the judgment of the Board of Directors, so long as that judgment is rational and the Board appears to have made an educated judgment with due consideration. This is known as the "business judgment rule". This assumes that the Board appears to have acted in line with its fiduciary duties to the company and its shareholders as a whole, including its duty of loyalty. If the Board, after due and educated consideration, has concluded that the company must either reduce or eliminate the dividend, the Board's decision will be upheld, notwithstanding the wishful thinking of investors who believe that they deserve to continue to receive the windfall of historically unprecedented dividend yields.

In addition, it will be difficult for shareholders to contend that the company promised them that it would "always" pay a dividend when its IPO prospectus and repeated disclosure since that time stated just the opposite.

Will the securities regulators make us pay a dividend?

Neither any U.S. stock exchange nor the Securities and Exchange Commission (SEC) will force a company to pay dividends on its common

[1] *Existing shareholders may be grandfathered to own higher levels of shares at the time a poison pill is adopted, but those shareholders will typically be prohibited from exceeding a higher threshold without Board approval.*

shares. So long as the company has (repeatedly) disclosed that the payment of dividends is discretionary, then the company should succeed on any claim by a shareholder that the shareholder was misled into purchasing common shares on the basis that payment of a dividend was "guaranteed".

There are certainly exceptions. Suppose a company's prospectus for an IPO states that a company's target dividend is $0.10 per share per quarter and that payment is in the Board's discretion. At the time the prospectus is used, however, the company has absolutely no intention of paying a dividend. That certainly sounds like a material misrepresentation or omission.

THE PRESENT SITUATION

Boards that are currently considering reducing or eliminating dividends find themselves in an extremely sensitive situation. Their managements receive emails from investors who claim that their dividends are sacrosanct, and want reassurance that they will be paid, even at the currently unprecedented high yields. At the same time, lenders may be pressuring the companies to reduce or eliminate their dividends. Advisors may be coming up with contradictory theories:

Theory 1: "You were established as a full payout company. The market will clobber you if you eliminate your dividend."

Theory 2: "The market knows that you need to conserve cash at a time like this, and will reward you if you eliminate your dividend".

How do you, or should you, and when should you disclose to the market that you are considering changing your dividend policy? How do you keep the market informed of material events while giving yourself the flexibility to consider the questions properly and negotiate with lenders, if necessary?

How the market will react to news, or to no news, or to delayed news, is primarily a question not for lawyers but rather for bankers and investor relations (IR) experts. If your IR people cannot help you to understand how your investors will react to news, or no news, at a given time, consider hiring different IR people who can help.

From the legal point of view, the easiest situation is when a Board of Directors has decided to reduce, suspend or eliminate a dividend. This is material news and should be disclosed as soon as possible.

The recent example of Diana Shipping (NYSE:DSX) in paying its third quarter dividend in full and at the same time announcing it was eliminating its dividend starting with the fourth quarter provides an example of very effective disclosure. An investor could hardly complain when it was given more than two months' notice that the dividend was being eliminated.

What about when a Board is considering making a change while its management is in negotiations with the lenders? This is a much harder question. Insecurity, that is, lack of definitive news, creates problems in the market, while at the same time, incomplete news creates both market and legal risk. Many times, principles come in dualities. That is the case here: One principle is: "communicate, communicate, communicate". Another principle is: "finish negotiating before you communicate". Overly soon communication creates not only commercial risk, but also the legal risk of making material misstatements if conditions change. Under-communication creates the risk of making material omissions. How Boards operate with both principles in mind, especially now, reflects whether they are meeting their duties both to their companies and to the marketplace.

Gary J. Wolfe is a Partner at Seward & Kissel LLP and can be reached at +1212 574 1223 or at wolfe@sewkis.com.

Publicly traded shipping companies that have a poison pill and / or Staggered Boards

Company	Effective date of Poison Pill	Trigger Threshold	Grandfather Terms	Notes	Staggered Board
1. Arlington Tankers Ltd.	6/27/08	20%		A person will not trigger the poison pill if the 20% threshold is crossed solely if the 20% threshold is crossed solely as a result of Company share buy backs, unless person acquires any additional shares after buy back	Yes (Three Classes)
2. Bird Acquisition Corp (formerly Quintana Maritime Ltd.)	11/12/07	15%		A person will not trigger the poison pill if the 15% threshold is crossed solely as a result of Company share buy backs or as a result of stock dividend or other distribution or stock split, unless person acquires additional shares equal to 1% of then outstanding shares	N/A